

# TAX NEWS & COMMENT

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## IRS MATTERS

### 2009 REGS., RULINGS AND PRONOUNCEMENTS OF NOTE

#### I. Treasury Regulations & Proposals

¶ Treasury issued final regulations limiting the estate tax deduction for unpaid claims and expenses. With respect to decedents dying on or after October 20, 2009, an estate may deduct an expenditure only if the claim or debt is *actually paid*. Under the new regs, the amount of claim or expense may be determined by (i) court decree; (ii) consent decree; or (iii) settlement. No deduction is allowed to the extent a claim or expense is or could be reimbursed by insurance. Notice 2009-84.

Nevertheless, several exceptions exist to the rule requiring actual payment. If a potential for reimbursement exists, the claim may still be deductible  
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## FROM THE COURTS

### 2009 Gift & Estate Tax Decisions of Note

#### I. Valuation Discounts

In *Estate of Litchfield*, T.C. Memo 2009-21, the Tax Court generally approved the lack of control (14.8%), lack of marketability (36%), and built-in capital gains (17.4%) discounts for minority interests in closely-held S corporation stock owned by the decedent at his death. In reaching its holding, the Tax Court emphasized that while the taxpayer's appraiser had interviewed corporate officers, the IRS appraiser relied solely on outside data.

In *Estate of Hester*, 99 AFTR 2d 2007-1288, *aff'd per curiam*, 102 AFTR 2d 2008-6716, *cert. denied sub nom.*, 128 S.Ct. 2168 (2009), the decedent  
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## FROM WASHINGTON

### 2010 TAX OUTLOOK

#### I. Proposals From the White House

President Obama favors permanently extending tax cuts enacted in 2001 and 2003 for individuals with incomes above \$200,000 and families with incomes above \$250,000, but allowing tax cuts for those whose income exceeds those thresholds to expire in 2010. Under the proposal, the two top individual income tax rates would rise from 33% to 36%, and from 35% to 39.6%. President Obama also proposes the following changes:

¶ Capping at 28% the rate at which high-income households can itemize their deductions. Today, the  
**Tax Analysis**  
(Please turn to page 2)

### 2009 Decisions and Rulings Under IRC Section 1031

#### I. Acquisition of All Partnership Interests Takes Exchange Out of IRC § 1031(a)(2)(D)

PLR 200909008 concluded that an Exchange Accommodation Titleholder ("EAT") may acquire a 50% partnership interest as replacement property for the taxpayer's exchange where the taxpayer owns the other 50%. Although §1031(a)(2)(D) precludes the exchange of a partnership interest, under Rev. Rul. 99-6, the acquisition by a partner of all of the remaining interests of a partner  
**Tax Planning**  
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## DOMESTIC ASSET PROTECTION TRUSTS

#### I. Introduction

Many estate planning trusts also possess significant asset protection features. A qualified personal residence trust ("QPRT") results when an interest in real property, which could be attached by a creditor, is converted into a mere right to reside in the residence for a term of years. The sale of an asset to a "defective" grantor trust in exchange for a promissory note converts the asset into an instrument which may be unattractive to a creditor if it provides only for interest payments.

Since these trusts are ubiquitous  
(Please turn to page 11)

## MARCH COMMENT

### Estate Planning in 2010

#### I. Period of Uncertainty

The federal estate tax was repealed midnight, December 31, 2009. If Congress fails to act in 2010, the estate of every decedent who dies this year will owe no federal estate tax. This could complicate existing wills. As it now stands, the estate tax will return on January 1, 2011, and the exemption amount will be reset at pre-2001 levels. This means the applicable exclusion amount will be \$1 million, and the highest estate tax rate will be 55%.  
**Estate Planning**

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**2010 TAX OUTLOOK, CONT.**

(Continued from page 1)

value of a deduction is equal to the taxpayer's top income tax bracket. The White House estimates that capping the rate on deductions could produce \$291 billion in revenues over 10 years.

¶ Reinstating the estate tax in 2011 with a \$3.5 million exemption amount and a 45% tax rate.

¶ Eliminating the capital gains tax on small business stock held for at least five years. The measure would apply only to stock acquired after February 17, 2009. "Small businesses" are companies with gross assets of \$50 million or less.

¶ Permanently changing the Alternative Minimum Tax (AMT) in such a way that it would no longer effect middle-income families. The cost of such a change is estimated to be \$660 billion over 10 years. The AMT "patch" expired on 12/31/09.

¶ Extending the "Make Work Pay" credit, which increases workers' paychecks by a few dollars each pay period. The extension is expected to cost \$61.2 billion over 10 years.

¶ Raising taxes on investment fund manager profits. Currently, profits paid to managers of hedge funds are taxed at the 15% capital gains tax rate. Mr. Obama would seek to tax that remuneration as ordinary income.

¶ Permanently expanding the low-income tax credit. The stimulus package in 2009 temporarily expanded the earned income tax credit for low-income families with three or more children. The expansion meant that those families could claim a credit equal to 45% of their qualifying earnings, up from 40%, for a maximum credit of \$5,657. President Obama favors making the expansion permanent. The estimated cost would be \$15.2 billion over 10 years.

¶ Expand the child-care tax credit, by allowing families making less than \$85,000 to double the child and dependent care tax credit for which they currently qualify. The cost is estimated to be \$12.6 billion over 10 years.

¶ Permanently extend the American Opportunity Tax Credit and make it partially refundable. The credit is worth up to \$2,500 for higher educa-

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**2010 TAX OUTLOOK, CONT.**

tion expenses, up from \$1,800 previously. Making the credit permanent would cost an estimated \$75.4 billion over 10 years.

¶ The Administration may propose as part of the fiscal year 2011 budget a new fee on banks, insurance companies, and other financial businesses with more than \$50 billion in assets. The fee would be expected to raise \$90 billion over 10 years.

**II. Proposals From the Capitol**

Various tax relief provisions are set to expire in 2010. If Congress fails to act, (i) current individual ordinary income tax rates would return to pre-2001 levels; (ii) the capital gains tax rate would increase to 20 percent; (iii) dividends, now taxed at 15 percent, would be taxed as ordinary income; and (iv) the estate tax would return with a \$1 million exemption and a 55 percent top tax rate.

The Joint Committee on Taxation estimates that a tax relief bill in 2010 which preserves most or all of the 2001 and 2003 tax cuts, and extends the estate tax at 2009 levels, will reduce

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**ESTATE PLANNING IN 2010,***(Continued from page 1)*

This “default” scenario could change if Congress passes legislation later this year (retroactive legislative action after 2010 would likely raise constitutional problems) which President Obama signs. The House passed a bill in December that would have permanently extended the \$3.5 million exemption and the 45% top estate tax rate in effect in 2009. However, the Senate failed to act, with Republicans and conservative Democrats favoring a higher exemption amount of \$5 million. Mr. Obama favors a \$3.5 million exemption amount and a top estate tax rate of 45%.

Given fiscal considerations, Congress may reinstate the estate tax retroactively to January 1, 2010. Most believe that the longer Congress takes to act, the less likely it is that reinstatement of the estate tax will be retroactive. However, if accomplished within the next few months, retroactive reinstatement would probably not be unconstitutional. The Supreme Court, in *U.S. v. Carlton*, 512 U.S. 26 (1994), held that Congress may validly impose retroactive legislation concerning an estate tax deduction. The Court remarked: “The amendment at issue here certainly is not properly characterized as a ‘wholly new tax,’ and its period of retroactive effect is limited.”

If Congress waits past the summer to reinstate the estate tax, Congress may decide to forego retroactivity. This, despite the significant loss in tax revenues. If Congress does elect to reinstate the estate tax retroactively any time this year, the Supreme Court will more than likely be called upon to decide the constitutionality of the measure.

*Note: New York still imposes an estate tax on taxable estates in excess of \$1 million. Therefore, it may be prudent for a New York testator to leave at least that amount outright or to a credit shelter trust to make use of the \$1 million New York exemption amount.*

**II. Carryover Basis**

Prior to 2010, property acquired from a decedent by bequest, devise or inheritance generally received a stepped-up basis under IRC § 1014. The purpose of the statute is to avoid the double taxation that would result if the asset were first subject to estate tax at the death of the decedent, and then to income tax when the beneficiary sold the asset after the decedent’s death. Since the estate tax has, for the time being at least, been repealed, no double taxation would result from the loss of the step-up in basis at death.

