The Texas Tax Lawyer

May, 2001
Vol. 29, No. 3
www.texastaxsection.org

TABLE OF CONTENTS

THE CHAIR'S MESSAGE

I was warned. My two immediate predecessors as Chair of the Tax Section, John Brusniak and Brent Clifton, both warned me that chairing the Section would be time consuming. They were right. They also assured me that chairing the Section would be an opportunity to work with great people on meaningful projects to help the Section remain a valuable resource to its members. They were right about that also.

At the Section's annual meeting on Friday, June 15, 2001, in conjunction with the State Bar's annual meeting in Austin, my tenure as Chair will officially end, and a talented, enthusiastic, well-prepared Willie Hornberger will move from Chair-elect to Chair. In addition, we will officially elect new officers and Council members to work with Willie for the 2001-2002 term. The Nominations Committee has recommended the following: Chair-elect: Robert Gibson; Secretary: Jasper Taylor; and Treasurer: David Wheat.

Additionally, the Nominations Committee has recommended electing the following to three-year terms on the Council: Jeffrey Sher, Steven Erdahl, and Gene Wolf.

One of the greatest rewards of working with the Tax Section has been working with these individuals as well as with the others who have comprised our Council and Committee leadership and over the last several years. The opportunity to meet and work with fine individuals like these is a great incentive for all of us to be active in the Section.

I would like to highlight two of the tasks we have worked on most diligently during this last year. After the Section's prior success in creating a website, we chose this year to focus on improving the website – both design and functionality. This project has required significant time and energy. It is my hope that by the time you read this letter, the website update will be well underway, and the website will be on its way to becoming a far more useful tool to tax practitioners. (Check it out at www.texastaxsection.org). Special thanks to Steve Erdahl and Robert Gibson, who have worked especially diligently on this task.

We have also worked to increase Section membership, particularly among younger lawyers. One of the tools we've used to accomplish this goal is to extend a one-year free membership in the Tax Section to all who graduate from law school and join the Texas Bar this year.

In my first letter to the Section, I noted that we should pay attention to the tasks at hand, make good decisions as we move into the future, and try to make a difference. This year's Section leadership has worked hard to accomplish these goals. I have every faith and confidence that those who follow us will work just as hard. I wish them, and you, every success in the coming year.

Cindy Ohlenforst
Chair, Section of Taxation
State Bar of Texas

P.S. I am not taking any State Bar or Tax Section furniture with me.

PROPERTY TAX LAW DEVELOPMENTS

John Brusniak, Jr.[1]

TEXAS SUPREME COURT

TAXING UNIT IS REQUIRED TO INCLUDE ALL UNENCUMBERED FUND BALANCES FROM ALL SOURCES IN ITS "TRUTH-IN-TAXATION" NOTICES; COMPTROLLER'S REGULATIONS WILL BE GIVEN DEFERENCE IF THEY ARE CLEAR AND IF THEY DO NOT CONFLICT WITH A STATUTE'S PLAIN LANGUAGE.

Gilbert v. El Paso County Hospital District , 44 Tex. Sup. Ct. J. 338 (January 18, 2001).

Taxpayers filed suit seeking declaratory and injunctive relief contending that the taxing unit was violating the "truth-in-taxation" provisions by failing to publish information regarding all unencumbered fund balances, including monies received from sources other than ad valorem taxation. Taxing unit contended that the Truth-in-Taxation guide published by the Comptroller's office did not require it to publish information on monies received from sources other than ad valorem taxes. The court ruled "that taxing units must report their entire unencumbered maintenance and operations and general fund balances, including money received from sources other than property taxes." It further ruled that before it would consider an administrative interpretation of a statute by the Comptroller's office, such construction needed to be clear prior to a legislative re-enactment of the statute, and that the administrative construction could not be in conflict with the statute's plain meaning and purpose."

TEXAS COURTS OF APPEALS

AN ERRONEOUS LISTING OF A PROPERTY IN THE NAME OF A LESSEE IS NOT INDICATIVE OF ATTEMPTED TAXATION OF A LEASEHOLD ESTATE.

County of Dallas Tax Collector v. Roman Catholic Diocese of Dallas, No. 05-99-01608-CV (Tex. App.–Dallas, January 25, 2001, no pet. h.) (to be published).

A church entered into a long-term lease with a private developer which allowed the developer to construct a private office building and parking garage on a portion of the church grounds. The appraisal district cancelled the church's exemption of those grounds, and after suit, a settlement recognizing the taxability of the property was agreed upon by the church, the developer and the appraisal district. The appraisal district, however, listed the developer as the owner of the property on its records. After the developer defaulted on its leasehold obligations and on its obligation to pay the property taxes, the taxing units sued the church for the deficiency. The church defended the suit on the grounds that it was not the owner of the property because the taxable estate was the leasehold estate owned by the developer. It cited the appraisal listing of ownership as its proof. The court disagreed ruling that errors in ownership on an appraisal roll may be corrected, and that there was no other evidence to establish an underlying exempt estate, coupled with a taxable leasehold estate. Without such proof, the property was taxable to the church as the fee simple owner of the property.

TAXABLE SITUS AND STATUS OF AN AIRCRAFT ARE DETERMINED BY ITS USE IN THE YEAR PRECEDING JANUARY 1 AND NOT BY ITS STATUS ON THAT DATE; STATUTORY PROVISION WHICH DEFINES STORAGE OF AN AIRCRAFT AFTER REMOVAL FROM AIR SERVICE AS BEING "TEMPORARY" IS NOT UNCONSTITUTIONAL

Fairchild Aircraft, Inc. v. Bexar Appraisal District, No. 04-00-00321-CV (Tex. App.–San Antonio, January 24, 2001, no pet. h.) (to be published).

