

TAX NEWS & COMMENT

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IRS MATTERS

2007 REGS., RULINGS AND PRONOUNCEMENTS

A. New Regs Govern Estate Deductions

All federal circuits, except the Eighth, have long adhered to the view that post-mortem events must be ignored in valuing claims against an estate. *Ithaca Trust Co. v. U.S.*, 279 U.S. 151 (1929) held that “[t]empting as it is to correct uncertain probabilities by the now certain fact, we are of the opinion that it cannot be done, but that the value of the wife’s life interest must be established by the mortality tables.” Proposed Regs. §20.2053-1(a)(1) state that post mortem events *must be* considered in determining amounts deductible as expenses, claims, or debts against the estate.

The proposed regs. limit the deduction for contingent claims against
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FROM THE COURTS

2007 Decisions of Note

The 11th Circuit, reversing the Tax Court, held that an estate properly reduced the value of the decedent’s interest in a company holding marketable securities by the company’s entire \$51 million built-in capital gain tax liability. *Estate of Jelke Est. v. Com’r*, ___ F.3d ___, 2007 WL 3378539 (11th Cir. 11/16/07), *rev’g*, T.C. Memo 2005-131. The Tax Court had discounted the capital gains tax liability to reflect the likelihood that stocks owned by the company would not be liquidated for many years following the decedent’s death.

The court of appeals found that the Tax Court’s choice of a 16-year period to reflect when the corporation would sell all of its marketable securities at the present turnover rate was not “persuasive” since “[w]e are dealing with
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FROM WASHINGTON

TAX OUTLOOK FOR 2008

PRESIDENT BUSH PROPOSES \$150 BILLION STIMULUS PACKAGE

A. Proposed Legislation

President Bush has proposed and the House has approved a \$150 billion economic stimulus package to increase consumer spending and business investment. The stimulus package calls for a tax rebate of up to \$800 for individual taxpayers and \$1,600 for married couples. Rebates will be phased out for single taxpayers whose income exceeds \$75,000 and married couples whose income exceeds \$150,000.

A temporary increase in the IRC §179 expense limitation to \$250,000 is also part of the stimulus package. Senate Majority Leader Harry Reid (D-Nev.) and Senate Finance Committee Chairman
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Tax Analysis

Article 78 Review of Tax Appeals Tribunal

A. Pre-Tribunal Adjudication

The Bureau of Conciliation and Mediation Services (BCMS) comprises a separate operating bureau within the Division of Taxation, and reports directly to the Commissioner of Taxation and Finance. The goal of the Conciliation Conference is to resolve tax disputes without the necessity of a formal hearing before the Division of Tax Appeals.

A request for a Conciliation Conference must generally be made within 90 days after the issuance of a Notice of Determination. The taxpayer who deems the Conciliation Order issued by the Conferee following the Conference
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FILING OF GIFT TAX RETURN REQUIRED (AND ESSENTIAL) EVEN IF

A. Introduction

The requirement of filing a federal gift tax return arises when one has made a *completed* taxable gift. Incomplete gifts do not impose any gift tax filing requirement. Thus, the donor’s gift of a diamond ring would exemplify a completed gift. However, if the donor reserved the power to revest beneficial title in the ring to himself at a later date, the gift would be incomplete.

Many transfers in trust result in incomplete gifts. The donor who transfers property in trust with the direction to pay income to himself or to accumulate it in the discretion of the trustee, while retaining a testamentary power to appoint the remainder among his descendants, has
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FEBRUARY COMMENT

Gain, Loss, Basis & Debt Issues in Like-Kind Exchanges

A. Gain or Loss in Exchange

Where a taxpayer “trades up” in a like-kind exchange by acquiring property more valuable than the property relinquished and no boot is received, Section 1031 operates to defer recognition of all realized gain. However, if the taxpayer “trades down” and acquires property less valuable than that relinquished — thereby receiving cash or other nonqualifying property in the exchange — like kind exchange status will not be imperiled, but the taxpayer will be forced to recognize some of the realized gain.

Nonqualifying property, or “boot” may consist of (i) cash; (ii) relief from
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Tax Planning

2007 DECISIONS OF NOTE, CONT.

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hypothetical, not strategic, willing buyers and willing sellers. As a threshold assumption, we are to proceed under the arbitrary assumption that a liquidation takes place on the date of death. Assets and liabilities are deemed frozen in value on the date of death and a “snap shot” of value taken.” The appeals court upheld the Tax Court’s determination that the claimed minority discount of 25% and the claimed marketability discount of 35%, should be reduced to 10% and 15%, respectively.

An estate which owned a one-half interest in 19 valuable paintings claimed a 44% discount for lack of marketability and control, resulting in a reported value of \$1.42 million. *Stone v. U.S.*, 2007 WL 1544786, 99 AFTR2d 2007-2992 (N.D. Ca. 5/25/07) (slip opinion), final opinion 2007 WL 2318974, 2007 TNT 158-15 (N.D. Ca. 8/10/07) (slip opinion). The IRS valued the decedent’s interest at 50% of the value of the entire collection. The District Court agreed that a discount should be allowed, but that it should be substantially less than the 44% claimed.

The court found persuasive the testimony of the IRS Art Advisory Panel, comprised of a collection of unpaid art experts, which based its valuation on comparable sales of similar paintings near the date of valuation. Rejecting the estate’s analogy to discounts allowed for sales of undivided interests in real estate, the District Court agreed with the IRS contention that the only discount allowable was a 2% discount for partition. The court reasoned that a hypothetical willing seller of an undivided interest in art would likely seek to sell the entire work of art and divide the proceeds by partition, rather than sell its fractional interest at a discount.

The IRS was successful in 2007 in a number of cases involving valuation discounts in the context of transfers to family limited partnerships. The Service continued to rely on IRC §2036 to pull back into decedents’ estates assets nominally transferred to FLPs but in which the decedents continued to retain possession, enjoyment or the right to income from the transferred assets.

In *Estate of Gore*, the *inter vivos* (Please turn to page 6)



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2007 REGS. AND RULINGS, CONT.

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an estate by providing that an estate may deduct a claim or debt, or a funeral or administration expense, only if the amount is actually paid. An expenditure contested by the estate which cannot not be resolved during the period of limitations for claiming a refund will not be deductible. However, the executor may file a “protective claim” for refund, which would preserve the estate’s ultimate right to claim a deduction under IRC §2053(a). A timely filed protective claim would thus preserve the estate’s right to a refund if the amount of the liability is later determined and paid.

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

A second limitation on deductible expenses also applies: Estate expenses would be deductible by the executor only if approved by the state court *whose decision follows state law*, or established by a *bona*

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FROM WASHINGTON, CONT.

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Max Baucus (D-Mont.) have expressed support for tax rebates.

