

TAX NEWS & COMMENT

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(516) 466-

VOL. XVI NO. 1

MARCH 2007

www.nytaxattorney.com

IRS MATTERS

2006 REGS, RULINGS & PRONOUNCEMENTS

Since IRA accounts often reflect a lifetime of retirement savings, their inclusion in a QTIP trust is important. Rev. Rul. 2000-2 stated that IRA proceeds may qualify for a QTIP election if the surviving spouse may compel a trustee to make annual income distributions. Rev. Rul. 2006-26 added that (i) a separate QTIP election must be made for the IRA and the trust receiving the IRA payments; and (ii) income must be determined separately for the trust and the IRA.

Given the present estate tax uncertainty, few people will risk making gifts exceeding the \$1 million gift tax exemption. Formula clauses could be employed as a "hedge" against the possibility of gift tax where the value of
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FROM THE COURTS

Supreme Court Upholds NYC Tax Suits Against India

The Supreme Court ruled that the Foreign Sovereign Immunities Act (FSIA) does not immunize a foreign government from a lawsuit to declare the validity of real property tax liens. *Permanent Mission of India to the U.N. v. City of New York*, Docket No. 06-134, 6/17/2007).

[India's permanent mission to the U.N. is situated in Manhattan owned by India. Several floors are used for diplomatic offices, but 20 floors contain residential units for diplomatic employees, all Indian citizens below the rank of Ambassador.]

Under New York Law, real property owned by a foreign government is exempt from taxation if it is "used exclusively" for diplomatic
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FROM WASHINGTON

TAX OUTLOOK FOR 2007

Although Democrats significantly outnumber Republicans on the House Ways and Means Committee, and hold a 31 member majority in the full House, legislation raising marginal, capital gains or dividend rates in 2007 is not likely to be enacted this year. The Tax Reconciliation Act of 2005 extended through December 31, 2010, the dividend and capital gains tax reductions enacted in 2003, which had been set to expire on December 31, 2008. AMT legislation appears likely in 2007.

Support for tax rate increases also appears weak in the Senate Finance Committee, which Democrats control by a single vote, and in the Senate itself. Senate Budget Chairman Conrad (D-ND)
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Tax Analysis

The IRC § 2036 Trap in Planning With FLPs & Grantor Trusts

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

REAL ESTATE TITLE ISSUES IN ESTATE PLANNING

Estate planning and administration frequently involve the transfer of real estate to family members. The choice of deed to convey title is important, as the rights of the grantee may be significantly affected. The use of an incorrect deed might cause title insurance to lapse. It is also important to ensure that title protection afforded by the policy remains effective following intrafamily transfers.

Transferring title without considering title insurance coverage could have the unintended effect of terminating policy coverage. Although most title insurance policies extend coverage to grantees who succeed in interest by operation of law, coverage may not be effective where voluntary transfers are
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MARCH COMMENT

Reverse Exchanges

Although the deferred exchange regulations apply to simultaneous as well as deferred exchanges, they do not apply to reverse exchanges. See *Preamble to final Regulations*, 56 *Red. Reg.* 19933 (5/1/91). Reverse exchanges occur where the taxpayer acquires replacement property before transferring relinquished property. Perhaps because they are intuitively difficult to reconcile with the literal words of the statute, reverse exchanges were slow to gain juridical acceptance.

An early case, *Rutherford v. Com'r*, TC Memo (1978) held that purchases followed by sales could not
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Tax Planning

FROM WASHINGTON, CONT.

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has ruled out raising tax rates. Democrats appear reluctant to risk new found political capital by voting to increase taxes even on a relatively small percentage of taxpayers.

The House voted 360-45 on February 16 to pass the Small Business Tax Relief Bill of 2007. Expected to cost \$1.3 billion over 10 years, H.R. 976 would (i) increase the hourly minimum wage to \$7.25 over two years; (ii) provide a one-year extension (through 2010) of IRC § 179 expensing limits, increase the annual limit to \$125,000, and boost the phaseout threshold from \$450,000 to \$500,000, effective for the 2007 tax year and beyond; (iii) extend the work opportunity tax credit (WOTC) for one year, expand it to include disabled veterans, and increase the age limit from 25 to 40; and (iv) allow an unincorporated business that is jointly owned by a married couple in a non-community property state to file as a sole proprietorship without penalty.

Funding for H.R. 976 would be accomplished by (i) denying the lowest capital gains and dividend rate (5% for 2007; 0% for 2008) to dependent children of high-income taxpayers (to prevent income-shifting); (ii) providing the IRS with four additional months (22 from 18) to give notice to taxpayers that they failed to comply with their tax obligations before being required to suspend the imposition of interest and penalties on underpayments; and (iii) increasing estimated taxes in 2012 for corporations with assets of at least \$1 billion.