For decedents dying after December 31, 2009, the basis of property acquired from a decedent is the lesser of (i) the decedent’s

adjusted basis or (ii) the fair market value of the property at the decedent’s death. IRC § 1022(a)(2). Many estates that would not have been subject to estate tax at the \$3.5 million applicable exclusion amount threshold will be subject to the new carryover basis regime.

To temper the harshness of the new rule, Congress provided that the executor may allocate (i) up to \$1.3 million to increase the basis of assets, and (ii) up to \$3 million to increase the basis of assets passing to a surviving spouse, either outright or in a QTIP trust. Although constitutional arguments could be made against the retroactive repeal of the new carryover basis provisions, few would likely object, since it is difficult to envision a situation in which the new carryover basis provision could benefit an estate.

*If Congress does not retroactively repeal the carryover basis provisions in 2010, failure to either make an outright bequest to a spouse, or failure to fund a QTIP trust might waste the \$3 million basis allocation that could be made to the QTIP trust. (An income interest in a credit shelter trust given to a surviving spouse would not qualify for the \$3 million spousal allocation of basis.)*

**III. Transfers to Trusts**

IRC §2511(c) treats transfers to trusts made after December 31, 2009 as taxable gifts unless the trust is a wholly grantor trust under IRC §§ 671-679. The statute is intended to prevent the donor from making a transfer complete for income tax purposes but incomplete for transfer tax purposes, thereby shifting income tax responsibility without incurring gift tax.

**IV. GST Tax Uncertainties in 2010**

Although technically not repealed in 2010, the generation-skipping transfer (GST) tax will have no application in 2010, as there is no estate tax. This also means that transferors will not be able to allocate any GST exemption to transfers made in 2010. As is the case with the estate tax, the GST tax will “spring back” into life on January 1, 2011.

However, by reason of the language in the sunset provision in the 2001 Tax Act, *i.e.*, “the the Internal Revenue Code of 1986 shall be applied . . . as if the provisions [in the 2001 Tax Act] had never been enacted,” various uncertainties arise in the application of the GST tax. For example, will GST exemptions allocated trusts after 2001 but before 2010 be allowed? Also, will decedents who die in 2010 with testamentary trusts be treated as transferors for GST purposes? Since transfers to trusts will not be subject to estate tax in 2010, such decedents might not be considered “transferors” within the

meaning of IRC § 2652(a).

A number of GST provisions are also scheduled to sunset in 2011 without further legislation. Among those are the allowance of a retroactive allocation of GST exemption under certain circumstances, and a late election to allocate the GST exemption.

**V. Review of Existing Documents**

Wills for testators at risk of death in 2010 should be reviewed. Existing wills may contain a formula provision allocating the maximum amount which can pass free of estate tax to a credit shelter trust. Since there is no estate tax in 2010, the amount called for in the formula could consume the decedent’s entire estate. Most testators who included this formula provision were motivated by a desire to avoid burdening the estate of the surviving spouse with unnecessary estate tax liability, not a desire to disinherit the spouse. However, if no estate tax exists, then this could result. Similarly, a bequest to a QTIP trust of the maximum amount qualifying for the estate tax deduction may be difficult to interpret if there is no estate tax for which a deduction could be claimed.

A client, even an elderly one at risk of death in 2010, may resist drafting a new will which might be effective only for only one year, since it is remote that estate tax reprieve will more than temporary. A simple codicil may provide an effective solution. The codicil could provide that (i) should the client die at a time when the estate and GST tax do not apply, and (ii) if the estate tax and GST tax are not retroactively reinstated, then (iii) notwithstanding any contrary provisions in the will, for purposes of all formula computations, it would be conclusively presumed that the estate tax laws in effect on December 31, 2009 would be applicable at the client’s death. This would prevent the overfunding of the credit shelter trust. The language of such a codicil could read:

Article [ ]

**Intent if No Federal Estate Tax**

“For purposes of gifts made under this Will, if at the time of my death there is no federal estate tax, and it appears to my Executor that retroactive reinstatement by Congress of the federal estate tax is unlikely to occur, it is my intention that all dispositive provisions under my Will be given the same force and effect as if I had died in 2009, and that all dispositive provisions in my Will be interpreted according to the federal tax law as it existed in 2009, regardless of the federal tax law in effect at the time of

*(Please turn to page 4)*



## ESTATE PLANNING IN 2010, CONT.

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my death.”

VI. Planning for Married Persons

It appears likely that the estate tax will be reinstated no later than 2011, and that the exemption amount could be between \$3.5 million and \$5 million. As seen, under many current wills, if either spouse were to die in 2010 at a time when there is no estate tax, the credit shelter trust could be overfunded. Overfunding of the credit shelter trust could also result in unintended (and costly) New York state estate tax consequences, since the New York state estate tax exemption amount is only \$1 million.

One interesting approach discussed at the University of Miami Heckerling Institute on Estate Planning in Orlando during the week of January 25th, 2010, which seeks to exploit the uncertainty in the estate tax in 2010, is to maximize dispositions to QTIP trusts.

Assets in a QTIP trust with respect to which no estate tax marital deduction is allowed at the death of the first spouse will not be includible in the estate of the surviving spouse under IRC § 2044. If no estate tax exists at the death of the first spouse in 2010, and all of the estate is left to a QTIP trust, no QTIP election will be necessary to save estate taxes on the first spouse to die. If no QTIP election is made, none of the assets in the QTIP trust will be included in the estate of the surviving spouse, *even if the estate tax is reenacted prior to the death of the surviving spouse.*

[Note: The rights accorded to a surviving spouse in a QTIP trust are insufficient to pull the QTIP trust assets back into her estate under §2036. QTIP assets are includable only if the executor of the first spouse to die makes a QTIP election and deducts the value of the assets from the gross estate of the first spouse. By making the election, the executor is agreeing to include the value of the assets in the estate of the second spouse (at their fair market value at the death of the surviving spouse). If no election is made, QTIP trust assets will not be included in the estate of the surviving spouse. Inclusion arises by virtue of the QTIP election, not by virtue of the QTIP trust being funded. If no election is made, no inclusion in the estate of the surviving spouse will result even if the QTIP trust was funded.]

In contrast, if all of the assets are instead left outright to the surviving spouse, those assets **would be included** in the estate of the surviving spouse if the estate tax were reenacted prior to the death of the surviving spouse. Therefore, a QTIP trust may effectively shield the estate of the surviving spouse from potential estate tax liability. The QTIP trust may also impart a significant degree of asset protection into the inherited assets, when compared to an outright bequest. Another advantage to funding the QTIP trust is to ensure that the \$3 million spousal basis adjustment can be utilized, if needed. By inserting a disclaimer provision in the will, the surviving spouse could decide whether to

disclaim amounts not needed for the \$3 million spousal basis adjustment.

Despite the alluring federal estate tax consequences of generously funding a QTIP trust in 2010, a dark cloud in the form of New York state estate tax liability may appear, since New York does not recognize a “state-only” QTIP election. That is, if no QTIP election is made on the 706 (and no election will be made since none is needed to eliminate the federal tax in 2010, no separate New York QTIP election would also likely be possible, since New York does not appear to allow a QTIP election if no federal QTIP election is made.

This means that if all assets are transferred to a QTIP trust, the cost of obtaining no federal estate tax bill on the death first spouse (by reason of there being no estate tax) or on the death of the second spouse (by reason of there having been no QTIP election, meaning that while a transfer to a QTIP trust was made, no election was made to deduct the amounts transferred, and therefore no obligation to include those assets at fair market value on the 706 of the surviving spouse arose) may be a New York state estate tax on the size of the entire estate, less \$1 million (the QTIP trust would qualify for New York’s \$1 million lifetime exemption amount, since it would be treated for New York estate tax purposes as a garden variety credit shelter trust.)

Although the New York state estate tax could be avoided — and no increase in federal estate tax would arise — by making an outright disposition to the surviving spouse in 2010, this would result an avalanche of potential future federal estate tax on the death of the surviving spouse, unless of course, the surviving spouse also dies before 2011, or consumes or gifts the entire amount before her death.