Mr. Bush on January 7th, addressing business leaders in Chicago, called upon Congress to make permanent the 2001 and 2003 tax cuts. The President added that if the tax cuts are not made permanent, 26 million small business owners would see their taxes increase by almost 17%. House Speaker Nancy Pelosi (D-Calif.) stated that Democrats favor tax cuts for the middle class.

On December 26th, President Bush signed into law the Tax Increase Prevention Act of 2007 (H.R. 3996), which provides a one-year "patch" of the AMT for 2007, but does not offset the revenue cost with revenue raising provisions. Without further Congressional action, the AMT amounts for individuals in 2008 will revert to 2000 levels.

B. Position of Candidates

Senator McCain was one of only two Republicans who opposed the Bush tax cuts in 2001, and one of only three who opposed the tax cuts in 2003. At the time, he stated the tax cuts were "fiscally reckless" and that they "disproportionately" favored the rich. However, Mr. McCain supported extending the tax cuts in 2007. Senator McCain stated in 2007 that tax system is fair and that the wealthy pay bulk of taxes. Mr. McCain is the only Republican candidate who has refused to commit to not raising marginal income tax rates. Senator McCain favors repealing the AMT, which he states "is eating Americans alive." He supports a \$3,000 tax credit for health insurance, which he states would give low-income Americans access to health care. Tax News & Comment strongly endorses Senator McCain for the Republican Presidential nomination. Senator McCain possesses integrity and strong leadership qualities.

Senator Obama has stated that the estate tax affects only the wealthiest 1/3 of 1% of Americans in 1989 and believes "it would be hard to find a tax cut that was less responsive to the needs of ordinary Americans." Still, he supports increasing the estate tax exemption amount to \$5 million, effective 2015, and reducing the estate tax rate. In 2007, Mr. Obama voted against repealing the AMT, and voted against raising the estate tax exemption amount to \$5 million. In 2006, Senator Obama voted against retaining the reduced taxes on capital gains and dividends. Mr. Obama characterizes the tax system as "skewed" in favor of the wealthy, and advocates a restoration of progressivity in the tax code. Senator Obama states that reducing the Bush tax cuts would pay for health care and other programs.

Senator Clinton favors freezing the estate tax exemption amount at \$3.5 million, and supports reducing the current 45% estate tax rate which she has characterized as "confiscatory." Ms. Clinton in 2007 voted against repealing the AMT. In 2006, Senator Clinton voted in favor of extending the capital gains tax cuts. Ms. Clinton voted against the Bush tax cuts in 2003. In 2007, Senator Clinton voted against raising the estate tax exemption amount to \$5 million. Ms. Clinton favors retaining middle-class tax cuts and favors "restor[ing]" the tax rates of the 1990's. She supports "raising taxes on corporations and wealthy individuals." Senator Clinton has suggested that the current \$95,000 ceiling for payroll contribution be eliminated.

Governor Romney in 2007 pledged not to raise taxes, but had declined to make a similar pledge in 2002. While Governor of Massachusetts, Mr. Romney did not raise taxes, but Mr. Romney did raise fees on individuals and corporations by more than \$500 million. Governor Romney favors eliminating taxes on capital gains and dividends for taxpayers with less than \$200,000 of income. Mr. Romney favors complete elimination of the estate tax. While Governor Romney is concerned about the taxes middle class families are paying, he "do [es not] stay awake at night worrying about the taxes that rich people are paying." Governor Romney stated that "[g]etting rid of IRS is something we'd all love."

C. Gift & Estate Tax

Rep. Harry E. Mitchell (D-Ariz.) introduced legislation that would increase the unified credit, in phases, from \$3.75 million in 2010, to \$5 million in 2014. The proposal would reunify the estate and gift tax exemptions, which would vastly increase the amount of lifetime gifts one could make before incurring a gift tax. Today, the limit on lifetime gifts is \$1 million. The proposal would also (i) reduce the estate and gift tax rates to the top capital gains tax rate, which is scheduled to increase to 20% in 2010; and (ii) permit the executor of the estate to elect to transfer any remaining unified credit to the surviving spouse.

Proposals made by other Congressional Democrats would also increase the unified credit to amounts ranging from \$3 million to \$3.5 million in 2010, and would reduce estate and gift tax rates to rates ranging from 39% to 47%. All of the proposals would retain the present basis step-up rules. A few proposals would index the unified credit and GST exemption for inflation after 2007. Permanent repeal of the estate and gift tax — regardless of the

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ARTICLE 78 REVIEW, CONT.

(Continued from page 1)

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

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

Following a hearing, any party may appeal all or part of the Determination to the Tax Appeals Tribunal, provided a Notice of Exception is filed within 30 days after service of the Determination on the parties. A brief may be filed within 30 days after the filing of the Notice of Exception. 30-day extensions for filing a Notice of Exception may be granted "for cause." *In practice, such extensions are granted as a matter of course, provided a letter requesting the extension is received by the Division of Tax Appeals within the 30-day period for filing the Notice of Exception.*

Taxpayers not representing themselves at the Division of Tax Appeals may be represented by an accountant or an attorney. *Pro se* taxpayers generally fare poorly at the Division of Tax Appeals and create a hearing record so decidedly adverse that a later appeal to the Tax Appeals Tribunal handled even by a competent attorney becomes problematic.

B. Tax Appeals Tribunal

The Tax Appeals Tribunal, also located in Troy, has three Commissioners who serve nine-year terms and who may be removed only for cause. Tax procedure in the administrative tax tribunals is governed by rules promulgated by the Tax Appeals Tribunal. In many respects, these rules resemble procedural rules found in the CPLR, but are more flexible. Oral argument may be requested before the Tax Appeals Tribunal,

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2007 REGS. & RULINGS, CONT.*(Continued from page 2)*

fide settlement agreement or a consent decree resulting from an arm's length agreement. This requirement is apparently intended to prevent a deduction where a claim of doubtful merit was paid by the estate.

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

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

GAIN IN LIKE-KIND EXCHANGES, CONT.*(Continued from page 1)*

liabilities; (iii) property that could be exchanged under Section 1031, but is not of "like kind" to the relinquished property (e.g., a truck for a horse); or (iv) property expressly excluded from exchange treatment under IRC §1031(a)(2) (e.g., partnership interests).

Realized gain equals the sum of money and the fair market value of property received in the exchange, less the adjusted basis of property transferred. IRC §1001(a); Regs. § 1.1001-1(a). Realized gain is *recognized* to the extent of the sum of money and the fair market value of nonqualifying property received in the exchange. IRC § 1031(b).

If liabilities associated with the relinquished property are assumed by the other party to the exchange, the taxpayer is deemed to receive cash. IRC §1031(d); Regs. §1.1031(b)-1(c); *Coleman v. Com'r*, 180 F2d 758. *Whether* another party to the exchange has assumed a liability of the taxpayer is determined under IRC §357(d).