Taxpayer leased an aircraft to an Argentine corporation from January 1995 to December 1996. The Argentine corporation was the equivalent of a certified air carrier under Argentine law. From January 1, 1997 to October 1997, the aircraft was located in Texas between leases and was in storage being repaired, inspected and maintained. The appraisal district claimed that the aircraft was fully taxable in Texas because it was not being used as a commercial aircraft on January 1, 1997. It alternatively claimed that Section 21.05(c) of the Texas Tax Code, which provides that commercial aircraft that are removed from service for repair, storage or inspection are presumed to be in interstate commerce and not located in Texas for more than a temporary period, is an unconstitutional exemption. The court disagreed. It ruled that the taxable situs and taxable status of an aircraft is determined by the usage of the aircraft during the year preceding January 1. It stated, "[The appraisal district's] argument would take an aircraft out of Section 21.05's scope if the company that owned the aircraft leased it to a certified air carrier every day of the year, except on January 1. This is an absurd result not contemplated by the legislature." It further ruled that Section 21.05(c) does not provide an unconstitutional exemption, but rather provides a methodology for allocating to Texas the portion of the commercial aircraft's value that fairly reflects its usage in Texas.

TAXABLE SITUS AND STATUS OF AN AIRCRAFT ARE DETERMINED BY ITS USE IN THE YEAR PRECEDING JANUARY 1 AND NOT BY ITS STATUS ON THAT DATE; STATUTORY PROVISION WHICH DEFINES STORAGE OF AN AIRCRAFT AFTER REMOVAL FROM AIR SERVICE AS BEING "TEMPORARY" IS NOT UNCONSTITUTIONAL

First Aircraft Leasing, Ltd. v. Bexar Appraisal District, No. 04-00-00320-CV (Tex. App.–San Antonio, January 24, 2001, no pet. h.) (to be published).

Taxpayer leased an aircraft to various certificated air carriers from February 1992 to September 1995. From September 1995 to December 1996, the aircraft was located in Texas between leases and was in storage being repaired, inspected and maintained. The appraisal district claimed that the aircraft was fully taxable in Texas because it was not being used as a commercial aircraft on January 1, 1996. It alternatively claimed that Section 21.05(c) of the Texas Tax Code, which provides that commercial aircraft that are removed from service for repair, storage or inspection are presumed to be in interstate commerce and not located in Texas for more than a temporary period, is an unconstitutional exemption. The court disagreed. It ruled that the taxable situs and taxable status of an aircraft is determined by the usage of the aircraft during the year preceding January 1. It stated, "[The appraisal district's] argument would take an aircraft out of Section 21.05's scope if the company that owned the aircraft leased it to a certified air carrier every day of the year, except on January 1. This is an absurd result not contemplated by the legislature." It further ruled that Section

21.05(c) does not provide an unconstitutional exemption, but rather provides a methodology for allocating to Texas the portion of the commercial aircraft's value that fairly reflects its usage in Texas.

DELINQUENT TAX LIENS ATTACH TO PROPERTY WHICH IS ENCUMBERED WITH A LIEN OWNED BY THE F.D.I.C.; PENALTIES WILL ONLY ATTACH TO THE EXTENT THE PROCEEDS FROM THE FORECLOSURE SALE EXCEED THE AMOUNT OF THE UNDERLYING LIEN.

PNL Asset Management Co. v. Kerrville Independent School District, No. 04-00-00138-CV (Tex. App.–San Antonio, December 13, 2000, pet. filed) (to be published).

Taxpayer acquired a lien interest from the F.D.I.C. on real property which the borrower from a failed bank had defaulted in his obligations to pay the underlying property taxes. Taxpayer foreclosed the lien interest. Taxing units suit the taxpayer for the delinquent taxes. Taxpayer defended on the grounds that the provisions of FIRREA prevented the delinquent tax lien from attaching to the real property. The court disagreed, ruling that the provisions of FIRREA only prevented the lien from attaching to the F.D.I.C.'s lien interest, and not to the underlying fee estate, and that the penalties were similarly not barred from attaching because the taxing unit "should be paid the penalties because its lien securing payment of the penalties had priority over [the taxpayer's] security interest."

DELINQUENT TAX LIENS ATTACH TO PROPERTY WHICH IS ENCUMBERED WITH A LIEN OWNED BY THE R.T.C.

Sadeghian v. City of Denton, No. 2-00-063-CV (Tex. App.–Fort Worth, December 7, 2000, pet. filed) (to be published).

Taxpayer acquired a mortgage lien interest on property from the R.T.C. and subsequently foreclosed title. Taxpayer sued the taxing units for declaratory judgment under the terms of FIRREA contending that no delinquent tax lien attached to the property. The court disagreed, ruling, "...because the RTC held only a lien interest, and did not acquire an ownership interest in the property during the tax years in question, '1825(b)(2) does not act as a bar to attachment of a tax lien on the underlying real property during the period that the mortgage [was] held in receivership by the RTC."

DELINQUENT TAX LIEN ON SEPARATELY OWNED REAL ESTATE IMPROVEMENTS ATTACHMENTS TO UNDERLYING LAND WHEN THE TWO ESTATES MERGE.

Franz v. Katy Independent School District, 35 S.W.3d 749 (Tex. App. – Houston [1st Dist.] 2000, no pet. h.).

Taxpayer leased land to a restaurant owner for construction of building. The lease provided that the lessee would be responsible for payment of the taxes on the improvement, but that title to the improvements would not vest in the taxpayer/lessor until the end of the leasehold term or until a termination of the lease upon default by the lessee. The appraisal district, based on a request by the parties, listed ownership of the improvements in the name of the lessee. Lessee failed to pay the property taxes on the improvement and also defaulted on the lease. The lessor took possession of the improvements and filed suit for declaratory judgment against the taxing units seeking a declaration that the lien on the improvements did not extend to the underlying land. The court ruled against the lessor stating that the lien on the improvements extended to the underlying land as a result of the doctrine of merger immediately upon the termination of the lease and the assumption of ownership of the improvements.

