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TAX NEWS & COMMENT

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IRS MATTERS

RECENT DEVELOPMENTS

IRS Commissioner Douglas Shulman announced at the National Press Club on April 13 that the IRS wants to provide "tangible relief to taxpayers in distress while also helping others from straying across the line into non-compliance. Mr. Shulman stated that the "tax professional community" is "an integral part" of the tax administration system, constituting a "first line of defense against non-compliance and stop a small problem from becoming a big one."

¶ Rev. Proc. 2009-20 provides safe harbor treatment for "qualified investors" who experienced losses in certain criminally fraudulent investment arrangements. A uniform

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FROM THE COURTS

Surrogate Finds Tax Apportionment Clause "Beneficial Disposition" Under EPTL 3-3.2(a)(1)

Manhattan Surrogate Kristin Glen, in a case of first impression, held that the named beneficiary of life insurance proceeds passing outside the probate estate, who was also one of two witnesses to the will, was liable for his proportionate share of estate tax, despite a tax apportionment clause directing that estate taxes were to be paid entirely out of the residuary probate estate. *In Re Estate of Wu*, 2009 NY Slip Op 29181, 4/27/09).

[The Executor sought to require the decedent's brother, who was the named beneficiary of $3.14 million life insurance policy, to pay his share of estate tax. EPTL 3-3.2(a)(1) voids a "beneficial disposition" to an attesting

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FROM WASHINGTON

PRESIDENT OBAMA ASSERTS COST OF HEALTH CARE & ENVIRONMENTAL INITIATIVES SHOULD BE ASSUMED BY CORPORATIONS & AFFLUENT

Tax Analysis

President Obama recently announced plans to create a $630 billion "health care reserve fund" to provide health insurance to the more than 40 million uninsured Americans. Most costs would be assumed by higher income taxpayers in the form of (i) a 39.6 percent tax rate for married couples whose income exceeds $250,000; (ii) a 28 percent cap on itemized deductions (meaning that high income taxpayers will not receive a full deduction for mortgage interest, state and local taxes, and charitable deductions); and (iii) a new capital gains rate of 20 percent.

Mr. Obama advocates increas-

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The Decedent's Final Income Tax Return

Estate Planning

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

Liability issues may arise if a joint

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DISTRIBUTABLE NET INCOME & INCOME IN RESPECT OF A DECEDENT

In general, any distribution of income or principal by an estate will cause the beneficiary to be taxed to the extent of the lesser of (i) the estate's "distributable net income" (DNI) or (ii) the amount of the distribution. Estate income is said to be "carried out" to the beneficiary. Capital gains are an exception; since they are allocated to corpus and are not distributed to beneficiaries currently, they are generally excluded from DNI.

Two other important exceptions to the general rule for carrying out DNI exist. First, payment of specific bequests, *i.e.*, a specific sum of money or specific property, provided they are as-

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JULY COMMENT

Marital Deduction Planning

Estate Planning

By making a QTIP election, the Executor will enable the decedent's estate to claim a full marital deduction. To qualify, the trust must provide that the surviving spouse be entitled to all income, paid at least annually, and that no person may have the power, exercisable during the surviving spouse's life, to appoint the property to anyone other than the surviving spouse. Since the Executor may request a 6 month extension for filing the estate tax return, the Executor in effect has 15 months in which to determine whether to make the QTIP election.

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FROM WASHINGTON, CONT.

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ing corporate tax revenues by eliminating tax provisions which enable companies to defer paying tax on overseas profits provided those profits are reinvested in foreign subsidiaries. Such a change would increase the effective multinational tax rate by 6 percent to 32 percent and provide $210 billion in tax revenues. A Treasury Department official said the Obama administration wants to keep U.S. firms competitive, but remove tax code "distortions" that cause a firm to shift jobs overseas. Republicans and some Democrats feel that increasing the effective corporate tax rate is will stifle corporations.

