

TAX NEWS & COMMENT

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IRS MATTERS

RECENT DEVELOPMENTS

TERMINOLOGY OF IRS RULINGS &

IRC § 6166 provides for an extension of time to pay estate tax where an estate consists largely of an interest in a closely held business. Rev. Rul. 2006-34 enumerates factors relevant in determining whether a deceased owner's activities were sufficient to support a finding that the real property interest constituted a closely held business.

Although "no single factor" is dispositive, the IRS will consider (i) time devoted to the business; (ii) whether an office was maintained; (iii) the extent of the decedent's involvement in finding tenants or negotiating leases; (iv) the extent of landscaping or other services provided that were beyond the mere furnishing of leased premises; and (v) the extent to which the decedent handled
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FROM THE COURTS

2nd Circuit Limits Estate's Charitable Deduction Pursuant to IRC § 642(c)(1)

The 2nd Circuit, affirming an order granting summary judgment to the United States, held that payments by an estate to charities pursuant to a testamentary power of attorney exercised by the surviving spouse over the principal of a marital trust, did not qualify for a charitable deduction under IRC § 642(c)(1), since the bequest was not made "pursuant to the terms of the governing instrument." The court held that Lucien Brownstein's earlier will — and not the power of attorney exercised by Ethyl Brownstein, the surviving spouse — was the "governing instrument." *Estate of Ethyl Brownstein v. U.S.*, No. 04-4061 (9/27/06).

[Lucien Brownstein died testate in 1971. His will left his wife Ethyl an interest in a marital trust with a general testamentary power of appointment. The bequest qualified for the marital deduction under IRC § 2056(b)(5). Upon her death in
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FROM WASHINGTON

BUSH TAX INCENTIVES APPEAR DOOMED; CONGRESS MULLS AMT & ESTATE TAX

HIGHER INDIVIDUAL RATES POSSIBLE BUT UNLIKELY

No reduction in individual tax rates appears likely in 2007. Although some Democrats favor rate decreases for middle and lower-income individuals, Mr. Bush has long been a proponent of across-the-board decreases. Conversely, tax increases for high income individuals also appears improbable at the present, despite vocal support from some Democratic leaders, including incoming House Majority Leader Speaker Nancy Pelosi (D-Calif.).

Senator Clinton recently remarked that "[t]ax cuts are not the cure-all for everything that ails the American economy." Nevertheless, Ms. Clinton has also implied that tax increases should be imposed on wealthier Americans, despite the strong economy and stock market, and low unemployment. Ms. Clinton has long called for increased government spending
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Tax Analysis

Installment Sales in Real Estate Transactions

A. Introduction

An installment sale is a disposition of property in which at least one payment is to be received after the close of the taxable year in which the disposition occurs. IRC § 453(b)(1). The installment method is the default method imposed by the Code for reporting income from installment transactions. An election not to report an installment sale on the installment method is permissible, but must be made no later than the due date of the return (including extensions) for the taxable year in which the disposition occurs. IRC § 453(d)(1).

Under the installment method, the amount of any payment which is income is the gross profit percentage, which is defined
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LIKE-KIND EXCHANGES OF PERSONAL PROPERTY

Although real estate drives most like-kind exchanges, personal and even intangible property may also qualify for like-kind exchange treatment. However, the expansive definition of "like kind" property applicable to real estate does not carry over to exchanges involving personal or intangible property. Such exchanges qualify for tax-deferred exchange treatment under Section 1031 only if the relinquished and replacement properties bear a strong resemblance to one another.

The "similar or related in service or use" test of IRC § 1033(a)(1), which is somewhat restrictive, appears to be the standard called for by Regs. § 1.1031(a)(2) in determining whether personal property is of like-kind to other personal property. Rev. Rul. 82-166 opined that gold bullion and silver bullion are not of like-kind since "silver and gold are intrinsically different metals...used in
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NOVEMBER COMMENT

Validity, Interpretation & Effect of Wills Having Jurisdiction Outside of New York

The burden of proof that a will was executed in accordance with formal requirements imposed by EPTL § 3-2.1 is on the will's proponent, who may be the executor, a beneficiary, or an interested person. These requirements are intended to prevent revisions to the will after it has been executed. Even if there are no objections, SCPA § 1408 provides that the court must be satisfied that will has been properly executed.

EPTL § 3-5.1 sets forth rules governing wills having some relation to a jurisdiction outside of New York. For a will to be admitted to probate in New York, it must be executed either in accordance with local law formalities imposed by (i) EPTL §
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Estate Planning

FROM THE COURTS, CONT.

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1996, Ethyl directed that her residuary estate be distributed among various charities. Pursuant thereto, the Trustee of the Trust distributed \$1 million to the Executor of Ethyl's estate, which claimed a \$1 million charitable deduction on an amended return seeking a refund for tax already paid. Following an IRS denial of the refund claim, an action was commenced in the Southern District. This appeal followed summary judgment granted to the United States.]