TAXPAYER MAY NOT UTILIZE SECTION 25.25(D) OF THE TEXAS TAX CODE TO CHALLENGE THE UNDERLYING PRIOR YEAR VALUATIONS OF A PROPERTY SUBJECT TO AN OPEN SPACE LAND ROLLBACK TAX; THE TAX CODE PROCEDURES DO NOT VIOLATE THE DUE PROCESS PROVISIONS OF THE TEXAS CONSTITUTION.

Tarrant Appraisal District v. Gateway Center Associates, Ltd., 34 S.W.3d 712 (Tex. App.–Fort Worth 2000, no pet. h.).

Appraisal district issued a notice of rollback on property which had been previously granted open space land valuation. The taxpayer did not challenge the rollback, but instead filed a motion, under Section 25.25(d) of the Texas Tax Code seeking to challenge the underlying appraised values of the property for the years subject to the rollback assessment. The court ruled that it did not have jurisdiction to consider the motion since it was not timely filed. "No new valuation of the property is made to set the amount of the rollback tax; the tax amount is simply calculated based on the past market values set forth in the tax rolls. ... Because owners of agricultural land are informed of the appraised market value of their land in the notices of appraised value, they are sufficiently alerted to any error in the appraised market value at the time of the appraisal. ... Therefore, even though they are not taxed on the market value of their land, these owners have the right to protest the appraised market value immediately upon receiving their notice of appraised value, long before any rollback tax may be imposed because of a change in use. ... Any motion made pursuant to section 25.25(d), including a motion to correct the appraised market value of agricultural property, must be filed before the date the yearly property taxes-not the rollback taxes-on the subject land become delinquent." The court further ruled that no due process rights were violated because the taxpayer had been given notice of the market value of the property in each of the underlying years and had also been afforded the opportunity to have a hearing on those valuations during those years.

<u>TEXAS ATTORNEY GENERAL OPINIONS</u>

TAX ASSESSOR-COLLECTOR MAY UTILIZE INTEREST EARNED ON MOTOR VEHICLE TAX TO SUPPLEMENT OWN SALARY IF IT IS A LEGITIMATE COST OF ADMINISTRATION.

Op. Tex. Att'y Gen. JC-0348 (2001).

A county tax assessor-collector wished to utilize some of the interest earned on the motor vehicle inventory tax escrows to supplement the assessor's own salary. The attorney general ruled that the assessor could do so, if such supplementation proved to be a legitimate cost of administration for the program and if the supplementation served a public purpose. Such a determination would be subject to judicial review, and the county auditor would be allowed to audit such expenditures.

PENALTIES AND INTEREST ON PROPERTIES WHICH HAVE FAILED TO RECEIVE THE MANDATORY FIVE YEAR NOTICE DO NOT BEGIN TO ACCRUE UNTIL AFTER THE STATUTORY PERIOD FOR DELIVERY OF NEW NOTICE

EXPIRES; ALL PRIOR PENALTIES AND INTEREST ARE CANCELLED.

Op. Tex. Att'y Gen. JC-0328 (2001).

Taxing units are required to provide a notice of delinquency to taxpayers whose property taxes have been delinquent more than one year in each year that is divisible by five. If the unit fails to do so, all penalties and interest are cancelled. By legislative amendment, the taxing units may reinstate penalties and interest by providing new notice. The Attorney General was asked when such new penalties and interest would begin to accrue. The Attorney General ruled that such penalties and interest would begin to accrue anew on the first day of the first month that begins at least twenty-one days after delivery of a proper new notice.

ENDNOTE

1. Brusniak Clement & Harrison, P.C., 17400 Dallas Parkway, Suite 212, Dallas, Texas 75287-7306, (972) 250-6363, (972) 250-3599 fax

SIGNIFICANT DEVELOPMENTS APPLICABLE TO TAX-EXEMPT ORGANIZATIONS

Jeffrey E. Sher and Robert D. Perkins[1]

The following is a summary of selected current developments in the law applicable to tax- exempt organizations, prepared by Robert D. Perkins and Jeffrey E. Sher of Fizer, Beck, Webster, Bentley & Scroggins, P.C., as a project to the Tax-Exempt Organizations Committee, Jeffrey E. Sher, chairperson. Unless otherwise indicated, all section references contained herein are references to the Internal Revenue Code of 1986, as amended (the "Code"), and all references to the Internal Revenue Service are abbreviated as IRS.

A. LITIGATION

Arkansas State Police Association, Inc. v. Commissioner (T.C. Memo 2001-38). Arkansas State Police Association, Inc. ("ASPA") is a tax-exempt organization under Section 501(c)(5) of the Code formed to promote law enforcement and cultivate fraternity and cooperation between Arkansas law enforcement community and the people of Arkansas. ASPA published a magazine three-times annually under an agreement with an Arizona publishing company. Various businesses advertised in each issue, and these ads were solicited by the publisher. The publisher designed the presentations used to solicit advertisers, but this promotional material and the advertising copy were subject to review by ASPA. The publisher was authorized to use the ASPA name and logo in the solicitation of advertisers and publication of the periodical. The tax court held that ASPA's participation in the development and publication of its magazine was not de minimis or passive in nature. The monies received by ASPA from the publisher as its share of the advertising proceeds were treated as unrelated business income and not passive royalty income.