Mr. Obama has requested that Congress increase the IRS budget by 8 percent to $5.5 billion in the fiscal year 2010 to strengthen tax enforcement and increase collections. The President plans to establish a task force, headed by former Federal Reserve Chairman Paul Volker, to narrow the "tax gap," which is the difference between tax which is owed and tax which is paid. $100 billion of the $300 billion gap is thought to be collectible. Mr. Obama also wants the IRS to increase enforcement efforts. This could mean more tax audits.

The $787 billion economic stimulus package passed by Congress in February provides more than $71 billion in energy investments, infrastructure and transportation improvements, environmental clean-up and clean water investments, and scientific research. Climate change funding appears to be less of a priority to President Obama than health care reform. Long-term AMT relief appears unlikely at this time.

Senator Max Baucus (D-Mont), Chairman of the Senate Finance Committee, recently introduced legislation that would freeze the estate exemption amount at $3.5 million, and freeze the maximum estate and gift tax rate at 45 percent. The proposal would reunify the estate and gift tax, thus allowing lifetime gifts of up to $3.5 million before gift tax liability arises. (Currently, gifts in excess of $1 million require payment of gift tax.) The bill would also allow "portability" of the exemption, so that a surviving spouse could utilize the unused exemption amount of the predeceased spouse. Estate and gift tax laws would also be revised to require a consistent valuation of property for income and transfer tax purposes.

The administration also advocates changing tax laws involving investments in hedge funds. U.S. banks have utilized complex swaps to enable foreign investors to benefit from investing in the U.S. stock mar-

DAVID L. SILVERMAN, ESQ.

J.D., Columbia Law School, LL.M. (Taxation) NYU Law School. Formerly associated,Pryor Cashman, LLP, Manhattan. Former editor, ABA Taxation Newsletter. Author, *"Like Kind Exchanges of Real Estate Under IRC § 1031."* (2007). Former Treasurer, NY Virtuosi Symphony Orchestra. Approved sponsor for CPE credits, NYS Board of Public Accountants.

nytaxatty@aol.com

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Law Offices of David L. Silverman
2001 Marcus Avenue, Ste. 265A South
Lake Success, NY 11042
Tel. (516) 466-5900 Fax (516) 437-7292
www.nytaxattorney.com

SHIRLEE AMINOFF, ESQ.

Ms. Aminoff earned her J.D. from Benjamin N. Cardozo School of Law, with a concentration in property and real estate. Ms. Aminoff is admitted to the New York State Bar. Ms. Aminoff practices tax, trusts & estates, estate administration, real estate, tax litigation, trademarks, and estate planning.

aminoffs@gmail.com

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witness whose testimony is necessary to prove the will. The Court found that the non-apportionment of estate taxes, which conferred a significant monetary benefit on the brother, was itself a "beneficial disposition." Accordingly, the Court denied the benefit of the tax apportionment clause to the brother, and required him to pay his proportionate share of estate tax under EPTL 2-1.8, which apportions estate tax among beneficiaries according to the value of their bequest.]

Although the brother may have been unaware his legacy (and presumably would not have witnessed the will had he known), the Court concluded that "animating the invalidiation of a legacy to a person whose testimony is required for probate is equally applicable to a benefit conferred by a tax clause." The Court noted that the legacy itself was not voided; the brother only was required to pay tax on what he received — the same had there been no tax apportionment clause.

If a decedent's will provides that taxes are to be paid out of the residuary estate (as in Wu), beneficiaries of nonprobate assets would ordinarily pay no estate tax. (Wu's brother had to pay because he was denied its benefit.) For this reason, the Surrogate Glen warned that drafters of nonapportionment clauses should be aware of the nature and extent of nonprobate assets. A tax apportionment clause may exclude nonprobate assets, and provide that taxes imposed on probate assets be paid out of

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GENERAL POWERS OF APPOINTMENT, CONT.