Another peculiar disadvantage to funding the QTIP trust with all of the estate assets, rather than leaving assets directly to the children, is that the surviving spouse will incur taxable gifts if lifetime transfers to children are desired. That is, the surviving spouse may not wish to wait until her will takes effect to transfer wealth to children. Recall that although the estate tax has been repealed, the gift tax exemption remains at \$1 million in 2010. (The rate of tax applied to gifts has been reduced, however, from 45% to 35%.)

Although a disclaimer creates post-mortem flexibility, a significant disadvantage to disclaimers is that the surviving spouse must actually disclaim. Some surviving spouses may not disclaim, even if sensible from a tax standpoint. If this is a concern, the surviving spouse may instead be given more rights and powers over assets funding the credit shelter trust. For example, (i) the spouse might be named co-trustee of the trust; (ii) the spouse might be given a testamentary limited power of appointment over the credit shelter trust; (iii) the trustee might be directed to make greater distributions to the surviving spouse; or (iv) the trustee or “trust protector” might be given authority to make discretionary distributions to the spouse of as much of the income or principal of the trust as the trustee or trust

protector believes is in the best interest of the spouse. The credit shelter trust could also provide that the spouse would no longer be a beneficiary if the spouse were to remarry.

Giving the spouse more rights in a credit shelter trust (as would transfers to a QTIP trust where no QTIP election is made) may eliminate the need to rely on a disclaimer. However, this solution would result in significantly less flexibility, and would almost certainly result in New York state estate tax on the death of the first spouse. (Again, the only way to avoid New York estate tax on the death of the first spouse is to make a transfer qualifying for the New York state estate tax deduction. This type of transfer could be (i) an outright transfer to the surviving spouse; (ii) a QTIP transfer for which a QTIP election is made on the 706; or (iii) a general power of appointment trust. A final disadvantage to foregoing the QTIP in favor of a credit shelter trust is that as indicated above, only outright transfers or transfers for a QTIP trust are eligible for the \$3 million basis allocation at the death of the first spouse.

VII. Transfer Planning in 2010

Many clients wish to transfer assets to their children during their lifetimes rather than at their death. Therefore, lifetime transfer planning remains important for reasons wholly independent from the fate of the estate tax. While the \$1 million lifetime gift tax exclusion amount is a hindrance to large gratuitous transfers, gifts of interests in discounted family entities, installment sales to grantor trusts, and transfers to annuity trusts can significantly leverage the \$1 million gift tax exclusion amount.

The federal gift tax (New York has no gift tax) has not been repealed, although the tax rate for gifts in 2010 is 35%, down from 45%. Although the 35% rate is not scheduled to increase in 2011, Congress has historically imposed the same rate of tax on both gifts and estates. Since the 35% tax rate may be only temporary, large gifts of \$1 million or more made in 2010 may be considerably less expensive than the same gifts would be in 2011. Another important reason to consider transfer planning in 2010 is that President Obama seeks to curtail valuation discounts, either by means of new legislation, or by issuing regulations under IRC §2704. This prospect, in combination with the historically low gift tax rates now in effect, makes transfer planning in 2010 particularly attractive.

¶ Although Congress is contemplating requiring a minimum 10-year period for GRATs, this would not effect the client’s ability to utilize a “zeroed-out” GRAT, which would result in little or no current taxable gift.

¶ The gift tax annual exclusion amount remains for 2010 remains at \$13,000. Much wealth can be transferred without gift or estate tax consequences by prudent use of annual exclusion gifts, either outright or in trusts providing *Crummey* powers.

## 2009 DECISIONS OF NOTE, CONT.

(Continued from page 1)

dent breached his fiduciary obligations with respect to a trust created at the death of his wife by transferring all of the trust assets into his own name. He then pledged the distributed trust assets as security for margin loans, withdrew over \$450,000 in cash, and collected \$280,000 from a promissory note held by his late wife's estate. Despite this misappropriation of funds, no one appeared at a "debt and demands" hearing to oppose the distribution of assets pursuant to his will.

The decedent's estate paid \$2.727 million in estate taxes, and made a claim for refund, which was denied by the IRS. The court ruled that since no claim was made against the estate and none was "reasonably expected," the estate was not entitled to a deduction under §2053(a)(3) as a claim against the estate, or under §2053(a)(4) as a debt of the decedent.

*Note: The Estate chose to pay the tax and then file a claim for refund in the Virginia District Court, rather than proceed to Tax Court, where the deficiency may be litigated before any obligation to pay arises. This strategy, as will be seen below, has been successful in a number of cases.*

A divided Tax Court, in *Pierre v. Com'r.*, 133 T.C. No. 2 (2009) held that a single member LLC, though ignored for income tax purposes, must be respected as a separate entity for gift and estate tax valuation discount purposes. The IRS was unsuccessful arguing that the election under the "check-the-box" regulations to treat the entity as being disregarded for tax purposes should also result in its being disregarded for gift and estate tax valuation discount purposes. *The case illustrates the danger of using single member LLCs — or any disregarded tax entity such as a single-shareholder S corporation — if the objective is to validate estate or gift tax valuation discounts.*

The Ninth Circuit, in *Stone v. U.S.*, 103 AFTR2d 20091379, affirmed a decision of the Tax Court limiting the estate's discount to a collection of valuable artwork to 5%. The IRS was successful in limiting the lack of marketability discount to the costs of a partition action.

## II. IRC § 2036 Inclusion

Section 2036 continued to play a decisive role in many decisions involving valuation discounts.

¶ In *Estate of Hurford*, T.C. Memo 2008-278, the Tax Court disallowed all discounts, and included the undiscounted value of the underlying assets in the decedent's estate. The case had bad facts. Employment agreements with children were never executed, stock certificates, regulations, and organizational minutes of LLCs were unsigned, FLP operation was sloppy, assets of marital trusts were withdrawn to fund FLPs in violation of trust provisions, and the surviving spouse, who had sole check-writing authority over the FLP accounts, transferred money without regard to the interests of the partners and without recording the transactions.

¶ The IRS was also victorious in *Estate of Jorgensen*, T.C. Memo 2009-66. Col. and Ms. Jorgensen funded a Virginia limited partnership with marketable securities. Their children were named as general partners even though they made no contributions to the partnership. The Tax Court held that the transfer to the partnerships was not a *bona fide* sale for adequate and full consideration so as to come within the exception under IRC § 2036(a), since there was no "legitimate and significant nontax reason for creating the family limited partnership."

¶ In *Estate of Miller*, T.C. Memo 2009-66, the decedent created an FLP and gifted interests to her children. The FLP hired a corporation managed by her son to manage investments. At her death the estate claimed a 35% discount for FLP interests held in trust. The Tax Court held that securities transferred in 2002 were not includible in the decedent's gross estate, and approved the discount for lack of marketability. However, later transfers made when the decedent was in declining health were found to be includible in the gross estate since they were not made with a "legitimate and substantial nontax purpose."

¶ In *Estate of Keller*, 104 AFTR 2d 2009-6015 (S.D. Tex.), the decedent, who had been ill, signed various documents organizing LLCs before her death. Some organizing documents contained blanks because of uncertainty about fair market values. The decedent died before accounts were opened and the LLCs were formally funded. Believing that the LLCs had not been properly formed, the estate took no discounts and paid estate taxes of \$147.8 million.

Thereafter, the decedent's son

learned of the decision in *Church v. U.S.* 85 AFTR 2d 2000-804 (W.D. Tex. 2000), which had allowed valuation discounts for an unfinished family partnership. The estate filed a claim for refund, which the IRS denied. Holding for the estate and allowing the discounts, the District Court in Texas found that the decedent intended to fund a valid Texas LLC whose purpose to protect family assets. Since any estate tax savings which accrued were merely incidental, the transfers were found to be for full and adequate consideration.

¶ In *Estate of Malkin*, T.C. Memo 2009-212, the decedent created an FLP and assigned to it stock of a company in which he was the CEO. The FLP interests were then sold to trusts for a self-cancelling installment note. The assets were later pledged to secure a bank debt. The Tax Court held that since the stock was used to secure a personal debt, the decedent retained the right to beneficial enjoyment of the stock, resulting in inclusion in his gross estate under IRC 2036(a).

