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TAX NEWS & COMMENT

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IRS MATTERS

RECENT DEVELOPMENTS

Over 50 million Americans are now filing tax returns showing no income tax liability. This represents approximately 35 percent of all personal income tax returns filed. A family of four would typically owe no tax until income exceeded $51,000. This phenomenon illustrates the use tax expenditures, rather than governmental expenditures, to further social objectives.

Utilizing the Internal Revenue Code to achieve societal objectives appears defensible on a philosophical as well as practical basis, since Congress and the President ultimately legislate the appropriate tax laws. The more difficult task, like identify-

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FROM THE COURTS

TAX COURT DEFIES IRS: EXPANDS USE OF DEFINED VALUE CLAUSES

The recent loss by the IRS in the Tax Court case *Wandry v. Com'r*, T.C. Memo 2012-88, added to the string of defeats the IRS has suffered in formula clause disputes, and has effectively dealt a final blow to *Proctor v. Com'r*, 142 F.2d 824 (4th Cir. 1944), a seminal case which held that formula clauses attempting to reallocate completed gifts operate as a condition subsequent and are void as against public policy.

Even before *Wandry*, the IRS had been unable to stem the tide, losing cases in situations where defined value clauses were held effective in shifting to charity the overflow of gifts of partnership interests whose

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FROM WASHINGTON

HISTORIC CHANGES IN TAX LAW APPEAR IMMINENT

Tax Analysis

Barring a significant change in voter sentiment in Ohio, and to a lesser extent in Florida and Virginia, President Obama, despite his lackluster performance in the first debate, and despite being burdened with an unusually high rate of unemployment for an incumbent seeking reelection, appears to be a heavy odds-on favorite to capture the 270 electoral votes necessary to win. Nevertheless, should the popular vote contest tighten, the odds could change.

Especially if Obama is reelected, federal tax law will most likely undergo profound change in January

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Income Tax Planning For New York Trusts

Tax Planning

I. Taxation of Resident Trusts

"Resident" New York trusts which are not "grantor" trusts must pay New York State fiduciary income tax on all income and gains at rates which approach 9 percent for New York residents and 13 percent for New York City residents.

[Income earned by grantor trusts is taxed directly to the grantor at the grantor's income tax rate. Most states, including New York, adopt the federal definition of what constitutes a grantor trust. The

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Tax and Non-Tax Issues Involving Irrevocable Trusts

I. Introduction

Prior to the Statute of Wills, enacted by Parliament in 1540, it was impossible for a landowner to devise title in land to heirs. Moreover, under the harsh common law rules of primogeniture, if a landowner died without living relatives, his land would escheat to the Crown.

To illustrate other legal difficulties encountered prior to the Statute of Wills, landowners leaving to fight in the Crusades might convey title in land to another person, expecting that person to reconvey title when

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OCTOBER COMMENT

Gain, Loss, and Depreciation Issues in Like Kind Exchanges

Tax Planning

Note: Excerpted from *Like Kind Exchanges of Real Estate Under IRC. §1031* (David L. Silverman, 3rd Ed.,1/11).View treatise at nytaxattorney.com]

I. Calculating Gain or Loss

Realized gain in a property transaction equals the amount realized less the adjusted basis of transferred property. Similarly, in a like kind exchange, realized gain equals the sum of money and the fair market value of property received less the adjusted basis of property

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as the Bush tax cuts are scheduled to expire on December 31, 2012. Although scheduled to expire, not all of the Bush tax appear fated for extinction: Some will likely survive, regardless of who wins the election. Fewer Bush tax cuts will survive if Mr. Obama wins reelection, and those that do will likely survive in attenuated form. Congress appears likely to remain split, with the House remaining solidly Republican; however, especially given the Akin debacle in Arkansas, the Democrats appear likely to add to their slim majority in the Senate.

Ordinary Income

Mr. Obama supports extending the ordinary income component of the Bush tax cuts for families whose income does not exceed $250,000. (Versus, for example, the dividend and capital gains components of the Bush tax cuts which Mr. Obama has indicated that he would allow to expire.) If the Bush tax cuts expire with respect to ordinary income, tax rates on earned income will increase to levels not seen since 2002.

As of January 1, 2013, ordinary income will be taxed by Washington at a maximum rate of 39.6 percent, with an additional 3.8 Medicare surtax for some taxpayers with passive income. Thus, the top federal income tax rate for ordinary income will jump to 43.4 percent on income earned in the active conduct of a trade or business, or salary income.

New York State residents will be harder hit if the Bush tax cuts expire: New Yorkers are subject to state income tax of up to 8.97 percent, and New York City residents with must pay an additional income tax of up to 3.87 percent. This means that New York residents *not subject* to the Medicare surtax could face a top income tax rate of 48.57 percent on active business or salary income; and those in New York City of up to 52.44 percent.

Income Tax Proposals of Governor Romney

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Mr. Romney supports (i) the permanent extension all of the Bush tax cuts now scheduled to expire in 2013; (ii) the repeal of the 2010 health reform legislation (but is in favor of leaving health care legislation to individual states); (iii) the

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reduction in individual income tax rates by 20 percent, so that the top rate would fall from 35 percent to 28 percent; (iv) the reduction of the corporate tax rate to 25 percent and the passage of legislation making the research and experimentation credit permanent; (v) the permanent repeal of the 3.8 percent Medicare tax imposed by the 2010 health care legislation; (vi) the reduction of dividend and capital gains taxes on families with incomes below $200,000.

Mr. Romney states that revenue losses occasioned by these reductions in taxes would be recouped by reducing or eliminating certain tax entitlements. Mr. Obama has taken issue with Mr. Romney's pledge to cut taxes and reduce the deficit, remarking that "I guess my opponent has a plan, but there's one thing missing from it: arithmetic. They couldn't answer the question of how you have deficits, you add five trillion dollars in new tax cuts, two trillion dollars in new defense spending and somehow you're going to close the deficit without raising taxes on the middle class families."

Mr. Romney also favors repealing the corporate AMT. The Obama administration advanced a proposal earlier in the year that would restrict the application of AMT to taxpayers whose adjusted gross income exceeded $1 million.

Medicare Surtax

To cover the costs of federal health care legislation, as of January 1, 2013, some individuals, trusts and estates will become subject to a "Medicare surtax" of 3.8 percent. The tax will be applied to the lesser of (i) net investment income or (ii) the amount by which "modified" AGI exceeds the "threshold amount." The threshold amount is $200,000 for single filers and $250,000 for joint filers. Net investment income includes, *inter alia*, interest, dividends and net capital gains. Modified AGI does not include (i) active trade or business income; (ii) distributions from IRAs or qualified retirement plans; or (iii) gain excluded from the sale of a personal residence under IRC §121.

Capital Gains

After December 31, the rate of tax imposed on long term capital gains will increase by a third, from its current rate of 15 percent to between 20 and 23.8 percent, depending on whether the taxpayer is subject to the new Medicare surtax on long term capital gains. In perspective, the long term rate at 23.8 percent will remain in the lower to middle end of the historical spectrum. It is not entirely clear where whether Mr. Obama would be content with merely permitting the Bush tax cut on capital gains to expire; he has not indicated otherwise.

Perhaps Mr. Obama will seek counsel from Mr. Clinton on this issue. In 1997, Mr. Clinton signed legislation reducing the capital gains tax rate from 29 percent to 21 percent. Following the passage of that legislation, economic growth rose from an average of 3.1 percent to 4.5 percent per year.

Mr. Clinton warned of the dangers posed by the abrupt termination of the Bush tax cuts in a interview candid with Maria Bartiromo of CNBC in June. Mr. Clinton stated that the country "can't have a balanced budget unless there is growth" and stressed the importance of "find[ing] a way to keep the expansion going . . . Find[ing] some way to avoid the fiscal cliff, to avoid anything that would contract the economy." Mr. Clinton expressed the view that the Bush tax cuts should be extended until at least the beginning of 2013.

Health Care Legislation

Governor Romney argues that the federal health care legislation enacted by President Obama should be repealed. However, this seems unlikely since, as noted by Mr. Obama in the first Presidential debate, repeal would require Congressional approval which, at least now, appears doubtful.

Mr. Romney's stated desire to repeal "Obamacare" also seems a touch disingenuous, since Mr. Romney, when Governor of Massachusetts, introduced legislation mandating that nearly every Massachusetts resident obtain a minimum level of health care insurance coverage and provided free health care insurance for residents earning less than 150 percent of the federal poverty level.

Dividends and Interest

As of January 1, 2013, dividends will lose their favorable 15 percent tax rate, which they now share with long term capital gains, and will again become taxed as ordinary income. Coupled with a new top ordinary income tax rate of 43.4 percent (including the Medicare surtax), the tax imposed on dividends will increase by an astounding 189 percent. New York City residents would pay an additional tax of 3.8 percent on their income.

The tax effect of such an increase could be felt on Wall Street. While high dividend paying stocks have a superior track record to low-dividend paying growth stocks over the long term, their current sheen could lose some lustre. Adversely affected could be high-dividend stocks in the telecom, drug, and tobacco sectors. Conversely, technology, materials and airline sectors could benefit, at least in relative terms.

The astronomical increase in federal income tax could actually cause an exodus from New York of wealthy residents who derive most of their income from passive income sources such as dividends, since their federal and state tax rate would increase from 15 percent to 52.37 percent living outside of New York City, and to 56.24 percent for those living in the five boroughs. (New York also imposes an estate tax on residents of up to 16 percent on large estates. The estate tax exclusion in New York is $1 million.)

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Corporate Taxes

Both President Obama and Governor Romney would reduce the corporate income tax, which at 35 percent, is among the highest in the world. Mr. Obama disapproves of what he characterizes as "loopholes" which permit corporations to significantly reduce tax liability. In return for eliminating these tax provisions, Mr. Obama has advanced the proposition that the corporate tax rate should be reduced from its current rate of 35 percent, which is among the highest, if not the highest, in the world.

Mr. Romney and Mr. Obama's Views on Gift and Estate Taxes

If Congress does not act, significant changes to the gift and estate tax laws will also occur on January 1st, 2013. Most significantly, the unified credit will be decimated: The current $5 million exemption amount will revert to $1 million. Astute wealthy taxpayers who are benevolently inclined may consider making use of the $5 million gift tax exemption during the remainder of 2012.

Although making use of the $5 million exemption in 2012 appears to carry with it little tax risk, there is a chance that if the exemption amount is reduced $3.5 million or less, Congress could seek to "recapture" the tax benefit previously conferred on those making $5 million gifts today. However, it seems more likely that the tax benefit of those perspicacious enough to utilize the $5 million exemption in 2012 will be grandfathered, even if the $5 million amount is reduced in future years.

