

Tax NEWS & COMMENT

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IRS MATTERS

EXTRACTING TAX-FREE CASH IN A TAX-FREE EXCHANGE

Refinancing before or after a like-kind exchange may enable the taxpayer to extract tax-free cash in addition to reporting no gain on the exchange. Depending on the size of the mortgage encumbering the property to be replaced, refinancing may actually be necessary to avoid boot gain caused by debt relief. However, since refinancing during a like-kind exchange transforms what would otherwise be taxable boot or taxable debt relief into tax-free loan proceeds, the IRS may argue that the transaction is taxable unless an independent business purpose justifies the refinancing.

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FROM THE COURTS

2nd Circuit Dismisses EU Suit to Recover Lost Tax Revenue

Citing the common law doctrine known as the “revenue rule,” the 2nd Circuit, on remand from the Supreme Court, dismissed a civil suit brought by the European Union under the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961-1968 (“RICO”) against RJR Nabisco, Inc., which suit sought to recover lost tax revenues due to alleged smuggling. *European Community v. RJR Nabisco, Inc.*, Dcket Nos. 02-7325 (L); 9/13/05.

[The EU alleged RJR had participated in a smuggling enterprise within the meaning of RICO and had committed various predicate acts of racketeering, including mail and wire

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FROM WASHINGTON

HURRICANE AID AND NEW TAX EXPENDITURES THREATEN PROPOSED TAX CUTS; DEFICIT MAY INCREASE

President Bush urged Congress to provide tax incentives to invigorate areas destroyed by Katrina and to pay for relief initiatives, already over \$70 billion, by reducing nondefense spending. Bush administration’s proposals for defense and homeland security may portend a \$400 billion deficit in fiscal year 2006.

Revenue shortfalls may force Congress to eliminate preferential rates for capital gains and most corporate dividends scheduled to expire in 2008. Senate Finance Chair Chuck Grassley (R-Iowa) accused the Bush Administration of stalling a

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Estate Planning Important Despite Uncertain Repeal

Budgetary constraints may force Congress to abandon permanent repeal the of estate tax. Even so, the exclusion amount is unlikely to settle much below \$3.5 million, the EGTRRA figure for 2009. The \$1 million gift tax exclusion amount appears unlikely to change. The rate of tax imposed on taxable gifts and estates — nearly 50% — is high in historical perspective and may face downward pressure.

New York continues to impose an estate tax on estates over \$1 million. Before EGTRRA, New York imposed a “pick up” estate tax on the

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AVOIDING CHALLENGES TO TESTAMENTARY INSTRUMENTS

Protracted legal proceedings by disgruntled descendants and relatives asserting lack of testamentary capacity or undue influence deplete the estate and delay distribution. Therefore, steps taken by the testator before death which minimize the possibility of later challenge are essential. Although somewhat surprising, the mere choice of who witnesses the will execution may later determine the success of a will contest. *Favorable testimony given by attesting witnesses at an SCPA § 1404 deposition may facilitate the admission of the instrument into probate, or at least force a favorable*

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OCTOBER COMMENT

Trust May Compliment Prenuptial Agreement

The prenuptial agreement effectively protects against the vagaries of marital dissolution. However, even a well-drafted prenuptial agreement will not always succeed in fully accomplishing this objective. For example, the agreement will likely not prevent separate property from becoming marital property if assets are commingled.

Nor is there any assurance that a prenuptial agreement will not be declared invalid in whole or in part if circumstances have changed during a long marriage, or if the equities of the case run against the party in whose

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To illustrate *preexchange* refinancing, assume the relinquished property is heavily mortgaged but the replacement property is unencumbered or subject to only a small mortgage. Regs. §1.1031(d)(2) treats debt relief as cash received in the exchange. However, the Regs. also permit the “netting” of mortgages, suggesting that boot gain may be avoided by “evening up” the mortgages prior to the exchange. Encumbering the replacement property by an amount equal to the existing mortgage on the relinquished property would accomplish this equilization. Will this strategy work?

The taxpayer in *Wittig v. Comr.*, T.C. Memo, 1995-461 equalized the mortgages by encumbering the replacement property prior to the exchange, extracting cash from the new mortgage in the process. Since the assumption of the taxpayer’s liabilities with respect to the relinquished property equaled the new liabilities assumed by the taxpayer, the taxpayer reported no gain. PLR 9853028 concurred, stating that a new mortgage placed to acquire the replacement property could be netted against the existing mortgage on the relinquished property.

