TAX NEWS & COMMENT

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IRS & NYS DTF MATTERS

Recent Developments & 2013 Regs. & Rulings of Note

I. IRS Matters

Final Regulations For Health Insurance

As of January 1, IRC § 5000A requires that all "non-exempt" individuals obtain "minimum essential healthcare coverage." Final regulations governing penalties for noncompliance have been issued. (T.D. 9632).

The regulations provide, *inter alia*, that (i) if an individual has coverage or is exempt from coverage for a single day of the month, that individual will be so treated for the entire month; (ii) penalties will not be imposed for a failure to obtain coverage

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FROM FEDERAL COURTS, NYS COURTS & NYS TAX TRIBUNALS

Recent Developments & 2013 Decisions of Note

I. Federal Courts

The Supreme Court in *United States v. Windsor* declared unconstitutional Section 3 of the Defense of Marriage Act of 1996 (DOMA), as violating the due process clause of the Fifth Amendment, which guarantees every person equal protection of the law. S.Ct. No. 12-307 (2013). The landmark decision will have a significant impact on federal tax law.

Following the *Windsor* decision, Treasury announced that a same-sex union celebrated in a jurisdiction recognizing such marriages would be respected, for federal tax purposes, in all states. Rev. Rul. 2013-17. The

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FROM WASHINGTON & ALBANY

WASHINGTON: NEW TAXES ARRIVE GOVERNOR CUOMO: NY TAXES TOO HIGH

Marginal Individual Rates Highest Since Before Tax Reform Act of 1986

I. From Washington

A rainbow of new federal income taxes arrived on January 1, 2014, led by the new 3.8 percent "Medicare" tax imposed by IRC §1411.

Tax Analysis

Although enacted as part of the health care legislation of President Obama, the new tax will actually augment the General Fund of the Treasury. In practice, the predominant effect of the Medicare tax will be to increase the capital gains tax rate on taxpayers to whom the 39.6 percent ordinary income rate applies, to 23.8 percent from 20 percent.

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Like Kind Exchanges in 2014: An Oasis of Income Tax Tranquility

I. Introduction

High income New York City residents selling fully depreciated real estate this year will incur a capital gains tax of about 39 percent, consisting of a federal tax of 28.5 percent (25 percent on IRC §1250 unrecaptured gain plus 3.8 percent under IRC §1411) and a New York tax of 12.5 percent [6.85 percent to NYS (if taxable income exceeds $2 million, the marginal rate increases to 8.82 percent) and NYC tax of 3.65 percent].

Income Tax Planning

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Challenging The Account of a Trust Fiduciary

I. Trustee Commissions

Trustees are entitled to compensation for serving in their fiduciary capacity. The trust may provide a fee schedule or may provide for a waiver of fiduciary fees. If the will is silent or provides for statutory commission, then reference should be made to Section 2309 of the Surrogates Court and Procedure Act (SCPA).

Trustees are entitled to annual commissions as well as commissions based upon amounts paid out. SCPA §2309(2) provides that trustees are entitled to annual commissions at the

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FEBRUARY COMMENT

Rev. Rul. 85-13: Is There a Limit to Disregarding Disregarded Entities?

I. Introduction

Although the federal estate tax is not extinct, with the combined marital exemption now north of $10 million, it is an endangered species. Recently, Governor Cuomo signaled his intent — likely to be affirmed by State Republicans — to increase the New York estate tax exemption to perhaps the federal level.

Income Tax Planning

With the threat of high federal estate taxes no longer a concern for the vast majority of taxpayers, atten-

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FROM WASHINGTON & ALBANY, CONT.

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A summary of major changes under the American Taxpayer Relief Act (ATRA):

¶ Marginal rates on taxpayers with over $400,000 of ordinary income ($450,000 for joint filers) will rise to 39.6 percent; marginal rates on other taxpayers will remain unchanged. These thresholds will be adjusted for inflation.

¶ The new 3.8 percent "Medicare" tax will be imposed on "net investment income" of taxpayers whose AGI exceeds threshold levels.

¶ A new payroll tax of 0.9 percent will be imposed on wages above $200,000 ($250,000 for joint filers).

¶ Capital gains and dividend income will remain taxed at 15 percent for taxpayers not in the 39.6 percent bracket. The rate for taxpayers in the 39.6 percent bracket will rise to 20 percent.

¶ Itemized deductions as well as personal exemptions are phased out for taxpayers whose AGI exceeds certain thresholds.

¶ The Alternative Minimum Tax exemption amount has been increased and is now indexed for inflation.

¶ The gift and estate tax exclusion has been increased to $5 million permanently, and is indexed for inflation. The inflation-adjusted amount for 2014 is $5.34 million. The tax rate on gifts and estates once the lifetime exemption has been absorbed has risen from 35 percent to 40 percent. The concept of "portability," intended to prevent the loss of one spouse's unused exemption, has been made permanent.

The upshot is that high income taxpayers will face significantly higher effective tax rates on earned income as well as investment income. The loss of itemized deductions for high AGI taxpayers will further increase effective federal tax rate by a few percentage points.

Taxpayers whose taxable income is between $300,000 and $2 million will incur a state tax 6.85 percent; the rate for those whose taxable income exceeds $2 million is 8.82 percent of that excess.

New York City imposes an income tax of between 3.53 percent and 3.876 percent. Mayor de Blasio is currently in disagreement with Governor Cuomo concerning the desire of Mr. de

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FROM WASHINGTON & ALBANY , CONT.

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Blasio to increase the top NYC income tax rate to 4.41 percent.

As though it were not already apparent, high income NYC wage earners face a daunting effective federal and NYS income tax rate of 51 percent (39.6 + 6.85 + 3.65 + 0.9) which exceeds that of France (49 percent), Germany (45 percent), Norway (48 percent), and the UK (45 percent) but not that of the Netherlands (52 percent), Finland (53 percent) and Sweden (57 percent).

Those taxpayers subject to the New York City Unincorporated Business Tax will pay an additional 4 percent. The UBT is imposed on any individual or unincorporated entity, other than a partnership, that is carrying on or currently liquidating a trade, business, profession, or occupation within New York City. City residents whose net self employment earnings are not more than $100,000 will not incur the tax. The 4 percent UBT is phased in for taxpayers whose self employment income is between $100,000 and $150,000.

The combined federal and state capital gains rate for NYC taxpayers in the 39.6 percent bracket (whose taxable income is not greater than $2 million) is now 34.3 percent (20 + 3.8 + 6.85 + 3.65).

New York has what could be considered a "long arm" residency statute which makes it relatively difficult to maintain ties to New York and still achieve nonresident status for income tax purposes.

A. New Medicare Surtax

Beginning January 1, 2013, a new 3.8 percent Medicare tax is imposed on the **lesser of** (i) "net investment income" (gross investment income less allowable deductions) or (ii) **the excess** of the taxpayer's AGI over a threshold amount, which is $200,000 for individuals, or $250,000 for joint filers. Thus, if no AGI "excess" exists, no Medicare tax liability will arise. Contrariwise, if AGI excess exists, then the tax will target the lesser of that excess or "net investment income." (The statute actually references "modified" AGI, which for the vast majority taxpayers will be identical to AGI.)

Taxpayers subject to the Medicare tax include U.S. individual taxpayers (not nonresident aliens), as well as trusts and estates (except grantor trusts). Corporations are not subject to the tax (although S Corporate income will flow through to taxpayers who are subject to the tax).

Net investment income includes income from the following sources:

(i) interest, dividends, royalties and rents;

(ii) trade or business activities of the taxpayer in which the taxpayer does not materially participate;

(iii) profits from trading in financial instruments (even if taxpayer materially participates); and

(iv) net gains attributable to the disposition of property that qualifies as a capital asset under IRC §1221, as well as gains from ordinary income that do not so qualify.

NOTE: Taxable gains arising from the taxpayer's participation in a trade or business in which the taxpayer materially participates or income from rents or royalties arising from a trade or business in which the taxpayer materially participates, **do not constitute net investment income** (NII) if the income is a "core source" of income from the trade or business in which the taxpayer materially participates. Note also that interest which is deductible, as well as taxes arising from investment income, may reduce NII.

(i) Interest, dividends, royalties and rents. All generally NII. However, tax exempt interest is not NII. Interest, dividends, royalties and rents earned by an entity, such as an LLC or S Corporation in which the taxpayer has an interest will constitute NII, even if the taxpayer materially participates in the business.

Passive loss rules restrict taxpayer deductions arising from rental real estate activities. The regulations under IRC §1411 provide that a "real estate professional" will not be subject to NII provided (i) the IRC §469 passive loss rules are met and (ii) the rental real estate activity constitutes a trade or business of the taxpayer.

(ii) Trade or business activities of the taxpayer in which the taxpayer does not materially participate. IRC §1411 defers to the passive loss rules of IRC §469 for purposes of determining whether the taxpayer has met the material participation test such that the activity is not a passive activity.

(iii) Profits from trading in financial instruments (even if taxpayer materially participates). A "trader" is one who seeks to profit from "short term market swings" and whose trading is "frequent and substantial." An investor, whose income is not NII, is a person who purchases and sells securities to realize investment income. The management of one's own investments will not cause the person to become a trader, regardless of the extent of investments. IRC §1411(c)(2)(B); Reg. §1.1411-5(c).