Since Lucien's will expressed no charitable intent, Ethyl Brownstein's Estate had to establish that Lucien's will was not the "governing instrument." This obstacle proved insurmountable. Lucien's estate had claimed a marital deduction. As the court noted, this deduction was wholly dependent on a qualifying income interest with general power of appointment having been given to Ethyl under Lucien's will. Unless Ethyl were free to exercise her general power of appointment at her own death, Lucien's estate would not have been allowed the marital deduction.

Ethyl's Estate attempted to circumvent this problem by arguing that Lucien's will and Ethyl's power of appointment together represented the "governing instrument," and that Ethyl's will did express charitable intent. However, the court found this argument unconvincing, since the term "governing instrument" does not comprehend reference to more than one instrument. Combining Ethyl's power of appointment with Lucien's will would "strain the statutory language."

The Court then discussed another requirement of section 642(c), *i.e.*, that the distribution have been made made "pursuant to" the governing instrument. If Lucien's will were the governing instrument, and Ethyl's will merely carried out its intent, Lucien's will did not express "sufficient charitable intent" with respect to the eventual disposition of the Trust principal. The court noted that Ethyl "could have distributed the Trust principal entirely to private individuals." Since Ethyl was not required to give "one penny" to charity, the statutory language was not satisfied. Therefore, Ethyl's will did not make the charitable distribution "pursuant to" the terms of Lucien's will.

The Court's decision was expressly informed by the doctrine enunciated by the Supreme Court in *New Colonial Ice Co. v. Helvering*, 292 U.S. 435 (1934), that "whether and to what extent deductions shall be allowed depends upon legislative grace." The court observed that were a Trustee permitted to "agglomerate" the separately manifested intents of various testamentary instruments to create a single, "chimerical" governing instrument, income tax deductions to trusts would be greatly enhanced, a proposition for which Congress had made "no provision."



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FROM WASHINGTON, 2007 TAX OUTLOOK,

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on health care and education, which would require new revenues.

Senator Clinton voted against, and Senator McCain (R-Ariz.) for, cutting taxes by \$1.35 trillion over 11 years in 2001. On other tax issues, the Senators have parallel voting records. In 2003, both voted against a \$350 billion tax cut and against extending the preferential rates for capital gains and dividends. However, Mr. McCain on other occasions has expressed support for a lower capital gains rate. Senator McCain also favors a flat tax of 15% for all middle-class Americans. In 2001, both voted in favor of eliminating the marriage tax penalty and increasing tax deductions for college tuition. In the past, both Senators have also expressed interest in maintaining the estate tax with a higher exemption amount of about \$5 million, although Ms. Clinton's position on this issue is no longer clear. President Clinton strongly opposed elimination of the estate tax.

Rep. Charles B. Rangel (D-NY), new chairman of the tax-writing House Ways and Means Committee, recently remarked that Democrats do not favor "retroactively rolling back the tax cut," but would permit the tax incentives to remain effective until their scheduled expiration in 2010. Mr. Rangel stated that he "cannot think of one tax cut" he would extend beyond 2010. Representative Rangel, among others, also favors a sweeping revision of the alternative minimum tax (AMT).

Mr. Rangel also favors "ending tax shelters that move jobs overseas." However, Representative Rangel — although clearly opposing an extension of lower capital gains and dividend rates — may not actually seek vast changes in tax policy, at least until after 2008. Mark Bloomfield of the Economic Council on Capital Formation believes that Mr. Rangel will be a "centrist legislator" who "understands the importance of economic growth."

In contrast to the themes expressed by Senator Clinton and Representative Rangel, Rep. Nancy Pelosi (D-Calif.), who will preside as the new Speaker of the House, has urged immediate tax relief for some, recently stating that "[w]e will revisit the tax cuts at the high end in order to give tax cuts to the middle class." Representative Pelosi believes that tax rates for individuals whose incomes are \$250,000 or higher should be rolled back to Clinton era levels. Ms. Pelosi has also vowed to seek an end to "tax subsidies" for oil companies, and has criticized what she terms "Republican tax breaks for the super rich that have led to a budget that is grossly out of balance and a national debt that is morally indefensible."

The Democratic Congress will probably focus on providing relief for lower and middle-income families. Non-controversial initiatives such as a child credit, a lower tax rate of 10% for low-income taxpayers, and relief from the "marriage penalty" appear to interest most Democrats. Many in Congress, both Democrats and Republicans, also favor reducing the burden of the AMT, whose reach now extends to a far greater number of taxpayers than initially intended. However,

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RECENT IRS DEVELOPMENTS, CONT.