What if the loan is obtained shortly before the exchange? Although Regs. §1.1031(b)-1(c) would treat such as *bona fide* debt, *Garcia v. Comr* 80 T.C. 491 (1983) held that a loan obtained shortly prior to the exchange would be as cash received on disposition of the relinquished property unless the new debt had “independent economic significance.” *Fredericks v. Comr*, T.C. Memo, 1994-27 blessed pre-exchange financing where it was not conditioned on closing of title and was dependent on the taxpayer’s creditworthiness. Even here, the step-transaction doctrine could be invoked by the IRS if pre-exchange financing was in integral part of the exchange. *See, e.g., Behrens v. Comr.*, T.C. Memo 1985-195. Ideally, refinancing should be entirely unrelated to the exchange.

In contrast to preexchange financing, no judicial or legislative authority appears to place restrictions on encumbering replacement property following an exchange. The ease of post-exchange financing might be explained by the fact that here the taxpayer remain economically answerable for the new debt. (In preexchange refinancing, the

newly encumbered property is relinquished.)

Nevertheless, to avoid the step-transaction doctrine, title in the replacement property should be acquired before engaging in post-exchange financing. *Post-exchange financing proceeds should not be paid at the closing or appear on the closing statement.* If additional construction draws will be made following acquisition of the replacement property, only the advance

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FROM THE COURTS, CONT.

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fraud, and money laundering. The complaint sought to recover treble damages pursuant to RICO for duties and taxes not paid on cigarettes; and injunctive relief to end smuggling and to ensure future compliance.]

The appeals court initially observed that under the “revenue rule” courts of one nation will not enforce final tax judgments or unadjudicated tax claims of other nations. The rationale for the rule is predicated in the belief that the judiciary should not evaluate enactments of a foreign sovereign. The EU asserted, however, that the the revenue rule had been abrogated by amendments to RICO embodied in the Patriot Act.

The court acknowledged that various provisions in the Patriot Act did address the conduct alleged. However, it found that neither the amendments nor legislative history evidenced a Congressional intent to abrogate the doctrine, which was necessary for two reasons: First, serious policy implications and “embarrassment” might follow if one nation’s courts analyzed the validity of another’s laws; and second, the executive, rather than the judicial branch, should decide when one nation should enforce another nation’s tax laws.

The EU cited *Pasquantino v. U.S.*, 125 S.Ct. 1766 (2005) for the proposition that the revenue rule had not barred prosecution under 18 U.S.C. § 1343 where Canada had been fraudulently deprived of its right to collect tax money. Although prosecution did in a sense “enforce” Canadian law, the court found the connection was nevertheless “too attenuated” to be significant, since the U.S., rather than a foreign sovereign, had commenced the prosecution.

The court concluded that where a domestic sovereign enforces its *own* penal law, there is little risk of causing the evil against which the revenue rule was traditionally thought to guard: judicial evaluation of “policy-laden” enactments of foreign sovereigns. However, where the executive branch does not expressly consent to the litigation, separation of powers militates against the judiciary being drawn into foreign relations issues

From Washington, Cont.

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bipartisan healthcare bill, and warned of a “domino effect” that would doom the investment tax cuts.

The House narrowly passed a bill intended to increase oil-refining capacity by easing regulatory constraints, and also to avert a projected home heating-oil crisis in New England this winter by enlarging a federal oil reserve in New York harbor. The bill also proposed federal penalties (up to \$11,000 per incident) for price gouging by oil companies or retailers of petroleum products. *Although Republican House leaders refused to allow debate concerning increased fuel efficiency standards, the Senate may revisit that issue and may also endorse a proposal allowing states to waive a federal moratorium banning drilling for natural gas on federal land off their coastlines.*

The Energy Policy Act of 2005 provides new tax credits for the purchase of (i) hybrid, fuel cell, advanced diesel and other alternative power vehicles placed in service after 2005, and (ii) qualifying residential solar water heating, photovoltaic equipment and fuel cell property (up to a maximum credit of \$2,000). *The Act also provides for (i) a new \$2,000 business tax credit for the construction of new energy efficient homes, and (ii) a new deduction for energy efficient commercial buildings.*

The President’s Advisory Panel on Tax Reform is due to report November 1. Many Eastern European countries have recently adopted a flat tax. Romania’s S&P credit rating is now investment grade; tax revenues in Russia have increased dramatically since adopting a 13% flat tax. *The Wall Street Journal*, citing Code “complexity,” urged the Panel to reject fairness arguments and “endorse a simple, broad-based, single-rate tax system. (“The World is Flat,” 10/7/05).