(iv) gains from the sale or exchange of property (except those gains associated with a trade or business in which the taxpayer materially participates.) NII generally includes gains from the sale or exchange of property. However, an exception to this rule applies if the taxpayer materially participates. In addition, gains deferred or excluded under other provisions of the Code are deferred for purposes of IRC §1411 (*e.g.,* like kind exchanges, IRC §121 exclusion, IRC §1033 involuntary conversions, and IRC §453 installment sales).

B. Payroll Tax Increases

Effective January 1, 2013, a new 0.9 percent Additional Medicare

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FROM WASHINGTON & ALBANY, CONT.

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tax will be imposed on wages and other compensation in excess of $200,000 ($250,000 for joint filers). Employers are required to withhold the tax, but are not required to match it. Final regulations were issued in November.

C. The Affordable Care Act

The Affordable Care Act became law on January 1, 2014 and requires all taxpayers to obtain health coverage, or incur a penalty. On February 10, the Administration announced modifications to the employer mandate intended to ease the burden on large employers. Thus, companies employing 100 or more workers must now obtain health insurance for only 70 percent of workers by 2015, but by 2106 for 95 percent of workers.

Medium sized companies employing between 50 and 99 workers must provide health insurance by 2016, and must certify under penalty of perjury that their payrolls were not reduced to avoid the health insurance mandate required for large companies.

Companies subject to the mandate are required to provide health insurance for employees who work 30 hours or more. Those companies which (i) fail to provide an "affordable premium" comprising no more than 9.5 of an employee's income and (ii) fail to pay for 60 percent of the premium, will incur a penalty of $2,000 per employee for noncompliance. The penalty increase to $3,000 of an employee not offered coverage purchases a subsidized plan on a federal or state exchange.

Small companies, which comprise 96 percent of all businesses, are exempt from the Affordable Care Act employer mandate.

The individual mandate, which requires all individuals to obtain minimum essential coverage, was not delayed. However, individuals who experience a short delay in obtaining coverage will not be subject to the penalty. Under IRC §36B, individuals who obtain insurance on an exchange may be entitled to receive a refundable tax credit, depending upon their income.

D. Reinstatement of Phaseout of Itemized Deductions

Beginning in 2013, itemized deductions will again be phased out. Three factors determine the phaseout: First, the "threshold" amount which, for single filers, is $250,000. Second, the percentage limitation, which is 3 percent for all taxpayers, regardless of filing status. Third, the taxpayer's adjusted gross income (AGI).

The reduction in itemized deductions equals three percent of the difference between AGI and the threshold amount. To illustrate, single taxpayer has AGI of $750,000 and $100,000 in itemized deductions. The difference between AGI and the threshold amount is $500,000, three percent of which equals $15,000. The taxpayer's itemized deductions would be limited to $85,000.

E. Reinstatement of Phaseout of Personal Exemptions

In a manner similar to that which determines the phaseout of itemized deductions, Congress has imposed the same "thresholds" for determining the phaseout of personal exemptions. For single taxpayers, the threshold is $250,000. Again, the difference between the taxpayer's AGI and the threshold amount is the starting point for determining the phaseout. The taxpayer will forfeit 2 percent of the allowable exemption for every $2,500 of that difference.

For example, assume the single taxpayer's AGI is $250,000. The phaseout will not apply. However, if single taxpayer's AGI is $450,000, the difference between AGI and the threshold amount is $200,000. Personal exemptions are phased out to the extent of 2 percent of every incremental $2,500 "difference" between AGI and the threshold amount. $200,000 divided by $2,500 equals 80. Therefore, the taxpayer would lose all of his personal exemptions.

A difference between AGI and a threshold amount of $125,000 or more will extinguish all of the taxpayer's personal exemptions (*i.e.*, $2,500 x 50). Note: The $125,000 differential between the threshold amount and AGI is the same regardless of whether the taxpayer is a single filer, files jointly, or files separately. The threshold amounts are higher for married filers.

F. Alternative Minimum Tax

The AMT exemption amounts have been increased beginning in 2013, and are now indexed for inflation.

G. Estate & Gift Taxes

The feature of "portability" has become permanent. Gift and estate taxes are again unified. The lifetime exemption amount in 2013 is $5.25 million, and for 2014 is $5.34 million. The exemption is now indexed for inflation. The rate of tax once the lifetime exemption has been exhausted (either during life or at death) has been increased from 35 to 40 percent.

II. From Albany

Governor Cuomo, facing reelection this November, and apparently with ambitions for higher office, recently unveiled his proposed $137 billion budget for the 2015 fiscal year starting April 1. Mr. Cuomo maintains that under his administration, New York has gone from an $8 billion deficit to a $2 billion surplus. Mr. Cuomo is currently enjoying a resurgence in popularity; his approval rating stands at 54 percent, with two-thirds of those polled viewing him favorably, and 57 percent inclined to re-elect him.

While most residents favor the legalization of marijuana, they disagree with the method which Mr. Cuomo has chosen to accomplish that objective. Governor Cuomo has attempted to begin legalization through quasi-administrative fiat. Most New Yorkers polled prefer a state referendum,

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which is the procedure used in other states that have legalized marijuana.

New York's higher personal tax rate was extended for three years, from 2015 through 2017. The highest rate imposed on individuals, now 8.87 percent, had been slated to revert to 6.85 percent.

Budget Proposals of Governor Cuomo

Mr. Cuomo's budget divides the state into two regions: "upstate" and the rest of the New York. Upstate comprises all of New York except Long Island, New York City, Westchester, Rockland, Orange, Putnam, and Dutchess counties. Most if not all tax incentives intended to benefit businesses target only upstate, thereby excluding the city and above-referenced regions.

Proposals intended to help individual taxpayers are less skewed: Citing property taxes that are among the highest in the U.S., Mr. Cuomo proposed "freezing" real property taxes for two years, thus providing $1 billion in tax relief. An important proviso to this relief is that local governments must reign in tax increases as well.

Citing the 3.3 million persons who rent their homes, Mr. Cuomo proposed a refundable tax credit available to renters whose incomes are below $100,000. This measure would, according to the Governor, provide more than $400 million in tax relief to the 2.6 million taxpayers who rent homes.

To discourage older residents from retiring in Florida and elsewhere, Mr. Cuomo proposed phasing out the estate tax over six years, with the eventual aim of reconciling the state exemption with the federal exemption by 2019. The maximum rate of estate tax would also be reduced to 10 percent within four years.

Although not mentioned by the Governor in his January 8 State of the State Address, rumors have surfaced of an effort to reinstate the New York gift tax. Since New York has an estate tax with an exemption of only $1 million, wealthy New York residents may reduce potential New York estate tax liability by making large gifts. This change would impede this strategy.

Mr. Cuomo also proposed reducing the corporate tax rate to 6.5 percent, which would be the lowest such rate since 1968. The proposal would also provide a refundable tax credit to upstate businesses equal to 20 percent of a company's annual property taxes, and would eliminate corporate income tax entirely for upstate manufacturers. Mr. Cuomo believes these measures would provide $346 million in annual tax relief.

The cost of these tax incentives, including estate tax relief, would be significant: Revenues would decline by $381 million in fiscal year 2016, by $627 million in fiscal year 2017, and by $772 million in fiscal year 2018. The hope of Mr. Cuomo is that these short-term revenue losses would be offset by increased revenues from attracting capital into the State and retaining the wealth of affluent taxpayers who would otherwise depart.

New York is also expected to benefit from Washington's largesse, courtesy of higher federal taxes. Medicaid revenues are expected to increase by 4.6 percent to $58.2 billion; and federal aid to schools is expected to increase by 3.8 percent to $21.9 billion.

Mr. Cuomo is apparently in disagreement with Mayor Bill de Blasio concerning who will pay the $1.5 billion needed to provide statewide pre-kindergarten programs and to expand after school programs. While Mr. Cuomo would like New York to provide funding, Mr. DeBlasio would like the funds to be provided by a new income tax imposed on wealthy New York City residents.

New Laws as of January 1, 2014

The following new laws took effect in New York on January 1, 2014:

¶ Small businesses will benefit this year from tax reductions totaling $35 million.

¶ The New York State corporate tax imposed on manufacturers will be reduced by 10 percent, providing about 13,000 manufacturing companies with $30 million in tax relief.

¶ Under the "Family Tax Relief" program, a state Republican initiative, families with at least one dependent whose household income is between $40,000 and $300,000 will receive $350 in tax relief.

¶ The "Start-up NY Economic Development Program" will create tax-free areas near state universities and colleges. Businesses relocating to these area will be exempt from virtually all corporate, income, sales, use and property taxes for 10 years (provided their businesses do not compete with existing businesses in these areas).

¶ New York's minimum wage has been increased to $8 from $7.25.

Tax Losses From Nonresident Trusts

Former Comptroller Carl McCall, heading a state tax commission, has proposed to limit the tax losses New York is incurring by wealthy residents using out of state nongrantor trusts.

Trusts established jurisdictions which permit "self-settled" trusts have been used principally for asset protection proposes. Although the degree of asset protection these trusts provide is debatable, because of the IRS ruling which permits the use of nongrantor trusts in tax-free jurisdictions, New York is losing an estimated $150 million per year in tax revenues.