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tenant repairs and requests. The ruling illuminated these factors with several examples:

In Situation 1, A, who handled the day-to-day operations of a strip mall qualified, since the A provided "significant services" and the owner's activities went beyond that of a "mere investor."

B's mere ownership of an office park, in Situation 2, managed by a property management company in which B had no ownership interest, did not rise to the level of an active trade or business. However, if B owned 20% of the management company (Situation 3), B's "significant interest" in the managing company would enable the office park to qualify as an interest in a closely held business for purposes of § IRC 6166.

In Situation 4, C owned a one percent general partnership interest and a 20 percent limited partnership interest in a limited partnership that owned three strip malls. C, as general partner, was required to manage the strip malls. Since C's management activities, which included maintenance, repairs, collecting rents and negotiating leases were significant, C's interest qualified as an interest in a closely held business.

* * *

Rev. Proc. 2006-31 provides guidance with respect to when the IRS will consent to a taxpayer's request to revoke an election made under IRC § 83(b). The advice also describes the procedure for submitting such a request.

[Under IRC § 83(a), if property (e.g., stock) is transferred in connection with the performance of services, the excess of the fair market value (FMV) of the property (determined without regard to any restriction, other than a restriction which, by its terms will never lapse) as of the first day that the transferee's rights in the property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over the amount paid for the property, is included in the service provider's gross income for that taxable year.

IRC § 83(b) and Treas. Regs. § 1.83-2 (a) permit the service provider to elect to include in gross income the excess of the FMV of the property at the time of transfer (determined without regard to any lapse restriction) over the amount paid for the property, as compensation for services. If this election is made, the subsequent appreciation in value of the property is not taxable as compensation. (Although appreciation may later be taxed as short or long-term capital gain.)]

Under IRC § 83(b)(2), an election under § 83(b) must be filed with the IRS no later than 30 days following the transfer of property to the service provider. IRC § 83(b)

(2) and Treas. Regs. § 1.83-2(f) provide that an election may not be revoked without the consent of the Commissioner, and such permission will only be granted if (i) the person so electing was under a mistake of fact underlying the transaction, and (ii) the request is made within 60 days after learning of the mistake of fact. A request for consent to revoke an election must be made under the procedures for requesting a letter ruling, and must contain a description of the mistake of fact and the date on which the election was made.

Several examples illuminate Rev. Proc. 2006-31:

One example involves the transfer by Company M of 100 shares of substantially nonvested stock to employee A. The restricted stock agreement provides that the stock will revert to Company M if A's employment is terminated for any reason prior to July 10, 2010. A pays \$50x dollars for the stock, which has a FMV of \$100x on July 10, 2006. A files a valid § 83(b) election on that date. On July 28, 2006, A learns that the forfeiture provision means that A will forfeit the stock even if Company M terminates A's employment without cause. On August 16, 2006, A files a request to revoke the election. While the request was timely, denial results because A's failure to understand the employment agreement is not a "mistake of fact underlying the transaction."

In a variation of the example, A requests consent to revoke the election on August 4, 2006. In this case, consent to revoke will be granted for any reason, since the request was filed within 30 days of the time when the § 83(b) election itself could have been made.

In another example, on August 31, 2006, B begins employment with Company O under an employment agreement providing that B will receive Company O Class A common stock. On September 1, 2006, Company O transfers 50x shares of substantially vested Class B common stock. On September 15, B makes a valid § 83(b) election. On September 29, B discovers that Company O has two classes of stock and that B received Class B common stock rather than Class A. On November 1, B files a request to revoke the § 83(b) election. B's request to revoke will be granted since (i) the request consisted of a mistake of fact as to the underlying the transaction; and (ii) the request was timely, since it was made within 60 days after B learned of the mistake of fact.

In a variation of this example, B filed a request to revoke on December 15. Since the request was filed more than 60 days after B learned of the mistake of fact, the request to revoke the § 83(b) election would be denied.

Terminology of IRS Rulings & Procedures

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INTERPRETATION OF WILLS, CONT.

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3-2.1; (ii) the jurisdiction where the will was executed; or (iii) the jurisdiction where the decedent was domiciled, either at the time of execution, or at the time of the decedent's death. If a will has been executed in accordance with local law, EPTL § 3-5.1(c) (3) further provides that "[a] will disposing of personal property, wherever situated, or real property situated in this state . . . is formally valid and admissible to probate in this state."

Thus, the will of a California domiciliary, whose will was executed in accordance with the laws of France, where decedent was domiciled when the will was executed, may be offered for probate in New York, if the will disposes of (i) any personal property, regardless of where the personal property is situated, or (ii) real property situated in New York. However, a New York Surrogate may decline to probate a will under the doctrine of *forum non conveniens* if decedent had minimal contacts with New York.