However, Congress is unlikely to abandon progressive tax rates. Americans and Western Europeans view the flat tax with contempt. German Chancellor Schröder seized upon his opponent’s named choice of a flat-tax advocate for finance minister, warning that Germany should not host an “unjust tax experiment.” His opponent’s lead in the polls evaporated. *Contrary perhaps to popular view, new IRS data show that the*

top 1% of taxpayers paid more than a third, and the top half of taxpayers paid for all but 4%, of total personal income tax in 2003, demonstrating the “steeply progressive nature of the federal income tax,” according to Joint Economic Committee Chair Rep. Jim Saxton (R-N.J.).

Thus far in 2005, 91 U.S. companies have announced plans to repatriate about \$206 billion in foreign profits under a one-year tax break enacted as part of the American Jobs Creation Act of 2004. While U.S. companies generally pay U.S. income tax on foreign source income, profits permanently reinvested overseas are generally excepted. During 2005, companies may repatriate profits from overseas operations at a special rate of 5.25%, rather than the typical effective rate of 25%. *Although job growth cannot be tied directly to the tax provision, employment growth has been moderate in 2005, and unemployment fell to 4.9% in August, a four-year low. Companies are required to file board-approved plans to the Treasury Department for “approved uses,” although they are not required either to isolate funds or to show that spending on approved uses exceeds that which would have otherwise occurred.*

Mutual funds invested in Latin American funds and funds specializing in natural resources are expected to make large capital gains payouts in December. Under federal law, mutual funds are required to pay out any net realized capital gains to their shareholders each year. These gains, which derive from stock trades or other investment income, may be either short-term or long-term. The type of gain — and therefore its tax treatment to investors — is based upon how long the fund held the particular security, and not how long the investor owned the mutual fund. Since short-term capital gains are taxed at the taxpayer’s regular income tax rate, investors should be careful about investing in these funds in the final weeks of 2005. Note that funds held in a tax-favored retirement account such as an IRA are not subject to current tax on capital gains. Accordingly, capital gains distributions to these accounts do not pose a similar concern.

As U.S. Treasury Secretary John Snow embarks on a trip to China, central-bank head Zhou Xiaochuan said that China must reexamine the value of its currency in light of its soaring trade surplus. *Chief Asia economist for Credit Suisse First Boston, Don Tao, said China will address currency reform “at its own pace.”*

Trusts in Marital Planning, Cont.

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favor enforcement of the prenuptial agreement would inure. Fortunately, the prenuptial agreement need not stand alone: Inherited family wealth and to a lesser extent assets acquired before marriage may be protected by a trust.

Typically, a trust designed to protect family wealth would be created by a parent for the benefit of the either spouse. Unlike a prenup, the trust could be implemented at any time, even after marriage, and could exist without the knowledge other spouse. Trust distributions could be within the unreviewable discretion of the trustee, who might be the parent implementing the trust. *Generally, inherited property, even that acquired during marriage, remains separate property.*

During the pendency of a divorce proceeding, the trustee could cease making distributions. Since the beneficiary could not force the trustee to make a distribution during the divorce, *a fortiori* the creditor-spouse could not. A creditor’s rights cannot exceed those of the debtor. (However, an exception might exist for court-ordered child support or alimony payments. A court might invade even a discretionary trust to satisfy these obligations.)

Where a spouse has herself accumulated significant wealth before marriage, asset protection need also not stop with the prenup. Although NY EPTL § 7-3.1 has long provided that trusts created by the grantor for her own benefit which purport to shield trust assets from creditors are unenforceable, not all domestic jurisdictions continue to adhere to this common law view.

A decade ago, one attempting to circumvent the EPTL prohibition against “self-settled” spendthrift trusts might have ventured to a remote venue with a tropical — or vaguely sinister — name. Today, one need venture no further than Delaware. This does not mean that a New York court would not look askance upon such a trust. Nonetheless, a New York court seeking to invade the trust might find it difficult to convince a Delaware court in whose jurisdiction the assets reside of the inapplicability of the Full Faith

TESTAMENTARY INSTRUMENTS, CONT.*(Continued From First Page)*

settlement.

The ideal witness recalls the ceremony and can testify that statutory procedures were followed. Friends and relatives make poor witnesses, as they are more likely to have competing loyalties to the litigants. Similarly, secretaries may be difficult to locate and may be unfriendly if their employment was terminated. Attorneys and law students, on the other hand, make excellent witnesses. They likely to accurately recall the ceremony and realize the significance of the affidavit made immediately thereafter attesting that “[t]he testator . . . was suffering from no defect of sight, hearing or speech or from any other physical or mental impairment which would affect his capacity to make a valid Will.”

The witnessing attorney should also be present during a portion of the meeting prior to the actual signing to facilitate their giving credible testimony concerning the testator’s capacity and awareness of his current circumstances. Witnessing attorneys might also draft

short memoranda detailing their own observations and impressions of the testator.