Perhaps the difference in tax philosophies between Mr. Obama and Mr. Romney is most poignantly illustrated in the two candidates' differing views with respect to the estate tax. While one would presume that Mr. Obama would support a return to the $3.5 million gift and estate tax exemption of 2011 — and not seek a lower threshold, Mr. Romney staunchly advocates eliminating transfer taxes entirely.

Whether Mr. Romney could repeal the estate tax if elected President is another matter, as passage of a bill to repeal would be required by both the House and the Senate. Unless both houses of Congress were controlled by Republicans, it is doubtful that Mr. Romney could accomplish what neither President Reagan or President Bush could in this regard.

Nevertheless, the trend in estate tax, at least at the federal level, has been toward its diminution. The unified credit, now $5 million, can be shared by a married couple, effectively making the exemption amount no less than $10 million for a married couple. At some point, a reduced tax rate and an elevated exemption amount would cause the Treasury to expend such a high proportion of tax revenues in administering the tax as to diminish the practicality of the tax.

In spite of its recent downward trend, the current estate tax rate is scheduled to increase 55 percent in January when EGTRRA (*i.e.,* the Bush tax cuts) sunsets, and the exemption amount will return to $1 million, unless new legislation is passed. There is no indication that if reelected, President Obama would oppose legislation reestablishing the $3.5 million exemption amount, nothing is written in stone. No one expected the estate tax to expire in 2012. Therefore, for the present time at least, gift and estate tax planning appears prudent, if not necessary.

Report on Mr. Obama's First Term

Mr. Clinton argued eloquently at the Democratic National Convention that given the state of the economy when President Obama took office, "no president" could have cured the nation's economic ills. This new found respect by Mr. Clinton for the President's economic policies may be genuine, but it also clearly reflects a healthy dose of partisanship. In truth, it cannot fairly be said that Mr. Obama's tax and economic policies have been more than an extremely modest success. The economy is improving at a glacial rate and even the positive momentum of earlier this year has dissipated.

Conversely, Wall Street has prospered under the Obama administration. Some credit for this should be given to the fiscal stewardship of the Federal Reserve, led by Chairman Bernanke. Credit for low interest rates (and the propping up of securities) should also be given to China, which has made a large bet on the U.S. economy. China now holds $1.2 trillion in promissory notes of the United States.

What Mr. Obama would seek to accomplish in his second term with respect to tax policy is unclear. However, it is quite clear that the President is resolute in his determination to prevent wealthy taxpayers with large amounts of investment income from being taxed at lower effective rates than the majority of taxpayers. Recent increases in the President's approval rating seem to suggest that Americans agree that taxpayers with large amounts of investment income should be taxed at higher marginal tax rates.

If elected to a second term, Mr. Obama will likely seek to further his political philosophy that Americans should all share in national prosperity. At the same time, perhaps Mr. Obama will take a lesson from former Presidents Reagan and Clinton who both, though from entirely different political perspectives, realized that recent experience seems to demonstrate that lower income taxes tend to promote rather than impede economic growth.

Nevertheless, much of the criticism of the President's economic and tax policies is unfair. President Obama did not oppose extending the Bush Tax cuts in 2010. Marginal income tax rates remain much more compressed now than they were even under President Eisenhower. Viewed in a historical perspective, income tax rates are at the lower end of progressivity. Economic growth, though anemic, is at least not spiraling downward as it was when President Bush left office.

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* * *

Upcoming Presidential Election Viewed In Historical Perspective

If Mr. Obama has not succeeded on the domestic front, it seems that his principal fault in this regard has been his inability to work with Congress in achieving a consensus in finding legislative solutions to pressing tax, economic, energy, health and environmental issues. The federal system cannot function properly unless the President and Congress work effectively together. The Senate has been controlled by Democrats during Mr. Obama's entire term, and the House for the first two years of his term.

While part of the blame for the failure of Congress and the President to cooperate rests with the House of Representatives and, to a lesser extent, with the Senate, the President bears a good measure of responsibility. Perhaps that is why Mr. Clinton has been surprisingly candid in his critique of the economic policies of the Obama Administration.

Previous administrations were able to cooperate with Congress and accomplish laudable tax and non-tax goals. The last two budgets of President Reagan were passed by a Democratic Congress. During most of both terms of President George W. Bush, the Senate was split and the House was Democratic. Even President Nixon, whose Presidency was marred by his resignation following serious wrongdoing, made historic advances in foreign policy, civil rights, social welfare, and environmental issues at a time when both houses of Congress were controlled by Democrats.

Americans infrequently deny an incumbent president a second term. President Carter's quest for a second term was dashed by double-digit inflation, recession, the energy crisis, the Iranian hostage crisis, Three Mile Island, and perhaps Americans' displeasure with his pessimism and officiousness. Americans also failed to reelect President George H.W. Bush in 1992 at a time when the unemployment rate was 7.8 percent and the economy had entered into a mild recession.

The case for the reelection for Mr. Obama most parallels that of the elder Mr. Bush. Perhaps Mr. Obama will benefit from facing a Republican candidate who, though actually not as conservative as President Reagan, has been unable to capture the support of as broad a spectrum of the middle electorate as was Mr. Reagan. Perhaps Mr. Romney moved so far to the right to win the Republican nomination that his moderate political philosophy has been obscured. Yet it must be noted that Mr. Romney appeared quite moderate in the first Presidential debate.

Mr. Obama is also not facing a candidate as charismatic as Mr. Clinton, as was the elder President Bush, who made no secret of his preference for foreign policy, and seemed to genuinely disdain involvement in domestic affairs. Americans also seem to like Mr. Obama, even if they are not pleased with his performance. Few doubt his intellect, integrity, or compassion, all important qualities for a President.

Mr. Romney may have made the contest a horse race after his stellar performance at the first debate, as he appeared in command of the issues, and demonstrated a decidedly Presidential mien. Still, one swallow does not a summer make, and Mr. Obama will no doubt improve off his dull performance in the initial debate.

Since assuming the Presidency, Mr. Obama, to his credit, has become more moderate in his views, especially with respect to foreign policy. The gulf between the views of Mr. Romney and Mr. Obama in matters of foreign policy appear less wide than with respect to domestic issues. Mr. Obama seems to recognize, if belatedly, the importance of maintaining strong relations with close allies such as Britain, France, Germany, Israel and Japan. Mr. Romney, on the other hand, has never left any doubt of his firm commitment to the nation's allies, especially Israel.

With respect to matters involving federal taxation, if reelected, President Obama may realize that raising income taxes to stratospheric levels could do more harm than good, and that an attempt to redistribute the nation's wealth through taxation could prove neither practical nor effective. Mr. Obama may realize that this fiscal conclusion, shared even by prominent Democrats such as Mr. Clinton, is worth examining when implementing federal tax policy, and that his failure to impose new federal income taxes would not necessarily conflict with the President's commitment to increasing the wealth of less affluent Americans.

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values had been upwardly revised by the IRS.

Wandry let open floodgates in approving the effective reallocation of assets to the transferor pursuant to a defined value clause in the transfer documents. The end result reached in *Wandry* is virtually indistinguishable from the result which the Fourth Circuit forbade in *Proctor*. The case has been appealed to Tenth Circuit.

[*In Wandry, the taxpayer made gifts of family limited partnership interests to their children. The assignments and memorandums of gift used to effectuate the gifts each stated the gifts in dollar values of membership interests, and provided that in the event that "a final determination of a different value is made by the IRS or a court of law, the number of Units gifted shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above." In other words, the petitioners used a defined valuation clause but without the familiar charitable overflow beneficiary.*

In 2004, the year of the gifts, the partnership capital accounts of the taxpayers' were decreased, and the donees' capital accounts were increased to reflect the gift. Likewise, the taxpayers' gift tax returns for the year reported gifts in accordance with the values stated in the transaction documents, which values were corroborated by a valuation obtained by the taxpayers. In 2006, the IRS asserted a gift tax deficiency, claiming that partnership interests were undervalued.

The IRS argued that (i) the schedules supporting the gift tax returns, which stated the exact percentage interests transferred, constituted admissions by petitioners that they had transferred fixed percentage interests; (ii) the partnership capital accounts were dispositive; and (iii) the adjustment clause created a condition subsequent to a completed transfer, thus violating Proctor's prohibition against transfers that are void as against public policy.

The Tax Court dismissed the first two arguments, stating that it was clear that the taxpayers intended to make gifts of specific values, not set partnership interests, and capital accounts do not control gifts when the gift documents used are unambiguous and gift tax returns are filed. The Tax Court then held that the adjustment clause should be respected, and therefore no additional gifts were made upon the later revaluation of the interests by the IRS.]

Wandry is significant for several reasons: First, it serves as yet another example of the diminishing importance of *Proctor*. Second, it reinforces the distinction between a reversion and a clause that simply defines a gift, clarifying that a clause defining a gift in dollar terms does not operate to take anything back in the event of a revaluation. Third, it provides a roadmap for the use of formula clauses, emphasizing the importance of expressing the gift consistently as a dollar value in all relevant documents. Fourth, and perhaps most importantly, it stated the previously evasive holding that it is "inconsequential that the adjustment clause reallocates membership units among petitioners and the donees rather than a charitable organization."

Prelude to Formula Clauses

When it comes to value, the Internal Revenue Code applies a simple test: Something is worth what someone will pay for it. Treas. Reg. §20.2031-1(b). However, since this test ignores relatedness, transfers among family members have long been "subject to special scrutiny" by the IRS. *Estate of Reynolds,* 55 T.C. 172 (1970). The necessary inference is that a related buyer and seller, or donor and donee, will act collaboratively rather than independently in valuing a transferred asset. Complicating matters further, such transfers routinely involve interests in closely-held entities, such as limited partnerships, which are inherently hard to value. Therefore, a cornerstone of most properly executed gift and sale transactions among related parties is a professionally prepared valuation. The problem, of course, with using a valuation to determine the value of assets gifted or sold is that the IRS may challenge the valuation. If the IRS believes that the value placed on the transferred asset was too low, the Service could assert a gift or estate tax deficiency.

Illustration

To illustrate, assume wealthy taxpayer wishes to fully utilize his $5.12 million lifetime gift and estate tax exemption before the exemption sunsets in January 2013. An expert appraises Park Avenue building owned by the taxpayer at $51.2 million. The taxpayer transfers a 10 percent interest in the building to his son in December of 2012. In April of 2013, the taxpayer files a gift tax return reporting a gift of $5.12 million. In January of 2016, the IRS, after audit, proposes a deficiency of $308,000, asserting that the building was worth $60 million at the time of the gift (i.e., a 35% gift tax on the additional $880,000 transferred).Had father used a defined value clause, he might have limited his tax exposure.