The Senate overwhelmingly approved an increase in the hourly minimum wage to \$7.25, as well as an \$8.3 billion package of small business tax incentives favorably reported out of the Senate Finance Committee. Although a House-Senate conference has not been scheduled, Senate Finance Committee Chairman Baucus (D-Mont.) believes differences among the House and Senate versions will be resolved. *President Bush favors an increase in the minimum wage, but believes that it should be coupled with tax relief for small businesses which employ low-wage earners.*

House Majority Leader Steny Hoyer (D-MD) indicated that the House will include, as part of its supplemental appropriations bill, funding for Katrina victims. Representative Charles Rangel (D-NY), Chairman of the House Ways and Means Committee, stated the Katrina tax



**DAVID L. SILVERMAN, J.D.,
LL.M.**

J.D., Columbia Law School, LL.M. (Taxation) NYU Law School. Formerly associated, Pryor Cashman Sherman & Flynn, Manhattan. Former editor, ABA Taxation Newsletter. Treatise author, *"Like Kind Exchanges of Real Estate Under IRC § 1031."* (2006). Former Treasurer, New York Virtuosi Chamber Symphony Orchestra. Approved sponsor for CPE Credits, NYS Board of Public Accountants.

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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**

package will extend various tax provisions enacted in 2005 to provide hurricane relief. Mr. Hoyer has indicated that he will reintroduce an energy bill called the "Progress Act" that will include tax-exempt bonds to promote high-speed rail travel.

The Alternative Minimum Tax, which is essentially a flat tax of 28 percent imposed on income without the allowance of many deductions to which taxpayers are accustomed, has become immensely unpopular, presumably because for the first time, tax computed under the AMT exceeds many taxpayer's tax liability computed without regard to the AMT.

The Tax Increase Prevention and Reconciliation Act of 2005 increased the AMT exemption amount through December 31, 2006 to \$62,550 for married persons filing jointly. However, the AMT exemption level for 2007 reverts to \$45,000 for joint filers, and to \$33,750 for single taxpayers. Thus, unless Congress acts, the AMT tax liability for 23.4 million taxpayers in 2007. Although the estimated cost of full repeal of the AMT is \$1.2 trillion through 2015, the cost could be reduced to \$529 billion through 2015 if AMT "preferences" were changed to allow a deduction for state and local taxes.

Since AMT may be triggered by a large capital gain, an installment sale might minimize AMT exposure. If AMT tax liability will exceed regular tax liability for a given year, depending upon timing considerations, it might be prudent to accelerate income into that year to benefit from the lower marginal AMT rate of 28 percent. Similarly, in years in which the AMT will apply, the taxpayer might consider deferring expenses (including the payment of state income taxes) not deductible for AMT purposes until another year in which the AMT will not apply.

Spousal beneficiaries may roll over inherited IRAs into their own plans. However, *nonspouse* beneficiaries may never roll over inherited benefits to their own plan. The nonspouse beneficiary has been required to withdraw all inherited money from a retirement plan, either as a lump-sum distribution or within five years. By not qualifying for an extended payout, the nonspouse beneficiary has been forced to forego years of tax-free growth. Until 2007, only one exception existed: a non-spouse beneficiary could transfer an inherited IRA owned by one participant to another inherited IRA owned by the same participant. The

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FROM WASHINGTON, CONT.

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Pension Protection Act of 2006 (PPA) added a new exception. Beneficiaries of retirement plans, such as 401(k)s, 403(b)s and Section 457 plans, may transfer those assets into an "inherited IRA" established for the purpose of receiving the distribution and making payments to the beneficiary. Beneficiaries may then make withdrawals over their own life expectancies.

However, the IRS recently stated that retirement plans are not required to allow nonspouse beneficiaries to make direct transfers to inherited IRAs. To avoid the uncertainty of company plan rules when the participant is certain of a desire to leave a retirement plan to a nonspouse, the participant might consider rolling funds into an individual IRA immediately.

President Bush proposed a plan intended to make private health insurance more affordable. A standard inflation-adjusted tax deduction of \$15,000 would be provided for every family and individual covered by a private policy purchased individually or through an employer. No income or payroll taxes would be due on the first \$15,000 of income. However, employer-provided health insurance, now excluded from income, would become taxable. Employers would continue to be allowed a deduction for premiums paid. Federal grants would be made to states providing poor and difficult to insure citizens with low-cost private insurance. A top aide to House speaker Pelosi stated that Mr. Bush's proposal will be pushed aside for at least two years, and "is dead for now."

Florida's Intangible Personal Property Tax (IPPT), an annual tax based on the value of intangible personal property owned or controlled by Florida residents, or by persons doing business in Florida, was abolished on January 1, 2007. Florida legislators are also considering a constitutional amendment that would abolish all property taxes on homesteads in exchange for increasing sales tax from 6 to 8.5 percent, (which would be the nation's highest). Property taxes for non-homestead properties such as second or vacation homes, or to rental or business property, would decline but would not be eliminated.