B. IRS RULINGS, NOTICES, AND PROPOSED LEGISLATION

1. *Hospital-Run Fitness Center Ruled Exempt (PLR 200051049)*. A hospital purchased a sports and fitness center which contains an open fitness room (complete with cardiovascular and strength equipment), an indoor track, exercise rooms, racquetball and tennis courts, swimming pools, roller skating rink, nutrition center and juice bar, tanning beds, and child care areas. Within the center, the hospital seeks to establish a cardiac rehabilitation program dedicated to patients who have suffered heart-related illnesses. The fitness center also provides a variety of health-related services such as weight management and nutrition counseling, smoking cessation classes, arthritis therapy, personal training, and stress management programs. The facilities and services provided by the fitness center are available only to members. The membership consists of three distinct groups (general public, hospital employees, and rehabilitation patients), and several different categories of membership are available, with fees corresponding to the member's age and restrictions placed on use of the facilities. The center hosts sports leagues, birthday parties, and other community events, and non-members may rent space in the facilities for a fee. The hospital also leased space in the fitness center to a chiropractor and a physical therapist. The IRS held that the operation of the fitness center and a cardiac rehabilitation program is substantially related to the business of the hospital and furthers the hospital's tax- exempt purpose of promoting health in the community. The IRS also determined that (i) the operation of the roller skating rink was permissible because of its affordability to the general public and (ii) the leasing of office space to the chiropractor and physical therapist was substantially related to the hospital's exempt purpose.

2. *Charitable Giving Tax Relief Act*. On February 28, 2001, Congressman Phil Crane introduced legislation to extend the tax deduction for charitable contributions to those taxpayers (over 70%) who do not itemize their deductions on their tax returns.[2] A similar version of the proposal introduced by Congressman Crane in the last Congress received the co-sponsorship of 80 Republicans and 69 Democrats. The proposal would allow taxpayers to deduct 100% of their charitable contributions, up to the amount of the standard deduction applicable to the taxpayer's filing status.[3] Prior proposals have imposed a threshold amount which the taxpayer's total charitable contributions must exceed in order to obtain the deduction. The current proposal removes the threshold to eliminate any disincentive for nominal contributions.[4] According to a report prepared by PriceWaterhouseCoopers for Independent Sector, the proposal would stimulate an additional $14.6 billion in charitable giving in the first year and more than $80 billion over five years, yielding an 11% annual increase in charitable giving.[5] The most significant increase in new donors would be among the low and middle income taxpayers; 75% of the estimated 11.7 million new givers have incomes under $40,000.[6] Independent

Sector notes that 70% of contributions made by this demographic go to religious organizations, making religious organizations the biggest beneficiaries of the proposal.[7] Although the effect of such legislation is speculative, this proposal would likely bolster the financial status of the institutions and organizations through which the White House Office of Faith-Based and Community Initiatives is seeking to fulfill its mandate.

3. *Final Regulations on Prevention of Abuse of Charitable Remainder Trusts*. Regulations were finalized to prevent taxpayers from using certain charitable remainder trusts to obtain a tax-free return of corpus under Section 664(b)(4) of the Code. In these abusive transactions, a taxpayer contributes highly appreciated assets to a charitable remainder trust having a relatively short term and high payout rate. To satisfy the obligation to the income beneficiary, the trustee borrows money against the trust's corpus rather than sell a portion of the trust's highly appreciated assets, and the parties attempt to characterize the distribution as a return of corpus. Effective January 5, 2001, Regulations 1.643(a)-8, 1.664-1, 1.664-2, and 1.664-3 deemed the trust as having sold a pro rata portion of the corpus in such situations. As a result, in an abusive transaction like the above, the loan proceeds received in excess of the asset's basis will be deemed a capital gain (provided the assets pledged are capital assets and requisite holding periods satisfied), and the distribution will be characterized as a tax-free return of corpus only to the extent the distribution exceeds the deemed capital gain. Moreover, the basis of the pledged assets will be adjusted by adding the capital gain recognized in the "sale" to the basis of the pledged assets in order to compute any gain or loss if those trust assets are subsequently sold and the proceeds used to satisfy the indebtedness.

4. *Final Regulations on Lifetime Charitable Lead Trusts*. Under Sections 170(c), 2055(c)(2), and 2522(e)(2) of the Code, the permissible term for a charitable lead interest must either be a specified number of years or the lives of individuals living at the date of the transfer. Regulations were proposed to eliminate certain schemes utilizing seriously ill individuals, unrelated to the grantor or remainder beneficiaries, as measuring lives. Effective January 5, 2001, Regulations 1.170A-6, 20.2055-2, and 25.2522(c)-3 expanded the class of permissible measuring lives to include an individual who, with respect to all non-charitable remainder beneficiaries, is either a lineal ancestor or the spouse of a lineal ancestor of those beneficiaries. As a result, remainder beneficiaries may include step-children and step-grandchildren of the individual who is the measuring life, as well as charitable organizations. These final regulations also introduce a probability test to allow the flexibility of providing for alternative remainder beneficiaries in case the primary remainder beneficiary and his or her descendants predecease the measuring life. The trust will satisfy the requirement that all non-charitable beneficiaries be lineal descendants of the individual designated as the measuring life (or that individual's spouse), if there is a less than 15% probability that individuals who are not lineal descendants will receive any trust corpus.

5. *Voluntary Compliance and Plain-Language Publications (2001-7 I.R.B. 648; Announcement 2001-14)*. The Customer Education and Outreach office was established within the Exempt Organizations division of the IRS (as part of the Tax Exempt and Government Entities (TE/GE) Division of the IRS), and is responsible for coordinating the interaction of the Exempt Organization division with the community. In addition, the IRS is contemplating the creation of an office of voluntary compliance in TE/GE. Customer Education and Outreach office intends to develop a web page for Exempt Organizations and is soliciting public comments regarding design and content. Exempt Organizations has also iterated its plans to "aggressively" issue plain-language publications (which the IRS believes aids in voluntary compliance), and has solicited written suggestions from the public regarding future topics for such publications. As part of its customer education and outreach initiative, Exempt Organizations anticipates the establishment of several targeted voluntary compliance programs which, by definition, are narrow in scope (e.g. 1992-19 I.R.B. 89; Announcement 92-70 establishing a voluntary compliance program to resolve exemption tax exemption issues arising from gross or net revenue stream joint ventures between hospitals and their medical staffs).