The law of the forum state applies to issues of due execution. However, in the context of a will contest, Surrogate Holtzman, citing EPTL § 3-5.1(c), held that New York law exclusively governs issues of testamentary capacity, fraud and undue influence, regardless of the forum in which the will was executed. *In re Gottfried, N.Y.L.J., May 20, 2002 (Surr. Ct. Bronx Cty.)*

Most states recognize the common law doctrine of "incorporation by reference," which permits a will to reference extraneous documents. New York does not. Thus, a will consisting of a pre-printed form upon which the testator had written "see attached" was denied probate. However, EPTL § 3-3.7 creates a limited exception, permitting the testator to direct that probate assets "pour over" to an existing revocable or irrevocable trust. The rationale for this exception, which codified a decision by Judge Cardozo, is that the execution of trust instruments is customarily accompanied by ample safeguards. *In re Rausch, 222 N.Y. 222 (1918)*.

Can a lost or destroyed will be admitted to probate? Yes. SCPA § 1407 provides that a lost or destroyed will may be admitted if it is established that (i) the testator had not revoked the will; (ii) due execution is proved in the manner required for an existing will; and (iii) all of the will provisions are clearly proved by at least two credible witnesses, or by a copy or draft of the will proved to be true and complete.

What if a will executed later in time has been intentionally destroyed by a beneficiary of an earlier will, who seeks to probate the earlier will? In such a case, the requirements of SCPA § 1407 with respect to proving the validity of a lost or destroyed will might be difficult to establish. Where the requirements of SCPA § 1407 could not be satisfied, the court admitted the earlier will to probate, but denied the right of the person who destroyed the later will to benefit under the earlier will. A constructive trust was imposed for the benefit of the testator's son, who would have benefited under the destroyed will. *In re Katz, 358 N.Y.2d 616 (Sur. Schoharie Cty, 1974)*.

LIKE-KIND EXCHANGES, CONT.*(Continued From First Page)*

different ways." Regs. § 1.1031(a)-2 provides that depreciable tangible personal property qualifies for exchange treatment if the properties are of "like kind" or "like class." Properties are of "like class" if, on the exchange date, they are of the same (i) "General Asset Class" or (ii) "Product Class." Regs. § 1.1031(a)-2(b)(2) provide a list of thirteen General Asset Classes. The SIC codes for Product Classes were replaced by the North American Industrial Classification System (NAICS) for exchanges after August 13, 2004. NAICS categories are narrower than the SIC Codes formerly used.

Under Regs § 1.1031(a)(2)(b), a light general purpose truck is not of the same General Asset Class as a heavy general purpose truck. Nor is a computer of the same General Asset Class as office furniture. However, an automobile and a taxi are. The origin of Regs. § 1.1031(a)-2 appears to be Rev. Proc. 87-56, which lists depreciable asset classes. IRC §1031(h)(2) provides that personal property used predominantly in the U.S. is not of like-kind to personal property used predominantly outside the U.S. Predominant use is based on the 2-year period preceding and following the exchange.

Exchanges involving both real and personal property may produce boot. For example, relinquished property may consist of an apartment building containing furniture or other assets. Since real property cannot be exchanged for personal property, the IRS views such transactions as exchanges of multiple assets rather than exchanges of one economic unit. Accordingly, the properties transferred and received must be separated into

"exchange groups," by matching properties of like-kind or like-class to the extent possible. After matching, boot gain may result if if non-like kind assets remain. Regs. § 1.1031(j)-1. In practice, this problem can be minimized if in the contract of sale the parties agree to allocate little consideration to the personal property being transferred.

In *Peabody v. Com'r*, 126 T.C. No. 14 (2006), a coal mine was exchanged for real estate. The IRS asserted that a coal supply contract, rather than the mine supplying the coal, possessed most of the value of relinquished property. Therefore, upon the receipt of a gold mine as replacement property, although a good exchange occurred, boot gain resulted, since the supply contract and gold mine were not of like-kind. The Tax Court disagreed, holding that the right to mine and sell coal are inherent in fee ownership, and the two cannot be separated. Thus, there was no boot.

Like-kind exchanges involving intangible personal property, consisting of customer lists, going concern value, and good will, although less common, may also occur. An exchange of business assets requires the transaction to be separated into exchanges of its component parts. Rev. Rul. 57-365. No "like classes" are provided by the Regs. for intangible personal property, and the liberal rules with respect to exchanges of real estate are of course inapplicable. Therefore, whether such exchanges qualify relates back to the question of whether the exchanged properties are of "like kind" under Section 1031 itself. Regs. §1.1031(a)-2(c) provide some guidance, stating that whether intangible personal properties are of like kind depends on the nature and character of (i) the rights involved and (ii) the underlying property to which the intangible personal property relates.