Defined Value Clauses

Defined value clauses are "formula" clauses used to prevent unintended gifts. They operate by defining the transfer in terms of a *specific dollar amount* of assets, rather than a *percentage of the assets*, and provide for an adjustment to the transfer if the IRS or a court later determines that the value the taxpayer ascribed to the transferred asset was incorrect.

Using the example from above, had the father transferred "an interest in the building worth $5.12 million," this would have "defined" the transfer in terms of value rather than partnership units. In the event the IRS determined that the building was worth more than $51.2 million, a sufficient quantum of the amount initially transferred to the son would be deemed not part of the original transfer, or, if provided for, reallocated to a nontaxable

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entity, thus resulting in no gift overage.

Evolution of the Case Law

Defined value clauses are effective valuation risk-reducing tools, which attorneys have been using for decades. However, the IRS has been hostile to formula clauses in general, and have long challenged their propriety. The case law addressing formula clauses in transfer documents spans nearly 70 years.

The seminal case on formula clauses is *Com'r v. Procter*, 142 F.2d 824, 827 (4th Cir. 1944). In Procter, the donors assigned gifts of remainder interests in trusts to their children, but provided that "any excess property. . .decreed by the court to be subject to gift tax shall automatically be deemed not to be included in the conveyance." This formula clause operated to cause a reversion to the grantor of property that would be subject to a gift tax. Although the taxpayer prevailed in Tax Court, the Fourth Circuit reversed, holding that the reversion was a *condition subsequent* to a completed gift, and therefore impermissible. The court also found that the clause was void as against public policy, because any attempt to collect tax would merely reverse the gift. Proctor referred to the savings clause as a "device," and made clear that, no matter how fancy such a "device" is, it cannot operate to cause the taxpayer to reacquire property that has been irrevocably gifted.

Later attempts to undo completed gifts through savings-type clauses were also unsuccessful. *See Ward v. Com'r*, 87 T.C. 78 (1986). However, the lasting effect of *Procter* and its progeny was to spur an increase in the use of formula clauses designed to cap transfers without the use of a reversion, thus expressly avoiding the public policy objection underscored in Procter.

McCord v. Commissioner (2006)

In *Succession of McCord v. Com'r*, 461 F.3d 614 (5th Cir. 2006), *rev'g* 120 T.C. 358 (2003), donors gifted the majority of interests in a limited partnership to their sons, trusts for their issue, and to two charities. An "assignment agreement" provided that the sons and the trusts were to collectively receive partnership interests worth $6.9 million; any value in excess of $6.9 million was to be reallocated to the charities. The assignment agreement also permitted all three assignees to allocate among themselves their interests in the gifted property, and to purchase interests from each other at later agreed upon values. The later agreed upon values were memorialized in a "confirmation agreement." The IRS assessed a deficiency and argued in Tax Court that the formula clause was void as against public policy under *Procter*.

The Tax Court focused on the values memorialized in the confirmation agreement, rather than the dollar value gifts articulated in the assignment agreement. Therefore, the IRS deficiency was sustained, since the values in the confirmation agreement resulted in a greater taxable gift than would have resulted if the dollar value of the gifts articulated in the assignment agreement were respected.

The Fifth Circuit reversed and found for the taxpayer. The court first noted that a gift is valued on the date of the gift, and not by subsequent events. The court then found that the value of the assets was properly reported by the taxpayer. Therefore, the parties' post-gift "confirmation agreement" was irrelevant to the determination of gift tax. In ruling on this issue, the Fifth Circuit left no doubt that it disapproved of the Tax Court's rejection of the formula clause, and left the impression that defined value clauses are inherently proper. The Fifth Circuit admonished the Tax Court for its "palpable hostility" to the expression of a dollar value gift through a formula clause, and caustically remarked that "[r]egardless of how the transferred interest was described, it ha[d] an ascertainable value" on the date of the gift.

The formula clause apparently validated in *McCord* differed from the savings clause held void as against public policy in *Procter* in two significant ways: First, it defined the gift as a *specific dollar* amount, rather than as an interest which was to be redistributed in the event of a redetermination of value of the transferred asset; and second, it operated to cap the gift not by effectuating a reversion in the grantor, but by reallocating the interests among beneficiaries to accord with the stated dollar amount gifts made. The *McCord* formula clause was simply a defined value clause coupled with a reallocation provision.

Christiansen v. Commissioner (2008)

The next in the progeny of formula clause cases was *Christiansen v. Com'r*, 130 T.C. 1 (2008), *aff'g* 586 F.3d 1061 (8th Cir. 2009). In *Christiansen*, the decedent's will left her entire estate to her daughter, but provided that 25 percent of any amount disclaimed by her daughter would pass to a charitable foundation. Following the decedent's death, daughter disclaimed all amounts over $6.35 million "as finally determined for federal estate tax purposes." On audit, the IRS challenged the value of the gross estate. The parties eventually settled on a increased value. That increased value increased the amount which passed to the charitable foundation under the formula clause. The estate claimed an additional deduction for the excess amount that passed to the charity. The IRS disagreed, arguing that since the valuation was finally determined *after the death* of the decedent, Treasury Regulation §20.2055-2(b)(1) barred the additional deduction sought by the taxpayer. The Commissioner also argued that the disclaimer clause was void as against public policy, since formula disclaimers which could provide no possibility of enhanced tax receipts eliminated the incentive of the IRS to audit.

The Tax Court rejected the Commissioner's argument, and decided that the Estate was entitled to the

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increased deduction. In affirming, the Eighth Circuit held that the Treasury Regulation cited by the Commissioner "clear[ly] and unambigous[ly]" requires only the existence of a final transfer at the date of death, and not a final determination with respect to valuation. Applying the Regulation to the facts, the court found that all that remained uncertain at the decedent's date of death was the value of the estate, and that "[t]he foundation's right to receive twenty-five percent of that amount in excess of $6.35 million was certain." As to the Commissioner's policy argument, the Court was blunt, remarking that "the Commissioner's role is to enforce the tax laws," not merely maximize tax receipts. The Eighth Circuit went further, stating that "even if we were to find [such] a general congressional intent," the Commissioner's policy argument is based on the flawed premise that the Service's "marginally decreased incentive to audit" would promote undervaluation of estate assets. In any event, proclaimed the Court, there are "countless other mechanisms," such as state and federal laws, in place to ensure accurate reporting.

The formula clause in *Christiansen* was a disclaimer that operated precisely like a defined value clause. *Christiansen* not only validated the efficacy of the clause itself, but diminished the application of *Procter* policy rationales often invoked by the IRS to attack formula clauses. The *Christiansen* court implied that those policy arguments are inapplicable when there is no reversionary component to the formula clause. *Christiansen* also stood for the proposition first noted in *McCord, i.e.*, that post-gift valuation disputes are irrelevant to the existence, or lack thereof, of a final transfer on the date of the gift.

Petter v. Commissioner (2011)

In *Estate of Petter v. Com'r*, T.C. Memo. 2009-280, *aff'd*, 653 F.3d 1012 (9th Cir. 2011), the IRS Commissioner again challenged formula clauses which defined transfers as dollar amounts "as finally determined for federal gift tax purposes." The Tax Court in Petter approved the transactions and for the first time, using the prior case law as indicia, sanctioned the use of formula clauses in clear terms, noting that "[t]he distinction is between a donor who gives away a fixed set of rights with uncertain value – that's *Christiansen* – and a donor who tries to take property back – that's *Procter* . . . A shorthand for this distinction is that savings clauses are void, but formula clauses are fine." Without so much as even addressing public policy, which argument was abandoned by the Commissioner on appeal, the Ninth Circuit affirmed.

After a long evolutionary line of cases, *Petter* finally established the validity of formula transfer clauses, at least in the influential Ninth Circuit. However, the transfer documents in *McCord*, *Christiansen*, and *Petter* all had a common thread separate and apart from their use of a formula clause: The pour-over recipients of any value above the value transferred to the primary recipients flowed to charity. The type of defined value clauses used in those cases has become known as a "charitable lid," and is now commonly used. However, one basic uncertainty remained: What if the overflow beneficiary is a non-charitable entity or the definition clause effectuates a redistribution of interests among the transferor and transferees? *Wandry* held this distinction to be "inconsequential."

Conclusion

Since transfers among family members so often include interests in closely-held entities which are inherently difficult to value, attorneys should consider risk-reducing strategies when effectuating transfers of family assets. Case law now appears to firmly sanction the use of formula clauses designed with a pour-over gift to charities. For taxpayers not inclined to make charitable gifts, the use of a defined value formula clause, such as that in Wandry, may be considered. However, one must note that although the trend of case law is clearly moving in the direction of blessing in entirety formula clauses framed in terms of defined dollar values, no Courts of Appeal have completely rejected *Proctor*, nor have any ruled on the use of a defined value clause with no pour-over charitable beneficiary. *Wandry* is now being appealed to the Tenth Circuit. The aggressive use of defined value formula clauses without a charitable beneficiary may remain problematic until the Tenth Circuit has decided the appeal.

Compliance Considerations

The use of defined value clauses increases the administrative burden associated with a gift, since there exists a heightened importance of ensuring that the gift tax return is consistent with the transaction. Any gift tax return should express the gift as the specific dollar amount used in the defined value clause, and should reference the terms of the original gifting documents.

It should be noted that an income tax corollary may also result from the use of defined value clauses. If the value of the gift is successfully adjusted upward by the IRS, and the defined value clause is respected, the interests owned by various persons or entities will also change. This may require amendments to income tax returns. The use of a grantor trust as the donee or purchaser could help to alleviate this problem.

IRS MATTERS, CONT.

(Continued from page 1)

ing elusive muon particles in physics, is deciding whether the tax expenditure or the revenue expenditure, as the case may be, is itself "fair."

* * *

National Taxpayer Advocate Nina Olson recently issued a report detailing the issues on which the IRS will focus during the fiscal 2013 tax year. IR-2012-66. The Taxpayer Advocate is required by federal law to issue two reports annually directly to the House Ways and Means Committee and to the Senate Finance Committee without prior review by the IRS, the Treasury, the IRS Oversight Board, or the Office of Management and Budget.

In the June 2012 Report, Ms. Olson expressed particular concern that "the continual enactment of significant tax law and extender provisions late in the year has led to IRS delays in handling millions of taxpayers' returns and caused many taxpayer to underclaim benefits because they did not know what the law was." Ms. Olsen added that "the 2013 filing season is already at risk."