6. *Charity malls*. Practitioners and commentators are debating the tax deductibility of "donations" made through charity malls. Charity malls are websites that host several online retailers and offer to donate a portion of an item's purchase price to charity designated by the user if the user buys that item from one of the retailers listed on the website. The donated portion of the purchase price is a percentage of the commission (and in some cases 100% of the commission) paid to the mall by the retailer. Without question, such a program allows consumers to support charitable causes of interest to them; however, the tax deductibility of the funds transferred to the charity as part of the transaction is in dispute. Charitymall.com does not assert that such contributions are tax-deductible to the user, but iGive.com contends that such contributions qualify as tax-deductible donations. In general, payments made by charity malls will not qualify as tax-deductible charitable contributions unless the online purchaser can demonstrate (i) that he paid in excess of fair market value for the goods received, and (ii) that he intended the excess to be a gift to the charitable organization. Nevertheless, an iGive.com representative explained that the amount given to the designated charity is characterized as a rebate and held in a voluntary account for the purchaser.[8] The purchaser has the option of receiving this rebate in cash or donating it to a charity, thereby insuring that the purchaser has exercised donative intent. Arguably, this position is consistent with the method approved by the IRS in PLR 9623035 in which credit card holders were permitted to claim charitable deductions for purchase rebate amounts donated to charities. Another potential hurdle for charity malls is that for a purchaser to obtain a Section 170 charitable deduction, the mall itself must qualify as a Section 501(c)(3) organization or be deemed an agent of such an organization. Although the IRS has not yet provided guidance with respect to charity malls, the

Exempt Organization's Continuing Professional Education text for fiscal year 2000 addresses these topics.

7. Temporary Regulations on Section 4958 Excess Benefit Transactions. Section 4958 of the Code imposes an excise tax on transactions that provide excess economic benefits to "disqualified persons" of public charities and certain other applicable tax-exempt organizations. The excise tax is equal to 25% of the excess benefit, and increases to 200% if the excess benefit is not corrected within a specified time period. Moreover, the IRS levies on managers who participate in such a transaction knowingly, willfully, and without reasonable cause an additional excise tax equal to 10% of the excess benefit (to a maximum of $10,000 per transaction). The temporary regulations clarify the manner in which excess benefits are corrected by the disqualified person and provide five new examples to illustrate acceptable forms of corrective action.[9] The temporary regulations also stipulate that an organization manager's participation in an excess benefit transaction will ordinarily not be deemed to be "knowing" to the extent the organization manager has fully disclosed the factual scenario to an "appropriate professional" and relies on a reasoned written opinion prepared by that professional.[10] The temporary regulations provide a general rule that an excess benefit transaction occurs, if at all, on the date the disqualified person receives the economic benefit and continues to reference the 3-year statute of limitations on assessment and collection.[11] As a general rule, the temporary regulations disregard for Section 4958 purposes all fringe benefits excluded from income under Section 132 (e.g. certain reasonable travel expenses of an employee).[12] Although the temporary regulations further defined "disqualified persons" to include those individuals serving as treasurers and chief financial officers, the IRS remained silent regarding contributors to donor-advised funds.[13]

ENDNOTES

1 Fizer, Beck, Webster, Bentley & Scroggins, 1360 Post Oak Boulevard, Suite 1600, Houston, Texas 77056; Phone: (713) 840-7710; Fax: (713) 963-8469

2 Independent Sector Public Policy Position Statement, March 2001. Independent Sector is a nonprofit, nonpartisan coalition of more than 700 national nonprofit organizations, foundations and corporate philanthropy programs.

3 Incentives for Nonitemizers to Give More: An Analysis prepared for Independent Sector, January 2001.

4 For example, if a deduction were not allowed until the taxpayer's total charitable gifts exceeded $1000, the taxpayer would have no incentive to give unless he knew in advance that his total contributions would eventually exceed the $1000 threshold.

5 Ibid.

6 Ibid.

7 News Release from Independent Sector, January 31, 2001.

8 The Exempt Organization Tax Review, Feb. 2001, pp. 158-159

9 Payment of the correction amount must be made in cash or cash equivalent to the organization by the disqualified person, and the disqualified person may not participate in the organization's decision whether to accept as a correction payment the return of specific property transferred in the excess benefit transaction. See Treasury Regulation 53.4958-7T.

10 Appropriate professionals may include legal counsel, certified public accountants, and independent valuation experts. See Treasury Regulation 53.4958-1T.

11 Oddly, Section 4958 of the Code does not specify when an excess benefit occurs. See Treasury Regulation 53.4958-1T.

12 See Treasury Regulation 53.4958-4T.

13 Contributors to a donor-advised fund do not have legal control over the funds donated; however, such persons may exercise substantial influence over the amount, timing, and recipients of distributions from the fund. See Treasury Regulation 53.4958-3T.

RECENT DEVELOPMENTS: SECTION 1032 AND "ZERO BASIS" ISSUES AFFECTING PARTNERSHIPS

by Robert B. Young[1]

In Technical Advice Memorandum 9822002 (Oct. 23, 1997), the IRS determined that a corporate partner was entitled to nonrecognition treatment under Section 1032 of the Code[2] when the partnership used its stock to purchase an operating business. Since that time, there have been a number of developments regarding the effect of Section 1032 of the Code and the "zero basis" problem on partnerships, culminating in the release of proposed regulations under Section 705 of the Code on January 3, 2001.[3]

Background

Section 1032 of the Code generally provides that a corporation shall not recognize gain or loss on the receipt of money or other property in exchange for its stock.