(Continued from page 1)

Nevertheless, electing QTIP treatment is not always advantageous. Inclusion of trust assets in the first spouse to die may "equalize" the estates. Equalization may have the effect of (i) utilizing the full exemption amount of the first spouse and (ii) avoiding higher rate brackets that apply to large estates. Still, the savings in estate taxes occasioned by reason of avoiding the highest brackets may itself be diminished by the time value of the money used to pay the estate tax at the first spouse's death. On the other hand, if the second spouse dies soon after the first, a credit under IRC §2013 may reduce the estate tax payable at the surviving spouse's death.

Although the IRS had at one time litigated the issue, it now appears that the Executor may elect QTIP treatment for only a portion of the trust, with the nonelected portion passing to a credit shelter trust. If a partial QTIP election is anticipated, separating the trusts into one which is totally elected, and second which is totally nonelected, may be desirable. In this way, future spousal distributions could be made entirely from the elected trust, which would reduce the size of the surviving spouse's estate.

When the surviving spouse dies, QTIP property is included in her estate at the value at the date of her death. Her estate is entitled to be reimbursed for estate taxes paid by recipients of the trust property. The amount of reimbursement is calculated using the highest marginal estate tax brackets of the surviving spouse. The failure to seek reimbursement of estate taxes is treated as gift made by those persons who would have benefited from reimbursement. However, the failure by the estate of the surviving spouse to seek reimbursement will not be treated as a gift if the decedent's will provides that reimbursement will not be made from QTIP property.

Care must be taken when making the QTIP election, since the IRS takes the position that if the election taken on the initial federal and state estate tax returns was defective — but the IRS did not notice the defect and allowed the marital deduction — the assets will be includible in the estate of the surviving spouse under IRC §2044. The IRS takes the position that the assets are includible even if the estate of the first spouse would have incurred no estate tax liability if the QTIP election had not been made. *See* PLR 9446001.

On the other hand, an unnecessary QTIP election will occasion of fewer harsh results. Under Rev. Proc. 2001-38, an unnecessary QTIP election for a credit shelter trust will be disregarded to the extent that it is not needed to eliminate estate tax at the death of the first spouse. Similarly, a mistaken overfunding of the QTIP trust will not cause inclusion of the overfunded amount in the estate of the surviving spouse. TAM 200223020.

Since the estate tax is a "tax inclusive," as opposed to the gift tax, which is "tax exclusive," there is a distinct tax benefit to making lifetime transfers. A QTIP trust can assist in accomplishing this objective. Assume at a time when the applicable exclusion amount (AEA) is $3.5 million, father has an estate of $6 million., and mother has an estate of $2.5 million. Father (who has made no lifetime gifts other than annual exclusion gifts) wishes to give his children $4.5 million. If $4.5 million were left to the children outright, the $1 million excess over $3.5 million would attract a federal estate tax of $450,000, and a New York estate tax of $160,000, for a total tax of $610,000. This would leave only $390,000 of the $1 million bequest to the children. If instead of leaving $4.5 million to his children outright, father were to leave only $3.5 million to them, and place $1 million in a trust qualifying for a QTIP election, many estate taxes could potentially be saved.

IRC §2519 provides that "any disposition of all or part of a qualifying income interest for life in any property to which this section applies is treated as a transfer of all interests in the property other than the qualifying income interest." Therefore, were wife to gift one-half of her qualifying income interest, she would be deemed to have made a gift of the entire remainder interest in trust, in addition to the gift of the income interest. Under IRC §2207A(a), she would have a right to recover gift tax attributable to a deemed transfer of the remainder interest under IRC §2519.

Proposed regs provide for "net gift" treatment of the deemed gift of a remainder interest under IRC §2519. (A net gift occurs if the donee is required, as a condition to receiving the gift, that he pay any gift taxes associated with the gift.) The gift taxes so paid by the donee may be deducted from the value of the transferred property to determine the donor's gift tax. Assume the value of each of the income interest and the remainder interest in the QTIP trust are $500,000. If wife makes a gift of half her income interest, or $250,000, she would be deemed to have made a net gift of the entire $500,000 remainder interest. If the gift tax rate were 50%, wife would have made a net deemed gift of the remainder interest constituting $333,333, resulting in a gift tax of $167,667.