Such trusts, most commonly formed in Delaware, Nevada or South Dakota, are attractive since Nevada imposes no personal income tax, and Delaware imposes no income tax on out of state beneficiaries. It is possible, because of a fairly recent IRS ruling, for a New York resident to establish trusts in those jurisdictions and thereby avoid New York income tax.

Thus, if the assets of a business generate no New York source income, if all of the corpus of the trust is outside of New York, and if no trustees reside in New York, the trust, even though settled by a New York resident, will not be subject to New York income tax.

FROM THE COURTS, CONT.

(Continued from page 1)

IRS stated that for tax years in which the statute of limitations is still open, same sex couples may file amended returns.

* * *

The Supreme Court, in cases involving Amazon and Overstock, declined to exercise *certiorari* to hear facial Constitutional challenges to New York's revenue law which imposes sales tax on internet sales based upon a "presumption" of nexus in New York. The decision by the New York Court of Appeals, which upheld the taxing statute, was in effect upheld. *Amazon.com LLC v. N.Y.S. Dep't of Taxation & Fin*., No. 13-259 (12/2/2013); *Overstock.com., Inc. v. N.Y.S. Dep't of Taxation & Fin.,* No. 13-252 (12/2/2013).

* * *

In *Obergefell v. Kasich*, 2013 U.S. Dist. LEXIS 10277 (S.D. Ohio 2013), the Court forbade the Ohio registrar from issuing a death certificate unless the death certificate reflected the marriage by the same-sex couple in Maryland shortly before the decedent's death. The plaintiff Obergefell argued that he would suffer irreparable harm unless the death certificate indicated his marriage. The Ohio constitution prohibits same-sex marriage, but such marriages are legal in Maryland.

* * *

Syring v. U.S., 2013 WL 4040445 (W.D. Wis.) underscores the importance of properly designating tax payments. Taxpayers should designate tax payments to the oldest tax liability; otherwise the government may apply the tax to penalties and more recent tax liabilities, which may be disadvantageous. In *Syring*, under a belief that the estate would owe more than $600,000 in taxes, it made an undesignated payment to IRS of $170,000.

Later, the estate filed a return indicating no estate tax due. At the same time, the IRS found a tax due, but only of $25,526. The taxpayer claimed a refund which was denied by IRS. The Service asserted that the three-year period for claiming a refund had lapsed. Holding for the IRS, the District Court found that the payment, when made, was neither designated as a deposit, nor made with the intent that it constitute a deposit. Accordingly, the Service was correct in treating the remittance as a payment, in accordance with its own advice in Rev. Proc. 2005-18.

* * *

In *U.S. v. Blake*, 111 AFTR 2d 2013-1722 (E.D.N.Y. 2013), the decedent's estate owed $253,590 in estate tax. The decedent had died in 1989. The IRS pursued collection, and in 1993 filed a proof of claim against the estate. The executor of the estate, the decedent's daughter, entered into an installment agreement to satisfy the then outstanding estate tax liability of $560,215 in August of 1995.

The executor died in 2005, and the estate defaulted on the installment agreement. The IRS then proceeded against the granddaughter, who was the named executor of the daughter's estate, by filing notices of tax lien in 2005 on two parcels of real property owned by the granddaughter. In response, the executor commenced a quiet title action in New York Supreme Court in 2010. While that action was pending, the United States brought an action in federal court, seeking payment.

The district court granted the executor's motion to dismiss, citing the factors set forth in *Colorado River Water Conservation District v. U.S.,* 424 U.S. 800 (1976). Among the factors weighing most heavily against the government was the fact that state court already had jurisdiction over the res of the action, and that the federal action would be "duplicative" in nature.

* * *

The Supreme Court denied *certiorari* in a case brought by an Albany strip club, which had argued unsuccessfully in New York tax tribunals, and then in the 3rd Department, that the imposition of sales tax was improper. The position of the club was that it was exempt from sales tax, since the admission charges related to "musical arts or choreographed performances." *Matter of New London Corp. v. N.Y.S. Tax App. Trib.*, 19 N.Y.2d 1058 (2012), *cert. denied*, 134 S.Ct. 422 (2013).

* * *

In a stinging rebuke to the Northern District, which had found that New York had acted unconstitutionally, the Second Circuit Court of Appeals reversed, and found that New York had neither erred nor violated the Constitution when it imposed a civil penalty following the conviction of the taxpayer for tax fraud. *Abuzaid v. Mattox*, Nos. 10-1210-cv, 10-1785-cv (2d Cir. 8/12/13).

The case involved a taxpayer who had pled guilty to crimes involving cigarette stamp fraud, only to be later assessed by the Department under a civil penalty statute. The taxpayer argued successfully in District Court that the later imposition of a civil penalty under a statute, tinged with criminal overtones, violated the taxpayer's right not to be subject to double jeopardy under the Fifth Amendment.

The Court of Appeals (after deliberating for two years) however, found that the civil penalty was just that — a civil penalty, and that the taxpayer had not been subject to criminal prosecution for the same offence twice. Having reversed the holding of the District Court, the Court of Appeals did not stop there. It then mused over whether to dismiss the appeal with prejudice or to dismiss it without prejudice.

Ultimately, the Court of Appeals dismissed it with prejudice, thereby preventing any New York taxpayer from again challenging the statute in New York State court. The argument against dismissing the case without prejudice consisted of a comi-

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ty argument — *i.e.,* that the federal judiciary should not interfere with state courts. However, the Second Circuit scathingly noted that dismissal with prejudice was warranted in order to prevent "meritless" litigation in state court, and that this consideration outweighed in this case the importance of the doctrine of comity.

II. New York Courts

The Appellate Division, Second Department, recently upheld a constitutional challenge to the MTA payroll tax by Nassau County. *Mangano v. Silver, et al.,* 107 A.D.3d 956 (2nd Dep't 2013). Earlier, the Third Department had rejected a challenge to the tax made by Rockland County, which argued that it failed to receive services commensurate with the tax imposed on its residents. *Vanderhoef v. Silver*, No. 516180, 2013 NY Slip Op. 8486 (3rd Dep't, 12/19/13).

* * *

The Appellate Division, Third Department, reviewed and affirmed a decision of the Tax Appeal Tribunal in *Matter of Xerox Corp. v. NYS Tax Appeals Tribunal*, 2013 Slip Op 06899 which upheld the interpretation given by the Department to Tax Law §208 (6), which defines "investment income" for purposes of the corporate franchise tax.

Xerox sold office equipment to governmental agencies under fixed purchase option leases and installment agreements. Xerox filed amended returns for the tax years 1997, 1998 1999 recharacterizing interest income from "investment capital" to "investment income." The change resulted in a refund request, which was denied.

Following a hearing in the Division of Tax Appeals, the ALJ found for Xerox. On appeal, the Tax Appeals Tribunal reversed. The Appellate Division, hearing the matter in an Article 78 proceeding pursuant to Tax Law §2016, affirmed the decision of the Tax Appeals Tribunal.

Business income is defined as "entire net income minus investment income." Investment income is defined as "income . . . [derived] from investment capital" less allowable deductions (Tax Law §208[6]), which is "investment in stocks, bonds and other securities, corporate and governmental . . ." (Tax Law §208[5]). Xerox took the position that the finance agreements constituted "securities" for purposes of Tax Law §208[5].

The Appellate Division rejected the appeal of Xerox on two grounds: First, the Third Department explained that "[u]nder well-established law, "an agency's interpretation of the statutes it administers must be upheld absent demonstrated irrationality or unreasonableness." The Court explained:

> [while] deference to an administrative agency is not required where the question is one of pure statutory interpretation, deference is appropriate where the question is one of specific application of broad statutory term[s] by the agency charged with administering the statute.

Against this backdrop, the Appellate Division then noted that although the franchise tax statutes do not define the term "security" or "other securities,"

> under the principle of *ejusdem generis* — of the same kind — the scope of general statutory language, if unclear, is limited by specific terms or phrases that precede it. . .

The Court remarked that where the statute provides no definition, reference should be made to the "plain meaning" of the words. Here, the Xerox had adduced no evidence to show that the finance agreements were ever sold on an "open market or a recognized exchange," or were "commonly recognized by investors as securities."

III. New York Administrative Tax Tribunals

In *Matter of Steven E. Breitman*, DTA No. 824268 (2013), a New York Administrative Law Judge rejected the challenge by the taxpayer, a New Jersey resident, of New York's imposition of a tax on a sale of the taxpayer's leasehold interests in Pennsylvania. The taxpayer's corporation had elected S corporate status, and the taxpayer had filed a nonresident return in the year in question, reporting no New York source income.

The Department argued that a portion of the gain constituted New York source income. The ALJ agreed, remarking that in order to avoid the portion of gain that was determined to be New York source income, the taxpayer would have had to show that the gain which New York had characterized as New York source income was "grossly disproportionate," a finding which the taxpayer had failed to demonstrate.

* * *

The rules of the CPLR apply equally to disputes in the Division of Tax Appeals. So held the Tax Appeals Tribunal in rejecting the decision of the Administrative Law Judge in *Matter of Medical Capital Corp*., DTA No. 824837 (7/25/13). The taxpayer had received a Notice of Deficiency from the New York asserting a tax due of $48,000. The Department made a motion to dismiss, which was granted by the ALJ. On appeal, the Tax Appeals Tribunal held that under CPLR §3211, every pleading must be given a liberal construction and that the taxpayer should have been given the benefit of "every possible inference."