Taxpayers whose AGI exceeds \$100,000 have been prevented from converting a traditional IRA to a Roth IRA. Beginning in 2010, this rule will no longer apply. Rules governing Roth IRAs do not require annual minimum distributions after reaching age 70½. Therefore, the Roth IRA could make possible many years of tax-free

growth.

The IRS has found significant reporting errors and omissions by tax-exempt organizations in the areas of excess benefit transactions, transactions with disqualified persons, and loans to officers. A compliance check, begun in 2004, has resulted in more than \$21 million in excise taxes.

The deduction for investment interest is limited to "net investment income." IRC § 163(d)(1). Any interest that is not deductible may be carried forward to future tax years, subject to the same limitation. An election made under IRC § 1(h)(2) to include capital gains and dividends in investment income would raise the net investment income ceiling. Although the election will cause capital gains and dividends to be taxed at ordinary income rates, taxpayers anticipating little investment income in future years might consider the election.

Hospital Corporation of America, 109 T.C. 21 (1997) held that tangible personal property includes many items permanently affixed to a building. The decision made viable the use of cost analysis studies to allocate building costs to structural components and other tangible property. By reclassifying property, shorter costs recovery periods can be used. A successful cost segregation study would convert Section 1250 property to Section 1245 property with depreciation periods of five or seven years, using the double-declining balance method in Section 168(c) and (e)(1).

The IRS Cost Segregation Audit Techniquet Guide states the study should be prepared by a person with knowledge of both the construction process and the tax law involving property classifications for depreciation purposes. Cost segregation professionals must verify the accuracy of blueprints and specifications, and take measurements to calculate the cost of assets and then to segregate them. *The average cost segregation study may identify 25 to 30 percent of a property's basis that is eligible for faster depreciation.*

To illustrate the tax savings possible with component depreciation, assume a Manhattan office building worth \$3 million with an adjusted basis of \$1 million being depreciated using the straight-line method over 39 years. A cost segregation study determines that 25 percent of the value of the building is personal property qualifying for a 7-year recovery period using the 200 percent declining balance method of depreciation. *Cost segregation could increase*

TITLE ISSUES IN ESTATE PLANNING,

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made to entities created when planning the estate.

The deed conveying the greatest number of rights to the grantee is the *warranty deed*. The grantor of a warranty deed guarantees that he owns the property and has a right to convey it. The warranty deed, which purports to convey property free and clear of all encumbrances, creates liability in the grantor if the title transferred is defective. The guarantee extends to prior owners as well, so that the grantor is guaranteeing title against all claimants beginning from the first owner's period of ownership.

Bargain and sale deeds also guarantee that the grantor is the owner and has the right to convey. However, the warranty against defects in title is limited to defects arising through the grantor, and does not extend to defects in title attributable to predecessors in interest. At the other end of the spectrum lies the *quitclaim deed*, which carries with it no implied warranties, and makes no representations concerning the condition of title. The quitclaim deed conveys only those rights the grantor possesses, but no more. Consequently, the quitclaim deed does not give rise to damages in the event title is defective.

Since liability arising from defects in title would not likely be a concern in most intra-family or post-mortem transfers, it might seem logical to choose a quitclaim deed. Although that deed protects the grantor, it might also extinguish the grantee's right to pursue claims against the grantor's predecessors for defects in title. Rights provided under the grantor's title insurance policy could also be lost. A quitclaim deed would be a poor choice in an intrafamily transfer.

Choosing a bargain and sale deed might also be unwise, since remedies against the grantor's predecessors in interest arising from earlier title defects could be extinguished. The best choice might be the warranty deed. Concerns about potential liability of the grantor can be addressed by drafting the deed so that it limits the grantee's right to recover to claims against the grantor's predecessors in interest.

The trend in title policy language is to expand the definition of the "insured" to include entities commonly succeeding to interests owned by family members. Nevertheless, inquiry should

IRC § 2036 TRAP IN PLANNING, CONT.*(Continued From First Page)*

or enjoy the property or the income therefrom.

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

Gifts of partnership interests shift wealth and future appreciation, and are effective in transferring management and control of family businesses to younger generations. Various discounts, which reflect the lack of control and the lack of transferability of the transferred interests, as well as built-in capital gains tax liability, have enabled the estate planners to leverage both the \$1 million gift tax exemption and the \$2 million lifetime exemption. The largest discounts, which may exceed 50 percent, arise with respect to family entities owning real estate.