Although realized *gain* is recognized to the extent nonqualifying property is received, realized *loss* with respect to like-kind property relinquished

The existence of a large protective claim might also tempt the IRS to look more closely at other valuation issues involving other expenses claimed by the estate as a hedge against the possibility of a large future deduction by the estate.

B. Preparer Penalties Under IRC §6694

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

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

tax return is only a small part.

Notice 2008-13 contains new guidance concerning the imposition of return preparer penalties. It provides that until the revised regs (expected to be issued before the end of 2008) are issued, a preparer can generally continue to rely on taxpayer and third party representations in preparing a return, unless he has reason to know they are wrong. In addition, preparers of many information returns will not be subject to the new penalty provisions unless they willfully understate tax or act in reckless or intentional disregard of the law.

Revised IRC §6694 joins Circular 230, now two years old (which Roy M. Adams observed effectively "deputizes" attorneys, accountants, financial planners, trust professionals and insurance professionals) in "extend[ing] the government's reach and help[ing to] fulfill a perceived need to patch up the crumbling voluntary reporting tax system." The Changing Face of Compliance, Trusts & Estates, Vol. 147 No. 1, January 2008. The perilous regulatory environment in which attorneys and accountants now find themselves counsels caution when advising clients concerning tax positions. Although a taxpayer's right to manage his affairs so as to minimize tax liabilities is well-settled, Congress has signified its intention to hold tax advisers to a higher standard when

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in the exchange is never recognized. IRC §1031(c). *However, this does not mean that loss will never be recognized in a like kind exchange.* Section 1031 takes a restrictive view of nonqualifying property *received* in an exchange, since it undermines the purpose of the statute. However, under IRC §1031(c), both gains and losses are recognized with respect to *nonqualifying property transferred* in a like-kind exchange. Thus, IRC §1031 has no effect on the income tax treatment of nonqualifying property transferred in the exchange.

To illustrate, assume taxpayer exchanges property in Florida which has declined in value, for an oil and gas lease in Montana, and cash. Realized loss with respect to the Florida property is not recognized because loss is not recognized with respect to the transfer of qualifying property. However, if as part of the consideration for the Montana property the taxpayer also transfers Ford stock which has declined in value, realized loss on the Ford stock will be recognized because both gains and losses with respect to the *transfer* of nonqualifying property in a like-kind exchange are recognized.

As noted, the receipt of cash or other nonqualifying property would

normally produce taxable boot to the extent of realized gain. However, Revenue Ruling 72-456 provides that brokerage commissions and perhaps all transaction costs may offset boot. *Blatt v. Com'r*, T.C. Memo (1994-48) held that expenses incurred in connection with an exchange and not deducted elsewhere on the taxpayer's return offset boot. Prop. Regs. §1.263(a)-1(c)(2) provide that transaction costs incurred in connection with the sale of property must be capitalized, but those expenses reduce the amount realized. The ABA also endorses this position.

B. Basis Rules

Unlike IRC §121, which *excludes* realized gain, IRC §1031 operates merely to *defer* recognition of realized gain. Basis rules under Section 1031 provide the mechanism by which deferred gain is preserved for future recognition the if the replacement property is later sold. (The deferral would, of course, become permanent if the taxpayer dies owning the replacement property, since the basis would then be stepped up to fair market value by virtue of IRC §1014(b).)

IRC §1031(d) and the Regs provide

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2007 REGS. & RULINGS, CONT.

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rendering tax advice.

C. Other Developments

Final Regs. §301.6111-3(b)(1) under IRC §6011 impose substantial reporting and record-keeping requirements upon professionals who furnish advice relating to the filing of estate and gift tax returns. 72 Fed. Reg. 43146, 43154, 43157 (8/3/07). The final regs create a new category of reportable transactions, termed "transactions of interest," for which the taxpayer or advisor must file a disclosure form and maintain records. Transactions of interest identify those transactions which the IRS believes have the potential for tax avoidance. The final regs also impose disclosure and record keeping requirements upon "material advisors," who are persons providing any "material aid, assistance or advice regarding the organization, management, promotion, sale, implementation, insurance, or conduct of any reportable transaction, and derives substantial income from that aid, assistance, or advice."

The IRS stated that it may impose a gross valuation misstatement penalty against an appraiser for post-May 25, 2007, estate and gift tax appraisals under new IRC §6695A, as adopted by the Pension

Protection Act of 2006. The penalty is the greater of \$1,000 or 10% of the amount of the underpayment attributable to the misstatement (but not more than 125% of the gross income received by the appraiser for preparing the appraisal). TAM 2007-0017.

The IRS re-issued proposed regulations under IRC §6159 describing how installment payment arrangements are requested, accepted and administered. The regs clarify when the IRS can terminate an installment payment agreement and recommence collection action. REG-10084172 Fed. Reg. 9712 (3/5/07). The IRS may reject an installment agreement by notifying the taxpayer or the taxpayer's representative in writing of the reasons for the rejection and the taxpayer's right to appeal to the IRS Office of Appeals within 30 days.

The IRS may cancel an installment agreement for reasons which include (i) nonpayment of any required installment payment when due; (ii) inaccurate or incomplete information; (iii) a determination that the collection of tax is in jeopardy; (iv) a significant change in the taxpayer's financial condition; or (v) the failure of the taxpayer to pay any other federal tax liability when due. Prop. Regs. §301.6159-1(e)(4).

Notice 2007-90 provides guidance for estates seeking to defer payment of estate tax attributable to a closely held business under IRC §6166. The IRS will determine on

a case-by-case basis whether security is required to protect the government's interest in obtaining full payment of the estate tax. A primary factor will be the nature of the business generating the income on which estate taxes are owed.

Proposed regs articulate expenses of a trust or estate that are subject to the 2% floor on miscellaneous itemized deductions. The regs state that those costs which could not have been incurred by an individual in connection with property not held in a trust or estate are exempt from the 2% floor. Examples of costs *excluded* from the 2% floor include costs associated with fiduciary accountings, judicial or quasi judicial filings required in trust or estate administration, or fiduciary income tax returns, since those costs could not have been incurred by an individual. Expenses *subject to the 2% floor* include costs associated with the custody or management of property, advice on investing for total return, the defense of claims by creditors of the decedent or grantor, or the purchase, sale and management of business property. Reg.-128224-06, 72 Fed. Reg. 41243 (7/27/07).

FILING OF GIFT TAX RETURNS, CONT.

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made an incomplete gift. Treas. Reg. §25.2511-2.

The situation may arise where the taxpayer is unsure whether the gift is complete or incomplete. Treas. Reg. §301.6501(c)-1(f)(5) provides that adequate disclosure of a transfer that is reported as a completed gift will commence the running of the 3-year statute of limitations for assessment of gift tax, even if the transfer is ultimately determined to be an incomplete gift. However, in the converse situation, where a gift is reported as incomplete, but it is later determined to have been a completed gift, the result is less favorable: The period for assessing a gift tax will not commence to run until after a return has been filed reporting the completed gift.