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for less than three months; and (iii) an individual is liable for penalties for any dependent, whether or not the taxpayer claims the person as a dependent for the tax year.

Rev. Proc. 2013-35: Inflation-Adjusted Amounts for 2014

The inflation-adjusted amounts for exemptions and deductions for 2014 include (i) an estate, gift and GST exemption at $5.34 million; (ii) an annual gift tax annual exclusion of $14,000; (iii) an annual exclusion for gifts to non-citizen spouses at $145,000; (iv) a personal exemption of $3,950; and (v) a standard deduction of $12,400 for married taxpayers filing jointly; and $6,200 for married taxpayers filing separately and for individuals.

Final Regulations Governing Deductions for Tangible Property

The IRS has issued final regulations governing the deduction and capitalization of expenses relating to tangible personal property. In general, expenses must be capitalized if the amount paid is to "improve" property. Improvement occurs where amounts are expended (i) for the betterment of the property; (ii) to restore the property; or (iii) to adapt the property to a new or different use. (T.D. 9636)

The regulations contain a number of safe harbors which dispense with the need to capitalize. Thus, amount paid for "routine maintenance" of a building, coop or condominium are not deemed to constitute improvements.

A qualifying small taxpayer may also expense, rather than capitalize, amounts paid for repairs, maintenance and improvements if the amount expended on such activities does not exceed the lesser of $10,000 or 2 percent of the unadjusted basis of the building.

Finally, a taxpayer with an "applicable financial statement" (AFS) may rely on the safe harbor permitting expensing where the amount paid for property does not exceed $5,000 per invoice, or per item as substantiated by the invoice.

PLR 201310002: Nevada & Delaware Non-Grantor Trusts

PLR 201310002 blessed a theorized tax planning and asset protection strategy that fuses elements of grantor trusts, asset protection and trust taxation in a manner that accomplishes salient tax and asset protection objectives. These trusts are referred to as "Delaware Incomplete Non-Grantor Trusts," or "Nevada Incomplete Non-Grantor Trusts."

The objectives are achieved by forming a nongrantor trust in a state with no income tax that also recognizes the ability of a grantor to establish a self-settled spendthrift trust. Once accomplished, the grantor, who resides in an income tax jurisdiction, will have avoided state income tax. No complete gift will have occurred at the time the trust is funded. Rather, a gift will occur only when the beneficiary receives a trust distribution, or when the grantor dies, at which time the remaining assets will be included in his estate.

New York is so irritated by the prospect of losing tax revenue from these trusts that a special tax commission has been charged with assessing the propriety of these trusts. However, it is doubtful that New York would prevail should the matter reach litigation by reason of the holdings in the following cases:

In *Mercantile-Safe Deposit & Trust Co. v. Com'r*, 15 NY2d 579 (1964), the decedent, a New York resident, created a revocable *inter vivos* trust which became irrevocable at his death. The trust provided that upon his death, income would be paid to his surviving spouse, a New York resident. The trustee and the intangible property constituting corpus were at all times in the Delaware trustee's "exclusive possession and control."

Court of Appeals held that Due Process prohibited New York from imposing income tax on the Delaware Trustee.

A later case, *Taylor v. NYS Tax Commission*, 445 N.Y.S.2d 648, 85 A.D.2d 821 (3rd Dept. 1981) held that under the 14th Amendment, "a state may not impose tax on an entity unless that state has a sufficient nexus with the entity, thus providing a basis for jurisdiction." Codification of *Taylor* occurred through enactment of Tax Law §605(b)(3)(D)(I), which taxes such trusts created by New York residents as nonresident trusts.

More recently, in *McNeil v. Pennsylvania*, 2013 Pa. Comm. LEXIS 168 (2013), a Pennsylvania sate court held that an attempt by Pennsylvania to tax a trust settled by a Pennsylvania resident, but whose assets and trustees were all outside of Pennsylvania, violated the Commerce Clause of the Constitution. Therefore, as unhappy as New York may be with the IRS ruling which may effectively deprive New York of the ability to impose tax on such trusts, their validity may be upheld if challenged, and an attempt by New York to legislate their tax benefits out of existence could be doomed to failure.

Late S Corporate Election Relief

Rev. Proc. 2013-30 simplifies the procedure and expands the time available to obtain relief for various late S corporation elections (*e.g.*, qualified subchapter S subsidiary , electing small business trust, qualified Subchapter S subsidiary, and corporate classification elections). The advice consolidates previous separate revenue procedures. Generally, taxpayers will now have 3 years and 75 days after the date the election was required to be effective to request relief. However, in some cases there is no deadline.

Relief From Unnecessary QTIP Elections

The IRS announced the circumstances where it will disregard an erroneously claimed QTIP election. One

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such circumstance is where an estate tax return was filed only because it was necessary to elect portability, and the decedent's remaining applicable exclusion amount would have resulted in no federal estate tax. Rev. Proc. 2001-38. This ruling is consistent with the policy of the IRS with regard to administrative relief for mistaken QTIP elections in other circumstances. *See* PLRs 201345006, 201338003 & 201338003.

Final Regulations Issued Re Net Investment Income Tax

The IRS in late November issued regulations governing the treatment of the disposition of interests in S corporations and partnerships for purposes of net investment income subject to the 3.8 percent Medicare tax. The regulations provide a "primary" method and an optional "simplified" method, but restrict the use of the simplified method.

The regulations also (i) clarified that capital losses may offset investment income; (ii) provided a safe harbor for real estate professionals that prevents rental income from being classified as net investment income; (iii) revised the method for properly calculating itemized deductions; (iv) partially allowed the use of net operating losses; and (v) allowed the regrouping of activities under the IRC §469 passive loss rules.

Equitable Innocent Spouse Relief

The IRS issued proposed regulations under IRC §6015 that eliminate the two-year statute of limitations for requesting equitable innocent spouse relief. Instead, the aggrieved spouse must now file a request for relief within the IRC §6502 period for collection of tax or the IRC §6511 period for requesting a tax refund. The IRS also acquiesced to *Wilson v. Com'r*, 2013-1 USTC ¶50,147, where the 9th Circuit countermanded the view of the IRS that the Tax Court may review an IRS determination with respect to innocent spouse relief only where the IRS had abused its discretion.

Broker Option Reporting Must Include Basis

In regulations, Treasury announced that effective January 1, 2014, brokers must now report the basis of options and other less complex debt instruments sold on behalf of individuals. Brokers will be required to report basis on more complex debt instruments on Janaury 1, 2016. (T.D. 9616.)

II. NYS-DTF Matters

Warrantless Income Executions

Pursuant to statutory authority, the Department of Taxation & Finance may now serve income executions (wage garnishments) on delinquent taxpayers without filing a warrant with the County Clerk. Officials of the Department have defended the measure, stating that the warrantless income executions will free the taxpayer from the stigma of having the income execution become a public record. The measure will expire on April 15, 2015.

Suspension of Drivers' Licenses

The New York legislature has granted the Department of Taxation authority to require the Department of Motor Vehicles to suspend the drivers license of taxpayers with past-due liabilities exceeding $10,000, provided the taxpayer has been given 60 days notice. During that 60-day period the taxpayer may presumably satisfy the tax liability by paying the tax or otherwise entering into a payment arrangement with the Department. Affected taxpayers may receive an exemption for certain critical driving needs, such as commuting to work or for medical reasons.

E-File Mandate For Return Preparers

Tax preparers who prepare tax documents for more than 10 different taxpayers during any calendar year, and in a succeeding year prepares one or more "authorized" returns using tax software, must file all authorized tax documents electronically in that succeeding year as well as each year thereafter. The term "authorized" tax document means all returns except those returns or reports that cannot be filed electronically.

Department Opines That Lease Agreements Are Subject to Sales Tax

In an Advisory Opinion, the Department has stated that a 36-month lease agreement involving computer hardware, software, and office furniture was subject to sales tax at inception, rather than over the term of the agreement. The Department noted that although the transaction was evidenced by a lease agreement, that agreement bore the attributes of an installment agreement. TSB-A-13(20)S (7/15/13).

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However, taxpayers who decide to swap their property in a like kind exchange will incur only a transfer tax, which is 0.4 percent for nonresidents of New York City, and 3.05 percent for New York City residents. While like kind exchanges have become a fixture of the tax law, Washington, like a dog roused from its sleep by an intruder, has recently become perplexed by the foregone tax revenues occasioned by like kind exchanges. By most accounts, Section 1031 will live to see another tax year. However, it is worth noting well that no longer are like kind exchanges "below the radar" of either the Congress or the President.

Thus, in its 2010 Report, "The President's Economic Recovery Advisory Board" discussing "options for simplifying the taxation of capital gains," suggested the "option" of "limit[ing] or repeal[ing] the special treatment of like-kind exchanges under section 1031."