The "zero basis" problem arises in the following circumstances. If a corporation contributes its stock to another corporation in a transaction under Section 351 of the Code, or to a partnership in a transaction under Section 721 of the Code, the recipient of the stock contribution will have a zero carryover tax basis in such stock, and a resulting built-in gain.[4]

TAM 9822002 and Rev. Rul. 99-57: Section 1032 Is Applied Using the "Aggregate" Approach

In Technical Advice Memorandum 9822002, the taxpayer corporation and a foreign taxpayer agreed to form a partnership. Pursuant to a prearranged plan, the taxpayer corporation contributed cash and shares of its stock to a transitory corporation. The transitory corporation, in turn, contributed that cash and stock to the partnership in exchange for a partnership interest, and assigned its rights and obligations under the partnership interest back to the taxpayer, retaining legal title. The foreign taxpayer contributed an operating business to the partnership and immediately withdrew the cash and taxpayer stock contributed to the partnership by the transitory corporation, retaining a partnership interest in the partnership for the difference in value. A subsidiary of the taxpayer corporation contributed cash and assets to the partnership in exchange for the remaining partnership interest. Following the formation of the partnership, and a series of other transactions, the taxpayer corporation's subsidiary and the foreign taxpayer were the sole partners in the partnership.

The IRS concluded that the foreign taxpayer's exchange of a portion of its operating business for taxpayer stock and cash should be treated as a sale under Section 707(a)(2)(B) of the Code. The IRS also concluded that the taxpayer corporation was the actual owner of the partnership interest to which the transitory corporation held legal title. Because the partnership would realize a gain upon its exchange of the taxpayer stock in the deemed sale under Section 707(a)(2)(B) of the Code, and that gain would be allocated to the taxpayer corporation under Section 704(c) of the Code, the IRS then examined whether the taxpayer corporation should be required to recognize such built-in gain in light of Section 1032 of the Code.

The IRS noted that partnership taxation is a mixture of provisions that treat the partnership as either an aggregate of its members or a separate entity. Under the aggregate approach, each partner is treated as the owner of an undivided interest in partnership assets and operations. Under the entity approach, the partnership is treated as a separate entity in which partners have no direct interest in partnership assets and operations. The IRS then noted that treatment of the partnership as an entity could frustrate the purposes of Section 1032 of the Code, and determined that a partnership is properly treated as an aggregate of its partners for purposes of applying Section 1032 of the Code. Accordingly, the IRS determined that the taxpayer corporation was not required to recognize the built-in gain with respect to its stock.

In Revenue Ruling 99-57,[5] a C corporation and an individual formed a partnership for bona fide business purposes. The corporation contributed 100 shares of its stock, having a $100x value and a zero tax basis, to the partnership in exchange for a 50% interest in the partnership. The individual contributed a parcel of real property, having a $100x value and tax basis, to the partnership in exchange for a 50% partnership interest. One year later, after the value of the corporation stock increased to $120x, the partnership purchased property having a value of $60x in exchange for 50 shares of corporation stock, and services having a value of $60x in exchange for the other 50 shares of corporation stock. The partnership realized a gain of $120x, $100x of which was allocable to the corporation under Section 704(c) of the Code, and the remaining $20x of which was allocable to the corporation and the individual pursuant to the partnership agreement, $10x each to the corporation and the individual.

Under the principles first noted in Technical Advice Memorandum 9822002, the IRS determined that use of the aggregate theory of partnerships is appropriate for determining the application of Section 1032 of the Code to gains allocated to a corporate partner with respect to its stock. The IRS then determined that the corporation's $110x share of the partnership's gain was not subject to tax, and that the corporation's tax basis in its partnership interest would nevertheless be increased by $110x pursuant to Section 705 of the Code. The IRS also indicated that the same analysis would apply when a corporate partner is allocated a loss from a partnership transaction involving a disposition of the corporate partner's stock.

Notice 99-57: A Preemptive Finger in the Dam

Contemporaneously with the publication of Revenue Ruling 99-57, the IRS published Notice 99-57,[6] indicating its intention to promulgate regulations to prevent tax basis adjustments under Section 705 of the Code from generating recognizable loss in certain circumstances where no offsetting gain had been recognized pursuant to Revenue Ruling 99-57. In particular, the IRS indicated that regulations would be promulgated to address the case where a corporation acquires a partnership interest in a partnership that (i) already owns its stock, (ii) has no Section 754 election in effect, and (iii) later sells or exchanges the corporation's stock.

As an example, the IRS described the situation of an individual who purchases a 50% partnership interest in a partnership for $100x, where the partnership owns one asset with a tax basis of $100x and a value of $200x. If the partnership had made a Section 754 election, the individual would have a $50x special basis adjustment with respect to the partnership's sole asset under Section 743(b) of the Code (equal to the excess of the individual's $100x tax basis in his partnership interest over the individual's 50% share of the partnership's $100x tax basis in its sole asset, or $50x). Then, if the partnership sold its sole asset for $200x, the individual's special basis adjustment would exactly offset his $50x allocated share of the partnership's gain. By comparison, if the partnership had not made a Section 754 election, the individual would be allocated $50x upon the partnership's sale of its sole asset, and the tax basis of his partnership interest in the partnership would be increased by $50x under Section 705(a)(1)(A) of the Code. Upon a subsequent sale or liquidation of the individual's partnership interest, the individual would recognize an offsetting loss of $50x due to such tax basis increase. According to the IRS, without the Section 754 election, there might be a timing detriment to the individual, but the same amount of cumulative income or loss would be reported by the individual in either case. Because Revenue Ruling 99-57 permits a tax basis increase without the corresponding recognition of gain, the IRS was concerned that Revenue Ruling 99-57 would generate recognizable losses without offsetting gains where a corporation acquires a partnership interest in a partnership that (i) already owns its stock, (ii) has no Section 754 election in effect, and (iii) later sells or exchanges the corporation's stock.

The IRS also indicated in Notice 99-57 that the regulations would apply to tiered entity structures and to other situations where the price paid for a partnership interest reflects built-in gain or accrued items that will not be subject to income tax, or built-in loss or accrued deductions that will be permanently denied, when allocated to the acquiring partner, and a Section 754 election is not in effect.