Gifts qualifying for the annual exclusion, currently \$12,000, are neither reported nor taxed. Gifts qualifying for the annual exclusion must be gifts of a present interest. Gifts consisting of a future interest, *i.e.*, gifts in which the donee's right to use, possess or enjoy the property will not commence until a future date, will not qualify for the annual exclusion. Treas.

Reg. §25.2503-3. Transfers in trust that would otherwise constitute future interests may be converted to gifts of a present interest by the inclusion of what are termed "Crummey" withdrawal rights.

Certain transfers, which might otherwise be considered gifts, are by definition excluded from those transfers which require filing a gift tax return. Thus, under IRC §2503(e), the gift tax does not apply to "qualified transfers" made directly to (i) political organizations; (ii) "qualifying domestic or foreign educational organizations as tuition"; or (iii) medical care providers for the benefit of the donee.

Gifts to spouses may or may not require the filing of a gift tax return. Gifts qualifying for the marital deduction do not require the filing of a gift tax return, unless a QTIP election is contemplated, in which case the return must be filed in order to make the election. The gift of a terminable interest to a spouse also requires the filing of a gift tax return. The gift of a life estate, an estate for a specified number of years, or any other property interest that will terminate or fail after a period of time, will constitute a nondeductible terminable interest for which a gift tax return must be filed. IRC §2523.

Gifts to charities may require the filing of a gift tax return. If the donor's only gifts during the year were to charities, no gift tax return need be filed. However, if the donor is required to report noncharitable gifts, gifts made to charitable entities must be reported on the return.

Some gifts which requiring reporting may not involve a situation where a "transfer" has occurred in its ordinary sense. Thus, even the exercise or release of a general power of appointment may constitute a taxable gift by the person releasing the power. IRC §2514(b). If a trust beneficiary releases a power to consume the principal of the trust, this would constitute a taxable gift.

Unlike the filing rules relating to income tax returns, there is no provision for the filing of joint gift tax returns. However, spouses may "split" gifts. By splitting a gift, both spouses are deemed to have made one-half of the taxable gift, regardless of which spouse actually transferred the property. To report a split gift, one spouse would file a gift tax return on which the non-filing spouse formally consents to the splitting of the gift by signing the return. Generally, the decision to split gifts applies to all made during the year. Treas. Reg. §25.2513-1(b). The executor or administrator of a deceased

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transfer of assets to the FLP was never completed, since the formalities of transfer were not observed. While bank accounts and stock certificates were purportedly transferred to an FLP, names were not changed on any of the accounts, and Gore continued to collect income and dividends from the assets. T.C. Memo. 2007-169 (June 27, 2007).

In *Estate of Erickson*, the partnership agreement contemplated that assets would be transferred to the FLP when the operating agreement was executed. However, transfers were not made to the FLP until two days before the decedent's death, suggesting that partnership formalities had not been observed. Finding that Erickson had retained the benefit of the assets during her lifetime, and that no independent non-tax purposes existed for creating the partnership, the assets were includible in her estate under IRC §2036(a)(1). The court found that the partnership's purchase of assets from the estate to meet estate tax liabilities was also tantamount to the funds being available to the decedent. T.C. Memo. 2007-107 (April 30, 2007).

Estate of Korby posed a different

problem: distributions from the partnership were found to have been made under the pretext of "management fees," since no written management agreement concerning those fees was ever executed. Moreover, no record of management fees paid was kept, no management income was ever reported, and the management fees paid were greatly in excess of the amounts distributed to the limited partners. Since Korby had retained practically nothing outside the partnership, the Tax Court found an implied agreement that the assets transferred to the partnership would continue to be made available to Korby and her spouse during their lifetime. Thus, the "management fees" constituted an income interest which caused the assets transferred to the FLP to be includible in Korby's estate under IRC §2036(a)(1). 471 F.3d 848 (8th Cir. 2007).

Rounding out the significant partnership cases, *Estate of Bigelow*, decided by the 9th Circuit, held that Virginia Bigelow had retained an economic interest in residential real property transferred to an FLP, since the property secured a debt for which Bigelow was personally liable. Another problem was that the partnership continued to make monthly debt payments for Bigelow. Finding an implied agreement to retain

both the economic benefits (loan security) and the right to income (loan payments), the real property was includible in Bigelow's estate under IRC §2036. 503 F.3d 955 (2007).

Tax payment clauses are important, but often overlooked, provisions in testamentary trusts and wills. The decedent in *Estate of Sowder* bequeathed \$600,000 to persons other than his spouse, and left the residue of his estate to his wife, Marie "if she survives me, and if she does not survive me, or dies before my estate is distributed to her. . . ." 2007 WL 3046287, 100 AFTR2d 2007-6379 (9th Cir. 10/18/07) (slip opinion), *aff'g per curiam* 407 F. Supp.2d 1230 (E.D. Wash. 2005).

The IRS disallowed the marital deduction, asserting that the condition of survivorship caused the residuary bequest to constitute a nondeductible terminable interest under IRC §2056(b)(3). However, the district court concluded that the decedent's intent was for the residuary bequest to qualify for the marital deduction, citing as authority a Washington statute which requires construction of a marital bequest intended to qualify for the marital deduction in such a manner as to cause it to qualify. The 9th Circuit affirmed *per curiam*.

To assist a court in construing the will in a manner consistent with the

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FILING OF GIFT TAX RETURNS, CONT.*(Continued from page 5)*

spouse, or the guardian of a legally incompetent spouse, may validly consent to split a gift. Treas. Reg. §25.2513-2(c). The consent to split gifts may not be made after the gift tax return has been filed.

If no gift tax is owed, a six month automatic extension sought for an filing income tax return on Form 4868 will also automatically extend the period for filing a Form 709 gift tax return until October 15th. However, if gift tax is owed, or if no income tax extension is sought, Form 8892 must be used.

Form 709 requires a statement disclosing the adjusted basis of gifted property. No actual calculation of basis is required. Without a disclosure of basis, the return may not be accepted as filed by the IRS. Treas. Reg. §1.1015-1(g) provides that persons making or receiving gifts should preserve and keep accessible a record of facts necessary to determine the cost of property and its fair market value as of the date of the gift.

B. Gifts Requiring Disclosure

If the value of any item reported as a gift reflects any valuation discount, Form 709 requires that an explanation be attached to the return. The instructions specify that any gift reflecting, among others, a discount for lack of marketability, a minority interest, or a fractional interest in real estate, must be disclosed. *When claiming a discount, the taxpayer must offer evidence that the discount is appropriate. Mere reliance on previous cases where discounts were upheld is insufficient.*

Even if no gift tax is owed, the filing of Form 709 is crucial, as it commences the statute of limitations for revaluing the gift. Treas. Reg. §25.2504-2 (b) provides that gifts "finally determined" cannot be revalued. The value of a gift is finally determined if (i) the three-year period under IRC §6501 to assess the gift tax has expired; and (ii) the gift has been "adequately disclosed" on the gift tax return.