Sales to "defective" grantor trusts are useful where the size of the estate exceeds the \$2 million lifetime exemption. Assets (which could include partnership interests) are sold by the grantor to the trust in exchange for a promissory note. The sale accomplishes the following: (i) the asset, as well as future appreciation, is shifted out of the estate; (ii) "leakage" back into the estate is minimized by reason of the low interest rate of the note; (iii) the obligation to pay trust income tax remains that of the grantor, thereby enabling trust assets to grow without diminution for income taxes — accomplishing a gift-tax free payment of the trust's income tax liability by the grantor (hence, the term "defective"); and (iv) asset protection against potential creditors of the grantor and trust beneficiaries.

If discounted partnership assets are sold to the trust, the sale price — and consequently the principal amount of the note as well as interest payments — can be reduced. The reduction in purchase price will further enhance the estate planning

attributes of the transaction by stemming "leakage" back into the grantor's estate.

To illustrate, assume FLP owns appreciating real estate worth \$1 million. Father sells a 50 percent limited partnership interest to family trust in exchange for a 15-year interest only, balloon principal, promissory note. The note bears interest at the AFR of 6 percent, pursuant to IRC § 1274(b). Upon the advice of appraiser, father takes a 50 percent discount for the real estate within the FLP. Although 50 percent of the value of the real estate is \$500,000, the discounted value is \$250,000. Thus, the principal amount of the note is \$250,000. The note requires interest in year one of \$15,000, which is 6 percent of \$250,000.

If the property produces annual income of 10 percent, the value of the underlying assets in the partnership interest purchased by the family trust would increase by \$50,000 in year one. Since the trust is obligated to make only a \$15,000 interest payment, \$35,000 in growth is shifted out of the estate. Moreover, the income tax liability of the family trust — perhaps \$20,000 — will be paid by father, since the trust is a wholly grantor trust with respect to father. (Although an early ruling viewed the payment by father of the income tax liability of the trust as a taxable gift to trust beneficiaries, that argument was abandoned.)

Trend of Recent Cases

In *Estate of Stone*, 86 T.C.M. (CCH) 551 (2003), the IRS argued that Stone had retained possession or enjoyment of the property that had been transferred to separate FLPs owned by Stone's children. In rejecting the application of IRC § 2036, the Tax Court found the partnerships were the result of arm's-length negotiations in which each child was represented by independent counsel. The transfers were motivated primarily by "investment and business concerns" and a desire to avoid litigation.

Similarly, in *Estate of Kimbell*, Mrs. Kimbell held most of her assets in a living trust, of which she and her son were trustees. In exchange for trust assets, the trust received a 99 percent limited partnership interest. The district court held the partnership should be ignored under IRC § 2036(a). The Fifth Circuit reversed, holding that a "bona fide sale for adequate and full consideration" precluded the application of IRC § 2036. 371 F.3d 257 (5th Cir. 2004), *rev'g* 244 F.Supp. 700

(N.D. Tex. 2003). "[O]bjective facts" supported the conclusion that the transfer to the partnership was a *bona fide* sale. Credible non-tax reasons for the partnership formation included (i) creditor protection, which could not have been accomplished with a trust; (ii) the preservation of property as separate property for descendants, and (iii) the availability of a dispute resolution mechanism for the children.

Section 2036 may apply even in cases where no abuse has occurred. In *Estate of Abraham v. Com'r*, 87 T.C.M. 975 (2004), a guardian *ad litem*, with court approval, established an estate plan for Mrs. Abraham. The partnership agreement created pursuant to the estate plan required the partnership to "share equally any and all costs and expenses [related to] . . . the support of Ida Abraham." Since Mrs. Abraham had been given the legal right to continue to benefit from partnership assets, inclusion in her estate was "required." The First Circuit affirmed. 408 F.3d 26 (2005).

Some cases seemed destined to fall prey to IRC § 2036. The Eighth Circuit recently affirmed a Tax Court decision in *Estate of Korby*, 98 AFTR 2d ¶ 2006-5897, *aff'g* T.C. Memo, 2005-103. After attending an estate planning seminar in 1993, the Korbys created FLPs into which they transferred marketable securities. A gift tax return claimed a 43.61 percent discount. The Korbys died within five months of each other in 1998. The Tax Court, finding an implied agreement that the Korbys would continue to receive distributions "as long as they needed income," held that partnership assets were includible under IRC § 2036. The lack of a written management contract and Korby's failure to report self-employment income were cited by the court in rejecting the management-fee claim.

Estate of Bongard, 124 T.C. No. 8 (2005), reviewed by the entire court, demonstrated that significant non-tax reasons alone will not defeat the application of IRC § 2036. The court found "legitimate and significant non-tax reason[s]" for the creation of the FLP and acknowledged that "legitimate non-tax purposes are often inextricably interwoven with testamentary objectives." Nevertheless, since Bongard retained the practical control over the entities formed as CEO, the entire value of the partnership holdings were includible in his estate under IRC § 2036(a)(1).