Although there must be no prearranged agreement that wife will make the contemplated transfer of her lifetime income interest, it is evident that the gift of a qualifying income interest in a QTIP trust can be an effective means of leveraging the $3.5 million lifetime exemption amount by leaving assets to the surviving spouse, who is then expected — but not required — to make substantial gifts to children. Note that in the example the intended result would not be accomplished if wife simply disclaimed her interest in the QTIP, because in that case she would be treated as having

RECENT IRS DEVELOPMENTS, CONT.

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manner of determining theft losses alleviates "potentially difficult problems of proof" in determining how much income reported in prior years was fictitious or a return of capital. Taxpayers utilizing safe harbor treatment should append the language "Rev. Proc. 2009-20" on Form 4684, *Casualties and Thefts*.

¶ According to an audit report issued by the Inspector General for Tax Administration (TIGTA), the Treasury is foregoing more than $100 million in annual revenue by failing to collect unassessed failure to pay tax penalties. Audit Report No. 2009-30-052. TIGTA Report No. 2009-20-050 notes that the motor fuel excise tax compliance program, which accounts for between $30 and $40 billion in annual revenue, needs further improvement in the area of compliance and penalty program effectiveness.

¶ New York currently has a voluntary disclosure program covering all taxes, including income, corporate and sales taxes. Eligible taxpayers (i.e., those who (i) are not under audit, (ii) have not received a bill, and (iii) are not being criminally investigated by New York or any political subdivision thereof, may apply by providing a "detailed explanation" of (i) taxes owed; (ii) the reason for failure to report and pay; and (iii) the rationale for requesting a "limited look-back" clause (if one is being requested). If approved, the taxpayer will be sent a Voluntary Disclosure Agreement covering only the taxes and periods listed on the application. Penalties will be waived. However, if the taxpayer provides false information or incomplete information, intentionally fails to pay taxes covered by the agreement, or "intentionally violates any tax law in the future," New York may "use the information disclosed against [the taxpayer]" and may commence civil or criminal prosecution.

¶ The AFR short-term rate for June 2009 is 0.81%; the mid-term rate, 2.06%; and the long-term rate, 3.57%. Selling depressed assets to a grantor trust in return for an installment note may be effective in "freezing" values for estate tax purposes. Provided the sale is arm-length, the sale of assets comprising interests in an LLC or other family entity (which interests are discounted to reflect lack of control and lack of marketability) can leverage the current $3.5 million lifetime exemption. Note that since the trusts are taxed as grantor trusts, the seller recognizes no income tax gain when the assets are sold to the trust. It appears that the sale must also be preceded by a gift to the trust of assets whose value equals 10 percent of the assets to be sold to the trust. Since the assets will not be included in the estate, basis step up will be lost. However, this problem may be minimized if the trust provides that the grantor may at a future time substitute assets of equal value (with a higher basis).

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FROM THE COURTS, CONT.

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certainable under the terms of the will, will not carry out estate income to beneficiaries. Thus, property distributed in cash or in kind to a beneficiary will not trigger a distribution deduction at the estate level or generate gross income at the beneficiary level.

The second exception is termed the "separate share rule." To qualify, the governing instruments must require that distributions to beneficiaries be made in "substantially the same manner as if separate trusts had been created." Treas. Reg. §1.663(c)-3(a). The rule is intended to prevent one beneficiary from being taxed on income which was accumulated for another beneficiary, but was distributed to the first beneficiary.

To illustrate, assume that DNI equals 10, and the estate makes a distribution of 6 to one of two equal beneficiaries during the year, but makes no distribution to the other beneficiary. Without the separate share rule, the beneficiary receiving 6 would be taxable on 6, since 6 is the lesser of DNI (10) and the amount distributed (6). However, under the separate share rule, the beneficiaries would be treated as having separate equal shares of the trust. Thus, each separate "trust" would have DNI of 5. Thus, the beneficiary receiving a distribution of 6 would be taxed on 5 and would receive a principal distribution of 1. The separate share rule does not create a "flow through" system of taxation. The beneficiary receiving no distribution would not be taxed. Rather, the remaining 5 of income would taxed to the estate.