The Joint Committee on Taxation recently released its estimates of federal tax expenditures for the years 2012 through 2017. The five-year cost for Section 1031 was estimated to be $42 billion, which exceeded previous estimates. Although there is no bill on the floor of the House or Senate, like kind exchanges have aroused the attention of both the Senate Finance Committee and the House Ways and Means Committee. Congressman Dave Camp (R-Mich), Chairman of the House Ways and Means Committee, currently presides over a bipartisan tax reform working group examining Section 1031.

In 2005, based upon a total of 408,577 tax returns filed (293,676 of which were individual) total deferred gain in like kind exchanges entered into by individuals, corporations and partnerships totaled $1.01 trillion. Individuals accounted for $41.4 billion of that deferred gain.

In 2010, based upon data from 241,587 returns (158,299 of which were individual) the total deferred gain from reported like kind exchanges reported had diminished to $39.9 billion.

However, although accounting for nearly two-thirds of the filed returns in 2010, individuals accounted for only $2.72 billion of the deferred gain. The 64,401 corporate returns filed accounted for $31.26 billion, or 78 percent of the deferred gain. Source: Internal Revenue Service "Form 8824 Data for Tax Years 1995-2010."

The following are among the proposals of "working groups" of the Joint House and Senate Committee: (i) retaining present law like-kind exchange rules in their entirety, including the requirement for qualified intermediaries; (ii) retaining present law like kind exchange rules but simplifying the deferred exchange regulations with respect to qualified intermediaries; (iii) modifying rules to allow foreign real property to be exchanged for U.S. real property (but continue to exclude exchanges of U.S. property for foreign property); and (iv) imposing capital gains tax on like-kind exchanges and requiring an exchange broker to file an information return reporting the amount realized.

New York Times Reports Perceived Abuse Under Section 1031

The perceived abuse by corporations resulted in two articles appearing in the *New York Times*, the first of which appeared on January 6, 2013, and was entitled "Major Companies Push the Limits of a Tax Break." The article concluded that like kind exchanges were "divert[ing] billions of dollars in potential tax revenue from the Treasury each year." The opening paragraph of the article read:

> It began more than 90 years ago as a small tax break intended to help family farmers who wanted to swap horses and land. . . Over the years, however, as the rules were loosened, the practice of exchanging one asset for another without incurring taxes spread to everyone from commercial real estate developers and art collectors to major corporations. It provides subsidies for rental truck fleets and investment property, vacation homes, oil wells and thoroughbred racehorses, and diverts billions of dollars in potential tax revenue from the Treasury each year.

Another article appeared in the *Times* on March 16, 2013; this piece stated that "[g]overnment estimates say [like kind exchanges] cost about $3 billion a year, but industry data suggest the amount could be far higher."

Notably, one of the options considered by Congress would drastically change current law by imposing capital gains tax on like kind exchanges. It is unclear what this means, as the *raison d'etre* of Section 1031 is to defer capital gains. Therefore, imposing capital gains on like kind exchanges seems to be a contradiction in terms. In any event, whatever the report is alluding to, it is not an auspicious development. When one considers the fact that revenues from estate taxes have diminished from approximately $75 billion in 2008 to less than $10 billion in 2012 — and no one expects estate tax revenues to return to their previous levels — the fate of Section 1031 (and perhaps other deferral provisions in the Code which constitute tax expenditures) does appear less certain.

New Yorkers & Californians Would Suffer Disproportionately

The elimination of favorable tax treatment for like kind exchanges would be particularly detrimental for New Yorkers and Californians, among others whose states impose substantial income tax. For taxpayers living in those jurisdictions, the elimination of tax deferral would not only result in the imposition of a hefty federal income tax, but it would also result in a bonanza to New York and California.

Lobbyists from the Federation of Exchange Accommodators have

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descended upon Washington in an effort to "educate those on Capitol Hill about the benefits of using 1031 Like-Kind Exchanges."

It is unclear whether Senator Charles Schumer (D-NY), a member of the Senate Finance Committee, or Congressman Charles Rangel (D-NY), a member of the House Ways and Means Committee (and former chairman) would support legislation eliminating or curtailing the tax benefits of Section 1031. However, a desire on the part of Congressional Democrats to shift the tax burden to wealthier taxpayers such as corporations and high income individuals, combined with a desire of Congressional Republicans to reduce taxes, could result in pressure to diminish the tax benefits of Section 1031.

Nevertheless, it is unclear whether Republicans would favor the elimination or even the curtailing of tax benefits provided under Section 1031, since that would increase taxes for wealthy Americans and corporations, who form a base of the party.

Reasoning of Those Favoring Reform of Section 1031 Flawed?

The reasoning of those who would curtail the deferral provided by Section 1031 appears to be flawed for a number of reasons: First, those who favor reform or repeal implicitly assumes that those taxpayers who would engage in like kind exchanges would also engage in a taxable exchange if Section 1031 were repealed. If Section 1031 were repealed or its application were limited, there is no indication that many of the tax-free exchanges would become taxable exchanges. Many persons who engage in like kind exchanges might hold their property rather than engaging in a taxable exchange.

Second, many persons engage in multiple exchanges over the years, and "trade up" multiple times. Therefore, when interpreting the statistics for deferred gain, one must bear in mind that deferred gain for the same property may appear multiple times if there have been multiple exchanges.

Third, if Section 1031 were repealed and taxable sale were to transpire, deferred gain would no longer be present in the future (unless real estate prices rose substantially). Much of the gain now being deferred in Section 1013 exchanges is due to appreciation that occurred over many years. Once that gain is tapped and taxed by the Treasury, the reservoir of deferred gain available for future capital gains tax will have been depleted. Like known oil reserves, the reservoir of deferred gain is finite and subject to depletion. Accordingly, while it is true that repeal of Section 1031 would result in substantial revenues for Treasury, a number of factors — some of which are incalculable due to their unpredictability — suggest that the revenues generated by repeal could be transient.

Finally, Congress enacted the predecessor to Section 1031 nearly a century ago to prevent the taxation of gains where the investment continued unimpeded in substantially the same form. From a policy point of view, the argument for not taxing "paper gains" where the investment continues in nearly identical form is no less persuasive today than it was in 1928, when Section 112(b)(1), the predecessor to Section 1031, was first promulgated.

If one were to prognosticate, it would appear that there is little likelihood that any changes — substantive or not — to Section 1031 will occur in 2014. For the moment, Congressional attention appears to be focused elsewhere.

Hopefully, like past baseball stars whose admission to the hall of fame comes tantalizingly close in early years, but then fades as younger stars become eligible, and the older stars become forgotten, one may hope that the momentum for reform or repeal of Section 1031, which traces its lineage almost to the enactment of the income tax itself in 1918, will subside and eventually reverse direction.

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following rates:

(a) $10.50 per $1,000 or major fraction thereof on the first $400,000 of principal.

(b) $4.50 per $1,000 or major fraction thereon on the next $600,000 of principal.

(c) $3.00 per $1,000 or major fraction thereof on all additional principal.

Annual commissions may be computed either at the end of the year or, at the option of the trustee, at the beginning of the year; provided, that the option selected be used throughout the period of the trust. The computation is made on the basis of a 12-month period but is adjusted upward or downward for any payments made in partial distribution of the trust or the receipt of any new property into the trust within that period.

SCPA §2309(3) further provides that annual commissions shall be paid one-third from the income of the trust and two-thirds from the principal, unless the will or trust otherwise directs.

Commissions Based Upon Sums of Money Paid Out

In addition to annual commissions, SCPA §2309(1) provides for trustee commissions to be paid on the settlement of the account:

> On the settlement of the account of any trustee under the will of a person dying after August 31, 1956, or under a[n] [inter vivos] trust . . .the court must allow to him his reasonable and necessary expenses actually paid by him . . . and in addition it must allow the trustee for his services as trustee a commission from principal for paying out all sums of money constituting principal at the rate of 1 per cent. Therefore, the trustee is entitled to a commission of 1 percent.

Annual Accounting to Beneficiaries

Trustees are required to furnish annually as of a date no more than 30 days prior to the end of the trust year to each beneficiary currently receiving income, and to any other beneficiary interested in the income and to any person interested in the principal of the trust who shall have made a demand therefor, a statement showing the principal assets on hand on that date and, at least annually, a statement showing all receipts of income and principal during the period including the amount of any commissions retained by the trustee.

SCPA §2309(4) provides that a trustee shall not be deemed to have waived any commissions by reason of his failure to retain them when he becomes entitled thereto; provided however that commissions payable from income for any given trust year shall be allowed and retained only from income derived from the trust during that year and shall not be supplied from income on hand in respect to any other trust year.

II. Accountings

SCPA §§ 2201 through 2227 govern trust accountings. Often, an account may be settled informally by agreement among the trustee and all beneficiaries. If an informal settlement cannot be agreed upon, then a formal accounting will be required.

An accounting proceeding begins with a Petition, accompanied by the trustee's final account, which is filed with the Surrogate and served upon all beneficiaries. Beneficiaries may examine the fiduciary under oath, either before or after filing objections to the account.

III. Burden of Proof

In establishing fiduciary liability, the party on whom the burden of proof is imposed is a crucial factor. In an accounting proceeding

> [t]he accounting party has the burden of proving that she has fully accounted for all assets of the estate, and this burden does not change in the event the account is contested. While the party submitting the objections bears the burden of coming forward with evidence to establish that the account is inaccurate or incomplete, upon satisfaction of that showing the accounting party must prove by a fair preponderance of the evidence that his or her account is complete. (*Matter of Schnare*, 191 AD2d 859, 861 [3d Dept 1993], *lv denied* 82 NY2d 653 [1993] [internal citations omitted]).