In *Estate of Discrow*, 91 TCM 794 (Please turn to page 5)

REVERSE EXCHANGES, CONT.*(Continued From First Page)*

qualify under Section 1031. However, *Bezdiijan v. Com'r*, 845 F.2d 217 (9th Cir. 1988) held that a good exchange occurred where the taxpayer received heifers in exchange for his promise to deliver calves in the future. Following *Bezdiijan*, taxpayers began engaging in reverse exchanges in which either relinquished or replacement property was “parked” with an accommodator. Just as deferred exchanges were recognized by courts, so too, reverse exchanges soon received a judicial imprimatur.

Rev. Proc. 2000-37 Safe Harbor

Rev. Proc. 2000-37 was borne of an attempt by the IRS to provide a safe harbor that allows taxpayers intending to complete a like-kind exchange after acquiring replacement property to accomplish that result in a predictable fashion. Although the deferred exchange regulations do not govern reverse exchanges, many of its rules and time periods have been “borrowed” by Rev. Proc. 2000-37. Thus, the familiar 45-day identification and 180-day exchange periods which govern deferred exchanges

also appear in Rev. Proc. 2000-37, albeit in a different context.

The 45-day period limits the time in which the taxpayer may identify up to three properties to be relinquished in an “Exchange Last” reverse exchange. The 180-day period limits the time in which the taxpayer must relinquish one of those three identified properties. The 180-day period also applies with respect to the accommodator. The 180-day period limits the time in which an accommodator may hold and improve replacement property in an Exchange Last reverse exchange. The 180-day period also limits the time in which an accommodator may hold relinquished property for sale in an “Exchange First” reverse exchange.

Reverse exchanges under Rev. Proc. 2000-37 are effective with respect to an “Exchange Accommodation Titleholder” (EAT) that acquires beneficial title in either the relinquished or the replacement property. The IRS will not challenge the qualification of either replacement property or relinquished property, or the status of the EAT as owner for federal income tax purposes of such property, if the property is held in a “qualified exchange accommodation arrangement” (QEAA). The EAT in a QEAA may hold the exchange property

for no more than 180 days.

To be the tax owner, the EAT must possess “qualified indicia of ownership” (QIO) from the acquisition date until the date the property is transferred. While the taxpayer will want to profit while the property is held in a QEAA, if the EAT has actually acquired an ownership interest — which it must to engage in the exchange — the EAT must also profit from property appreciation during its period of ownership. The IRS states the EAT must have between three and seven percent of its equity at risk. The taxpayer may continue to lease or manage the property while it is parked with the EAT.

The EAT cannot be either the taxpayer or a “disqualified person.” Disqualification is determined under rules similar to those found in deferred exchange Regs. § 1.1031(k)-1(g). The QEAA must explicitly provide that the EAT is not the taxpayer’s agent for federal tax purposes since only the property owner can engage in a like-kind exchange. To avoid exposure to state and local taxes, the QEAA should also provide that the EAT is not taxpayer’s agent for state or local tax purposes.

[In contrast to the EAT in a
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IRC § 2036 TRAP IN PLANNING, CONT.*(Continued from Page 3)*

(2006), the decedent transferred her New York residence to a general partnership of which she, her children and her spouse, were partners. Within 30 days, she gifted her entire interest in the partnership (which owned no other assets) to the children. Pursuant to an implied understanding, she continued to live in the residence pursuant to below-market lease agreements until her death. The residence was included in her estate under IRC § 2036(a)(1).

In *Estate of Rosen*, 91 TCM 1220 (2006), Rosen created an FLP to which he contributed liquid assets worth \$2.4 million. The partnership was created after the decedent’s son-in-law attended an estate planning seminar. The court found the primary reason for creating the FLP was to avoid taxes and that no legitimate or significant non-tax reasons were present. There was an implied understanding that Rosen would receive partnership distributions. Since Rosen continued to “possess and enjoy the transferred assets until her death,” the entire value of the FLP was included pursuant to IRC § 2036(a)(1).

Tax Court’s holding in *Rosen* that

partnership distributions constituted a retained interest, rather than loans (as the estate argued) makes the case relevant in the context of asset sales to grantor trusts. The IRS may attempt to recharacterize the note received from the trust as a retained equity interest in trust assets, resulting in inclusion in the grantor’s estate of all trust assets. It is therefore critical that the note be respected as debt.

Debt Versus Equity Distinction

The starting point for determining whether a note constitutes true debt or a disguised retained equity interest is *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958). The Supreme Court held that where a decedent transfers property in exchange for the transferee’s promise to make periodic payments to the transferor, those payments are not chargeable to the transferred property but rather constitute a personal obligation of the transferee. Accordingly, the property is not includible in the transferor’s estate under IRC § 2036(a)(1).