¶ In *Estate of Murphy*, 2009 WL 3366099 (W.D. Ark.), transfers were made to limited partnerships, and discounts were taken for lack of control and lack of marketability. The District Court held that the value of the partnership interests retained by the decedent should reflect a 41% discount for lack of control and lack of marketability. The court rejected the IRS argument that the transfer was without consideration, noting that a *bona fide* sale occurs where a transfer is made in good faith with "some potential benefit other than the potential estate tax advantages that might result from holding assets in partnership form."

## III. Annual Exclusion Gifts

In *Barnett v. U.S.*, 104 AFTR 2d 2009-5143 (W.D. Pa.), the decedent executed a durable power of attorney in favor of his son, who then made 17 annual exclusion gifts. Twelve of the checks were given before the decedent's death, but were cashed after his death. The power of attorney did not contain an express authorization to make gifts. The District Court agreed with the IRS that all of the checks written by the son were includible in the decedent's estate since the son lacked authority to make gifts.

[Note: Under NY General Obligations Law §5-1501, which became (Please turn to page 6)]

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effective on 9/1/09, a power of appointment may contain a "Statutory Major Gifts Rider." This rider, which must be executed simultaneously with the power of attorney itself, authorizes the agent to make gifts. The individual executing the power may (but need not) also authorize the agent to make gifts to the agent himself.]

#### IV. Estate Tax Deductions

In *Estate of Williams*, T.C. Memo 2009-5, the decedent left interests in a Coca Cola bottling plant to four charities and to the children of her father's business partner. Litigation between the charities and the estate resulted in the each charities receiving an additional \$6 million. The IRS initially issued a deficiency, arguing that the estate had undervalued the stock. After the IRS abandoned this argument, the estate sought a refund based on the additional \$24 million in charitable distributions. The IRS denied the refund, reasoning that any increase in the charitable deduction was offset by an increase in the value of the gross estate. The estate argued, and the Tax Court agreed, that the shares were not part of the decedent's estate since the stock had been constructively sold years earlier.

In *Estate of Miller*, T.C. Memo 2009-119, a QTIP trust had been created for the benefit of the surviving spouse. However, no income was ever distributed to the surviving spouse, and the trust reported income on its own fiduciary income tax return. Upon the death of the surviving spouse, her estate argued that trust assets should not be included in her gross estate since she had never received income from it. [IRC §2044(a) includes in a decedent's gross estate the value of any property in which the decedent had a qualifying income interest for life.] The Tax Court held for the IRS, stating that §2044(a) applies to any property for which a deduction was allowed under §2056(b) (7).

In *Estate of Charania*, 133 T.C. No. 7 (2009), the decedent resided in Belgium at the time of his death. At that time, he owned 250,000 shares of Citigroup, Inc., which would be considered U.S. property for estate tax purposes. The decedent and his wife were both born in Uganda and were citizens of the United Kingdom. The estate claimed that only one-half of the stock was includible in the decedent's gross estate,

because the shares were community property under Belgian law.

In a case of first impression, the Tax Court, applying English law and English conflicts-of-law rules, held that the stock was not community property, since (i) under the principle of "immutability," property acquired after a change in domicile is subject to the regime established before the change in domicile; and (ii) although Belgian law contains a provision that would have allowed the decedent and his spouse to change the marital property regime, the couple did not avail themselves of that election.

#### V. Waiver of Penalties

In *Estate of Lee*, T.C. Memo 2009-84, relying on an attorney's professional advice, the estate claimed a marital deduction for a spouse who had actually died 46 days before the decedent. The rationale for taking the marital deduction stemmed from the naïve belief that a provision in the *predeceasing spouse's will* which provided that anyone who did not survive the testator by six months would be deemed to have predeceased the testator, justified the federal estate tax deduction.

Although the predeceasing spouse provision would be valid as against other takers under the will, the Tax Court articulated that that a will cannot presume survivorship sufficient to satisfy the marital deduction requirements (except where it is not possible to determine factually which spouse survived). Nevertheless, court chose to abate the accuracy-related penalties, stating that reliance on a tax professional may be justified if, under all the facts and circumstances, the reliance is reasonable and the taxpayer acted in good faith.

However, the *Estate of Fuertes* was not so fortunate with respect to the waiver of penalties. 2009 WL 3028823 (N.D. Tex. 2009). Twenty-seven days after the due date of the estate tax return, the attorney applied for an extension and made a tax payment of \$2.2 million. The IRS denied the extension and imposed late filing and late payment penalties totaling \$554,958.28. The court granted the IRS motion for summary judgment, noting that the taxpayer must show that the failure did not result from willful neglect. Reasonable cause does not exist where the taxpayer relies on a tax attorney to timely file a return, since that does not constitute reliance on the legal advice of a professional.

#### VI. Executor Liability

In *U.S. v. Guyton, Jr.*, 103 AFTR 2d 2009-2112, the District Court held the executor liable for unpaid taxes relating to gain from the sale of a chicken farm which was reported on the decedent's final income tax return. Although the taxes for which the executor was held liable related to an interest which passed outside of the probate estate, the court reasoned that state law provided an adequate remedy between the executor and his brother, who had entered into a written agreement concerning the payment of taxes. Moreover, since the IRS was not a party to that agreement, it could not be bound by its terms.

#### VII. Formula Disclaimers

The Eighth Circuit, in *Estate of Christiansen*, approved the use of formula disclaimers. \_\_\_F.3d\_\_\_, No. 08-3844, (11/13/09); 2009 WL 3789908, *aff'g* 130 T.C. 1 (2008). Helen Christiansen left her entire estate to her daughter, Christine, with a gift over to a charity to the extent Christine disclaimed her legacy. By reason of the difficulty in valuing limited partnership interests, Christine disclaimed that portion of the estate that exceeded \$6.35 million, as finally determined for estate tax purposes.

Following IRS examination, the estate agreed to a higher value for the partnership interests. However, by reason of the disclaimer, this adjustment simply resulted in more property passing to the charity, with no increase in estate tax liability. The IRS objected to the formula disclaimer on public policy grounds, stating that fractional disclaimers provide a disincentive to audit. The Eighth Circuit, in upholding the validity of the disclaimer, lectured the IRS, remarking that "we note that the Commissioner's role is not merely to maximize tax receipts and conduct litigation based on a calculus as to which cases will result in the greatest collection. Rather, the Commissioner's role is to enforce the tax laws."

Although "savings clauses" had since *Com'r. v. Procter*, 142 F.2d 824 (4th Cir.), *cert. denied*, 323 U.S. 756 (1944), *rev'g and rem'g* 2 TCM [CCH] 429 (1943) been held in extreme judicial disfavor on public policy grounds, carefully drawn defined value formula clauses have seen a remarkable rehabilitation. So much so that the Tax Court in *Christiansen* concluded that it "did not find it necessary to consider *Procter*, since the formula in question involved only the parties' current estimates of value, and not values finally determined for gift or estate tax purposes."



**2009 REGS. AND RULINGS, CONT.***(Continued from page 1)*

if the executor provides a "reasonable explanation" of why the burden of collection would outweigh the anticipated benefits of collection. Another exception provides that a claim or expense may be deducted by the estate if the amount to be paid is ascertainable with "reasonable certainty." No deduction may be claimed for claims that are contested or contingent.

¶ Although the IRS has been successful in challenging gift and estate valuation discounts with arguments premised on §2036, §2704(b) has rarely aided the IRS in litigation in the twenty years since its enactment. Treasury's 2010 budget proposal includes a provision that would expand the scope of §2704(b). Section 2704(b) ignores in valuing an interest in a closely held entity any "applicable restriction" on liquidation that would lapse or could be removed after the transfer. Restrictions in governing agreements, if not ignored, increase estate and gift tax discounts. Under the proposal, a new category of "disregarded restrictions" would be ignored under §2704(b). Disregarded restrictions would include limitations on the owner's right to liquidate the interest if the limitations are more restrictive than a standard identified in the regulations, even if they are no more restrictive than those imposed by state law. (Most states have enacted "friendly" statutes to take advantage of the "no more restrictive than state law" language in §2704(b), which has made it possible for estate planners to avoid the application of the statute.)

¶ Treasury's 2010 budget proposal includes a requirement that all GRATs have a term of not less than 10 years. This limitation would be intended to ensure that the transaction has at least some downside risk. The 10 year requirement would make it unlikely that many taxpayers over 75 years old would utilize a GRAT. Instead, those individuals would likely use sales to grantor trusts to shift appreciation in transferred assets to donees. Note that the proposal would not affect the use of "zeroed-out" GRATs, where the initial taxable gift is negligible.