The Regs. take the position that the

goodwill or going concern value of two businesses can never be of like-kind. Therefore, such exchanges will always produce boot. The Regs. state that a copyright on a novel is of like kind to a copyright on another novel, but is not of like kind to a song since, although the rights are identical, the nature of the underlying properties are substantially different. With this in mind, a taxpayer contemplating an exchange of businesses should first demonstrate that the intangible assets being swapped do not consist of goodwill. Then it must be demonstrated that the rights involved and the underlying properties are the substantially the same.

TAM 200035055 stated that the exchange of a radio license for a television license qualified under IRC § 1031 since the rights, and the property to which the rights related, involved differences only in "grade or quality," rather than in "nature or character." Both licenses enabled the licensee to broadcast over the electromagnetic spectrum, making the rights "essentially the same." The underlying property related to the use of the transmitting apparatus rather than the apparatus itself. Therefore, although the bandwidth of radio and television broadcasts are different, those differences are only in grade or quality, rather than in nature or character.

TAM 200602034 takes a restrictive view intangible exchanges, stating the standard for such exchanges is "still more rigorous" than for those involving tangible personal property. However, the rationale for this conclusion appears questionable.

INSTALLMENT SALES IN REAL ESTATE,*(Continued from First Page)*

as the gross profit divided by the total contract price. The gross profit is the gross selling price (i.e., without reduction for any existing mortgage), less the adjusted basis. The total contract price is the total consideration received, reduced by any "qualifying indebtedness" assumed or taken subject to by the purchaser. Qualifying indebtedness refers to a mortgage (or other indebtedness) not secured by the property itself, but assumed by the purchaser incident to the purchase of the property. Treas. Reg. §15A.453-1(b)(1)-(2).

Basis in an installment obligation is determined by multiplying the unpaid balance on the obligation by the gross profit percentage. An installment sale may yield ordinary income or loss, or capital gain or loss, depending on the property sold.

B. Limitations on IRC § 453 Reporting**1. Dealer Dispositions**

Installment reporting is not available with respect to "dealer dispositions." IRC §453 (b)(2)(A). Dealer dispositions include dispositions of real property held by the taxpayer in the ordinary course of business, and dispositions of personal property by a person who "regularly sells or otherwise disposes of personal property of the same type" under the

installment method. IRC § 453(l)(1)(B). However, sales of timeshares or residential lots may be reported on the installment method provided that (i) in the case of a timeshare, the interest involves a right to use a timeshare ownership interest in residential real property for not more than six weeks per year; and that (ii) in the case of residential lots, the taxpayer or related persons do not make improvements. IRC § 453(l)(2),(3).

2. Related Party Dispositions

IRC §453(e) prevents related persons from accelerating the receipt of cash — but at the same time deferring tax — by interposing a sham sale to a "related person." Thus, a taxpayer making an installment sale to a related person ("first disposition") may be required to accelerate all or a portion of the installment gain if the related person disposes of the property within two years ("second disposition"). A "related person" is one who bears the relationship to the taxpayer described in IRC §§ 318(a) or 267(b). IRC §453(f)(1).

Where a related party disposition occurs, the amount treated for any taxable year as received by the person making the first disposition is the lesser of (a) the amount realized on the second disposition or (b) the total contract price for the first disposition, reduced by the sum of (i) the aggregate amount of payments received with respect to the first disposition before the close of the taxable year

and (ii) the aggregate amount treated as received with respect to the first disposition for prior taxable years. IRC §453(e)(3). The related party rules cease to apply two years following the date of the first disposition. IRC §453(e)(2). (Note, however, that the two-year safe harbor rule does not apply with respect to dispositions of marketable securities.)

Some exceptions reduce the harshness of the related party rules. Thus, the rules do not apply to transactions in which tax-avoidance was not a principal purpose of the second disposition. IRC §453(e)(6). The rules also do not apply to the following dispositions: (i) reacquisition of stock by an issuing corporation; (ii) involuntary conversions; and (iii) dispositions at death. IRC §453(e)(7); see also S. Rep. No. 96-1000, 96th Cong., 2d Sess. 16 (1980). The related party rules apply to all other "dispositions," which include sales, exchanges, gifts, cancellations of debt, bequests, distributions, or transmissions of an installment obligation. If the second disposition is not a "sale or exchange," the fair market value of the property disposed of is substituted for the amount realized in determining gain.

For audit purposes, the period for assessing a deficiency expires no earlier than two years after the date on which the person making the first disposition furnishes a notice to the IRS advising of the occurrence of a second disposition to which IRC §453(e) may have

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INSTALLMENT SALES IN REAL ESTATE,

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applied. IRC §453(e)(8).

3. Depreciation Recapture

The general rule with respect to installment sales is that gain is reported ratably as payments are received. However, an installment sale of depreciable property may result in recapture gain in the year of sale. IRC §453(i)(1). The recaptured amount treated as ordinary income in the year of sale is any amount that would be treated as ordinary income under IRC §§ 1245 or 1250 if all payments were made in the year of disposition. IRC §453(i)(2). Recapture occurs under §§ 751, 1245 and 1250 notwithstanding any other provisions of the Code. IRC § 1245(d); 1250 (h).