Miller v. Com'r, 71 T.C.M. 1674 (1996), *aff’d*, 113 F.3d 1241 (9th Cir. 1997) distinguished *Fidelity-Philadelphia*, and held that the “mere promise” to pay a

sum of money in the future accompanied by an “implied understanding” that the promise would not be enforced is not evidence of a loan. Whether a “real expectation of repayment” exists depends upon factors such as whether (i) a promissory note existed; (ii) interest was charged; (iii) any security or collateral was advanced; (iv) a fixed maturity date was present; (v) a demand for repayment was made; (vi) any actual payment was made; and (vii) the transferee had the ability to repay.

The prominence of non-tax factors in transfers to family partnerships and “defective” grantor trusts appears to be a prerequisite to establishing the legitimacy of those transfers for gift and estate tax purposes. However, as *Bongard* clearly demonstrates, non-tax factors alone are insufficient to prevent the inclusion of partnership or trust assets pursuant to IRC § 2036, even if the general partner or trustee has respected fiduciary obligations.

Inclusion may be nearly unavoidable if (i) the decedent continued to control partnership property or could benefit from partnership or trust distributions pursuant to an express or even an implied agreement or (ii) the other partners’ or beneficiaries’ contributions

REVERSE EXCHANGES, CONT.

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QEAA, the QI in a safe harbor deferred exchange never has an equity stake in the transaction. The role of the QI is also distinguishable from that of the EAT in that the QI never acquires beneficial title in either the relinquished or the transferred property (and not even legal title if property is direct-deeded to the taxpayer) while the EAT must be the beneficial owner for tax purposes. Neither the QI nor the EAT is the taxpayer's agent for income tax purposes. However, the QI is the taxpayer's escrow agent for legal purposes. Since an escrow agent is bound by a fiduciary obligation, Regs. § 1.1031(k)-1(g)(3) provides that the taxpayer is not in constructive receipt of exchange funds held by the QI.]

“Exchange Last” and “Exchange First”

Rev. Proc. 2000-37 sanctions two types of reverse exchanges. The first is “Exchange Last.” Here, an accommodator acquires and “parks” replacement property until the taxpayer arranges to dispose of the relinquished property through a QI. Financing for the acquisition may be arranged by the taxpayer. The QI transfers proceeds from the relinquished property sale to the EAT in exchange for the parked replacement property. The EAT then transfers the replacement property directly to the taxpayer, completing the exchange. The EAT uses the cash received from the QI to retire the debt. While parked with the EAT, the replacement property may be net-leased or managed by the taxpayer.

Since the parked property will have been initially acquired by the accommodator and will not have been previously owned by the taxpayer, there is little risk the accommodator will be disregarded for tax purposes. Another advantage of Exchange Last is that following acquisition by the accommodator of the replacement property, the taxpayer can consider several potential properties to be relinquished, and ultimately choose that which generates the least gain. However, if the taxpayer elects to proceed under the safe harbor provided by Rev. Proc. 2000-37, flexibility will be limited, since the taxpayer must identify three potential properties to be relinquished within the 45-day identification period.

In Exchange Last, although the taxpayer eventually acquires title to the replacement property, while the

replacement property is parked with the EAT, the EAT is title owner of that property. Therefore, the EAT will be the borrower on a loan associated with the acquisition of the replacement property until the loan is satisfied by proceeds from the sale of the relinquished property. To avoid loan application problems, the taxpayer should apprise the lender at an early stage of the planned reverse exchange and the presence of the EAT. A build-to-suit exchange would typically employ the Exchange Last format, since the replacement property may be improved while parked with the accommodator.

Many “build-to-suit” arrangements will not be suitable for the Rev. Proc. 2000-37 safe harbor, since completion of improvements may not be possible within the 180-day period in which the property is held by the EAT. If it is necessary to go beyond 180 days (or if the EAT is a “disqualified person”) the taxpayer can still pursue “non-safe-harbor” or “pure” reverse exchange. Rev. Proc. 2000-37 states that “*the Service recognizes that parking transactions can be accomplished outside of the safe harbor.*” PLR 200111025 explicitly recognized that non-safe-harbor reverse exchanges survive Rev. Proc. 2000-37. Pure reverse exchanges free the taxpayer of constraints imposed by the 45-day identification period and the 180-day period during which the accommodator may improve the replacement property. However, pure reverse exchanges pose more tax risk, as they are burdened with issues of agency, constructive receipt and beneficial ownership.

Therefore, if more than 180 days are required, and a planned safe harbor Exchange Last reverse exchange is converted into a non-safe-harbor reverse exchange, liberties taken when planning under the safe harbor may have doomed a non-safe-harbor reverse exchange unless these troublesome issues are considered from the start.