IV. The Prudent Investor Standard

The common law standard required a trustee "to employ such diligence and such prudence in the care and management [of the trust], as in general, prudent men of discretion and intelligence in such matters, employ in their own like affairs" (*King v. Talbot*, 40 N.Y. 76, 85-86 [1869]). This common law rule was later codified in EPTL 11-2.2(a)(1). Under this standard, risk was discouraged (*see Bank of New York*, 35 NY2d 512 [1974]), and diversification was encouraged though not mandated (*see Matter of Newhoff*, 107 AD2d 417 [1985], *appeal denied* 66 NY2d 605 [1985]).

The standard was somewhat less strict *vis à vis* investments which the grantor transferred to a trust (*see Matter of Hahn,* 93 AD2d 583 [1983], *affirmed* 62 NY2d 821 [1984]). On January 1, 1995, the Prudent Investor Act [EPTL 11-2.3] became the governing standard for fiduciaries. It imposes an affirmative duty on a fiduciary "to invest and manage property held in a fiduciary capacity in accordance with the prudent investor standard defined by this section" (EPTL 11-2.3[a]).

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The standard of conduct under this role is *not* defined by "outcome." Rather, compliance "is determined in light of facts and circumstances prevailing at the time of the decision or action of the trustee" (EPTL 11-2.3[b][1]. *Matter of HSBC Bank USA*, N.Y., 2010 WL 5186667 at *9 (Sur. Ct. Erie Co. 2010), 30 Misc.3d 1201(A), 2010 N.Y. Slip Op. 52234(U).

Notably, an entity holding itself out with special investment skills, such as a bank, will be held to the standard of a prudent investor of discretion and intelligence having special investment skills. EPTL 11-2.3[b][6].

Cases Interpreting the Prudent Investor Standard

Matter of Korn, 36 Misc.3d 1224A (Sur. Ct. 2012) involved an objection to an accounting by a trust beneficiary, the brother of the trustee, who was also a trust beneficiary. The alleged breach of fiduciary duty related to whether the trustee had failed to act prudently in not exercising a right of first refusal to acquire certain real estate.

The Surrogate held that the prudent person standard of investing governed the trustee, and required that the trustee employ prudence in the care of trust assets equivalent to that of a prudent person of discretion and intelligence in managing his or her own affairs. Applying that standard, the Surrogate found that the trustee had invested prudently in that the trust had insufficient liquid assets available to purchase the real estate, and also was already heavily invested in real estate.

EPTL 11-2.3[b] (the NY Prudent Investor Act) provides that a trustee shall exercise reasonable care, skill and caution to make and implement investment and management decisions as a prudent investor would for the entire portfolio, taking into account the purposes, terms and provisions of the governing instrument.

In *Matter of Knox*, 2012 N.Y. App. Div, LEXIS 4880 (4th Dept. 2012), trust beneficiaries objected to a trust accounting alleging a failure to properly diversify stock investments. The beneficiaries alleged that the trustee had breached his fiduciary duty by imprudently retaining a high concentration of stock in two companies. The beneficiaries further alleged that the trustee had improperly relied upon the advice of a family member who was not a trustee. The Surrogate held that the trustee had negligently managed the trust by failing to maintain proper documentation and failing to develop an investment plan.

The Appellate Division reversed primarily on the ground that the trust instrument itself expressly granted the trustee the power to invest without regard to diversification. The Court also noted that even though assets were held in "overweight" positions, the objectant had failed to demonstrate that it was imprudent to do so, and the objectant had failed to show a financial loss from the holdings.

In contrast, in *Matter of Hunter*, 2010 NY Slip Op 50548U, the Surrogate of Westchester County imposed a surcharge of $4.322 million against JP Morgan Chase, a trustee that had failed to diversify a stock portfolio which consisted entirely of Eastman Kodak stock. The Surrogate held that a prudent trustee would have sold 95 percent of the Kodak stock, noting that JP Morgan Chase had no written investment plan for the trust, other than to eventually sell some of the Kodak Stock. The Surrogate imposed a surcharge based upon the lost capital to the trust.

On appeal, the Second Department found "no reason" to disturb the Surrogate's finding that JP Morgan Chase had violated both the prudent-person standard of investing and the Prudent Investor Act, noting that the high concentration of Kodak stock had been held for twenty years. The Appellate Division also remarked that JP Morgan Chase had "acted contrary to its own internal policies, which restrict the retention of any one stock unless certain circumstances existed, none of which were present. *Matter of Hunter*, NY Slip Op 08124, 11/28/12.

V. Delays in Distribution

When a trust terminates, trustees who delay in distributing assets to the beneficiaries do so at their own peril. In *Matter of McCluskey*, 951 N.Y.S.2d 852 (Nassau Cty Surr. 2012), the trustee failed to distribute trust assets for over a year after the trust terminated, by which time trust assets had declined in value. The trustee argued that damages should be mitigated if (i) the beneficiaries would have made the same mistake as the trustee or if (ii) the value of the trust assets appreciated subsequent to the distribution such that any theoretical loss was negated. Finding the arguments without merit, the Surrogate denied the motion made by the Trustee to compel production of the beneficiaries' personal investment portfolios for the period during which it was alleged that the Trustee had been neglectful in distributing trust assets.

Matter of Lasdone, 2011 NY Slip Op 51710U (NY Cty Surr. Court, 2011) also presented a situation where the trustee had delayed distribution of trust assets, during which time the value of trust assets declined. The trustee had refused to timely distribute trust assets to two beneficiaries who had been entitled to receive trust assets upon attaining the of age thirty-five. The Surrogate granted summary judgment to the beneficiaries on their surcharge claim.

With respect to the issue of damages, the Surrogate ruled that the surcharge award should not be reduced by the capital gains tax that would have been incurred by the beneficiaries, since the beneficiaries could have held the stock until their respective deaths, thus benefitting from a stepped up basis. The Surrogate held that reasonable attorneys' fees should be chargeable to the estate, and not to the trustee, since the cost of preparing the accountings and other work done by the attorneys was necessary to the ad-

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ministration of the estate.

VI. Surcharges

In *Matter of Janes*, 643 N.Y.S.2d 972, 976, 223 A.D.2d 20, 26 (4th Dep't. 1996), *aff'd*, 90 N.Y.2d 41 (1997) the trustee had invested the entire trust in Kodak stock which, over a period of years, eventually become worthless when Kodak filed for bankruptcy. The Fourth Department held that "the failure to act as a prudent person would have acted constitutes negligence for which a fiduciary may be surcharged and made to forfeit commissions." Similarly, Restatement 3d Trusts §76 provides:

> § 76. Duty To Administer The Trust In Accordance With Its Terms And Applicable Law
>
> (1) The trustee has a duty to administer the trust, diligently and in good faith, in accordance with the terms of the trust and applicable law.
> (2) In administering the trust, the trustee's responsibilities include performance of the following functions:
>
> (a) ascertaining the duties and powers of the trusteeship, and the beneficiaries and purposes of the trust;
> (b) collecting and protecting trust property;
> (c) managing the trust estate to provide returns or other benefits from trust property; and
> (d) applying or distributing trust income and principal during the administration of the trust and upon its termination.

The Appellate Division concluded that "the Surrogate properly imposed liability on the fiduciary for its initial imprudent failure to diversify as well as for its subsequent indifference, inaction, nondisclosure, and outright deception in response to the prolonged and steep decline in the worth of the estate." The court emphasized the corporate fiduciary's failure to formally analyze the estate's assets, the fiduciary's failure to consider the risks borne by the beneficiaries as a result of the concentration of assets, and the fiduciary's failure to adequately communicate with the beneficiaries. *Id.* at 31-32. The Court then articulated the rule for when a fiduciary will be surcharged:

> [A] fiduciary will be surcharged for losses resulting from negligent inattentiveness, inaction, or ill consideration *(see, Matter of Donner, supra*, at 586; *Matter of Wood*, 177 A.D.2d 161, 167-168. Thus, while mere erroneous judgment or poor investment performance cannot be the basis of a finding of imprudence, where the facts known at the time of the decision establish its unreasonableness, a finding of imprudence is warranted (*see, Matter of Wood, supra*, at 167-168). Generally, the determination of whether a fiduciary's conduct measures up to the appropriate standards of prudence, vigilance, and care is an issue of fact for the trial Court *(see, Matter of Donner, supra*, at 585, citing *Matter of Hubbell, supra,* at 258; *see also, Matter of Yarm*, 119 A.D.2d 754). *Id.* at 27.

The proper measure of damages "is the value of the capital that was lost. . .calculated by determining the value of the securities at the time they should have been sold, minus their value when ultimately sold or, if they are still retained by the estate, their value at the time of the accounting or the Court's decision [citations omitted]." *Id.* at 34.