Recapture under IRC §§ 751, 1245 and 1250 must be reported immediately, even though cash proceeds may not be received until later years under the installment sale agreement. This may create cash-flow problems to the seller, unless this issue is addressed during negotiations. Since only recapture gain is treated as received in the year of disposition, the balance of the gain is spread over the remaining payments. In computing gain recognized and the amount of each installment payment included in income, the adjusted basis of the property sold must be increased by the amount of recapture income recognized in the year of sale. IRC §453(i); see also S. Rep. No. 169, 98th Cong., 2d Sess. 466 (1984); IRS Pub. No. 537.

C. Unrecaptured IRC §1250 Gain

Unrecaptured Section 1250 gain generally refers to gain realized on the sale or exchange of real estate that has been depreciated on the straight-line basis. Such gain is taxed at 25 percent. IRC §1(h)(1)(D)(i). Treasury Regs. provide that unrecaptured Section 1250 capital gain may be reported on the installment method, provided the taxpayer is otherwise entitled to use the installment method. Treas. Reg. §1.453-12(a).

D. Assumption of Liabilities

Generally, if the seller's existing mortgage is assumed by the buyer, this will constitute "payment" to the seller for purposes of the installment sale rules. However, the receipt of "qualifying indebtedness" does not constitute "payment." Qualifying indebtedness refers to a mortgage or other indebtedness that is not secured by the property, but which is incurred or assumed by the purchaser incident to the acquisition of the property. Treas. Reg. §15A.453-1(b)(2)(iv).

E. "Wrap-around" Mortgages

Normally, the amount of indebtedness assumed or taken subject to by the buyer is treated as cash received in the year of sale by the seller. A "wrap-around" mortgage refers to an agreement in which the buyer *does not assume* all or a portion of

a mortgage encumbering the property, but instead issues to the seller an installment obligation. With payments under the installment note, the seller continues to service the "wrapped" debt. Since the buyer does not assume the mortgage, the seller remains legally obligated to make mortgage payments. Wrap-around mortgages reduce the seller's gain, since the amount realized is reduced by the amount of the wrapped indebtedness. Treas. Reg. § 15A.453-1(b)(3)(ii).

While the IRS initially challenged the tax treatment of wrapped indebtedness in temporary regulations, the Tax Court invalidated those regulations. See *Professional Equities, Inc. v. Comr.*, 89 T.C. 165 (1987), *acq.*, 1988-2 C.B. 1.

F. Disposition of Installment Notes

Disposition of an installment obligation may occur before all payments have been received. Section 453 is said to have a "hair trigger," since certain dispositions of installment obligations may trigger taxable gain even though the same disposition would not trigger a taxable event under other Code provisions. One example of this quality of Section 453 is the gift of an installment obligation. Although IRC § 102(a) provides that gross income does not include the value of property acquired by gift, the gift of an installment obligation will result in tax. Another example is the distribution by a corporation of an installment obligation. IRC § 453B(a). One purpose of the disposition rules is to prevent income-shifting.

Some important dispositions of installment obligations will not result in acceleration of gain or loss. Those include dispositions which occur during (a) certain corporate reorganizations and liquidations; (b) IRC § 351 transactions; (c) transfers incident to death or divorce; (d) distributions by a partnership; and (e) contributions to capital of a partnership. IRC § 453B.

In general, gain or loss recognized on the disposition of an installment obligation is equal to the difference between the fair market value of the obligation and its adjusted basis. The adjusted basis of an installment obligation is the unpaid balance on the installment obligation, reduced by the gross profit that would be realized if the holder collected the face amount.

G. Receipt of Installment "Boot" in Nonrecognition Transactions

Proposed Regulations address issues which arise when a taxpayer engages in a nonrecognition transaction under IRC §§ 1031, 351, 356 or 721, and receives "boot" in the form of an installment obligation. Treas. Regs. §1.453-1(f).

1. § 1031 Like-Kind Exchanges

IRC § 453(f)(6)(C) provides that for purposes of the installment method, the receipt of qualifying like-kind property will not be considered "payment." Therefore, the installment sale rules under IRC § 453 will not generally interfere with the application of IRC § 1031 if only qualifying like-kind property is received in the exchange. However, prior to the acquisition of replacement property, proceeds from the sale of relinquished property are typically held in escrow. A problem arises, because while the safe harbor deferred regulations under Section 1031 provide that cash placed in certain escrow accounts will not

result in constructive receipt — under Section 453, a seller is deemed to be in actual or constructive receipt when cash or cash equivalents are placed in escrow to secure payment of the sales price.