Final Section 1.1032-3 Regulations: New "Zero Basis" Regulations for Certain Transactions Involving Partnerships

On September 23, 1998, the IRS issued proposed regulations under Section 1032 of the Code to provide relief from the "zero basis" problem in certain circumstances. The final regulations, which were published on May 16, 2000, were expanded to apply to certain transactions involving partnerships.[7]

Specifically, Section 1.1032-3 of the Treasury Regulations provides that no gain or loss will be recognized when a partnership transfers the stock of a corporation in a transaction to which Section 1.1032-3 of the Treasury Regulations applies. Instead, the transaction is treated as if, immediately before the partnership transfers the corporation's stock, the partnership purchases the corporation's stock for its fair market value with cash contributed to the partnership by the corporation (or, if necessary, through intermediate corporations or partnerships). According to Section 1.1032-3(c) of the Treasury Regulations, these rules apply only if, pursuant to a plan to acquire money or property:

(1) the partnership acquires stock of the corporation directly or indirectly in a transaction in which, but for Section 1.1032-3 of the Treasury Regulations, the partnership's tax basis in such stock would be determined, in whole or in part, with respect to the corporation's tax basis in its stock under Section 362(a) or 723 of the Code;

(2) the partnership immediately transfers the corporation's stock to acquire money or other property (from a person other than an entity from which the stock was directly or indirectly acquired);

(3) the party receiving such stock does not receive a substituted tax basis in the stock; and

(4) the corporation's stock is not exchanged for stock of the same corporation.

The IRS specifically noted in Treasury Decision 8883 that Revenue Ruling 99-57 will continue to apply in cases where Section 1.1032-3 of the Treasury Regulations does not. As a consequence, a corporation that is itself a partner in a partnership will not recognize its share of any gain from the disposition of its stock, whether or not it meets the circumstances described in Section 1.1032-3(c) of the Treasury Regulations. However, where subsidiaries or partnerships are interposed between such corporation and the partnership that owns its shares, compliance with Section 1.1032-3 of the Treasury Regulations is necessary to avoid taxable gain. To date, the "immediacy" requirement set forth in Section 1.1032-3(c)(2) of the Treasury Regulations is undefined.

Proposed Section 1.705-2 Regulations: The Promise of Notice 99-75 is Kept

As promised in Notice 99-75, the IRS issued proposed regulations under Section 705 of the Code on January 3, 2001 to address the case where a corporation acquires a partnership interest in a partnership that (i) already owns its stock, (ii) has no Section 754 election in effect, and (iii) later sells or exchanges the corporation's stock.

According to Section 1.705-2(b)(1) of the Proposed Regulations, the increase (or decrease) in the corporation's tax basis in its partnership interest resulting from the sale or exchange of its stock equals the amount of gain (or loss) that the corporate partner would have recognized, absent the application of Section 1032 of the Code, if a Section 754 election had been in effect. Section 1.705-2(c)(1) of the Proposed Regulations further provides that, if a corporation acquires an indirect interest in its own stock through a chain of two or more partnerships, and gain or loss from the sale of the stock is subsequently allocated to the corporation, then the bases of the interests of the partnerships included in the chain must be adjusted in a manner consistent with the Proposed Regulation.

To date, Section 1.705-2 of the Proposed Regulations does not deal with the other situations specified in Notice 99-57; namely, other situations where the price paid for a partnership interest reflects built-in gain or accrued items that will not be subject to income tax, or built-in loss or accrued deductions that will be permanently denied, when allocated to the acquiring partner, and a Section 754 election is not in effect. For example, will tax basis increases under Section 705 of the Code be limited where a corporation, through a cash contribution under Section 721 of the Code, acquires a partnership interest in a partnership that (i) already owns its stock, and (ii) later sells or exchanges the corporation's stock? Questions such as this may be answered when the final Section 1.705-2 regulations are issued.

Conclusion

Although certain specific questions remain to be answered, Rev. Rul. 99-57, Section 1.1032-3 of the Treasury Regulations, and Section 1.705-2 of the Proposed Regulations go far to resolve the "zero basis" problem, as applied to partnerships, in a manner that upholds the nonrecognition policy underlying Section 1032 of the Code and is generally favorable to corporate partners.

ENDNOTES

1 Robert B. Young, Associate, Haynes and Boone, L.L.P., 1000 Louisiana, Suite 4300, Houston, Texas 77002, Phone: (713) 547-2000, Fax: (713) 236-5621, E-mail: youngr@haynesboone.com.

2 References herein to the "Code" are to the Internal Revenue Code of 1986, as amended.

3 66 Federal Register, 315-319. Minor corrections to the proposed regulations were published on February 27, 2001. 66 Federal Register 12448-12449.

4 *See* Rev. Rul. 74-503, 1974-2 C.B. 117 (in the case of a corporation); Rev. Rul. 99-57, 1999-2 C.B. ____ (in the case of a partnership).

5 *Supra*.

6 1999-51 I.R.B. 692.

7 *See* Treasury Decision 8883, 65 Federal Register 31073-31078, May 16, 2000.

SIGNIFICANT DEVELOPMENTS IN PARTNERSHIP AND REAL ESTATE TAXATION

by Steven W. Brady and Vicki L. Martin[1]

The following is a summary of selected 2000 developments in the federal income taxation of partnerships and real estate, prepared by Steven W. Brady and Vicki L. Martin, as a project of the Partnership & Real Estate Tax Committee, Richard M. Fijolek, chairperson. Unless otherwise indicated, all section references contained herein are references to the Internal Revenue Code of 1986, as amended.

A. Partnership Taxation.

1. Section 704 - Partner's Distributive Share.

(i) PLR 200017007 through 200017010 and PLR 200018006 through 20018012 - In eleven similar PLRs, a fund treated as a securities partnership was allowed to use an allocation system that aggregates built-in gains and losses from contributed qualified financial assets with built-in gains and losses from revaluations of qualified financial assets for purposes of making § 704(c)(1)(A) and reverse § 704(c) allocations. In addition, the fund was allowed to make § 704(c) allocations on an aggregate basis, netting pre-contribution gain and loss with respect to each sub-tier partnership pursuant to Regulation § 1.704-3(e)(3) (the partial netting approach).