¶ Treasury has also proposed that taxpayers who receive property by gift or by bequest from a decedent must use the gift or estate tax value for future income tax purposes, even if they disagree with that value. Thus, a taxpayer who receives property from a decedent would be required to use as his basis that reported for estate tax purposes. Similarly, a taxpayer receiving property by gift would be required to use the donor's basis as reported for gift tax purposes.

¶ Treasury announced new actuarial tables to reflect increased longevity. The new tables increase the value of lifetime interests and decrease the value of remainders or reversionary interests. T.D. 9448.

**II. Private Letter Rulings**

¶ In PLR 200944002, the grantor created a self-settled spendthrift trust for the benefit of himself, his spouse and his descendants. The trust provided that the trustees could not be related or subordinate to the grantor or his spouse, and that the grantor had no right to remove the trustees. Under state law, a trust instrument containing such restrictions prevents a creditor existing when the trust is created, or subsequent creditor, from satisfying a claim out of the beneficiary's interest in the trust, unless (1) the trust is revocable by the grantor without the consent of an adverse party; (2) the grantor intends to defraud a creditor; (3) the grantor is in default of a child support obligation; or (4) the trust requires that all or part of the trust's income or principal, or both, must be distributed to the grantor.

*The IRS concluded that the transfers to the trust were completed gifts for gift tax purposes since the grantor had no power to re-vest beneficial title. Furthermore, the trust assets would not be includable in the grantor's gross estate since the grantor's retained power to substitute assets did not constitute a reserved power to alter beneficial enjoyment by reason of the trustee's fiduciary obligations.*

¶ In PLR 200919003, the decedent's revocable trust created a marital trust intended to be a QTIP trust. However, the language creating the power made it both lifetime and testamentary. Noting that state law permitted reformation of a trust to correct a "scrivener's error" which had occurred, the IRS stated that the reformation would be accepted for estate tax marital deduction purposes.

**III. Chief Counsel Advisories & Notices**

¶ In CCA 200923024, the Office of Chief Counsel analyzed a case where taxpayer transferred S corporation stock to a partnership, and then formed an irrevocable nongrantor trust. An IRC § 754 election was made, stepping up the inside basis of S corporation assets. After this election, nongrantor trust status was terminated, and the trusts were converted into grantor trusts under IRC § 674. The CCA concluded that although the transactions were "abusive," they were not taxable since the conversion of a nongrantor trust to a grantor trust is not deemed to be a transfer for income tax purposes. The CCA has positive implications for asset sales to grantor trusts, where a "switch" in the trust instrument can be inserted to turn grantor trust status on and off.

¶ In Interim Guidance Memorandum 04-0509-009 (May 8, 2009), the IRS directed its estate tax attorneys to consider imposing preparer penalties under IRC §6694. The guidance states that during every examination, estate tax attorneys should determine if preparer penalties are appropriate, based on oral testimony and/or written evidence adduced during the examination process.

¶ CCA 200937028 confirmed that assets sold to an intentionally defective grantor

trust receive no basis step up at the Grantor's death. The IRS quoted Regs. §1014-1(a), and concluded that "it would seem that the general rule is that property transferred prior to death, even to a grantor trust, would not be subject to section 1014, unless the property is included in the gross estate for federal estate tax purposes as per section 1014."

¶ Notice 2008-13 provided guidance concerning the imposition of return preparer penalties. Notice 2009-5 provides that tax return preparers may apply the substantial authority standard in the 2008 Tax Act, or may continue to rely on Notice 2008-13, which provides interim guidance.

**IV. New York Developments**

¶ New York imposes estate tax on a *pro rata* basis to nonresident decedents with property subject to New York estate tax. NYS-DTF Memorandum TSB-M-92 provides that "New York has long maintained a tax policy that encourages nonresidents to keep their money, securities and other intangible property in New York State." TSB-A-85(1) further provides that shares of stock of a New York corporation held by a nonresident are not subject to New York estate tax since shares of stock are considered intangible personal property.

Still, TSB-A-08(1)M, provides that an interest of a nonresident in an S Corporation which owns a condominium in New York is an intangible asset *provided* the S Corporation has a legitimate business purpose. Presumably, if the S Corporation had only a single shareholder, and its only purpose was to hold real estate, New York could attempt to "pierce the veil" of the S Corporation and subject the condominium to New York estate tax in the estate of the nonresident.

¶ Assume a valid QTIP election is made on a New York estate tax return, but the surviving spouse is no longer a resident of New York at her death and the trust has no nexus to New York. Will New York seek to "recoup" the estate tax deduction claimed on the first spouse to die in a manner similar to the way in which California's "clawback" tax recoups deferred tax in a like-kind exchange if out-of-state replacement property is later sold? Apparently not, provided the surviving spouse is a *bona fide* nonresident of New York at her death.

Would the state in which the surviving spouse dies have a right to tax the assets in the QTIP trust? Also, probably not. Generally, a QTIP trust is not includable under IRC §2036 in the estate of the surviving spouse if no QTIP election is made. Although a QTIP election was made in New York, no QTIP election was made in the state in which the surviving spouse dies. Therefore, that state would seem to have no basis to impose estate tax on the assets in the QTIP trust.

[Note, however, that if the state in which the surviving spouse dies imposes an inheritance tax (such as that imposed by Pennsylvania) then this tax would not be avoided, since an inheritance tax is imposed on the transferee, rather than on the estate.]

## IRC § 1031 CASES &amp; RULINGS, CONT.

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ship is treated as the acquisition of a *pro rata* share of the underlying property, rather than the acquisition of a partnership interest.

## II. “Qualified Use” Requirement Relaxed Where Trust Funds LLC Which Engages in Swap

In PLR 200812012, under the terms of decedent’s will, Trust A was established to administer estate assets. The trust owned real property in various states which were held for investment. Pursuant to a termination plan formulated by the trustees, Trust A assets were contributed to an LLC. The issue raised was whether the LLC could thereafter engage in a like kind exchange. The IRS ruled favorably, noting that Trust A terminated involuntarily by its own terms after many years in existence. The ruling also noted that there was no change in beneficial ownership of the LLC, or the manner in which it holds or manages the replacement property. The ruling distinguished Rev. Rul. 77-337, which involved “voluntary transfers of properties pursuant to prearranged plans.”

## III. QI Status Not Affected By Conversion of S Corps to C Corps

In PLR 200908005, the IRS ruled that the conversion of three subchapter S corporations, which engaged in the business of acting as qualified intermediaries for like kind exchanges, to C corporations, would not be considered a change in the qualified intermediaries, despite the formation of three new taxpayer entities. The IRS reasoned that although the C corporation would no longer be a disregarded entity under federal tax law, the three entities would be the same for state law purposes, and there would be no change in the manner in which the corporations conducted business. This ruling leaves open the question of how the IRS would view the acquisitions of a bankrupt or insolvent qualified intermediary by another entity.

## IV. Acquisition of All Interests in Partnership Results in Good Like Kind Exchange

In PLR 200807005, taxpayer, a limited partnership, intended to form a wholly-owned LLC which would be a disregarded entity for federal tax purposes. It would then acquire 100 percent of the interests of the partners in a partnership in a like kind exchange. After the exchange, the LLC would be a general partner and the taxpayer a limited partner in the partnership.

The ruling raised two issues: First, does the exchange qualify for non-recognition under IRC § 1031? The ruling answered this in the affirmative. Pursuant to Rev. Rul. 99-6, the partnership is considered to have terminated under IRC §708(b)(1)(A), and made a liquidating distribution of its real property assets to its partners, and taxpayer is treated as having acquired those interests from the partners, rather than from the partnership, for federal tax purposes. Accordingly, the transaction is a like kind exchange, rather than an exchange of partnership interests.

The second issue raised was whether the taxpayer may hold the replacement property in a newly-created state law partnership that is disregarded for federal income tax purposes. Since the LLC is disregarded for tax purposes, and the taxpayer, who owns 100 percent of the partnership following the exchange, is considered as owning all of the real estate owned by the partnership, the ruling concluded that the taxpayer may hold the replacement property in a newly-created state law partnership that is disregarded for federal income tax purposes without violating the requirement of IRC § 1031 that replacement and relinquished property both must be held by the [same] taxpayer.