[Note: When considering the concept of DNI, one should distinguish IRC §102, which provides that gross income does not include the value of property acquired by gift or inheritance. Therefore, if a decedent died seized only of raw land in Nebraska generating no income, and that land were deeded to his daughters, there would be no DNI and no income tax would be imposed on the daughters by reason of the bequest. On the other hand, if the land were leased, income therefrom would generate DNI, which would be taxed either to the estate, or to the daughters, if distributed to them.]

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

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

IRC §691(b) permits deductions in respect of a decedent (DRD). Such deductions include trade or business expenses, interest, taxes, depletion, etc., which accrued before death but were not paid, and thus were not deductible on the decedent's final income tax return because the expenses had not been paid before death. Since these items constitute debts, they may be deductible on the the decedent's estate tax return, thus producing a double benefit.

Note that IRD items, in contrast to most other items included in the gross estate, do not receive a basis step up at the decedent's death. IRC §1014(c). This can be particularly disadvantageous if the decedent sold highly appreciated property immediately before death using the installment method to report gain. In this case, the gross profit ration would remain high. Had the contract been entered into after death, there would be no gain because the property

DECEDENT'S FINAL INCOME TAX RETURN, CONT.

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return is filed, since the executor and spouse become jointly and severally liable for any tax and penalties, unless otherwise agreed. Therefore, the executor should exercise caution before filing a joint return, even if fewer taxes would arise by doing so.

Income tax liability of the decedent which arose before his death constitutes a bona fide debt of the estate. Accordingly, such income tax liability may be deducted on the estate tax return. However, if a joint return is filed, only that portion of the income tax attributable to income for which the decedent was liable may be deducted. Other expenses incurred by the decedent and paid before death, as well as certain other items, are deductible only on the decedent's final income tax return. Such expenses and items include (i) medical and other deductible expenses paid prior to death; (ii) capital loss carryovers; (iii) charitable contribution carryovers; and (iv) net operating loss carryovers.

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

IRC §706(c)(2)(A) provides that the taxable year of a partnership closes with respect to a partner whose entire partnership interest terminates by reason of death. Therefore, the final return includes flow through items for the short year. Under the section 706 regulations, the allocation for the short year is made by effectuating an interim closing of the partnership's books at the decedent's death or, if all partners agree, on a pro rata basis based upon the number of days. A similar rule applies with respect to S corporation income. IRC §1377(a)(2). Allocating on a pro rata basis may be advantageous if it allows the use of carryovers that terminate with the decedent's death.

The executor may be personally be liable for taxes if a distribution results in an unpaid income or gift tax liability. Liable may exist for the period in which an assessment may be made, *i.e.,* 3 years from the date payment is required, or six years if there is a "substantial omission" (*i.e.*, 25%) of income. Liability may be imposed even if the executor had no actual knowledge of the tax liability. It is sufficient that the executor had knowledge of the facts which would cause a reasonable prudent person to be aware of the tax liability.

Under IRC §6501(d), the executor may request prompt assessment of income and gift taxes attributable to prior returns filed by the decedent. This will shorten the statute of limitations for collection and may benefit the beneficiaries as well as the executor. The executor may also file a written application requesting release from personal liability for the decedent's income and gift taxes. If the IRS fails to notify the executor of any amount due within 9 months thereof, the executor will be released from liability.

The executor may also incur personal liability for estate taxes. The executor may request a release from liability with respect to any estate tax found to be due within 9 months of making the application if the application is made before the return is filed, or within 9 months of the due date of the return. IRC §2204(a). The executor may remain liable for tax liabilities if beneficiaries seek early distributions. In that case, the executor may seek to protect himself by funding an escrow agreement or reaching some other satisfactory agreement with the beneficiaries.

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