Among the provisions that expired in 2011 were (i) the AMT "patch"; (ii) the deduction for state and local sales taxes; (iii) the deduction for mortgage insurance premiums; and (iv) the provision allowing taxpayers over 70½ to tax-free withdrawals from IRA accounts to take charitable contributions.

Provisions set to expire in 2012 include (i) the Bush tax cuts; (ii) reduced rates on long term capital gains and dividends; (iii) certain marriage relief provisions; (iv) certain aspects of the child tax credit; (v) the earned income tax credit; (vi) the adoption credit; and (vii) the moratoria on the phase outs of itemized deductions and personal exemptions.

The Report cited the vast increase in tax-identity theft, which increased 72 percent in tax year 2011. Where the IRS seeks to verify wage and withholding information, it is required to make a final determination within 11 weeks or release the claimed refund. By reason of budget limitations, the Service has placed "hard freezes" on cases it cannot process within 11 weeks. The Report states that the IRS has "little incentive to prioritize a case once a hard freeze has been imposed, resulting in harm to honest taxpayers."

The Report addresses Taxpayer Assistance Orders (TAOs) and Taxpayer Assistance Directives (TADs), which authorize the Advocate to direct the IRS to either take action or refrain taking action in a particular case in order to protect taxpayer rights. The Advocate alleges that over the past year the IRS has "ignored and sought to limit the Advocate's authority to issue TADs."

The Report states that the Advocate intends to focus on these additional issues in 2013: (i) the increased use of automated audit procedures which curtail taxpayer interaction with IRS employees; (ii) the impact of "draconian" penalties frequently imposed on taxpayers with offshore accounts, many of whom were not engaged in tax evasion; (iii) assessing the application of the IRS "fresh start" initiative, which allows struggling taxpayers to remain in compliance based upon their ability to pay;" and (iv) improving coordination between the IRS and other government agencies to protect taxpayer rights.

* * *

The IRS has announced that its Offshore Voluntary Disclosure Program (OVDP) has yielded in excess of $5 billion, and has released new details regarding the program. In tightening the eligibility requirements, IRS Commissioner Shulman noted that "[p]eople are finding it tougher and tougher to keep their assets hidden in offshore accounts." Details regarding eligibility issues are addressed in a new set of questions and answers which relate to the latest version of the OVDP, announced in January of 2012. IR-2012-64. The IRS extended OVPD following strong taxpayer interest in programs commenced in 2009 and 2011.

The IRS also took action to foreclose a perceived loophole: Under existing law if the taxpayer challenges the disclosure of tax information in a foreign court, the taxpayer must advise the Department of Justice of the appeal. Under new IRS policy, if the taxpayer fails to advise Justice of the appeal, the taxpayer will no longer qualify for OVDP. The IRS also put taxpayers on notice that their eligibility for OVDP could be terminated once the U.S. government has taken action with respect to their specific financial institution.

* * *

The IRS inspector general J. Russell George acknowledged that the IRS may issue as much as $21 billion in fraudulent tax refunds in the next five years. The problem, which he describes as growing "exponentially," is being perpetrated brazenly, since "[o]nce the money is out the door, it is impossible to get it back." In one case, a single Chicago address generated 765 tax returns showing more than $900,000 in tax refunds. The scam is most prevalent in Miami and Tampa. Mr. George believes that the IRS more resourcefully utilize the information which it has, and should seek other information which could be available to it.

* * *

According to the quarterly report issued by the Treasury, 189 persons renounced U.S. citizenship in the last quarter. Almost half of the list consists of taxpayers of Chinese origin. It has been suggested that the high rate of Chinese expatriation could be due to the fact that the highest marginal income tax rate in Hong Kong is 15 percent, and that Hong Kong imposes no capital gains tax and, unlike the U.S., does not tax foreign earnings

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unless repatriated. Interestingly, high net worth Chinese disproportionally choose the United States when deciding where to emigrate. The principle in U.S. international taxation of imposing tax on all income of U.S. taxpayers, regardless of source, may be a significant factor in the decision of many U.S. taxpayers to renounce U.S. citizenship.

* * *

The New York Attorney General, Eric Schneiderman, has begun an investigation into private equity firms, including Bain, with respect to whether those firms used abusive tax strategies to reduce partners' income taxes. The principal issue involves the propriety of converting management fees, normally taxed as ordinary income, into investment income reported as capital gains. The Service has identified the area as one of "possible noncompliance," but thus far has taken no action. There appears to be no consensus among tax professionals as to whether the practice is legitimate.

* * *

The IRS has announced tax relief to those affected by Hurricane Isaac in Louisiana and Mississippi. Various tax filing and payment deadlines occurring after August 26th will be extended until January 11, 2013. The relief includes individuals and businesses on extension until October 15th.

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TAX PLANNING FOR TRUSTS, CONT.

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grantor trust rules reside in Sections 671 through 679 of the Internal Revenue Code. IRC Sections 164(a)(3) and 641(b) also provide that state income tax is deductible for federal income tax purposes, although the benefit of the deduction for capital gains, which are now taxed at only 15 percent at the federal level, is paltry.]

Most states impose fiduciary income tax on "resident" nongrantor trusts at various rates, although some states impose no tax. Not surprisingly, New York and California impose relatively high rates of income tax on fiduciaries of resident trusts. Seven states: Alaska, Florida, Nevada, Washington, South Dakota, Wyoming and Texas, impose no income tax on fiduciaries of resident trusts.

Step One: Determining Whether The Trust is a Resident New York Trust

In analyzing whether and to what extent a trust is taxable in New York, one must first determine whether the trust is a New York resident trust. If the trust is not a New York resident trust, the trust (a "Nonresident Trust") could still be subject to New York income tax, but in that case (see below) only on its New York source income.

States generally utilize five criteria in determining whether a trust constitutes a "resident" trust:

(i) whether the trust is a testamentary trust created under the will of a resident;

(ii) whether the trust is an *inter vivos* trust created by a resident;

(iii) whether the trust is administered within the state;

(iv) whether the trustee is a resident of the state; and

(v), whether a noncontingent beneficiary is a resident of the state.

New York employs only the first two criteria in determining whether the trust is a New York resident trust. Thus, in general, a New York "resident trust" is (i) any trust created under the will of a New York domiciliary or (ii) any revocable or irrevocable *inter vivos* trust created by a New York domiciliary. Although one can only speculate as to why the legislature chose not to consider factors considered by many other states, Wall Street and the New York banking industry may have been considerations. The rationale for this conclusion is that an out of state resident, for example, from Florida, which imposes no fiduciary income tax, who never visited New York, would avoid choosing a New York trustee or a New York administrator if doing so resulted in the trust income being taxed in New York.

Exceptions to Trust Taxation

Having stated the requirements for a New York resident trust, it is important to emphasize that not all New York resident trusts are subject to New York income tax, mainly for Constitutional reasons. The Third Department, in *Taylor v. State Tax Commission*, 445 NYS2d 648 (3rd Dept. 1981), found that income from a testamentary trust of a New York resident whose assets consisted of land in Florida managed by Florida trustees, could not be subject to New York taxation. The Appellate Division reasoned that the "only substantive contact with the property was that New York was the domicile of the settlor of the trust, thus creating a resident trust."

The Third Department concluded that "[t]he fact that the former owner of the property in question died while being domiciled in New York making the trust a resident trust under New York tax law, is insufficient to establish a basis for jurisdiction." The authority cited was the Fourteenth Amendment, which provides that a state may not impose a tax on an entity unless that state has a sufficient nexus with the entity. Following the decision in *Taylor*, the exemption for some resident trusts was codified in Tax Law §605(b)(3)(D)(i).

In deference to the Fourteenth Amendment (and possibly also to wealthy New Yorkers who might otherwise leave the state) Tax Law §605 (b)(3)(D)(i) provides for a generous safe harbor under which a Resident Trust is not subject to New York. The safe harbor applies if

(i) all of the trustees are domiciled in another state;

(ii) the entire trust corpus is located out of state; and

(iii) all income and gains are derived from out of state sources.

For purposes of (i), TSB-A-10 (4) may imply, but does not explicitly state, that the removal of a New York trustee during the tax year might satisfy the statutory requirement of all trustees being domiciled in another state.

For purposes of (ii), the requirement that the "entire corpus [be] located out of state" is less exacting than it might appear. Article XVI of the New York Constitution provides that "money, securities and intangible property not employed in carrying on any business in the state is deemed to be located at the domicile of the owner for purposes of taxation, and, if held in trust, shall not be deemed to be located in [New York] for purposes of taxation [by reason of] the trustee being domiciled in this state."

For purposes of (iii), it is thought that even a small amount of New York source income will taint all trust income and render the entire trust income subject to New York tax, *i.e.,* the "one dollar" rule.

In 2010, Governor Patterson introduced legislation intended to eliminate the three-part exemption test provided by Tax Law §605(b)(3)(D)(i). However, the proposal was opposed by the New York Bar Association, and was subsequently tabled by the Senate and Assembly.

However, an unfortunate conse-

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quence of the failed legislative attempt to repeal the exemption appears to be that Albany has shown new interest in monitoring fiduciaries who claim the exemption by implementing new reporting requirements. In 2011, the Department promulgated TSB-A-11(4), which provides that "[as] of tax year 2010, even though the Trusts meet the conditions set forth in Tax Law §605(b)(3)(D), they are required to file Form IT-205 Fiduciary Income Tax Return and attach Form IT-205-C New York Resident Trust Nontaxable Certification to Form IT-205."

Additionally, Tax Law §685(c)(6) now requires that trustees make estimated income tax payments.

II. Taxation of Nonresident Trusts

Some trusts created by nondomiciliaries may still be subject to New York income tax. Tax Law §605 (b)(4) succinctly defines "Nonresident Trusts" as trusts which are not "Resident Trusts." In contrast to Resident Trusts, which are taxed on all income regardless of source, Nonresident Trusts are taxed only on New York source income or gains. New York source income includes income from (i) real or intangible personal property located in New York; (ii) a trade or business operating in New York; (iii) services performed in New York; (iv) lottery winnings from the NYS lottery in excess of $5,000; and (v) the sale or transfer of shares of stock in a New York coop.

Since New York defines a Nonresident Trust as any trust that is not a Resident Trust, the existence of a New York trustee would not alone cause a nonresident trust to be taxed in New York provided the trust had no New York source income. The reason for this is that although the domicile of the trustee is important in determining whether the *exemption from taxation* for resident trusts under Tax Law 605(b)(3)(D)(i) is applicable, New York does not consider the domicile of the trustee in determining whether the trust is a New York resident trust.