## V. Development Rights Are Real Property For Purposes of IRC § 1031

PLR 200901020 ruled that development rights qualified as real property for purposes of Section 1031. In the facts of the ruling, property owner contracted to sell (relinquish) certain parcels

of property. The contract contained a put option, which entitled the seller to transfer some or all of its residential development rights under a phased development plan. If the option was exercised, the buyer was required to sell certain hotel development rights back to the seller. After determining that the development rights constituted real property under state law, the PLR then stated that the development rights would qualify as like kind property if the rights were in perpetuity, and were directly related to the taxpayer’s use and enjoyment of the underlying property. The ruling concluded that the taxpayer had met these criteria.

## VI. Leasehold Interests Are of “Like Kind” to other Leasehold Interests; Basis of Property in Multiple Property Exchanges

In PLR 200842019, the taxpayer exchanged an existing leasehold interest for a new lease. The ruling stated that a leasehold interest with permanent improvements is of like-kind to another leasehold interest with permanent improvements. Variations in value or desirability relate only to the “grade or quality” of the properties and not to their “kind or class.” Depreciable tangible personal property is of like kind to other depreciable tangible personal property in the same General Asset Class. In this case, all of the depreciable personal property to be exchanged, *i.e.*, office furniture, fixtures and equipment, is in the same General Asset Class.

Treas. Regs. § 1.1031(k)-1(e)(1) provides that the transfer of relinquished property will not fail to qualify for non-recognition under § 1031 merely because replacement property is not in existence or is being produced at the time the property is identified as replacement property. Treas. Regs. §1.1031(j)-1(c) sets forth the exclusive method of basis computation for properties received in multiple property exchanges. In such exchanges, the aggregate basis of properties received in each of the exchange groups is the aggregate adjusted basis of the properties transferred by the taxpayer within that exchange group, increased by the amount of gain recog-

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## IRC § 1031 CASES &amp; RULINGS, CONT.

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nized by the taxpayer with respect to that exchange group, with other adjustments. The resulting aggregate basis of each exchange group is allocated proportionately to each property received in the exchange group in accordance with its fair market value. Therefore, the basis of property received by the taxpayer will be determined on a property-by-property basis beginning by first ascertaining the basis of each property transferred in the exchange and adjusting the basis of each property in the manner provided in Treas. Regs. § 1.1031(j)-1(c). Even if no cash is received in an exchange involving multiple properties, it is possible that boot will be produced, because property acquired within an exchange group may be of less value than property relinquished within that exchange group.

#### VII. Properties Can Be of "Like Kind" Without Being of "Like Class"

In PLR 200912004, taxpayer operated a leasing business, in which the taxpayer purchases and sells vehicles as the leases terminate. The taxpayer implemented a like kind exchange program pursuant to which the taxpayer exchanges vehicles through a qualified intermediary under a master exchange agreement. The taxpayer proposes to combine into single exchange groups all of its cars, light-duty trucks and vehicles that share characteristics of both cars and light duty trucks, arguing that all such vehicles are of like kind under Section 1031.

Ruling favorably, the IRS noted that although the taxpayer's cars and light duty trucks are not of like class, Treas. Regs. § 1.1031(a)-2(a) provides that an exchange of properties that are not of like class may qualify for non-recognition under Section 1031 if they are of like kind. Moreover, Treas. Regs. § 1.1031(a)(2)(a) provides that "in determining whether exchange properties are [of] a like kind no inference is to be drawn from the fact that the properties are not of a like class." Thus, properties can be in different asset classes and still be of like kind.

#### VIII. IRS Finds Trademarks Qualify as Like Kind Property

The IRS recently reversed its long held position that intangibles such as

trademarks, trade names, mastheads, and customer based intangibles could not qualify as like kind property under Section 1031. Chief Counsel Advisory (CCA) 20091106 stated that these intangibles may qualify as like kind property provided they can be separately valued apart from a business's goodwill, and that except in "rare or unusual circumstances" they should be valued apart from goodwill. Even so, the "nature and character" requirements of Treas. Regs. § 1.1031(a)(2)(c)(1) must still be met. Thus, not all trademarks, trade names and mastheads are of like kind to other trademarks, trade names and mastheads.

*CCA 20091106 opens up new planning opportunities for business owners seeking to swap similar businesses. Business owners may now defer gain not only with like-kind or like-class tangible assets, but also with like-kind non-goodwill intangibles disposed of in an exchange. Utilizing a "reverse exchange," taxpayers may "park" non-goodwill intangibles with an EAT, and use the parked property as part of a like-kind exchange within 180 days.*

#### IX. Ninth Circuit Affirms in Teruya

The Ninth Circuit upheld the Tax Court's decision in *Teruya*. No. 05-73779 (9/8/09). The Court of Appeals found that *Teruya* had "decreased their investment in real property by approximately \$13.4 million, and increased their cash position by the same amount." Therefore, *Teruya* had effectively "cashed out" of its investment. Noting that *Teruya* could have achieved the same property disposition through "far simpler means," the court concluded that the transactions "took their peculiar structure for no purpose except to avoid § 1031(f). The presence of the QI, which ensured that *Teruya* was "technically exchanging properties with the qualified intermediary . . . served no purpose besides rendering simple – but tax disadvantageous – transactions more complex in order to avoid § 1031(f)'s restrictions." The exception in § 1031(f)(2)(C) was inapplicable since "the improper avoidance of federal income tax was one of the principal purposes."

#### X. Ocumulgee Fields Further Restricts Exchanges Between Related Parties

In *Ocumulgee Fields v. Com'r.*, T.C. No. 6 (2009), the taxpayer transferred

appreciated property to a qualified intermediary under an exchange agreement, whereupon the QI sold the same property to an unrelated party and used the sale proceeds to purchase like kind property from a related person that was transferred back to the taxpayer to complete the exchange. The IRS assessed a deficiency, arguing that the exchange was part of a series of transactions designed to avoid IRC § 1031(f) and that the taxpayer had not established the "lack of tax avoidance" exception under § 1031(f)(2)(C). Citing *Teruya Bros., Ltd.*, the Tax Court agreed with the IRS, noting that the immediate tax consequence of the exchange would have been (i) to reduce taxable gain by \$1.8 million, and (ii) to substitute a 15% tax rate for a 34% tax rate.

*After Ocumulgee, and the Ninth Circuit decision in Teruya, it may be difficult to find a more likely than not basis to proceed with an exchange involving a related party in instances where the related party already owned the replacement property. The Tax Court came perilously close to holding that basis shifting virtually precludes, as a matter of law, the absence of a principal purpose of tax avoidance.*

#### XI. Related Party Rules Not Violated Where Equalizing Transfers of TIC Interests Made By Trust Beneficiaries

In PLR 20091027, the taxpayer, the taxpayer's sibling, and a trust were tenants in common of real property. The trustees of the trust wished to sell their interest in the real property. To increase the marketability of the interests sold, the three owners each agreed to exchange their undivided 1/3 interest in the property for 100 percent fee simple interests in the same property. The proposed division would split the property into three parcels of equal value.

The taxpayer sought a ruling regarding the applicability of IRC § 1031(f) to the proposed exchange. The ruling held that while the taxpayer and the taxpayer's sibling were related, neither intended to sell their property within two years. Furthermore, the taxpayer was not related to the trust within the meaning of IRC § 1031(f)(3); (*i.e.*, the trust did not bear a relationship to the taxpayer described in IRC § 267(b) or § 707(b)(1)). Accordingly, the

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ruling concluded that with respect to the taxpayer and the trust, there was no exchange between related persons for purposes of IRC §1031(f).

**XI. IRS Counsel Opines that Same Property May be Relinquished for Reverse Exchange and for Forward Deferred Exchange**

In CCA 200836024 the taxpayer, pursuant to Rev. Proc. 2000-37, first structured an “exchange last” reverse exchange. In the reverse exchange, Greenacre was acquired by the EAT as replacement property, and parked until the taxpayer identified property to be relinquished. Thirty-three days after Greenacre was acquired by the EAT, the taxpayer identified three properties to potentially serve as relinquished property for Greenacre. Redacre was one of those properties. On the 180<sup>th</sup> day following the EAT’s acquisition of Greenacre, Redacre was relinquished in the reverse exchange, and that exchange was unwound. However, since the value of Redacre far exceeded the value of Greenacre, the taxpayer structured a *second* like kind exchange to defer the gain that remained after the exchange of Redacre for Greenacre. Accordingly, 42 days after the sale of Redacre to cash buyer, the taxpayer identified three additional properties intended to be replacement properties for the relinquishment of Redacre in a deferred exchange.