For a gift to be adequately disclosed, the IRS must be apprised of the following information: (1) a description of the transferred property and any consideration received by the transferor; (2) the identity of, and the relationship between, the transferor and each

transferee; (3) if the property is transferred in trust, the trust's taxpayer identification number and a brief description of the terms of the trust, or in lieu of a brief description of the terms of the trust, a copy of the trust instrument; (4) a detailed description of the method used to determine the fair market value of the property transferred; and (5) a statement describing any position taken that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer.

A typical disclosure statement, for the sale of an LLC interest to a "defective" grantor trust, might contain the following language: "*The taxpayer sold 10 membership units in XYZ, LLC (the "LLC") to the John Smith Irrevocable Trust dated June 15, 2006. The sales price was \$3 million. The following adjustment clause was included in the Purchase Agreement: 'This transaction is intended to be an arm's length transaction, free from donative intent. Accordingly, if, after the close of the transaction, the IRS determines that the fair market value of the membership units of the LLC is greater or less than the value determined by the*

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2007 DECISIONS OF NOTE, CONT.*(Continued from page 6)*

decendent's intent, the inclusion of the following language might be advisable: "I intend that the value for Federal estate tax purposes of property given, devised or bequeathed outright or in trust to my spouse shall qualify for the marital deduction allowed by Federal estate tax law applicable to my estate."

The 2nd Circuit, in *Estate of Thompson*, 499 F.3d 129, 2007 WL 2404434 (8/23/09) vacated a decision of the Tax Court which held that the taxpayer had demonstrated reasonable cause for its understatement. The decedent's estate valued the decedent's block of stock at \$1.75 million, based upon an appraisal prepared by an attorney and an accountant, which claimed a 40% minority interest discount and a 45% lack of marketability discount. The court noted that the understatement penalty applies automatically, unless it is shown that reliance was reasonable. In this case, the taxpayer had failed to demonstrate that the estate's reliance on its experts was reasonable and in good faith, or whether the estate knew or should have known that the appraiser lacked the expertise to value the company. *This case underscores the importance of ensuring that the appraiser selected is qualified by virtue of a designation from a professional appraisal*

organization, and has relevant experience in the subject matter of the valuation.

The Tax Court, in *Estate of Roski*, 128 T.C. 113 (4/12/07) held that the failure of the IRS to exercise discretion with respect to the necessity of requiring an estate to (i) furnish bond equal to twice the estate tax deferred under IRC §6166(a)(1), (ii) provide the IRS with a special lien against estate assets under IRC §6324A, warranted further proceedings. The Tax Court rejected the IRS contention that Section 6166 provided for no judicial review, noting that neither the Code nor the legislative history expressly precluded Tax Court review of IRS discretion in this matter. The estate had attempted without success to obtain a bond and argued that it was barred from pledging business assets because the lien would violate covenants in the partnership agreement.

The use of domestic asset protection trusts has continued to increase, as more states have enacted favorable statutes. Tennessee and Wyoming in 2007 became the eighth and ninth states to permit self-settled trusts. Nevada broke new ground with legislation making it difficult for creditors of persons who own interests in private corporations to satisfy judgments. On July 1st, 2007, Nevada enacted legislation limiting the exclusive remedy for judgment creditors of stockholders in certain corporations to a charging order with respect

to the shares in the corporation. Creditors will therefore have no claim against corporate assets, and will be limited to making claims only against actual dividends paid from the corporation. Prior to this statute, this limitation of remedies was available only to LLCs and limited partnerships.

In *In Re Eversoff*, 2006 U.S. Dist. Lexis 69575 (E.D.N.Y. 9/27/07) the IRS claimed the taxpayer's transfer of property to an irrevocable trust was fraudulent. Eversoff transferred \$220,000 and a house into an irrevocable trust shortly after an IRS audit in which an assessment of \$700,000 was issued. Following the transfer, the taxpayer still possessed more than \$1 million in other assets, including several retirement accounts.

The IRS argued that the retirement accounts should not be considered in determining the taxpayer's solvency, and that the transfers rendered the taxpayer insolvent. However, the Eastern District held that under federal law, the IRS could levy on the retirement accounts and seize distributions. Since the taxpayer had sufficient funds to pay the tax assessment even following the transfers in trust, the taxpayer committed no actual or constructive fraud. The court held that the trust assets could not be used to satisfy the tax judgment.

FILING OF GIFT TAX RETURNS, CONT.*(Continued from page 6)*

appraisal used to establish the purchase price of the membership units, the purchase price will be adjusted to the fair market value as finally determined for Federal gift tax purposes by the IRS.' A copy of the appraisal of the membership units in XYZ, LLC is attached hereto as Exhibit 1."

With respect to item (4) above, the detailed description should include (a) financial data (e.g., balance sheets utilized in determining the value of any interest); (b) any restrictions on the transferred property that were considered in determining the fair market value of the property; and (c) a description of any discounts (e.g., minority or fractional interests; lack of marketability) claimed in valuing the property.

The disclosure required by item (4) above may also be satisfied by an appraisal which meets the requirements of Treas. Reg. §301.6501(c)-1(f)(3). Such an appraisal must be prepared by an appraiser who satisfies all of the following requirements: (i) the appraiser is an expert who regularly performs appraisals; (ii) the appraiser possesses the expertise required to make appraisals of the type of property being valued; and (iii) the appraiser is not the donor or donee or a member of the family of the donor or donee.

The appraisal must contain the following information: (A) the date of the transfer, the date on which the transferred

property was appraised, and the purpose of the appraisal; (B) a description of the property; (C) a description of the appraisal process employed; (D) a description of the assumptions, hypothetical conditions, and any limiting conditions that affect the analyses, opinions and conclusions; (E) the information considered in determining the appraised value; (F) the appraisal procedures followed; (G) the valuation method utilized; and (H) the specific basis for the valuation, such as specific comparable sales or transactions.

In some cases a decedent has failed to file required gift tax returns during his lifetime. In such a case, the executor, in computing the estate tax, must include any gifts in excess of the annual exclusion made by the decedent, or on behalf of the decedent under a power of attorney. The executor must make a "reasonable inquiry" as to such gifts, and the preparer should advise the executor of this responsibility. Instructions to Form 706, p. 4.

IRC Chapter 13 imposes a GST tax on all transfers, whether made directly or indirectly, to "skip" persons. Under IRC §2613 (a), a skip person includes a person who is two or more generations below the generation of the transferor or a trust, if all of the interests are held by skip persons. Under IRC §2611(a), transfers subject to the GST tax are direct skips, taxable distributions, and taxable terminations.