III. Conclusion

Pursuant to Tax Law § 605(b)(3)(D)(i), if (i) the entire corpus of a trust is located out of New York, (ii) there are no New York trustees, and (iii) the trust has absolutely no New York source income, then a New York Resident Trust will not be subject to New York income tax.

If the existence of a New York trustee is the only cause of the New York resident trust being taxed in New York, the trust could provide a mechanism whereby the beneficiaries could substitute another out of state trustee. If the trust does not so provide, and also in other situations, the approval of the Surrogate might be required. However, since the trustee is charged with a fiduciary obligation to reduce taxes, the Surrogate would likely be favorably inclined to issue an order granting a request to remove a New York trustee which is causing the trust to be taxed in New York.

As a proviso, it must be noted that every judge has a unique temperament and there is no way of predicting in advance how a particular judge or Surrogate may view the request to change the situs of a trust. Therefore, if court involvement can be avoided, that is the preferable route.

The assets of a trust subject to New York State income tax may also be decanted into another trust not considered a New York Resident Trust.

Similarly, if the New York Resident trust fails the exemption test by reason of the ownership by the trust of New York real property or the existence of any tangible property in the state, the sale of the real property or the removal of the tangible property to out of New York might well cure that defect.

Under the "one dollar" rule, even a small amount of New York source income will render New York Resident Trusts taxable on all income and gains. It is therefore important that the fiduciary ensure that no errant K-1s arrive showing New York source income, if the requirements for the exemption are to be met. It has been argued that the "one dollar" rule does not accord with Due Process, as articulated by the Court of Appeals in *Mercantile-Safe Deposit & Trust Co. v. Commissioner*, 15 NY2d 579 (1964). However, in this regard as in others, it is probably best not to tempt fate.

* * *

Estate tax and estate planning considerations may also inform the decision of a New York resident of where to situs a trust. Those considerations range from choosing a state with favorable asset protection laws, such as Nevada, Delaware, South Dakota, Wyoming, Tennessee, Utah, Oklahoma, Colorado, Missouri, Rhode Island and New Hampshire, to choosing one of the many states (of which New York is not one) which has either abolished the Rule Against Perpetuities or limited its application.

IRREVOCABLE TRUSTS, CONT.

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the Crusader returned. However, English law did not recognize the claim of the returning Crusader forced to sue if the legal owner refused to revest title in the original owner.

Turned away at courts of law, some Crusaders then petitioned the King, who referred cases to the Courts of Chancery. These equitable courts often compelled the legal owner (the "trustee") to reconvey the land back to the Crusader, (the "beneficiary" or *cestui que* trust) who was deemed to be the equitable owner.

Equitable remedies first recognized by Chancery Courts exist today in the form of injunctions, temporary restraining orders, and declaratory judgments, which remedies may be sought where there is no remedy at law. Despite the formal merger of law and equity in New York in 1848, the Court of Appeals has observed that "[t]he inherent and fundamental difference between actions at law and suits in equity cannot be ignored." *Jackson v. Strong*, 222 N.Y. 149, 118 N.E. 512 (1917).

The principles of recognition and enforcement of trusts enunciated by Courts of Chancery form the basis of modern trust law. A trust is thus a fiduciary relationship with respect to specific property, to which the trustee holds legal title for the benefit of one or more persons who hold equitable title as beneficiaries. Thus, two forms of ownership — legal and equitable — exist in the same property at the same time. [Restatement of Trusts, §2].

The essence of a trust then, is to separate legal title, which is given to someone to hold in a fiduciary capacity as trustee, from equitable title, which is retained by trust beneficiaries. Irrevocable trusts, if properly structured, permit the settlor (*i.e.,* the person transferring the assets into the trust) to retain control over the eventual disposition of the trust property.

Trustees are responsible, *inter alia*, for ensuring that trust property is made productive for beneficiaries. The trust instrument defines the scope of discretionary powers conferred upon the trustee. With respect to discretion involving distributions, the trust may grant the trustee (i) no discretion; (ii) discretion subject to an ascertainable standard (often described in terms of the "health, education, maintenance and support" of the beneficiary, or the "HEMS" standard); or (iii) absolute discretion. The scope of discretion granted has profound tax and non-tax consequences; even more so if the trustee is the grantor.

II. Scope of Trustee Discretion

No Discretion

The trust may provide that the trustee "distribute to Lisa annually the greater of $1,000 or all of the net income from the trust." In this situation, the grantor (also known as the trustor, settlor, or creator) of the trust could name himself as trustee with no adverse estate tax consequences, since he has retained no powers which would result in the property being considered part of his gross estate. (However, if Lisa were given a limited power to appoint income to which she would otherwise be entitled, to another person, a gift tax could result.)

Eliminating trustee discretion with respect to distributions provides certainty to beneficiaries, and reduces the chance of conflict. Nevertheless, the trustee will also be unable to increase or decrease the amount distributed in the event circumstances change.

If the trustee is given no discretion, the trust could also never be decanted, as a requirement of the New York decanting statute (as well as other states which have decanting statutes) is that the trustee have at least some discretion with respect to trust distributions.

Absolute Discretion

At the opposite end of the spectrum lie trusts which grant the trustee unlimited discretion with respect to distributions. If the grantor were the trustee of this trust, estate inclusion would result under IRC §2036 — even if the grantor could make no distributions to himself — because he would have retained the proscribed power in IRC §2036(a)(2) to "designate the persons who shall possess or enjoy the property or the income therefrom."

Disputes among beneficiaries (or between beneficiaries and the trustee) could occur if the trustee possesses absolute discretion with respect to trust distributions. However, by adding the term "unreviewable" to "absolute discretion," the occasion for court intervention would appear to be limited to those extreme circumstances where the trustee has acted unreasonably or acted with misfeasance.

The "decanting" statutes in all states which have enacted them, including New York, permit the creation of new irrevocable trusts where the trustee has been granted absolute discretion with respect to distributions. One significant advantage of utilizing a decanting statute is that no beneficiary consent is required and court supervision is generally unnecessary in order to create a new trust. Nor is there is a need to demonstrate a change in circumstances, only that the decanting Trustee exercise his power to decant in the best interests of a beneficiary.

Ascertainable Standard Discretion

In the middle of the spectrum lie trusts which grant the trustee distribution discretion limited to an ascertainable standard. If the trustee's discretion is limited by an ascertainable standard, no adverse estate tax consequences should result if the grantor is named trustee. Since this degree of discretion affords the trustee some flexibility regarding distributions without adverse estate tax consequences, and now qualifies under the New York decanting statute, many grantors find this model attractive.

As noted, a beneficiary's power to make discretionary distributions to himself without an ascertainable standard limitation would constitute a

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general power of appointment under Code Sec. 2041 and would result in inclusion of trust assets in the beneficiary's estate. However, if the standard is limited to distributions for the "health, education, maintenance, and support" of the beneficiary, estate tax inclusion in the estate of the beneficiary should not occur.

The beneficiary may also be given the right to demand the greater of 5 percent or $5,000 from the trust each year without causing adverse estate tax consequences. If the power is not exercised, it would lapse each year. The lapse of this power will not constitute the lapse of a general power of appointment under IRC § 2514.

Despite the flexibility afforded by trusts whose distributions are determined by reference to an ascertainable standard, issues may arise as to what exactly is meant by the standard used. Is the trustee permitted to allow the beneficiary to continue to enjoy his or her accustomed standard of living? Should other resources of the beneficiary be taken into account?

The trust should address, for example, with some specificity, what the accustomed standard of living of the beneficiary is, when invasions of trust principal are appropriate, and what circumstances of the beneficiary should be taken into account in determining distributions pursuant to the ascertainable standard. If the trust fails to address these issues, the possibility of disputes among current beneficiaries, or between current and future beneficiaries, may increase.

Investment Discretion

Investment of trust assets is an important consideration of the grantor. While the grantor may be content with delegating discretion for distributions to the trustee, he may have an investment philosophy which he wishes to be employed during the trust term. Unless otherwise stated in the trust instrument, the trustee is granted broad discretion with respect to the investment of trust assets. New York has not enacted the Uniform Prudent Investor Act. However, New York has enacted its own rule, found in EPTL §11-2.3, entitled the "Prudent Investor Act." Under the Act, the trustee has a duty "to invest and manage property held in a fiduciary capacity in accordance with the prudent investor standard."

The prudent investor standard encompasses the philosophy that the trustee will exercise reasonable care in implementing management decisions for the portfolio, taking into account trust provisions. The trustee should pursue a strategy that benefits present and future beneficiaries in accordance with the "risk and return objectives reasonably suited to the entire portfolio." If the grantor believes that the named trustee can make distribution decisions, but requires assistance in investing trust assets, the instrument may authorize the trustee to engage a financial advisor to provide professional guidance in making investment decisions.

III. Trust Protectors

Some jurisdictions, including New York, permit the use of trust "protectors" to provide flexibility in the administration of trusts. The Uniform Trust Code recognizes the principle that an independent person may be vested with the authority to direct the trustee to perform certain actions. Powers granted to the protector could include the power to (i) remove or replace a trustee; (ii) direct, consent or veto trust distributions; (iii) alter, add or eliminate beneficiaries; or (iv) change trust situs and governing law. To avoid adverse tax consequences, a trust protector should not be a member of the grantor's family. Attorneys, accountants, siblings or friends could be named as a trust protector. Corporate fiduciaries may not be a good choice, since their ability to exercise authority may in practical terms be constrained by the institution.

IV. Disputes Among Beneficiaries

Various avenues exist for disgruntled beneficiaries to challenge the manner in which a trust is being administered. Problems may arise where a beneficiary is also serving as co-trustee with an independent trustee. The most drastic step is to remove the trustee. In fact, discretionary trusts often provide for removal of the trustee, and replacement by the grantor or trust beneficiaries. However, the retention by the grantor of the power to remove the trustee may imbue the trust with transfer tax problems. Rev. Rul. 79-355 stated that a retained power by the grantor to remove a corporate trustee and appoint another corporate trustee was in essence the retention by the grantor of the trustee's powers. The retained power would constitute an "incident of ownership," and would cause the entire life insurance trust to be included in the grantor's estate.

However, the IRS in TAM 9303018 opined that the removal of a trustee "for cause" would not result in the power being attributed to the grantor. Some of the removal "for cause" powers cited include (i) the legal incapacity of the trustee; (ii) the willful or negligent mismanagement of trust assets; (iii) the abuse or inattention to the trust by the trustee; (iv) an existing federal or state criminal charge against the trustee; or (v) a relocation of the trustee.