The issue was whether the taxpayer could utilize Redacre both as the relinquished property in a reverse exchange, and also as the relinquished property in a deferred exchange. The answer was yes. Reasoning that the taxpayer had complied with identification requirements for both a reverse and a deferred exchange, the advisory concluded that the taxpayer could properly engage in both a reverse exchange and a deferred exchange with respect to the same relinquished property.

The CCA further noted that Rev. Proc. 2000-37 anticipated the use of a qualified intermediary in a reverse exchange. The advice also cited *Starker v. U.S.*, 602 F.2d 1341 (9<sup>th</sup> Cir. 1979) (transfers need not occur simultaneously); *Coastal Terminals, Inc., v. U.S.*, 320 F.2d 333 (4<sup>th</sup> Cir. 1963) (tax consequences depend on what the parties intended and accomplished rather than the separate steps); and *Alderson v. Com’r.*, 317 F.2d 790 (9<sup>th</sup>

Cir. 1963) (parties can amend a previously executed sales agreement to provide for an exchange), for the proposition that courts have long permitted taxpayers “significant latitude” in structuring like-kind exchanges.

**XII. IRS Declines to Regulate Qualified Intermediaries**

Consolidation of qualified intermediaries has raised concerns regarding transfers of QI accounts during exchanges. There continues to be concern with respect to QI insolvencies as a result of several well-publicized failures, e.g., LandAmerica, November 2008. The Federation of Exchange Accommodators (FEA) has asked the Federal Trade Commission (FTC) and the IRS to regulate qualified intermediaries. Both have declined. Nevada and California do regulate qualified intermediaries. Under California law, the QI is required to use a qualified escrow or trust, or maintain a fidelity bond or post securities, cash or a letter of credit in the amount of \$1 million. The QI must also have an errors and omissions insurance policy. Exchange facilitators must meet the prudent investor standard, and cannot commingle exchange funds. A violation of the California law creates a civil cause of action.

**Build-to-Suit Rules Relaxed in PLR**

In PLR 200901004, the IRS ruled favorable with respect to an exchange where taxpayer, engaged in the business of processing minerals in Old Facility, assigned easements to its wholly-owned LLC, which would then construct New Facility also for the purpose of processing minerals. The LLC would acquire funds for project financing through a syndicate of third party lenders, and the financing would be secured by the New Facility. Lenders would have the right to foreclose on the New Facility, including the rights of the LLC under the assigned easements. The ruling cautioned that the proposed exchange between the LLC and the taxpayer, though qualifying under Section 1031, constituted an exchange of multiple properties, both tangible and intangible, pursuant to Treas. Regs. § 1.1031(j)-1. This necessitated a property-by-property comparison to determine the extent of any boot present in the exchange.

**XIII. Ruling Provides Flexibility in Two-Party TIC Exchanges**

In three recent rulings, PLRs 200826005, 200829012 and 200829013, the IRS ruled that two 50% undivided fractional interests in real property did not constitute an interest in a business entity for purposes of qualification as eligible replacement property in a §1031 exchange. The rulings provide flexibility to two-party 50% tenancy-in-common ownership structures with regard to qualification as eligible replacement property. In approving a two-party 50% undivided interest structure for purposes of qualifying §1031 exchanges, the ruling modified several conditions specified in Rev. Proc. 2002-22:

¶ The Agreements between the two co-owners required the co-owners to invoke the buy-sell procedure prior to exercising their right to partition the property. Since Rev. Proc. 2002-22 provides that each co-owner must have the right to partition, the PLRs construed this requirement with great latitude. Although Rev. Proc. 2002-22 provides that each co-owner may encumber their property without the approval of any person, the Agreement in question allowed each co-owner the right to approve encumbrances. The IRS reasoned that since there are only two 50% owners, the restriction on the right of a co-owner to engage in activities that could significantly diminish the value of the other 50% interest without the approval of the other co-owner was consistent with the requirement that each co-owner have the right to approve an arrangement that would create a lien on the property.

¶ The PLRs modified a requirement within Rev. Proc. 2002-22 regarding proportionate payment of debt. While Rev. Proc. 2002-22 provides that each co-owner must share in any indebtedness secured by a blanket lien in proportion to their own indebtedness, the PLR approved an arrangement whereby an owner who paid more than 50% would have the right to be indemnified by the other co-owner. The Agreement provides a mechanism whereby the co-owners could pay an amount that deviates from their proportionate share of debt.

¶ While Rev. Proc. 2002-22 limits co-owners’ activities to those customarily performed in connection with the maintenance and repair of rental real property, the PLRs approved a provision allowing co-owners to lease the property to an affiliated entity. In each PLR, the properties were leased to an affiliate of one of the co-owners who conducts a business unrelated to the management and leasing of the property.

## ASSET PROTECTION TRUSTS, CONT.

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in estate planning, they are less likely to be vulnerable to a claim that they were formed with an intent to hinder, delay or defraud creditors. Less commonly, trusts are called upon to achieve *purely* asset protection objectives. Their effectiveness in this role appears to militate in favor of their greater use.

Asset protection features of an asset protection trust ("APT") may arise by virtue of a *discretionary distribution* provision in the trust. The trust may provide that the Trustees "in their *sole and absolute discretion* may pay or apply the whole, any portion, or none of the net income for the benefit of the beneficiaries." Alternatively, the Trustees' discretion may be *limited by a broadly defined standard, i.e., "so much of the net income as the Trustees deem advisable to provide for the support, maintenance and health of the beneficiary."*

The effect of a discretionary distribution provision on the rights of a creditor are profound. If the trust provides that (i) the beneficiary cannot compel the trustee to make distributions, and assuming that (ii) the rights of a creditor can be no greater than those of the beneficiary, it follows that (iii) a creditor cannot compel the trustee to make distributions. Therefore, properly limiting the beneficiary's right to income from the trust may well determine the extent to which trusts assets are protected from the claims of creditors.

Failure to properly limit the beneficiary's right to income from an APT can have deleterious tax consequences if the creditor is the IRS. TAM 0017665 stated that where the taxpayer had a right to so much of the net income of the trust as the trustee determined was necessary for the taxpayer's health, maintenance, support and education, the taxpayer had an identifiable property interest in the trust which was subject to a federal tax lien. Since the discretion of the trustee was broadly defined, and subject to an "ascertainable standard" rather than being absolute, the asset protection feature of the trust was diminished.

If asset protection is a major objective, it would be inadvisable to draft a trust in which the trustee's obligation to distribute income is subject to an ascertainable standard, rather than within the trustee's absolute discretion. However, that is not enough: Even if the trustee's discretion is absolute, a court may review the trustee's discretion. Fortunately, courts have generally been disinclined to substitute their judgment for that of the trustee, even where the trustee's discretion is absolute. The Uniform Trust Code is in accord, providing that a creditor of a beneficiary may not compel a distribution even where the trustee has abused his

discretion.

A beneficiary should not be named *sole trustee* of his own discretionary APT, since the interest of a beneficiary who has discretion to determine his own distributions may be attached by a creditor. On the other hand, if the sole trustee — even a beneficiary — has *no discretion* with respect to distributions made to himself, his in the trust would not likely be subject to attachment by a creditor. However, amounts *actually distributed* could be reached by a creditor.

## II. Spendthrift Trusts

Even if the trustee's discretion is absolute, the APT should also contain a valid *spendthrift clause*, since it is not enough for asset protection purposes that a creditor be unable to compel a distribution. *The creditor must also be unable to attach the beneficiary's interest in the trust.* A spendthrift provision prevents the beneficiary from voluntarily or involuntarily alienating his interest in the trust. The Supreme Court, in *Nichols v. Eaton*, 91 U.S. 716 (1875), recognized the validity of a spendthrift trust, holding that an individual should be able to transfer property subject to certain limiting conditions.