This standard for calculating damages was affirmed by the Court of Appeals. *Matter of Estate of Janes*, 90 N.Y.2d 41, 56, 659 N.Y.S.2d 165 (1997). In so affirming, the Court of Appeals clarified that the fiduciary was not surcharged for a failure to meet an absolute duty to diversify *per se*, but rather for failing to consider the continuing risk of the investment, failing to pay sufficient attention to the needs and interests of the beneficiary, and failing to exercise the due care and skill which it held itself out as possessing. *Id.* at 53-54. In the view of the Court, this amounted to a violation of "certain critical obligations of a fiduciary in making investment decisions under the prudent person rule," and therefore warranted surcharge. *Id.* at 53.

Matter of Estate of Janes was cited in *Williams v. J.P. Morgan & Co. Incorporated*, 199 F.Supp.2d 189 (S.D.N.Y. 2002). In *Williams*, a trust had been created in 1958, and funded with a corpus of $500,000. J.P. Morgan was appointed as trustee. J.P. Morgan invested in tax-free bonds since a treaty between the United States and Brazil was contemplated and this would have made the investment in tax-free bonds prudent. However, as it happened, the treaty was never ratified. In spite of the treaty never having been ratified, J.P. Morgan never divested itself of the tax-free bonds. Williams claimed that J.P. Morgan continued to invest in tax-free bonds when no longer required to do so, and sought to surcharge J.P. Morgan for its "negligent and imprudent failure to invest and/or diversify trust assets." *Id* at 191.

J.P. Morgan moved for summary judgment dismissing Williams' objections. Williams cross-moved for summary judgment. Applying New York law as articulated in *Matter of Janes*, and affirmed by the Court of Appeals, the District Court addressed the issue of whether – assuming Williams prevailed on the merits – the proper measure of damages was, as J.P. Morgan asserted, the lost capital only, or as Williams asserted, the lost profits. *Id*. at 192. The District Court found that under New York law, where the trustee had mismanaged a trust, the proper measure of damages was the value of lost capital. *Id.* at 196.

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tion has turned to the income tax, which has enjoyed a resurgence under the Obama Administration. An important objective in estate planning is now to preserve the step up in basis at death. This will provide heirs with the ability to sell inherited assets without incurring a capital gains tax.

For the past decade or so, an arrow in the quiver of estate planners seeking to reduce eventual estate taxes has been to sell or gift assets to a grantor trust. The objective of the sale was to make a complete transfer for transfer (estate and gift) tax purposes, but to retain enough powers such that the transfer was incomplete for income tax purposes.

The mechanism seemed to be perfect: appreciation of the assets sold to the trust was forever out of the grantor's estate, and the grantor would remain liable (if he wished, since he could be reimbursed) for the yearly income tax liability. This would result in a tax-free "gift" by the grantor to the trustee of the trust of the income tax liability of the trust. Trust assets would thereby grow unimpeded by an annual income tax. So far so good.

The catalyst that made possible the dichotomy in tax treatment for income tax and estate tax purposes was in substantial part the interpretation of the grantor trust rules in Revenue Ruling 85-13. There, the IRS found that the "sale" by the grantor of assets to a grantor trust was not a realization event for income tax purposes since the grantor was deemed to be making a sale to himself.

The ability to draft a trust constituting a grantor trust for income tax purposes, yet be irrevocable, so that for transfer tax purposes the sale was complete, was the linchpin of the technique. Many candidates emerged for making a trust a grantor trust. The ability to borrow from the trust without adequate security (IRC §675(2)) was one provision. Another was the ability to substitute assets of the trust in a nonfiduciary capacity for assets of equal value (IRC §675(4)(C)).

This latter "swap" power became the most popular provision to accomplish grantor trust status. The provision had another serendipitous benefit: if low basis assets had initially been sold to the trust, they could (presumably) later be swapped out with higher basis assets. This would enable the grantor's estate to receive a valuable step up in basis at the grantor's death. All seemed fine.

With the federal exclusion now so high, selling assets to grantor trusts is now less common; gifting assets to such trusts is now in vogue. The purpose of the gift may now be to utilize the federal exemption of the surviving spouse — which now includes the ported DSUE amount — in order to remove appreciation from the estate of the surviving spouse. The desired objective of swapping out low basis assets later in the life of the surviving spouse is to achieve basis step up to fair market value at his or her death.

The ability to substitute assets and obtain a basis step up is lauded by numerous tax authorities. However, anecdotal evidence seems to indicate that few practitioners have actually undertaken such swaps; certainly, the IRS has not ruled on the issue, and no cases have discussed whether the swap works. Some would dogmatically maintain that the swap clearly accomplishes the tax objective of accomplishing an ameliorative basis shift. However, reliance on dogma itself in this context could be risky.

How the IRS would learn of such a swap is debatable. Apparently, the swap would not be required to be reported on any tax return. However, one must assume, as is almost always the case, the IRS would find out. Given, then, the paucity of guidance on this issue, and its importance, a closer look at whether the technique is unassailable, is in order.

II. IRC Section 675(4)(C)

Section 675(4)(C) provides that

> [a] power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. For purposes of this paragraph, the term "power of administration" means any one or more of the follower powers . . . (C) a power to reacquire the trust corpus by substituting other property of an equivalent value.

Although not drafted particularly clearly, Section 675 is stating that if any person acting in a nonfiduciary capacity, can direct any person acting in a fiduciary capacity, to substitute trust assets of equal value, the trust will be grantor trust, to the extent of the power.

We note as an initial matter that the statute uses the term "substitut[e] property of an equivalent value." It appears that Congress was not contemplating basis implications when drafting Section 675. However, there is no reason to believe that the same immunization against income tax would not also apply to the swap. This is why estate planners believe that the assets swapped will carry their respective bases with them.

Now, let us look at an example. Suppose in the context of a gift or sale to a grantor trust, the grantor takes back a promissory note bearing adequate interest at the applicable federal rate. Later on, someone acting in a nonfiduciary capacity directs the trust to substitute higher basis assets with the grantor. The rationale for the substitution is to preserve the step up.

Is it clear that Revenue Ruling 85-13 and IRC §675(4)(C) unimpeachably allow the grantor to accomplish this tax result? Most have assumed that it would. However, if this assumption is wrong, then dire income tax consequences could ensue. It is therefore important to prove (or disprove) the validity of this assumption. To test the hypothesis, we first consult Revenue Ruling 85-13 itself. We next consider ancillary sources, such as rul-

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ings promulgated in the context of qualified personal residence trusts, court decisions, and Section 1031, which provides for tax-free exchanges of certain property in certain contexts.

III. Revenue Ruling 85-13

In Revenue Ruling 85-13, the Service explained that where the grantor reacquired the corpus of the trust for an unsecured promissory note pursuant to the terms of the trust, IRC §675(3) and Treas. Regs. §1.675-1 "treat the grantor as the owner of [the] trust." This is because administrative control is exercisable primarily for the benefit of the grantor.

Revenue Ruling 85-13 interpreted IRC §675(3), which provides that the grantor trust status will arise where the grantor his "directly or indirectly borrow[ed] the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the [next] taxable year.

The Ruling concluded that "[b]ecause A is treated as the owner of the entire trust, A is considered to be the owner of the trust assets for federal income tax purposes." [Citations omitted].

Revenue Ruling 85-13 mentions basis only once:

> A's basis in the shares received from T will be equal to A's basis in the shares at the time he funded T because the basis of the shares was not adjusted during the period that T held them. *See* Rev. Rul. 72-406, a ruling involving the determination of the grantor's basis in property upon the reversion of that property to the grantor at the expiration of the trust's term.

Apparently, most planners have blithely assumed that the basis implications provided for in Revenue Ruling 85-13, which involved a loan, and a reversion, would also extend to situations involving a substitution. While perhaps not an implausible or unjustified assumption, the nexus of this perceived connection must be examined.

Loans by their very nature do not constitute taxable events. The argument would apparently be that since a substitution of assets is also not considered a taxable event, the basis of assets received by the grantor in such a swap would be a substituted basis of those assets. However, the authority for treating a loan as a nontaxable event is doctrinal, whereas the authority for treating the swap as a nontaxable event emanates merely from IRS guidance.

Is it correct, or reasonable, to assume that the basis implications for assets received through an IRC §675 (3) loan are identical to those that result from an IRC §675(4) swap? Further inquiry is necessary. A first line of inquiry will be to consider qualified personal residence trusts, which have spawned similar basis issues, and later, an austere Treasury response.

IV. Qualified Personal Residence Trusts & Swaps

Qualified personal residence trusts (QPRTs), not yet quite in the dustbin of estate planners, but getting there, boast a statutory lineage. Also grantor trusts, they have been used to reduce gift and estate taxes. In creating a QPRT, the grantor transfers his personal residence to a trust, retains the right to live in the residence for a term of years, and makes a gift of the remainder interest. For the technique to work, the grantor must live to the trust term.

If the term of the QPRT is 10 years, the grantor is deemed to make a gift of the remainder interest in the trust corpus to trust beneficiaries. Reflecting the lengthy term of the QPRT, the amount of the gift would presumably be small, since most of the value of the trust principal would be locked up with the retained life estate of the grantor. The residual gift would tend to be small, because of its low present value.

However, as interest rates have declined, the present value of the remainder interests created by QPRTs has increased, thereby resulting in larger gifts to remainder beneficiaries. This, coupled with the massive increase in the federal gift tax exemption, and the decline in residential values, has made QPRTs rather unattractive today in most estate planning situations. [Some estate planners still advocate the use of QPRTs, although those planners are in the distinct minority. Without unduly digressing, it should be noted that QPRTs do possess some attractive nontax attributes, such as asset protection.]