V. Spendthrift Provisions & Trusts

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.

Under New York law, trust assets can be placed beyond the effective reach of beneficiaries' creditors by use of such a "spendthrift" provision. Most wills which contain testamentary

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trusts would incorporate a spendthrift provision. A spendthrift clause typically provides that the trust estate shall not be subject to any debt or judgment of the beneficiary. Therefore, even if the trustee's discretion is absolute, the trust 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 trust may 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.

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. Thus, in many states, spendthrift trust assets may be reached to enforce a child support claim against the beneficiary. Courts might also invalidate a spendthrift trust to satisfy a judgment arising from an intentional tort. Finally, a spendthrift trust would likely be ineffective against government claims relating to taxes, since public policy considerations in favor of the collection of tax may be deemed to outweigh the public policy of enforcing spendthrift trusts.

VI. Self-Settled Spendthrift Trusts

A trust beneficiary possesses equitable but not legal ownership in trust property. Therefore, creditors of a trust beneficiary generally cannot assert legal claims against the beneficiary's equitable interest in trust assets. A self-settled trust is one in which the settler is either one of the beneficiaries or the sole beneficiary of the trust.

Under common law, a settlor cannot establish a trust for his own benefit and thereby insulate trust assets from claims of the his own creditors. The assets of such a "self-settled spendthrift trust" would be exposed to creditor claims to the extent of the maximum property interest available to the settlor under the trust. 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.

Since 1997, five states, including Delaware and Alaska, have enacted legislation which expressly authorizes the use of self-settled spendthrift trusts. Statutes in these states mitigate the problem associated with self-settled spendthrift trusts by permitting the settlor to be a discretionary beneficiary of the trust. A self-settled spendthrift trust, if established in one of these jurisdictions, 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 exotic locales such as the Cayman and Cook Islands, and less exotic places such as Bermuda and Lichtenstein, which for many years have been a haven for those seeking the protection of a self-settled spendthrift trust.

New York has never been, and is not now, a haven for those seeking to protect assets from claims of creditors. 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 if the trust is not created with an intent to defraud existing creditors. New York's strong public policy against self-settled spendthrift trusts is evident in EPTL §7-3.1, which succinctly states: "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. Even though a New York Surrogate or Supreme Court Judge might look askance at an asset protection trust created in Delaware, the Full Faith and Credit Clause of the Constitution should imbue significant asset protection to such a Delaware trust.

If a self-settled spendthrift trust is asset protected, creditor protection may also reduce the possibility of estate inclusion under IRC §2036. Assets placed beyond the reach of creditors may also be considered to have been effectively transferred for estate tax purposes. However, the initial transfer in trust may be a completed gift.

VII. Decanting Trusts

Under the Uniform Trust Code and EPTL §10-6.6, a noncharitable irrevocable trust may be modified with court approval "upon the consent of all beneficiaries if the court concludes that modification is not inconsistent with a material purpose of the trust." The settlor, a beneficiary, or a trustee may initiate an action to modify an irrevocable trust. However, the court may approve the modification only if all of the beneficiaries have consented and the interests of all beneficiaries who have not consented will be adequately protected.

Where trust modification under the EPTL or under common law is either not possible — or even where it is possible, but unattractive — modification under New York's "decanting" statute may be preferable. New York was the first state to enact a

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"decanting" statute, which effectively permits the trustee acting alone to amend the terms of an irrevocable trust.

"Decanting" statutes in some jurisdictions, such as Delaware and Alaska, permit the appointment of irrevocable trust assets into a new trust where the trustee has significant — but not absolute — discretion with respect to distribution of trust assets. Former EPTL §10-6.6(b) had required that the trustee have unlimited discretion to invade principal in order to vest trust assets in a new irrevocable trust. Therefore, an "ascertainable standard" trust established in New York could not have availed itself of New York's decanting statute. However, New York in 2011 joined states such as Delaware and Alaska, and now permits decanting even where the trustee has only limited discretion.

The potential uses of decanting are manifest: Despite the best efforts of drafters to contemplate unforeseen circumstances, situations arise where dispositive trust provisions may not reflect the present circumstances of beneficiaries. If the trust is revocable, and the grantor is alive, the grantor may revoke or amend the trust. However, trusts are often made irrevocable for tax or asset protection purposes. In those cases, revoking the trust, while not impossible, may be extremely difficult, especially if minor beneficiaries are involved.

Where Trustee Has Unlimited Discretion to Invade Principal

Under amended EPTL §10-6.6 (b), if the trustee has unlimited discretion to invade trust principal in favor of "current beneficiaries," the decanting statute now allows the trust into which the assets are decanted, the "appointed trust," to benefit one or more beneficiaries to the exclusion of other beneficiaries. The rationale for this regime appears to be that if the trustee has unlimited discretion to invade principal in favor of one beneficiary, appointing all of the trust assets into a new trust which benefits only that person accomplishes the same result.

Where Trustee Has Limited Discretion to Invade Principal

Under EPTL §10-6.6(c), where the trustee has only limited discretion to invade principal, the appointed trust must have identical current and remainder beneficiaries as the invaded trust. Furthermore, the standard which guides the trustee in the appointed trust must be identical to that in the invaded trust for the duration of the original trust term. For example, if the invaded trust provided for principal distributions for the beneficiaries' "health, education, maintenance and support" (*i.e.*, the "HEMS" standard), then the appointed trust may not deviate from this standard.

Similarly, if the invaded trust were set to terminate when the beneficiary reached the age of 50, and required that the HEMS standard be utilized during the entire duration of the trust, statutory compliance would require that the discretion given to the trustee of the appointed trust be limited to the HEMS standard until the beneficiary reached the age of 50. For any period that assets are held in the appointed trust after the beneficiary reaches the age of 50, the discretion of the trustee may be unlimited.

Fixed Statutory Directives

As a prelude to the discussion of formal statutory requirements, it should be noted that the amended statute has dispensed with the requirement of court filing except in specific circumstances. Court filing is now required only for trusts which have been subject to prior court proceedings.

The procedure for invoking EPTL §10-6.6 is straightforward:

Under the revised statute, notice must be given to "all persons *interested* in the trust," and no trust may be invaded until 30 days after notice has been given. During this 30-day period, any interested party may object to the decanting by written notice of objection to the trustee. The invaded trust may be decanted immediately if all interested parties waive the 30-day notice period. The class of persons "interested" has been expanded, and now includes — in addition to those persons who would be required to be served with a trust accounting — the settlor of the invaded trust and any person who could remove the trustee (*e.g.,* a "trust protector").

The power of a trustee to decant is not dependent upon the consent of the beneficiaries. Therefore, even a timely objection by a beneficiary to a proposed decanting will not nullify the power of the trustee to decant. Conversely, the failure of a beneficiary to formally object within the 30-day notice period does not operate as a waiver of the beneficiary's right to object at a later date. Presumably, at that point Court involvement would be necessary.

Another limitation of EPTL §10-6.6 is that the fixed income right of any beneficiary cannot be reduced by reason of the decanting. This limitation has been construed as being applicable only to a named beneficiary identified in the trust instrument as having a right to income for a fixed period of time. One purpose of this requirement is to ensure that the marital deduction for estate and gift tax purposes is preserved, since the surviving spouse must have a right to all of the income during her life from the trust to ensure the availability of the deduction.

Fiduciary Considerations

Regardless of the degree of discretion given to the trustee with respect to distributions of principal, no trust may be invaded if there is evidence that the invasion would be contrary to the intent of the creator. A corollary of this rule is that any trust may explicitly state that the trust may not decant.

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In deciding whether to exercise a power to decant, the statute cautions that decanting should only be undertaken if a prudent person would consider it to be in the best interests of one or more, but not necessarily all, of the beneficiaries. No trustee has an affirmative duty to decant, even if decanting would be in the best interest of the beneficiaries. A trustee who does exercise the power to decant is under an affirmative duty to consider possible tax implications.

Circumstances Favoring Decanting

A trustee might seek to utilize EPTL §10-6.6 to accomplish any of the following objectives: (i) to extend the termination date of the trust; (ii) to add or modify spendthrift provisions; (iii) to create a supplemental needs trust for a beneficiary who is or has become disabled; (iv) to consolidate multiple trusts; (v) to modify trustee provisions; (vi) to change trust situs; (vii) to correct drafting errors; (viii) to modify trust provisions to reflect new law; (ix) to reduce state income tax imposed on trust assets; (x) to vary investment strategies for beneficiaries; or (xi) to create marital and non-marital trusts.

For example, an irrevocable trust might provide for a mandatory distribution of principal at age 25, with final principal distributions at age 30. However, such mandatory distributions might be inadvisable if the beneficiary has creditor problems, or is profligate or immature. In *In re Rockefeller,* NYLJ Aug. 24, 1999 (Sur. Ct. N.Y. Cty.), the Surrogate allowed trust assets to be decanted into a new trust which contained a spendthrift provision.

The beneficiary may have become subject to a disability after the trust had been drafted. To become (or maintain) eligible for public assistance, it might be necessary for the trust assets to be distributed to a supplemental needs trust. The Nassau Surrogate, in *In Re Hazan*, NYLJ Apr. 11, 2000 authorized the trustee of a discretionary trust to distribute assets to a supplemental needs trust whose term had been extended, to enable the beneficiary to continue to be eligible for public assistance.

If more than one trust has been created for a beneficiary, overall liquidity may be enhanced by transferring the assets of one trust into another trust. So too, combining multiple trusts into a single trust may greatly reduce administrative expenses. In *In Re Vetlesen*, NYLJ June 29, 1999 (Surrogates Ct. N.Y. Cty.), the court authorized the trustee to appoint trust assets to a testamentary trust with identical provisions to reduce administrative expenses.

EPTL §10-6.6 is particularly well suited to address problems where it may be desirable to appoint new trustees. *In re Klingenstein*, NYLJ, Apr. 20, 2000 (Surrogates Ct. Westchester Cty.) authorized the decanting of assets into multiple trusts which granted the beneficiary of each trust the power to remove the trustee. The creation of new trusts in *Klingenstein* also allowed the removal of the impractical limitation requiring any trustee acting as sole trustee to appoint a corporate co-Trustee, and allowed for the elimination of successor trustee appointments. The decanting statute could also be utilized to modify trustee compensation.