IRC §2602 provides that the amount of the GST tax imposed on a transfer is determined by multiplying the amount

transferred by the "applicable rate." Under IRC §2641, the applicable rate is the maximum federal estate tax rate multiplied by the "inclusion ratio." The inclusion ratio is one minus the "applicable fraction." The applicable fraction is a formula designed to reflect the property that will be taxed under the GST tax rules. The GST tax exemption is the numerator of the fraction. Therefore, if more of the GST tax exemption is allocated to the transfer, the fraction will be greater, the inclusion ratio will be less, and the GST tax with respect to the transfer will be less.

IRC §2631 allows every transferor a GST exemption that may be allocated to transfers made by the transferor either during the transferor's life or at death. Affirmative allocations of GST exemption are generally made on Form 709. Under IRC §2642(b)(1), if a transferor allocates GST exemption on a timely filed gift tax return, the transferor may allocate an amount of the GST exemption equal to the value of the property on the date of the transfer to reduce the inclusion ratio to zero.

Automatic allocations of GST exemption are made under IRC §2632 to certain transfers made during life that are direct skips, so that the inclusion ratio for such transfers may be reduced to zero even without any affirmative allocation of GST exemption.

ARTICLE 78 REVIEW, CONT.

(Continued from page 3)

but is not automatically granted.

C. Article 78 Appeals

Taxpayers wishing to contest adverse determinations of the Tax Appeals Tribunal generally have only one choice: an Article 78 proceeding to review the determination of a "state body" (i.e., the Tax Appeals Tribunal), pursuant to CPLR §7804. The action must be commenced in the Appellate Division, 3rd Department, in Albany, as provided for in Tax Law §2016. Tax Procedure in state courts is governed exclusively by the CPLR and, taxpayers who are not acting *pro se* may be represented only by an attorney.

The obstacles encountered in initiating Article 78 review are somewhat daunting. The first and perhaps most unpleasant surprise that awaits the taxpayer when petitioning for Article 78 review is the time period within which such review may be sought: CPLR § 217 provides that "a proceeding against a body . . . must be commenced within four months after the determination to be reviewed becomes final and binding." More than a few taxpayers have lost meritorious appeals based upon the failure to commence the Article 78 review within the four month period, which is jurisdictional.

Tax Law §2016 provides that the four-month period commences after notice of the Tax Appeals Tribunal is served. The statute then provides that "service by certified mail

shall be complete upon deposit of such notice . . . in a post office." Therefore, the taxpayer actually has *less* than four months from receipt of the notice in which to commence an Article 78 proceeding. The Department of Taxation keeps meticulous records, including affidavits by clerks, concerning the manner in which certified copies of decisions are mailed. Arguments made by the taxpayer concerning either the taxpayer's own timely mailing, or the Department's failure in this regard, will in all likelihood fail.

One might presume that only the Department of Taxation need be served with an Article 78 petition. This presumption would be erroneous: Tax Law § 2016 provides that "[t]he petitioner shall designate the tax appeals tribunal and the commissioner of taxation and finance as respondents in the proceeding for judicial review." (The Tax Appeals Tribunal does not, however, participate in the proceeding.) Section 2016 continues, providing that "[i]n all other respects the provisions and standards of article seventy-eight of the [CPLR] shall apply." CPLR §7804(c) provides that "notice of petition must be served upon the attorney general by delivery of such order or notice to an assistant attorney general." Therefore, the Department of Taxation, the Tax Appeals Tribunal and the Attorney General *must all be served* in an Article 78 proceeding.

One might also assume that since the taxpayer may be served with notice of the Tax Appeals Tribunal decision by certified mail, the taxpayer could, similarly, *commence* an Article 78 proceeding by serving the three required

recipients by certified mail. This is not the case: Although CPLR §307(2) does provide that personal service may be effected upon a state agency (i.e., Department of Taxation and Tax Appeals Tribunal) by certified mail, § 307(1) appears to require personal delivery by a process server upon the Attorney General. Additionally, one more trap awaits the unwary regarding service of process by certified mail: CPLR §307(2) provides that such service is not effective unless "the front of the envelope bears the legend "URGENT LEGAL MAIL." Given the tangle of statutory provisions governing service, it would appear far preferable to serve all parties personally by process server, rather than to serve by certified mail and hope that all statutory requirements have been met.

Although the taxpayer may have contested the deficiency to the Tax Appeals Tribunal without paying any disputed tax, this courtesy of the New York Legislature ends at the filing of the Article 78 petition, at least with respect to some types of tax. Thus, a jurisdictional prerequisite to instituting an Article 78 proceeding involving, *inter alia*, sales tax or real property transfer gains tax, is the filing of a bond to cover contested amounts and court costs.

Although a bond is not required in order to initiate an Article 78 proceeding based upon deficiency relating to income tax, the Department may nevertheless assess and collect a deficiency during the pendency of such an Article 78 proceeding. If the Department

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GAIN IN LIKE-KIND EXCHANGES, CONT.

(Continued from page 4)

that the basis of property received in a like-kind exchange equals the **aggregate basis** of property transferred, **decreased by** (i) cash received; (ii) debt relief associated with the relinquished property; and (iii) loss recognized with respect to the transfer of nonqualifying property. Basis of property received in an exchange is **increased by** (i) cash or notes transferred; (ii) the adjusted basis of nonqualifying property transferred; (iii) gain recognized on the exchange; and (iv) liabilities associated with the replacement property which are assumed by the taxpayer.

Where non-cash boot is received, basis must be allocated between the replacement property and the boot. Basis is allocated first to nonqualifying property (boot) to the extent of its FMV. Remaining basis is then allocated to nonrecognition properties in proportion to their respective fair market values. The holding period of qualifying property transferred is "tacked" onto the holding period of qualifying like-kind property received in the exchange. However, the holding period of boot received in the exchange begins anew.

To illustrate, assume taxpayer exchanges a building, with an adjusted basis

of \$500,000, a FMV of \$800,000, and subject to a mortgage of \$150,000, for consideration consisting of (i) a vacant lot worth \$600,000; (ii) \$30,000 in cash; and (iii) a Picasso sketch worth \$20,000. Realized gain (AR - AB) equals \$300,000 [(\$600,000 + \$150,000 + \$30,000 + \$20,000) - \$500,000]. Since debt relief is considered as cash received, \$200,000 of nonqualifying property (boot) has been received and will be subject to capital gains tax. The remaining \$100,000 of realized gain is deferred. Basis calculations are as follows:

1. Basis of Relinquished Building	\$500,000	
2. Basis Increase: Gain Recognized	\$200,000	
3. Basis Decreases:		
a. Money Received	\$30,000	
b. Debt Relief	<u>\$150,000</u>	
Total Basis Decreases	\$180,000	
4. Basis of Relinquished Building	\$500,000	
Plus: Basis Increase	\$200,000	
Minus: Basis Decreases	\$180,000	
Total Basis to be Allocated	\$520,000	
5. Allocation of Basis	<u>Allocated</u>	<u>Remaining</u>
Total Basis		
to be Allocated	\$520,000	
First: To Picasso Sketch		
to Extent of FMV	\$20,000	\$500,000
Next: Remainder of		
Basis to Land	\$500,000	-0-

Note: If one year following the exchange the vacant lot which is still worth \$600,000 and the Picasso sketch which is still worth \$20,000 are both sold, the Picasso sale will produce no gain, but the land sale will generate \$100,000 in recognized gain, which corresponds to the deferred gain from the initial sale. (If the Picasso had increased in value and were sold after one year, the sale would produce short-term capital gain, since the holding period for boot begins anew on the date of the exchange. The gain would be short-term because the property was not held for *more than* one year.)