The second type of reverse exchange is “Exchange First.” Here, the taxpayer sells relinquished property to an EAT through a QI. Shortly thereafter, the QI uses the sale proceeds to purchase replacement property, which is transferred directly to the taxpayer, completing the exchange. Although the exchange is complete, the EAT may continue to retain the relinquished property for up to 180 days, until the taxpayer arranges for a buyer. Since the replacement property is transferred directly to the taxpayer, the EAT never acquires ownership. This

eliminates the requirement that the EAT be involved in the loan process. It also eliminates the necessity of the EAT taking legal title, which may be advantageous from a transfer tax standpoint. Since the taxpayer is taking title to the replacement property immediately, it may be pledged as collateral for a loan. If management problems exist, it may also be preferable for the taxpayer to take immediate ownership in the replacement property.

An Exchange First reverse exchange might be desirable if the purchaser of the property to be relinquished has defaulted, leaving the taxpayer obligated to close on the replacement property or risk losing his downpayment. The taxpayer could acquire the replacement property before finding a new buyer for the relinquished property.

By structuring an Exchange First reverse exchange under the Rev. Proc. 2000-37 safe harbor, the taxpayer sacrifices the luxury of time, since he may no longer wait 45 days to identify potential properties to be relinquished, nor wait 180 days to choose among those properties that property to be relinquished. Instead, the taxpayer must choose the property to be relinquished when the replacement property is acquired, and must actually relinquish it, since the QI must have the sales proceeds in hand to acquire the replacement property. The only applicable time constraint in a safe harbor Exchange First reverse exchange is the 180-period during which the EAT must dispose of parked relinquished property.

The requirement that the EAT obtain legal title to the parked property makes reverse exchanges relatively costly. Accordingly, their use should be reserved to situations where a deferred exchange is impossible, such as where the relinquished property buyer has defaulted, or where improvements must be commenced prior to disposition of the relinquished property. If improvements can be completed within the 180-day period in which the property may be parked with the EAT, Rev. Proc. 2000-37 provides a degree of certainty. However, if more time is required for construction, a non-safe-harbor reverse exchange may be the only option.

The validity of a pure reverse exchange will depend upon whether the accommodator is respected as tax owner, or is merely deemed the taxpayer's agent. Just as pre-regulation case law remains relevant in resolving deferred exchange disputes, decisions predating Rev. Proc. 2000-37 are presumably still relevant in resolving disputes arising in reverse

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offices or for the residence of an Ambassador. N.Y. Real Prop. Tax Law § 418. If only a portion of the property is used for the purpose described, the remainder is subject to taxation.” Ibid.

For several years, New York City (City) levied property taxes against India for portions of buildings used to house lower level employees. By operation of law, unpaid taxes eventually became tax liens totaling \$16.4. In 2003, the City filed complaints in state court seeking declaratory judgments establishing the validity of the tax liens. India removed the case to federal court under 28 U.S.C. § 1441(d), which it argued that the FSIA’s general rule of immunity for foreign governments barred the suit. The District Court, relying on FSIA’s “immovable property” exception, held for the City. The Second Circuit affirmed. The Supreme Court granted certiorari. 549 U.S.____ (2007), and affirmed.]

The issue requiring resolution was whether the City’s tax lien fell within the scope of the “immovable property” exception in the FSIA. The Court, observing that that a tax lien “inhibits one of the quintessential rights of property ownership — the right to convey,” held that a suit to establish the validity of a lien implicates “rights in immovable property.” Support for this view comes from recognition that the United States has adopted the “restrictive theory” of sovereign immunity, under which sovereign acts (*jure imperii*) are immune, but not private acts (*jure gestionis*).

The Court observed, as a “threshold” matter, that property ownership is not an “inherently” sovereign function.

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gift is uncertain, by imposing a \$1 million “cap” on the gift. Historically, formula clauses have been viewed with disfavor. *Com’r v. Procter*, 142 F.2d 824 (4th Cir. 1944), *cert. denied*, 323 U.S. 756 (1944) held that such clauses tend to “discourage the collection of the tax . . . since the only effect of an attempt to enforce the tax would be to defeat the gift; and . . . the effect of enforcing the clause would be to obstruct the administration of justice by requiring courts to pass upon a moot case.” *However, other savings clauses may be less objectionable, particularly if they do not return transferred property to the donor as in Procter, but rather reallocate property among transferees.*

To illustrate, assume property of uncertain value is sold to a grantor trust. Such sales are intended to be free of gift tax. If the property has an ascertainable value, the note would reference that value. However, if the property has an uncertain value, immediate gift tax liability will result unless a savings clause is used to reallocate the value of the property in excess of the note. Shifting any gift in excess of \$1 million back to the grantor is not an option, since that would clearly violate *Procter*. *However, the governing instrument could provide that any excess value be allocated to a nontaxable donee. If trust beneficiaries include the grantor’s spouse, the excess could be shifted to the grantor’s spouse without gift tax, since the gift would qualify for the unlimited marital deduction.*

Recent rulings demonstrate the determination of the IRS to assert the applicability of IRC § 2036 in transfers to family entities. In PLR 200626003, A transferred real property to a family LLC, retaining a 25 percent interest. Following A’s death, the IRS determined that A’s retained right to income resulted in inclusion under IRC § 2036. The estate’s request for 9100 relief to file a late IRC § 754 election was denied. However, since the property was includible under IRC § 2036, the LLC’s inside basis in the assets was increased pursuant to IRC § 1014. Thus, the IRC § 754 basis increase sought was achieved under IRC § 1014.