EPTL §10-6.6 may also be utilized to change the situs of a trust for privacy reasons. The grantor of a trust may not want beneficiaries who are minors to become aware of the trust. To preserve secrecy, the trustee might wish to change the situs of the trust to Delaware, which limits the trustee's duty to disclose. If trust property is also located out of New York, changing the situs of the trust might also facilitate trust administration.

Drafting errors or changes in the tax law may also be occasions for seeking to distribute trust assets into a new trust. The Surrogate in *In re Ould Irrevocable Trust*, NYLJ Nov. 28, 2002 (Surrogates Ct. N.Y. Cty.) authorized the transfer of trust assets into a new trust where the retention of certain powers by the insured in the original trust may have resulted in estate tax inclusion.

If a single trust contains many beneficiaries, one investment strategy might not satisfy the differing objectives and needs of each beneficiary. Splitting the trust into individual trusts for each beneficiary might enable the trustees to manage each trust in accordance with the differing objectives of each beneficiary. The Surrogate in *In Re Estate of Scheuer*, NYLJ July 10, 2000 (Surr. Ct. N.Y. Cty.) authorized the trustees of the original trust to appoint trust assets into ten new trusts to accomplish this objective.

New York State Tax Considerations

Tax considerations may provide another compelling reason for decanting trust assets. Under NY Tax Law §603(b)(3)(D), even if the trust is sitused in New York, if there is (i) no trustee domiciled in New York, (ii) no New York source income, and (iii) no real or tangible property located in New York, then accumulated income and capital gains will not be subject to New York income tax. Accordingly, if a New York trust holds considerable assets outside of New York, decanting those assets into a trust in another jurisdiction might avoid New York income tax on capital gains and accumulated income sourced outside of New York.

Federal Estate Tax Considerations

Federal tax considerations may also warrant consideration of EPTL §10-6.6(b). For example, the statute could be used to create GST Exempt and GST Non-Exempt trusts. Investment strategy for the GST Exempt trust — which would not be subject to GST tax — could be aggressive, while investment strategy for the GST Non-Exempt trust could be used to make distributions to children who are exempt from the GST tax. For example, these distributions could be made for

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tuition or medical care. [PLR 200629021 ruled that dividing a GST exempt trust into three equal trusts to facilitate investment strategies for different beneficiaries would not taint GST exempt status.]

Dividing a trust into marital deduction and nonmarital deduction trusts may also yield both tax and non-tax benefits. Assets decanted into the marital deduction trust, which would ultimately be included in the estate of the spouse, could be invested in conservative securities and could be used for distributions of principal to the spouse. To the extent the marital trust is depleted, the amount of assets ultimately included in the spouse's gross estate would be reduced. Assets in the nonmarital trust, which would not be subject to estate tax in the estate of the spouse, could be in invested in growth assets for future beneficiaries.

A GST Exempt Trust is not subject to Generation Skipping Transfer Tax. Treas. Reg. §26.2601-1(b)(v)(B) states that the extension of an Exempt Trust in favor of another trust will not trigger GST tax. However, actual additions or deemed additions to a GST Exempt Trust would cause it to lose its exempt status. Therefore, care must be taken when utilizing EPTL §10-6.6 not to make an actual or deemed addition to the trust which would cause a GST Exempt Trust to lose its exempt status. If GST implications resulting from distributions to a new trust under EPTL §10-6.6 are unclear, a private letter ruling from the IRS should be obtained in advance.

The IRS could argue that decanting causes a taxable gift by the beneficiary to the trust. If the beneficiary is entitled to receive trust distributions at a certain age, and by reason of decanting, the assets are held in trust for a longer period, the IRS could make the argument that the right of the beneficiary to receive trust assets at a certain age is equivalent to a general power of appointment. Thus, if the beneficiary fails to object to the decanting, the beneficiary has, in effect, released a general power of appointment, which would result in a taxable gift. This argument is less cogent in states like New York, where the beneficiary does not have the power to prevent the decanting.

However, if a beneficiary could forestall an attempt by the trustee to decant, then the gift argument gains credibility. To weaken the argument that a taxable gift has occurred, the beneficiary could be given a limited power over trust assets in the new trust. The retention of a limited power of appointment generally should prevent the release from being a taxable gift. Treas. Reg. §25.2511-2(b).

Federal Income Tax Considerations

Decanting should result in no adverse income tax consequences. For gain or loss to occur, there must be either a sale or exchange of property, or the property received must be materially different from the property surrendered. Treas. Reg. §1.1001-1(a). The Supreme Court in *Cottage Savings Ass'n v. Com'r*, 499 U.S. 554 (1991) seemed to read out the word "materially" from the term "materially different" in holding that an exchange of similar mortgages triggered a taxable event. Nevertheless, the IRS has stated in recent rulings that a distribution in further trust will not trigger income tax provided the distribution is permitted either by the trust instrument or by local law.

If encumbered property is distributed pursuant a decanting statute, a potential income tax problem could arise under *Crane v. Com'r*, 331 U.S. 1 (1947), since that case held that the amount realized includes relief from liability. However, IRC §643(e) provides that distributions from a trust generally do not produce taxable gain. Therefore, substantial authority would appear to exist for the reporting position that decanting produces no realized even if liabilities exceed basis. In view of the preparer penalties under IRC §6694, practitioners might consider disclosing the position on the return.

IRS Interest in Decanting Statutes

In December of 2011, the IRS announced that it was considering the tax implications of trust decanting. Notice 2011-11. Among the tax implications the IRS is considering are (i) the addition of new beneficiaries; (ii) the conversion of a grantor trust to a non-grantor trust (and vice versa); (iii) the effect of consent of beneficiaries; (iv) whether the consent of a beneficiary to decant carries with it gift tax consequences; and (v) whether trust decanting constitutes a recognition event for income tax purposes.

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transferred.

What makes the like kind exchange attractive from a tax standpoint is not that realized gain is vanquished; it is not. Eventually, gain realized in a like kind exchange may be taxed when the property received in the like kind exchange is sold. Two exceptions to this exist: Further tax deferral could be achieved if the taxpayer engaged in another like kind exchange with the same property, or if the taxpayer died owning the property, in which case the property would receive a step up in basis.

When Section 1031 was drafted, Congress could have required that only like kind property be received in an exchange, and that the receipt of cash would result in Section 1031 being inapplicable. This was not the route Congress chose.

Instead, Congress decided that the receipt of other non-like kind property in an otherwise qualifying exchange would not take the transaction out of Section 1031, but would simply taint the exchange to some extent.

Congress decided that it would be appropriate to compel the taxpayer to recognize that portion of the realized gain to the extent of non-like kind property received in the exchange. Non-like kind property received in a like kind exchange is termed "boot". Boot may consist of cash, other property. Under *Crane v. Com'r*, boot may even consist of the assumption by the other party of a mortgage encumbering the property relinquished by the taxpayer in the exchange.

Realized gain in a like kind exchange then, is **recognized** to the extent of the sum of money and the fair market value of nonqualifying property received in the exchange. Thus, if property with a fair market value of 10x dollars and basis of zero is exchanged for like kind property with a fair market value of 5x dollars and 5x dollars in cash, realized gain would be 10x dollars, since AR—AB = 10x. That realized gain would be recognized to the extent of the 5x dollars in cash received.

For purposes of calculating the taxpayer's basis in the replacement property, the taxpayer's initial basis would be increased by 5x dollars to reflect gain recognized in the exchange. However, basis would also be decreased by 5x dollars to reflect cash received in the exchange. Therefore, basis in the replacement property would remain at zero.

Treatment of Liabilities

As noted, if liabilities associated with the relinquished property are assumed by the other party to the exchange, the taxpayer is deemed to receive cash. Section 1031(d); Regs. § 1.1031(b)-1(c); *Coleman v. Com'r*, 180 F2d 758 (8th Cir. 1050). *Whether* another party to the exchange has assumed a liability of the taxpayer is determined under Section 357(d). Although realized gain is recognized to the extent nonqualifying property is received in an exchange, Section 1031 (c) provides that realized loss with respect to relinquished exchange property is never recognized, even if nonqualifying property is received in an exchange.

Thus, if the taxpayer exchanges property with a basis of 10x dollars and a fair market value of 5x dollars for other property with a fair market value of 5x dollars, the taxpayer will not be permitted to recognize the loss. Rather, the loss would be deferred and would eventually be recognized when the taxpayer sold the property received in the exchange.

However, this does not mean that loss will never be recognized in a like kind exchange. Under Section 1001(c), both gains and losses are recognized with respect to *nonqualifying property transferred* in a like kind exchange. Section 1031 takes a restrictive view of nonqualifying property received in an exchange, since it undermines the purpose of the statute. However, Section 1031 imposes does not operate to disallow loss on the transfer of nonqualifying property in an exchange.

Example A

Taxpayer exchanges property in Florida which has declined in value, for an oil and gas lease in Montana, and cash. Realized loss with respect to the Florida property is not recognized because loss is not recognized with respect to the transfer of qualifying property, even if boot is received.

However, if as part of the consideration for the Montana property the taxpayer also transferred U.S. Steel stock which had declined in value, realized loss on the Ford stock would be recognized (whether or not the taxpayer received cash boot) because both gains and losses are recognized with respect to the transfer of nonqualifying property in a like kind exchange. When cash boot is received in a deferred exchange covering two taxable years, taxable income is presumably not recognized until the second year, when boot is received. See Revenue Ruling 2003-56.

"Trading Up" and "Trading Down"

Where a taxpayer "trades up" by acquiring property more valuable than the property relinquished and no boot is received, Section 1031 operates to defer recognition of all realized gain, (except in unusual circumstances involving depreciation recapture under Section 1245). However, if the taxpayer "trades down" and acquires property less valuable than that relinquished (thereby receiving cash or other nonqualifying property in the exchange) like kind exchange status will not (for this reason) be imperiled, but the taxpayer will be forced to recognize some of the realized gain.

Boot may consist of property excluded by definition in Section 1031 from like kind exchange treatment. For example, Section 1031 (a)(2)(D) states that Section 1031 "shall not apply" to the exchange of partnership in-

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terests, even though the exchange of partnership interests might otherwise be considered the exchange of like kind property.

Boot may also consist simply of property which fails to constitute property that is of like kind to the property relinquished in the exchanged (*e.g.*, the receipt of a truck in exchange for a horse).

The IRS has taken the position that boot may result even if no nonqualifying property is received in the exchange; for example in an exchange of real estate whose values are not approximately equal. *See* PLR 9535028. This result could also conceivably occur in a situation involving the exchange of property among beneficiaries during the administration of an estate.