Returning to our inquiry, we note that astute estate planners saw an opportunity to ameliorate adverse income tax basis problems by enabling the grantor of the QPRT to repurchase the residence prior to the expiration of the QPRT term. In response to a flood of grantors repurchasing residences to gain an increase in basis at death, Treasury promulgated Reg. §25.2702-5(c)(9) for trusts created after May 16, 1996.

Those regulations require that the governing instrument of the trust include a provision prohibiting the trust from selling or transferring the residence to the grantor, the grantor's spouse, or an entity controlled by either. The rationale for the regulation was well articulated in *CCH Financial and Planning Guide* (2009), at ¶2315.03:

> This requirement prohibiting a sale or transfer prevents families using personal residence trusts or QPRTs from realize large income tax savings. If the grantor leaves the residence in trust until expiration of its term, the remainder beneficiaries will acquire the property with a carryover basis from the grantor, often leaving them with a large built-in gain. On the oth-

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er hand, if the grantor were allowed to repurchase the residence just before the end of the term, more favorable tax results could be obtained. No gain would be recognized to the grantor on the repurchase, and at the end of the trust term, the beneficiaries would receive flat-basis cash. Further, the residence would return to the grantor, would be included in the grantor's gross estate, and would receive a step-up basis under Code Sec. 1014.

What Treasury addressed in Reg. §25.2702-5(c)(9) is essentially a rather close variation of the problem we are addressing. Now we must ask the question: Is it plausible that IRS would not object to a swap of assets by the grantor shortly before death if the principal purpose was to create a basis step up?

Revenue Rulings, now less common than they were in 1985, are pronouncements issued by the Service of its own accord. In contrast to Private Letters Rulings, taxpayers may rely on Revenue Rulings. (In practice, taxpayers rely on Private Letter Rulings as well). Assuming taxpayers can safely rely on Revenue Ruling 85-13, we then ask, does it unassailably support the proposition that the taxpayer may accomplish in the realm of a grantor trust swap what the Service forbade in the context of a QPRT? And even if it does, can the Service reverse itself; or worse, could Treasury enact regulations that could foreclose the technique? And if Treasury could so enact regulations, could those regulations be retroactive?

Ascertaining the likelihood of these various unpleasant scenarios should inform us of the risk we take should we advise our clients of the feasibility of substituting assets pursuant to IRC §675(4)(C) to achieve favorable basis results.

Undeniably, Revenue Ruling 85-13, standing alone, clearly supports the proposition that an ill grantor may shortly before death swap out low basis trust assets in order to achieve a basis step up at death.

Treas. Reg. §25.2702-5(c)(9), which applies in the case of QPRTs, was a "fix" implemented by Treasury to stop a technique perceived by Treasury as abusive. Notably, the regulations do not themselves purport to alter the income tax consequences of the technique in the context of QPRTs — they only forbid the taxpayer from executing a trust that permits the forbidden transaction.

Presumably, were the taxpayer to violate the regulation and the IRS to learn of it, the Service could argue in Tax Court — perhaps with success — that the QPRT failed. Whatever tax consequences this conclusion would entail, they would certainly not be pleasant. Therefore, all but the most uninformed planners would draft a QPRT containing such language. If such language were to inadvertantly appear, prudence would dictate that the power should lay dormant, so as not to increase the risk already attendant with the errant provision.

The Tax Court deciding such a case would not necessarily be required to decide whether the mere presence of the forbidden language in the QPRT — or an actual forbidden repurchase — would have achieved its intended result for tax purposes but for the regulation. Most likely, the Tax Court would not reach this issue, since the violation of the regulation forbidding the repurchase would suffice to decide the case.

The question then becomes what would occur if Treasury attempted to impede the desired swap through the implementation of regulations, as it did with QPRTs which attempted to accomplish the same objective?

V. The Swap Power

With the foregoing in mind, we return to IRC §675(4)(C), which provides that the grantor is treated as owner of any portion of a trust if any person in a nonfiduciary capacity exercises a power to "reacquire the trust corpus by substituting other property of an equivalent value."

Let us compare IRC §675(4)(C) with IRC §675(1) — the subject of Revenue Ruling 85-13 — which provides that grantor trust status will ensue where the grantor or a nonadverse party purchases, exchanges or otherwise deals with the or disposes of the corpus or income of the trust without adequate consideration in money or money's worth.

Since IRC §675(4)(C) uses the term "reacquire," it must be the grantor to whom the statute is referring as the person who substitutes the assets. Are the income tax consequences of a later "substitution" of property comparable to the initial sale of property to the trust? If they are, does that similarity arise from doctrinal sources, such as the grantor trust rules themselves? Or, could Congress enact regulations seeking to curtail the desired tax result?

A grantor trust becomes a nongrantor trust when the grantor dies. Tax attorneys are sharply divided concerning the income tax consequences arising on the death of the grantor of a trust trust holding appreciated property. There are three camps:

One camp, the majority, believes that no realization event occurs, and no basis step up results. The second camp believes that a recognition event occurs, a captial gains tax is imposed, and a basis step up occurs. The third camp, a distinct minority, believes that no realization or recognition event occurs, but that the beneficiares receive a basis step up. It is clear that no consensus exists as to what income tax rules govern the grantor trust when it becomes a nongrantor trust at the death of the grantor.

Similarly, no known adverse authority (by "authority," we expand the definition beyond what the IRS

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considers as authority, to include tax attorneys) exists which considers the possibility that the IRS could reverse course and attempt to limit the QPRT-like technique which we find in a substitution of assets to achieve a basis step up. Yet as noted, the IRS or the Treasury could conceivably attempt to forbid this transaction, and could possibly make the rule retroactive without violating the Constitution.

With that in mind, we next consider a swap of assets under IRC §1031. Section 1031 provides for nonrecognition of gain in the context of certain exchanges of property held for productive use in a trade or business or for investment. The statute and regulations governing like kind exchanges fastidiously require deferred basis to be later reported in the event of a taxable sale. Why should Congress be less concerned with basis consequences in the case of a swap of assets involving a grantor trust than in, for example, an exchange of assets under Section 1031? It is therefore Section 1031 that we shall turn for guidance as to how Congress views the taxation of swaps in other contexts.

VI. IRC Section 1031

Section 1031 enables taxpayers to sell assets and defer gain provided their investment continued unabated in identical, or nearly identical form. A formal examination is beyond the scope of this Note, and is, more importantly, unnecessary.

One of the basic precepts of Section 1031 is that a taxpayer cannot exchange property with himself. This rule was articulated in *Bloomington Coca-Cola v. Com'r*, 189 F.2d 14 (7th Cir. 1951) where Coca Cola conveyed land and cash to a contractor in exchange for the construction of a bottling plant on other land owned by Coca Cola.

Of course, a grantor who exchanges property with a grantor trust pursuant to the Section 675(4)(C) swap power is not engaging in a Section 1031 exchange. This is because the grantor trust is a disregarded entity. But with whom is the grantor exchanging property? Is it not the trustee, who is the legal owner of the trust? If this is the case, is not the transaction actually between two different legal entities, and would this not possibly implicate Section 1031?

Perhaps the income tax rules, like the Heisenberg Uncertainty Principle, can change, depending upon the reason one is looking at them. Take, for example, the *Pierre* case, where the IRS argued that fractional discounts should not be allowed to a single member LLC since the entity is disregarded for income tax purposes. A sharply divided Tax Court held that even though the entity was disregarded for income tax purposes, it was a separate legal entity, and thus the taxpayer was entitled to take a valuation discount. *Pierre v. Com'r*, 133 T.C. No. 2 (8/4/09)

Consider as another example the rules governing exchange proceeds in a Section 1031 exchange. Even though the taxpayer is not deemed to be in constructive receipt of exchange funds for purposes of Section 1031 if a qualified intermediary is employed, the taxpayer is considered as receiving the exchange funds for other income tax purposes. IRC §468B, Treas. Regs. §1.468B.

The point here is that while the basis consequences of the swap power may indeed be sanguine, one should not dogmatically assume such to be the case. Basis provisions for income and estate tax purposes are provided for in Sections 1011 through 1023 of the Code. Section 675(4)(C) makes no mention of basis.

The IRS issue no ruling with respect to the swap power in Section 675 (4)(C) and any basis consequences attaching to such a swap. It is somewhat disconcerting to realize that we may have inadvertently assumed that the Service would forever interpret Revenue Ruling 85-13 in the manner to which we have become accustomed. Quite conceivably, the IRS could come to view these swaps as it did grantors who repurchased assets from QPRTs to gain a basis advantage.

In conclusion, the Section 675 (4)(C) power of substitution is an excellent choice for conferring grantor trust status on a trust. However, those who view the transaction as also conferring upon the grantor a later ability to shift basis may do so at their own peril. In this sense, Revenue Ruling 85 -13 could be a Trojan Horse, inviting the taxpayer to reap substantial tax benefits only to incur unwarranted tax risks in doing so. Even if the IRS does not challenge the transaction, the victory — removing the appreciation from the grantor's estate — may be pyrrhic if, as many believe, the estate tax is eventually eliminated.