The Section 1031 regulations resolve the problem by providing that to the extent of any conflict, the Section 1031 regulations take precedence. However, relief from the otherwise operative installment sale rules of Section 453, which would result in constructive receipt of the exchange funds, ceases upon the earlier of (i) the end of the exchange period or (ii) the time when the taxpayer has an immediate right to receive, pledge, borrow, or otherwise obtain the benefits of the cash or the cash equivalent. Regs. § 1.1031(k)-1(j)(2)(vi).

The regulations under Section 1031 have their own important requirements. Regs. § 1.1031(k)-1(j)(2) provides that a transferor is not deemed to have received an installment payment under a qualified escrow account, provided the following two conditions are met: (i) the transferor has a *bona fide* intent to enter into a deferred exchange at the beginning of the "exchange period" (Regs. § 1.1031(k)-1(j)(2)(iv)), and (ii) the relinquished property does not constitute "disqualified" (*i.e.*, non-like-kind) property.

[The *bona fide* intent requirement is intended to prevent an unwarranted deferral of taxation. Without it, a taxpayer not intending to complete an exchange could, at the beginning of the exchange period, establish a qualified escrow account, and intentionally fail to identify replacement property during the 45-day identification period or fail to acquire replacement property during the exchange period. In either case, the taxpayer would become entitled to a refund of the escrowed installment obligations. If they were received in the following taxable year, the taxpayer would reap the windfall of a tax deferral, in circumstances in which the taxpayer never intended to complete a Section 1031 exchange.]

In exchanges involving installment notes, boot gain will result where (i) at the end of the exchange period, the QI (or other escrow agent) has not fully applied cash or cash equivalents (*i.e.*, the installment note) held during the exchange period for like-kind replacement property, or where (ii) the taxpayer receives boot outright (*e.g.*, an installment note or cash) at the beginning of the exchange period. Therefore, provided the taxpayer acquires replacement property of equal or greater value and receives no boot at the beginning of the exchange period, difficulties associated with constructive receipt under Section 453 can be avoided.

In like-kind exchanges where cash is received, boot gain is taxed immediately, to the extent of realized gain. However, taxation of boot received in the form of an installment obligation in an installment sale may not be immediate (except to the extent of depreciation recapture under IRC §§ 1245 or 1250). Regs. § 1.453-1(f) provide that a portion of each payment under an installment note will constitute taxable gain, and a portion will constitute a recovery of basis. Basis in the relinquished property is generally allocated entirely to the like-kind property received. The result is that less basis is allocated to the installment obligation. This is disadvantageous, since a greater portion of each payment received under the obligation will be subject to current tax.

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shifting the entire AMT burden to high-income taxpayers and corporations would be difficult, because expected federal tax revenues currently rely on AMT projections. Reducing the burden of the AMT could cost the government \$1 trillion over ten years.

The ultimate fate of most tax cuts enacted under President Bush will likely not be decided until after 2008. If a Democrat is elected, lower capital gains and dividend rates will probably terminate in 2010. However, the same could be true even if a Republican is elected. Prominent Democratic House leaders, including Representative Pelosi, have expressed support for raising income tax rates of high income individuals. However, many other newly-elected Democratic House members may not support any increase in IRC § 1 tax rates, even for taxpayers who earn \$250,000 or more. Assuming such a measure could clear the House, the Senate would likely approve.

The estate tax, scheduled to expire in 2010 — but for only a year — would, if nothing were done, return in 2011 with a pre-EGTRRA exemption amount of \$1 million. The current exemption of \$2 million is scheduled to increase to \$3.5 million in 2009. Congress may decide to increase the exemption to \$4 or \$5 million, and perhaps reduce the present tax rate which can reach as high as 47%. A reduction in the rate of estate tax to 20% or 25% has been discussed. However, the estate tax currently generates significant revenues, and at some

point, increasing the exemption while decreasing the tax rate would eviscerate the tax. Therefore, permanent repeal of the estate tax, or a dramatic decrease in the rate of tax appears remote in the foreseeable future. On the other hand, relief from the estate tax burden for closely held businesses and farms appears likely.

The gift tax, never slated for elimination, provides a \$1 million lifetime exemption. The tax rate imposed on taxable gifts in excess of that amount is scheduled to decrease to 35% in 2010. However, like the estate tax, if no legislative action is taken, the rate will revert to 47% on January 1, 2011.

The probable reluctance of the new Congress to raise income, capital gains, or dividend rates before 2008, will likely lead Congress to seek other revenue-producing measures. Many Democrats favor closing some tax-shelter loopholes, as well as eliminating tax incentives for multinational and oil companies.