Some Closing Expenses Offset Boot

The receipt of cash or other nonqualifying property would normally produce taxable boot to the extent of realized gain. However, Rev. Rul. 72-456 provided that brokerage commissions and many other transaction costs may be expensed, reducing gain realized and, in effect, also reducing recognized gain. *Blatt v. Com'r*, 67 T.C.M. 2125; T.C. Memo (1994-48) concurred, and held that expenses incurred **in connection with the exchange** and not deducted elsewhere on the taxpayer's return may offset boot. In such cases, the taxpayer may in effect "trade down."

On the other hand, some closing costs or transactional expenses that may be paid with exchange proceeds are not excluded from amount realized or added to the basis of replacement property. Rather, they are operating costs due to the ownership of real property. However, even though they may not affect calculations with respect to the like kind exchange (and may therefore not appear on Form 8824), they may be deductible elsewhere on the return.

II. Depreciation Issues

Section 1245 or Section 1250 depreciation recapture can affect depreciable property held for more than one year and disposed of at a gain by reclassifying that gain as ordinary income. Section 1245 property is any depreciable property consisting of either tangible personal property or intangible amortizable personal property described within Section 1245(a)(3)(B) through (F). Section 1245 property employs "accelerated" or "front-end loaded" methods of depreciation, such as 200 percent or 150 percent declining balance.

Whether property constitutes Section 1245 property for depreciation purposes is a federal tax determination. Local law classification of property as real property or personal property – though important for purposes of Section 1031 – has little relevance for purposes of determining whether property is Section 1245 property or Section 1250 property.

Section 1250 property, defined by exclusion, consists of depreciable real property, other than Section 1245 property. Commercial and residential real property both constitute Section 1250 property. Commercial property is depreciable over 39 years using the straight-line method, while residential real estate is depreciable on the straight-line method as well, but over 27.5 years.

Cost Analysis Studies

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

The IRS Cost Segregation Audit Techniques Guide states that a cost segregation study should be prepared by a person with knowledge of both the construction process and the tax law involving property classifications for depreciation purposes. In general, a study by a construction engineer is more reliable than one conducted by a person with no engineering or construction background. Cost segregation professionals must verify the accuracy of blueprints and specifications, and take measurements to calculate the cost of assets and then to segregate them. The average cost segregation study may identify 25 percent to 30 percent of a property's basis that is eligible for faster depreciation.

Example B

Taxpayer plans to exchange land and a building in that he has owned for seven years. The property has a fair market value of $3 million and an adjusted basis of $1 million. As Section 1250 property, it has been depreciated using the straight-line method over 39 years. Replacement property, consisting of land and an office building is acquired for $3 million, 80 percent of the value of which is allocated to the building.

The basis of the replacement building is therefore $800,000. The basis of the land is $200,000. A cost segregation study determines that 25 percent of the value of the office building is personal property qualifying for a 7-year recovery period using the 200 percent declining balance method of depreciation. The cost segregation study has increased the total first year depreciation deductions from $20,513 (i.e., $800,000/39) to $71,385

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[($600,000/39) + (2/7) x $200,000)].

The basis of replacement property reflects the basis of relinquished property. If relinquished property has been heavily depreciated and little basis remains (or had a low basis to begin with) an otherwise successful cost segregation study of the replacement property would yield little tax benefit. However, if new funds have been invested or borrowed to exchange into more valuable property, the basis of the replacement property will reflect that investment, and a cost segregation study might yield tangible tax benefits.

Some Section 1245 property, such as a barn, constitutes a "single purpose agricultural structure" under Section 1245(a)(3)(D). Section 1031 largely defers to local law in determining whether property is real or personal and it is remote that a barn would not be classified as real property for local law purposes. Therefore, some property may be classified as Section 1245 property for purposes of depreciation, since that is a federal tax determination, while at the same time be classified as real property for purposes of Section 1031, since that is a local law determination.

If Section 1250 property has been reclassified as Section 1245 property for purposes of depreciation but still is real property under local law, the taxpayer could enjoy the best of both worlds: faster depreciation and qualification as real property for future exchanges. However, assume reclassification results in Section 1245 property that constitutes personal property under local law. If that property is later exchanged for either (i) real property or (ii) personal property that is not of like class, boot gain will result. Therefore, if replacement property does not have the same "mix" of real and personal property for purposes of Section 1031 – or even the same "mix" of "like class" personal property, the resulting inability to completely satisfy the "like kind" exchange requirement will result in boot, and perhaps also depreciation recapture.

If Section 1245 property is classified as real property under local law, and is exchanged for property that is real property under local law, no boot will result. However, since Section 1245 trumps Section 1031, the taxpayer is not out of the woods, because the *operative provisions* of Section 1245, relating to depreciation recapture, might still apply. Depreciation recapture can occur in a boot-free like kind exchange if more Section 1245 property is relinquished in the exchange than is received.

If some or all of the relinquished property does not constitute real property under local law, it will not be of like kind to replacement property consisting entirely of real property. Boot gain could also result if the Section 1245 property relinquished is not of "like class" to the Section 1245 property received in the exchange. As in the case where no boot is present, depreciation recapture may also result if more Section 1245 property is relinquished than is received in the exchange. As noted, whether or not boot gain is present, Section 1245 ordinary income depreciation recapture may occur in an exchange if more Section 1245 property is relinquished than is received.

Section 1245(b)(4) provides that if property is disposed of in a §1031 exchange, depreciation recapture cannot exceed the amount of gain recognized without regard to Section 1245 **plus** the fair market value of non-Section 1245 property acquired in the exchange. Therefore, Section 1245 recapture cannot exceed the sum of (i) boot gain and (ii) the extent to which Section 1245 property relinquished in the exchange exceeds Section 1245 property received in the exchange. IRC § 1245(b)(4)(B). Ordinary income recapture cannot exceed gain realized in the exchange. Section 1245(a)(1)(B).

The Regulations under Section 1245 require only that the replacement property be Section 1245 property to avoid recapture. Thus, no depreciation recapture will result if Section 1245 property with a class life of 7 years is replaced with Section 1245 property with a class life of 10 years. However, the boot analysis under Section 1031 is different: Boot will result if the Section 1245 property exchanged and received are not of like kind or like class. In this respect, the boot rules of Section 1031 are more restrictive than the recapture rules of Section 1245.

The extent of depreciation recapture may depend on the value of Section 1245 property relinquished versus the value of Section 1245 property received in an exchange. If more Section 1245 property is relinquished than is received, ordinary income depreciation recapture may result. Anticipating efforts to undervalue Section 1245 property relinquished, Regs. § 1.1245-1(a)(5) requires the total amount realized on the disposition be allocated between Section 1245 property and non-Section 1245 property in proportion to their respective fair market values. If the buyer and seller have adverse interests, an arm's length agreement will establish the allocation. In the absence of an agreement, the allocation is based on a facts and circumstances approach.

Unrecaptured Section 1250 Gain

Property subject to unrecaptured Section 1250 gain is taxed at 25 percent when sold. Section 1(h)(7). This rate is 10 percent higher than the usual rate imposed for long term capital gains. The higher rate serves as a proxy for depreciation recapture. Unrecaptured Section 1250 gain applies to all depreciation taken on real property, whether straight line or otherwise, except for Section 1250 "excess" depreciation that is subject to ordinary income recapture.

What happens to unrecaptured Section 1250 gain following a like kind exchange? The Code does not address the issue. Presumably, unrecaptured Section 1250 gain would be

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treated in the same manner as Section 1250 excess depreciation, so that the deferred unrecaptured Section 1250 gain would roll over into the replacement property.

Although Section 1250 recapture with respect to which "additional depreciation" has been taken, can also occur in an exchange, TRA 1986 generally required that all real property be depreciated on a straight line basis. Therefore, Section 1250 recapture should no longer be an issue in most exchanges. Section 1031(d)(4)(D); Regs. § 1.1250-3(d)(5).

Basis must be allocated to reclassified replacement property consisting of both Section 1245 and Section 1250 property. The aggregate basis of the reclassified replacement property equals the basis of the relinquished property, with adjustments as provided for in Section 1031(d). Regs. §1.1245-5(a)(2) requires that basis first be allocated to non-Section 1245 property to the extent of its fair market value, with the residue being allocated to Section 1245 property. The effect of this forced allocation will be to produce longer depreciation periods.

Example C

Taxpayer sells a building containing Section 1245 property on June 30th, 2006, for $1 million. The building had originally cost $700,000. Depreciation deductions of $300,000 had been taken, of which $100,000 was subject to ordinary income depreciation recapture under Section 1245(a)(2). The sale would result in (i) $100,000 of "excess" depreciation under Section 1245 taxed at 35 percent; (ii) $200,000 of unrecaptured Section 1250 gain taxed at 25 percent; and (iii) $300,000 of long term capital gain taxed at 15 percent. A NYC taxpayer would incur a tax of $236,220, resulting in an effective tax rate of 39.37 percent, computed as follows: [($100,000 x .35) + ($200,000 x .25) + ($300,000 x .15) + ($600,000 x .0897) + ($600,000 x .0365) + ($1,000,000 x .004) + ($1,000,000 x .02625)].

If this property were instead exchanged, all of the LTCG and all of the unrecaptured Section 1250 gain would be deferred. The fate of the Section 1245 recapture gain would depend on whether more Section 1245 property was relinquished in the exchange than was received. The only tax that could not be deferred in the exchange would be the combined state and local transfer tax liability of $30,500.

Regulations Governing Depreciation of Property Received in Exchange

Treas. Reg. § 1.168(i)-6 governs the method of depreciating property acquired in a like kind exchange. The taxpayer may elect out of applying Reg. § 1.168(i)-6 by indicating on Form 4562 "Election Made Under Section 1.168(i)-6T(i)." If an election out is made, the taxpayer calculates depreciation based upon the entire basis of the replacement property at the time it is placed in service.

If no election is made not to apply Treas. Reg. §1.168(i)-6, the basis of replacement property will consist of (i) "Old Basis" and (ii) "New Basis". Old Basis is the adjusted basis of relinquished property, while New Basis is any additional basis arising in the exchange. In general, an election out may be desirable when the recovery period or depreciation method of the replacement property is different from that of the relinquished property. If an election out is made, the replacement property is depreciated using the recovery period and depreciation method of the replacement property, even if the recovery period is shorter and the depreciation method faster.

No depreciation is allowed during the exchange period. Accordingly, depreciation with respect to "Old Basis" and "New Basis" will both commence when the replacement property is acquired. The depreciation allowed will depend upon whether the replacement property has (i) a longer (or shorter) MACRS recovery period than the relinquished property and (ii) a slower (or faster) depreciation method than the relinquished property had.