IRC § 6324 provides for a special 10-year estate tax lien. FSA 20061702F addressed the issue of priorities among lienors. After inheriting property, Son defaulted on a loan in which the property had been pledged as collateral. Lender was reluctant to foreclose believing that the

estate tax lien might have priority. The FSA concluded that the pledge of the real estate as collateral constituted a “transfer” under IRC § 6324(a)(2), which divested the government’s lien interest. However, the lien remained to the extent the value of the real estate exceeded the balance of loan. Son also remained personally liable for the portion of the unpaid estate tax equal to the value of the real property.

Whether to file an amended return often sparks a lively debate. Taxpayers may view them as a “cure all” for previous tax transgressions. Practitioners are less sanguine, sometimes concluding that their filing may do more harm than good. Generally, no duty exists to file an amended return. The Supreme Court, in *Hillsboro National Bank v. Com’r.*, 460 U.S. 370 (1983), remarked that “the Internal Revenue Code does not explicitly provide either for a taxpayer’s filing, or for the Commissioner’s acceptance, of an amended return; instead, an amended return is a creature of administrative grace and origin.” Regs. § 25.2504-1(d) explicitly sanction an amended return if a gift was omitted from a previous return. It should be reported on Schedule B of Form 709 as part of gifts for previous years.

[Although the filing of a gift tax return is required only where a taxable gift has been made — and in the case of sales to grantor trusts that is usually not the case — filing a return (reporting the amount of the gift as zero) would start the running of the 3-year statute. If no gift tax return is filed, the IRS could many years later challenge the value of property sold to the trust.]

Circular 230 contains regulations governing the practice of Attorneys and CPAs before the IRS. Subpart B, §10.34 (a), which addresses standards for preparing or signing returns, provides that a practitioner may not sign a return if the position taken does not have a “realistic possibility of being sustained on the merits.” That standard is met if “a person knowledgeable in the tax law would . . . conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits.” The possibility that a return will not be audited or that the issue would not be raised on audit may not be taken into account.

Authorities that may be taken into account in assessing the “realistic possibility” standard are those enumerated in the substantial understatement penalty regulations, §1.6662-4(d)(3)(iii). They include (i) Code provisions; (ii) Treasury

Regulations; (iii) Rulings and Procedures; (iv) tax treaties; (v) case law (that has not been overruled); (vi) Committee Reports; (vii) Blue Book Explanations of Tax Legislation; and (viii) PLRs, TAMs, GCMs, Actions on Decision, Notices and Announcements. *Conclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by tax professionals are not substantial authority. However, authorities underlying such expressions of opinion where relevant may give rise to substantial authority for tax treatment of an item.*

Creating wholly grantor trusts without risking estate inclusion is difficult. In PLR 200606006, the trust provided the grantor’s spouse with a limited withdrawal right, and the grantor with the right to reacquire trust principal by substituting property of equal value. The ruling concluded the substitution power would not cause inclusion under IRC §§ 2033, 2036 or 2039, and the trust would be a wholly grantor trust as to the grantor. Although a beneficiary spouse may be treated as owner of the portion of the trust over which she has a withdrawal power, the trust is a fully grantor trust with respect as to the grantor since IRC § 678(b) trumps IRC § 678(a).

PLR 200620025 stated that an IRA may be transferred to a Supplemental Needs Trust (SNT) that is a grantor trust without income tax consequences. The ruling relied on Rev. Rul. 85-13, which holds that if a grantor is treated as the owner of a trust, the trust is ignored for income tax purposes, and any transactions between the grantor and the trust are also ignored. *Rev. Rul. 85-13 is one of the foundations upon which the technique of sales to “defector” grantor trusts relies.*

Controversial legislation passed in 2006 limited deductions for Americans working abroad. Notice 2007-25 increased the housing expense limits in approximately twenty foreign cities, and permits Americans working abroad to exclude up to \$82,400 of their foreign-earned pay. However, income in excess of that amount is subject to higher tax rates than before.

Announcement 2006-63 clarified rules relating to private collection agencies. PCAs may access non-IRS computer databases to obtain financial information, but may not inquire with the taxpayer’s employer, bank, or neighbors concerning the taxpayer’s financial condition. PCAs must safeguard taxpayer information and may not access unnecessary tax information. PCAs may