The Joint Committee on Taxation has considered ways of increasing federal tax revenues to close the estimated \$290 billion tax gap. One proposal by the Committee, prepared at the request of Senate Finance Committee Chairman, Charles Grassley (R-Iowa) and Senator Max Baucus (D-Iowa), calls for rules requiring brokers to report the adjusted basis of publicly-traded securities sold during the preceding taxable year to the IRS. This measure, which brokers would surely oppose, would produce new records which could document significant capital gains. The IRS estimates that underreporting of capital gains

resulted in \$11 billion in uncollected taxes in 2001. Since new reporting requirements would be difficult to administer with respect to existing accounts, the suggestion has been made that the new rules be prospective in nature. Senators Grassley, Baucus and Bayh (D-Indiana) have introduced basis reporting bills this year.

The Joint Committee also recommended changes in the mortgage interest deduction allowed to homeowners when refinancing. Points associated with refinancing must be prorated over the life of the loan. Interest on home equity loans of up to \$100,000 is deductible. The Committee proposes rules to clarify the limits and timing of deductions, since it believes that some taxpayers may be claiming more deductions than are allowed.

Finally, the Joint Committee report proposed changes in the manner in which S corporations pay self-employment tax. Currently, S corporations owned by family firms may pay family members a salary and distribute remaining profits as a dividend. Such dividends are not currently subject to self-employment tax. The Committee report proposes that S corporations be subject to the same rules regarding self-employment tax as are currently applicable to partnerships and sole proprietorships.

RECENT IRS DEVELOPMENTS, CONT.

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The Code is the primary statutory source of federal tax law. Treasury Regulations which are administrative, rather than statutory, illuminate many individual Code provisions, and often provide examples. "Proposed" Regulations, which do not have the force of law (*LeCroy Research Systems Corp. v. Com'r.*, 751 F.2d 123 (1984)) provide guidance upon which the taxpayer may rely pending IRS approval of "Final" Regulations, published in the form of a "Treasury Decision," which also usually contains a preamble summarizing pertinent taxpayer comments to the Proposed Regulations.

Treasury Regulations may be either "interpretative" or "legislative." Interpretative Regulations broadly interpret Code provisions. Legislative regulations, which are enacted pursuant to an express mandate in the Code itself (*e.g.*, "under regulations prescribed by the Secretary"), in theory at least, possess a higher degree of legal authority.

"Revenue Rulings" are statements of policy published by the IRS generally either in response to a taxpayer inquiry or as a result of a court decision. They represent the

official IRS interpretation of the tax law. As such, taxpayers may rely on Revenue Rulings when contemplating transactions arising out of similar facts and circumstances. Nevertheless, Revenue Rulings are mere "opinions" of the IRS, and are not binding on courts.

"Private Letter Rulings" (PLRs), like Revenue Rulings, are issued exclusively in response to a particular taxpayer inquiry concerning specific facts. PLRs are, by definition, less authoritative than Revenue Rulings, since they may only be relied upon by the taxpayer seeking the ruling. PLRs may not technically be used or cited as precedent by taxpayers other than the requesting taxpayer. Still, PLRs are often discussed and cited by tax practitioners as though they provided substantial authority for a tax position taken or planned. After reviewing a request for a PLR (or Revenue Ruling), the IRS may advise that it intends to issue a negative ruling. At this point, the taxpayer may withdraw the request.

"Revenue Procedures" are published to announce IRS practices and procedures that affect the rights or obligations of taxpayers under the Code. 26 C.F.R. § 601.601(d) (2002). Not only may Revenue Procedures be relied upon as substantial authority, but taxpayers who deviate from procedures enunciated therein do so at their own peril.

"General Counsel Memoranda" (GCM) are prepared by the Office of the Chief Counsel. They explain the rationale for Revenue Rulings,

PLRs, and Technical Advice Memoranda. GCMs possess "important precedential value in determining future tax questions." *Taxation With Representation Fund v. IRS*, 485 F.Supp. 263 (D.D.C. 1980).

"Notices" are intended to provide substantive or procedural guidance prior to the issuance of Revenue Rulings and Treasury Regulations. "Announcements" alert taxpayers to a variety of information, but lack the formality of Notices, Revenue Rulings, or Revenue Procedures. Both Notices and Announcements constitute authority for avoiding the substantial understatement penalty under IRC § 6662, and may be relied upon to the same extent as Revenue Rulings and Revenue Procedures.

"Delegation Orders" are issued by the Commissioner pursuant to IRC § 7122, and delegate to the Commissioner's subordinates authority to settle criminal or tax cases. "Executive Orders" are issued by the President, and in the federal tax realm include orders that give certain effects to provisions of the Code.

The IRS may decide to "acquiesce" to an adverse court decision, thereby foregoing the right to litigate the issue in another circuit. IRS policy is to announce whether it will acquiesce or not acquiesce to a particular Tax Court or Court of Appeals decision. An "Action on Decision," the vehicle for such an announcement, is not, at least in the opinion of the IRS, an affirmative statement of IRS position. Rev. Rul. 87-138.