A spendthrift trust will thus protect a beneficiary from (i) his own profligacy or bankruptcy; (ii) his torts; and (iii) many of his creditors, (including his spouse). No specific language is necessary to create a spendthrift trust, and a spendthrift limitation may even be inferred from the intent of the settlor. Still, it is preferable as well as customary to include spendthrift language in a trust. A spendthrift provision may also provide that required trust distributions become discretionary upon the occurrence of an event or contingency specified in the trust. Thus, a trust providing for regular distributions to beneficiaries might also provide that such distributions would be suspended in the event a creditor threat appears.

A few exceptions could reduce the effectiveness of a spendthrift trust. As indicated above, if a beneficiary is also the sole trustee of a discretionary spendthrift trust, the trust will be ineffective as against creditors' claims. Other exceptions are in the nature of public policy exceptions. Thus, assets in a spendthrift trust may be reached to enforce a claim against the beneficiary for support of a child. Courts might also invalidate a spendthrift trust to satisfy a judgment arising from an intentional tort. Furthermore, a spendthrift trust would likely be ineffective against claims made by the government relating to taxes, since the strong public policy in favor of the government collecting taxes may be deemed to outweigh the public

policy of enforcing spendthrift trusts.

## III. "Self-Settled" Spendthrift Trusts

A "self-settled" trust is one which the beneficiary creates for his own protection. Here, the settler is either one of the beneficiaries or the sole beneficiary of the trust. A self-settled trust may also be spendthrift. Prior to 1997, neither the common law nor the statutory law of any state permitted a self-settled trust to be endowed with spendthrift trust protection.

However, since 1997, five states, including Delaware and Alaska, have enacted legislation which expressly authorizes the use of self-settled spendthrift trusts. A self-settled spendthrift trust, if established in one of these five states, may effectively allow an individual to put assets beyond the reach of creditors while retaining some control over and access to trust assets. These states now compete with jurisdictions such as the Cayman Islands and Bermuda, which for many years have been a haven for those seeking the protection of a self-settled spendthrift trust.

Most states, including New York, continue to abhor self-settled spendthrift trusts. This is true even if another person is named as trustee and even the trust is not created with an intent to defraud existing creditors. New York's strong public policy against self-settled spendthrift trusts is evidenced in EPTL §7-3.1, which provides that "[a] disposition in trust for the use of the creator is void as against the existing or subsequent creditors of the creator." *Still, there appears to be no reason why a New York resident could not transfer assets to the trustee of a self-settled spendthrift trust situated in Delaware or in another state which now permits such trusts.*

Trust arrangements nominally not self-settled spendthrift trusts, but which seek to achieve that status by indirect means, will likely fail in that desired objective. Thus, a "reciprocal" or "crossed" trust arrangement, in which the settlor of one trust is the beneficiary of another, would likely offer little or no asset protection. (In fact, the "reciprocal trust doctrine" has often been invoked by the IRS to defeat attempts by taxpayers to shift assets out of their estates.)

Important estate planning objectives may be furthered by establishing an APT. However, normal estate tax rules must be considered. For example, the estate of a settler who retains the right to receive trust distributions will be required to include trust assets in the estate under IRC § 2036. This problem will not be avoided even if the "right" to receive income is within the discretion of the Trustees, since it is the *retained right* which causes inclusion. However, by utilizing a domestic APT in which the settler retains no right whatsoever to income, inclusion under IRC § 2036 should be avoided.



**2010 TAX OUTLOOK, CONT.**

(Continued from page 2)

federal revenues by more than \$2.1 trillion through 2019.

Although both the House Ways and Means Committee and the Senate Finance Committee are expected to hold hearings this year on tax reform, it appears unlikely that major tax reform legislation will occur in 2010. Charles Rangel (D-NY), Chairman of House Ways and Means, introduced a bill in 2009 which proposed lowering the corporate tax rate to 30.5 percent, but raising additional revenues through base broadening. Mr. Rangel may introduce a similar bill this year which could reduce corporate rates to as low as 28 percent, but with further base broadening make the legislation revenue-neutral.

Congress has also expressed support for a tax on securities transactions. While the Administration opposes such a bill, a securities transaction tax bill (H.R. 4191) introduced by Rep. Peter DeFazio (D-OR) has been estimated by its sponsors to have the potential to raise \$150 billion over 10 years.

Senate Finance Chairman Baucus and Ranking Member Grassley have asked Treasury to examine foreign-source income reporting. Senator Grassley has expressed interest in tax-exempt issues, including hospitals and universities.

### III. International Tax Proposals

To offset the expected loss in individual tax revenues, the President has proposed legislation that would modify international tax rules for companies doing business abroad. This legislation is expected to raise \$149 billion over 10 years. The entity classification rules, which the administration believes results in the avoidance of U.S. tax, would be modified to prevent foreign entities from electing to be taxed as disregarded entities.

The Administration also proposes (i) restricting rules which allow U.S. multinational corporations to claim foreign tax credit (FTCs) and (ii) addressing situations where a U.S. taxpayer claims FTCs paid on income that is not currently earned by that taxpayer under U.S. tax principles.

*The business community is expected to oppose these proposals arguing that they would reduce the ability of U.S. companies to expand into foreign markets and compete against companies subject to more favorable tax rules.*

### IV. Tax Treaties

The U.S. entered into new tax treaties with Italy and France in 2009. Modifications of treaties with Switzerland and Luxembourg, generally updating exchange of information provisions, are nearing completion. Treasury is currently negotiating treaties with Poland, Israel, South Korea, Vietnam, Brazil, Chile and Columbia. Preliminary treaty discussions have been held with Venezuela, Singapore and Spain.

### V. Proposals From Albany

Governor Patterson on January 19, 2010, released his executive budget proposal for New York's 2010-011 fiscal year. Among the important changes:

¶ Payments made to a non-resident would be subject to tax in New York if the payments relate to a business, trade, profession or occupation previously carried on in New York, unless such treatment is prohibited by federal law. For example, payments made pursuant to covenants not to compete or termination agreements would be within ambit of the new law. The proposed change would be effective 1/1/10.

¶ Certain gains from the sale of S corporation stock would be treated as New York source income for non-resident shareholders. In *Matter of Baum*, DTA Nos. 820838 and 820838 (2/20/09), the Tax Appeals Tribunal held that a sale of stock should not be treated as a sale of the corporation's assets for NYS tax purposes even though treated as a sale of assets for federal income tax purposes by reason of an election under IRC § 338(h)(10).

Under Mr. Patterson's proposal, such a transaction would be treated as a sale of the S corporation's assets (instead of a stock sale) and would require allocating the gain between New York and non-New York source income. The proposed change would apply to taxable years with respect to which the statute of limitations for seeking refund or assessing

tax are still open.

¶ Under current NYS law, a resident trust is exempt from tax if (i) all trustees are domiciled outside of New York; (ii) the entire corpus of the property, including real and tangible property, is located outside of New York; and (iii) all income of the trust is sourced outside of New York. A resident trust is any testamentary trust created under the will of a decedent who was domiciled in New York and any irrevocable lifetime trust created by a New York domiciliary.

Under current law, a resident trust with no property in New York and no New York source income can avoid New York tax by appointing only out-of-state trustees. The bill would repeal this exemption, and would add a rule providing that a resident non-testamentary trust with no New York source income would be taxed based on the ratio of New York beneficiaries to the total number of beneficiaries. The change would be effective 1/1/2010.

¶ Under current NYS and NYC law, recording of a mortgage on real property is subject to the mortgage recording tax. However, no tax is imposed where a financing statement is filed to perfect a lender's security interest in a cooperative housing unit. The proposed change would expand the tax base of the mortgage recording tax to include the principal amount of any loan secured by the filing of a financing statement. The rationale for the rule is that the filing of a financing statement for a lender's security interest in a coop is analogous to the recording of a mortgage on real property. The proposed change would take effect on the first day of the third month after the proposed change becomes law and would apply to financing statements filed on or after that effective date.

¶ New York provides for an exemption against New York estate tax equal to the federal estate tax exemption amount (subject to a maximum of \$1 million). By reason of the temporary "repeal" of the federal estate tax in 2010, there is no federal exemption amount for decedents dying in 2010. Therefore, without modification, taxable estates of decedents dying in 2010 subject to the NYS estate tax would be taxed on the full value of the estates without any estate tax exemption. The proposed change would preserve the \$1 million exemption for decedents dying in 2010.