Where nonqualifying property is transferred in the exchange, the transaction will still constitute a good like-kind exchange, but the consideration received must be allocated between the qualifying property and the nonqualifying property transferred in proportion to their respective fair market values. As noted, consideration allocated to nonqualifying property transferred in the exchange will result in gain or loss recognition under IRC §1001(c); Reg. §1.1031(d)-1(e). No gain or loss is recognized with respect to the transfer of cash, since no "sale or exchange" occurs.

To illustrate basis rules where nonqualifying property is transferred by the taxpayer seeking exchange treatment in a

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ARTICLE 78 REVIEW, CONT.

(Continued from page 8)

decides to assess tax during the proceeding (it may not come to the Tax Compliance Bureau's attention during the course of the proceeding), the taxpayer must either pay the deficiency or file a bond (a letter of credit may also be acceptable to the Department) pending ultimate disposition of the case.

The actual Article 78 proceeding is commenced by service of a Notice of Petition and Petition upon the parties described above made returnable to the Appellate Division, 3rd Department, on at least 20 days' notice. At least five days before the return date of the Petition, the adverse party must appear by serving an answer, or otherwise moving to dismiss. (A motion to dismiss could be based upon a lack of jurisdiction for failing to properly serve all parties or for failing to obtain the required bond, or dismissal could result from failing to state a cause of action.)

Although it may seem unjust for the Appellate Division to dismiss meritorious cases on procedural grounds such as the failure to serve the Article 78 petition in the proper manner — and perhaps it is unjust — a body of case law has evolved which makes it virtually impossible for a court to entertain a petition which suffers from jurisdictional defects.

The petition must be verified (CPLR §7804) and must comply with all provisions of the CPLR which govern pleadings. Thus, it

must make factual allegations in separately numbered paragraphs and must state a legally cognizable cause of action, or the action will be susceptible to a motion to dismiss.

The Court of Appeals held in *Spodek v. New York State Commr. of Taxation and Finance*, 628 N.Y.S.2d 256 (1995), that the commencement-by-filing provisions in CPLR §304 apply to proceedings originating in the Appellate Division. Thus, before service of the Article 78 petition on the required recipients, the Petition must be filed (and an index number purchased) from the Clerk of the Appellate Division. After purchasing the index number, personal service (preferably by a process server) must be made on the recipients. After such service is complete, proof of such service must be filed with the Appellate Division "not later than 15 days after the date on which the [four-month] statute of limitations expires." CPLR § 306(b)

Pursuant to Tax Law § 2016, the taxpayer must include as part of the petition (1) the determination of the Administrative Law Judge (ALJ), (2) the decision of the Tax Appeals Tribunal, (3) the transcript of the hearing (if any) before the ALJ, and (4) any exhibit or document submitted into evidence at any stage in the proceeding. Judicial review of the agency determination will be limited to a review of the record. After issue has been joined (*i.e.*, the Department has served an answer or moved to dismiss), and within nine months of the date of the Notice of Petition, the

taxpayer must file with the Appellate Division an original and nine copies of a reproduced full record, as well as ten copies of the taxpayer's brief.

In reviewing the determination of the Tax Appeal Tribunal, CPLR §7803 provides that the determination will be upheld if it is supported by "substantial evidence." In addition, the burden of proof is generally on the taxpayer to show that the agency determination was arbitrary or capricious, or not supported by the evidence. This includes responsible person determinations made under the income and sales tax laws for corporate officers and employees.

After submission of the record and brief, oral argument is scheduled. Taxpayer's counsel is generally allowed 15 minutes for oral argument. Approximately six weeks later, the Court will render a full opinion or memorandum decision. The prevailing party will then draft a proposed order for execution by the Appellate Division Clerk. After service of this order with Notice of Entry, the nonprevailing party will then have 30 days in which to seek leave (permission) to appeal to the Court of Appeals. The Court of Appeals seldom grants leave to appeal in tax cases.

GAIN IN LIKE-KIND EXCHANGES, CONT.

(Continued from page 8)

like-kind exchange, consider the taxpayer who exchanges a building, with an adjusted basis of \$1 million and a FMV of \$1.1 million, plus GM stock with an adjusted basis of \$400,000 and a FMV of \$200,000, for a vacant lot with a FMV of \$1.3 million.

The consideration of \$1.3 million is allocated between the building and the GM stock in proportion to their respective fair market values. The taxpayer realizes gain of \$100,000 in the building (\$1.1 million - \$1 million) and recognizes a loss (AB - AR) of \$200,000 on the GM stock (\$400,000 - \$200,000) under IRC §1001(c). The gain realized from the exchange of the building for the vacant lot is not recognized because those properties are of like-kind. The basis of the vacant lot is calculated as follows:

1. Loss on transfer of GM stock	
a. Adjusted Basis	\$400,000
b. Less: amount realized	<u>\$200,000</u>
c. Loss realized and recognized	\$200,000
2. Adjusted basis of	
relinquished building	\$1,000,000
Plus: Adjusted basis	
of GM stock	<u>\$400,000</u>
Aggregate basis of	
property transferred	\$1,400,000

3. Aggregate basis of	
property transferred	\$1,400,000
Less: Loss recognized	
on GM stock	<u>\$200,000</u>
Basis of vacant lot	\$1,200,000

IRC §453 provides that an installment sale is a disposition of property where at least one payment is to be received in the taxable year following the year of disposition. The receipt of an installment obligation will constitute boot, which may be eligible for installment reporting if the taxpayer otherwise qualifies to use the installment method.

Prop. Regs. §1.453-1(f) provide for the timing of gain upon receipt of an installment obligation received in an exchange. The Regs allocate basis in the transferred property *entirely* to like-kind property received in the exchange. This is disadvantageous, since a greater portion of each payment received under the installment obligation will be subject to current tax.

Relief from liabilities associated with relinquished property may trigger boot gain, or could require the taxpayer to pay cash. For example, if the replacement property is subject to a smaller mortgage than the relinquished property, the net relief from liability will be treated as cash being received in the amount of the net debt relief.