If the testator’s condition is poor on the scheduled date for signing, consideration might be given to rescheduling the signing. Similarly, a regularly scheduled medical examination coinciding with will execution might help in establishing the testator’s mental capacity. If serious mental capacity concerns exist, an examination by an independent geriatric physician might be considered. Finally, a will signing might be coincident with a family function; this might enable friends or relatives to be in a position to offer favorable testimony.

Mental capacity required to execute a will is substantially less than that required to enter into a contract: The testator need only know the extent of his estate and the natural objects of his bounty. *Horn v. Pullman*, 72 NY 269 (1878). Nevertheless, may an attorney draft and participate in the execution of a will if the testator appears to be under diminished capacity? The American College of Trusts and Estates, Model Rules of Professional Conduct takes the

position that “because of the importance of testamentary freedom, the lawyer may properly assist clients whose testamentary capacity appears to be borderline.”

If diminished mental capacity cannot be asserted, a disgruntled family member may claim undue influence, particularly where the testator left a large portion of his estate to one with whom he cohabited or married. A child might also make such an assertion where a sibling has received a larger portion of the inheritance. Yet it is not uncommon for a testator to leave a significant portion of his estate to one who was kind and attentive to him; nor is it unusual for one to leave unequal shares to various children for a myriad of reasons.

If the drafting attorney suspects undue influence, the testator should be interviewed alone by the attorney. Gifts that seem unusual should be discussed, so that the attorney understands the client’s motive in making the gift. Consideration might also be given to inserting a provision stating that the testator acknowledges that certain persons may not understand the reasons for the disposition chosen, but that the disposition was

IMPORTANCE OF ESTATE PLANNING,*(Continued from First Page)*

maximum credit for state death tax allowed by IRC § 2011. However, EGTRRA has eliminated that credit in phases. Rather than lose estate tax revenue, some states, including New York have “decoupled” their tax codes from the federal code. New York has accomplished this objective by remaining linked to federal law as it existed before EGTRRA.

Under pre-EGTRRA law, no federal estate tax would be imposed on an estate of \$1 million. Since there would be no federal tax, New York would have nothing to “pick up”. However, a taxable estate of \$1,093,755 would now incur tax of \$38,452, which is 41% of the amount in excess of \$1 million. If the taxable estate were greater than \$1,093,755, the same \$38,452 would be paid on the first \$93,755 in excess of \$1 million, but amounts in excess of \$1,093,755 would be subject to tax at rates beginning at 6% and rising, for very large estates, to 16%.

This rate structure, which causes a precipitous decline in tax rates after the taxable estate passes the \$1,093,755 threshold, results from the use of different

rate tables to calculate the tax: § 2011(e) provides that the federal state death tax credit cannot exceed the federal estate tax imposed by § 2001. For the first \$93,755 above \$1 million, the tax imposed by §2001 is actually less than that imposed by § 2011, even though § 2001 employs much higher rates. This seeming paradox is explained by the fact that only § 2001 contains an exemption for the first \$1 million. Therefore, a taxable estate of \$1,001,000 million would be required to pay a New York estate tax of \$460, which is the lesser of the tax imposed by § 2001, i.e., 47% of \$1,000, and the tax imposed by § 2011, i.e., \$27,600 + 5.6% of \$101,000, or \$33,256.

Florida, California and Texas are among 25 states that have not “decoupled” their estate tax systems, meaning that these states therefore no longer collect an estate tax.

Since the estate tax may well remain in some form after 2010, statutory exemptions should be maximized. Reducing the size of one’s estate, while retaining maximum control, remains an important objective. Every taxpayer may make gifts of up to \$1 million without incurring current gift tax liability. Annual exclusion gifts do not count toward the \$1 million

exclusion.

The transfer of appreciating real estate can significantly leverage the \$1 million gift tax exclusion. Assume parents give 99% of the value of a business owning real estate worth \$3 million to their children in the form of nonvoting partnership interests with no management rights. Provided marketability, minority and/or capital gain discounts of at least 33% can be applied, no current gift tax liability will arise. The underlying real estate will be worth \$6.48 million in 10 years, assuming an 8% rate of return.

The FLP agreement can place restrictions significantly decreasing the value of the entity for gift tax purposes. To determine the proper discount, a qualified valuation expert should be retained. Even if no gift tax liability arises, an information return adequately disclosing the claimed discounts should be filed to commence the 3-year limitations period. The IRS is most likely to challenge discounts associated with gifts of FLP interests where the donor retains excessive control, either by virtue of the governing instrument, or by implied agreement among family members.