This will result not only in boot gain, but will also necessitate payment by the taxpayer of cash to equalize the net disparity in debt among the properties relinquished and replaced. If the taxpayer could prevail upon the seller of the replacement property to increase the mortgage on the replacement property prior to closing, the taxpayer might be able to avoid boot gain. (However, the IRS might still argue that the taxpayer has received boot equal to the cash extracted by the seller of the replacement property, by arguing that in substance, the cash payment the taxpayer is no longer required to pay — and that could easily be extracted tax-free by refinancing after the exchange — is boot.)

Assume the converse situation: The relinquished and replacement properties are of equal value, but the replacement property is subject to a larger mortgage than the relinquished property. If nothing is done, the taxpayer will receive cash to offset the smaller liability associated with the relinquished property. This will result in boot gain. If the taxpayer refinanced the relinquished property prior to the exchange to "even out" the mortgages, the necessity of the taxpayer receiving cash — and therefore the necessity of the taxpayer reporting boot gain — might be avoided.

Fredericks v. Com'r, T.C. Memo (Please turn to page 10)

FROM WASHINGTON, CONT.*(Continued from page 3)**outcome of the presidential election — appears to be extremely remote.***D. New York State**

Governor Spitzer has proposed \$738 million in new taxes and fees to offset a projected \$4.4 billion budget deficit in the new fiscal year beginning April 1st, 2008. Although the income tax will not be increased, taxes on gasoline will increase, as will fees for home purposes over \$175,000. Taxes imposed on out-of-state residents working or doing business in New York will also be increased. Senate Republicans have objected to a decrease in the amount returned to homeowners under the School Tax Relief (STAR) program, from \$1.8 billion which had been planned, to \$1.25 billion.

E. Internal Revenue Service

The annual report of National Taxpayer Advocate Nina Olson focused on (i) problems associated with changes to the tax code enacted late in the year; (ii) the need for the IRS to address the \$345 billion annual tax gap and (iii) private debt collection.

The late enactment of the AMT patch — after tax packages had been prepared and software completed — will delay the filing

of various returns. The report states that tax changes enacted late in the year create hardship, since many taxpayers are not aware of tax benefits they might be entitled to claim.

The report urged the IRS to create a “Cash Economy Program Office” to coordinate various initiatives in this area. Ms. Olson recommended that Congress enact legislation that would (i) increase the use of the IRS electronic payment system for estimated tax payments; (ii) authorize voluntary withholding agreements; and (iii) require information reporting by financial institutions on credit card receipts.

Finally, the report reviewed the status of the IRS Private Debt Collection program. Ms. Olsen urged repeal of the initiative, which she stated is “failing in most respects.” Although in 2007 the IRS estimated the program would raise revenue of between \$1.5 billion and \$2.2 billion over 10 years, gross revenue for the fiscal year 2007 totaled only \$31 million. Costs had exceeded revenue and the IRS could not predict when the program would become profitable. The report concluded that private collection agencies are no better at locating or collecting tax liabilities than the IRS itself. National Treasury Employees Union President Colleen Kelly called the report “the most damning evidence yet of the incredible failure of this misguided program.”

* * *

When hiring an appraiser in connection with transfer taxes, to preserve the attorney-client privilege, the appraiser should be hired by the attorney, rather than by the client. In this way, the taxpayer will be able to argue that all correspondence is privileged, since the appraisal was intended to assist the attorney in rendering legal advice. Methodology involving the appraisal should be discussed with the appraiser prior to appraisal drafts being produced.

Similarly, because the tax practitioner privilege is less broad than the attorney-client privilege, the attorney, rather than the client, should engage the accountant. Such an engagement, termed a “Kovel Agreement,” after the landmark case, *U.S. v. Kovel*, 296 F.2d 918 (2nd Cir. 1961), should clarify that (i) the accountant is engaged by the attorney and is working under the attorney’s direction and control; (ii) the work is for the purpose of rendering legal advice and is not simply for the preparation of returns; (iii) the work of the accountant belongs to the attorney; and (iv) any communications to the accountant are made solely for the purpose of enabling the attorney to provide legal advice to the client.

GAIN IN LIKE-KIND EXCHANGES, CONT.*(Continued from page 9)*

1994-27 posed the scenario described above. *Fredericks* approved of the pre-exchange financing where it was (i) independent of the exchange; (ii) not conditioned on closing; (iii) dependent on the creditworthiness of the taxpayer, rather than the cash buyer; and (iv) made sufficiently in advance (*i.e.* “old and cold”) of any contemplated exchange. If these requirements are not met, the IRS may argue that the mortgage was, in substance, obtained by the cash buyer and constitutes taxable boot. Ideally, the taxpayer’s reasons for refinancing should be unrelated to the exchange, and should be motivated, at least in part, by an independent business purpose.

Pre-exchange financing carries with it the risk that the IRS may attempt to recast the cash extracted in the refinancing as taxable boot. Post-exchange financing, in contrast, carries with it much less risk. The differing risk reflects the obligation of the taxpayer *vis à vis* the loan following the like-kind exchange.

After engaging in pre-exchange financing, the taxpayer will dispose of the property subject to the new mortgage. Since the loan is presumably secured by the real property, the taxpayer’s liability vanishes once the like-kind exchange is consummated.

However, the situation with post-exchange financing is different: Here the taxpayer will remain “on the hook” with respect to the financing, since the replacement property will be encumbered. For this reason, little risk is thought to be associated with post-exchange financing.

Some practitioners adhere to the “millisecond” rule, which theorizes that post-exchange financing with respect to the replacement property may be undertaken a “millisecond” after the exchange. More cautious taxpayers will wait until the day following the exchange to complete the financing on the replacement property. In any case, the (i) a different lender should be used for the post-exchange financing; and (ii) no new financing proceeds should appear on the closing statement for the replacement property.

In addition, the taxpayer should not be economically compelled to engage in the post-exchange financing. If the taxpayer would be subject to monetary penalties were he not to proceed with the planned post-exchange financing, the IRS might argue that the cash received in the post-exchange financing actually constituted boot.

The deductibility of interest on refinanced indebtedness depends on the use to which the borrowed funds are placed. In general, interest expense on debt is allocated

in the same manner as the debt to which the interest expense relates is allocated. Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures. Temp. Regs. §1.163-8T(a)(3). Property used to secure the debt is immaterial. Temp. Regs. §1.163-8T(c)(1); §1.163-8T(a)(3).

Expenditures are allocated into one of six categories: (i) passive activities; (ii) former passive activities; (iii) investment; (iv) personal; (v) portfolio; and (vi) trade or business. Temp. Regs. §1.163-8T(a)(4)(i)(A)-(E). Thus, the investment of refinancing proceeds in tax-exempt bonds would result in a denial of the interest deduction. Likewise, personal use of refinancing proceeds will result in a complete denial of the interest deduction. The deduction for investment interest is limited to “net investment income.” IRC §163(d)(1). Investment interest does not include interest taken into account under the passive activity loss rules. IRC §163(d)(3)(A), (B). Proceeds of refinanced indebtedness used in an active business are subject to no limitations on deductibility. IRC §163(a).