(ii) PLR 200048033 - A securities partnership which serves as an investment vehicle for five funds may aggregate built-in gains and losses from revaluations of qualified financial assets for purposes of making § 704(c)(1)(A) and reverse § 704(c) allocations. In addition, the partnership may aggregate built-in gains and losses from qualified financial assets contributed to the partnership by its partners, with built-in gains and losses from revaluations of qualified financial assets held by the partnership for purposes of making § 704(c)(1)(A) and reverse § 704(c) allocations to the extent that the partners are qualified contributors.

(iii) PLR 200051019 - A limited partnership which serves as an investment vehicle for several funds may aggregate built-in gains and losses from assets contributed to the limited partnership by its partners, with built-in gains and losses from revaluations of qualified financial assets held by the partnership for purposes of making § 704(c)(1)(A) and reverse § 704(c) allocations, provided that a contribution or revaluation of property and the corresponding allocation of tax items with respect to the property are not made in an attempt to shift the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

2. Section 706 - Taxable Year/Partners and Partnership.

(i) PLR 200027024 - A partnership that filed an application for a change of taxable year after its due date as a result of an error or misunderstanding was found to qualify for an extension of the time allowed by Regulation § 1.706-1(b)(4)(ii).

3. Section 707 - Transactions Between Partner and Partnership.

(i) TAM 200004036 - The transfer of a note by a subsidiary of a partner to the partnership was a disguised sale of the Note by the partner under § 707(a)(2)(B). The IRS concluded that based upon the economic substance of the transaction, rather than the form adopted by the parties to the transaction, the transfer of the note to the partnership is properly characterized as a transfer by the partner to the partnership, followed by a transfer of money from the partnership to the partner.

(ii) TAM 200037005 - A transaction designed to restructure a partnership into an umbrella partnership real estate investment trust resulted in a disguised sale of a portion of the original partner's interest in the partnership to a separate partnership and the real estate investment trust. The IRS concluded that because the partnership made loans to certain partners and because those loans were retired through a series of transactions that resulted in the issuance of an interest in the partnership interest to a real estate investment trust and another partnership, the transaction effectuated a disguised sale of part of the debtor partners interest in the partnership to the real estate investment trust and the new partnership.

4. Section 708 - Continuation of Partnership.

(i) PLR 200033030, 200033032, 200033033 and 200033035 - In four similar PLRs, the IRS held that contributions of partnership interests that terminate partnerships result in partnership level recapture under section § 42(j) unless certain exceptions apply under the identity of interest rule under Regulations §§ 1.47-3 and 1.47-6.

5. Section 721 - Nonrecognition of Gain or Loss on Contribution.

(i) PLR 200002025 and 200008025 - In two similar PLRs, the IRS ruled that a transfer to a partnership of a diversified portfolio of stock and securities, within the meaning of Regulation § 1.351-1(c)(6)(i), will not be considered a transfer to an investment company, within the meaning of § 351, provided that this is the only transfer to the new partnership other than transfers solely for cash and/or other diversified portfolios. The IRS based is findings on the fact that the diversified portfolios satisfied the twenty-five percent (25%) and fifty percent (50%) diversification tests of § 368(a)(2)(F)(vi). Therefore, no gain or loss was recognized as a result of the contribution under § 721(a).

(ii) PLR 200006008 - Three members of a limited liability company that is taxed as a partnership transferred assets to the limited liability company upon formation. The amount of nonidentical assets amounted to less than five percent (5%) of the total assets transferred. The IRS ruled that the transfers are not transfers of property to a partnership that would be treated as an investment company, within the meaning of § 351, provided that there are no other transfers. Therefore, no gain or loss was recognized as a result of the contribution under § 721(a).

(iii) PLR 200015009 through 200015011 - In three similar PLRs, substantially all of the assets of three different trusts were contributed to a newly formed limited liability company taxed as a partnership. Because the IRS determined that less than eighty percent (80%) of the limited liability company's assets will be readily marketable securities or securities or interests in RICs or REITs, the IRS ruled that the limited liability company will not be an investment company within the meaning of § 351. Therefore, no gain or loss was recognized as a result of the contribution under § 721(a).

(iv) PLR 200019020 - The IRS ruled that the transitory existence of a newly formed partnership's subsidiary corporation will be disregarded and the merger of an existing corporation into the transitory subsidiary will be treated as a contribution by the existing corporation's shareholders of the their stock interests in the corporation to the newly formed partnership in exchange for a membership interest in the newly formed partnership. Therefore, if there are no additional facts that establish the existence of a disguised sale under § 707, no gain or loss is recognized as a result of the transaction under § 721.

6. Section 752 - Treatment of Certain Liabilities.

(i) PLR 200050032 - A partner contributed property subject to a mortgage to a partnership. The partnership assumed the mortgage, and the partner guaranteed the debt in a manner that allows the creditor to proceed directly against the partner without first attempting to collect from the partnership. In addition, the partner agreed to waive any right to repayment and agreed to indemnify the partnership if it is required to satisfy the debt. The IRS ruled that the debt on the real property is a recourse liability for purposes of § 1.752-2(a) and the liability will be allocated to the contributing partner.

7. Section 754 - Manner of Electing Optional Adjustment to Basis of Partnership Property.

(i) PLR 200019029, 200022040, 200037026, 200037028 through 200037029, 200038017 through 200038020, and 200038022 - In eleven similar rulings, the IRS granted a partnership's request for an extension to make a § 754 election to adjust the basis of partnership property.

8. Section 7704 - Certain Publicly Traded Partnerships Treated as Corporations.

(i) PLR 200023036 - The IRS held that a computerized matching service for purchase and sale of publicly registered limited partnerships meets the safe harbor requirements of § 1.7704-1(g) and will be disregarded in determining whether the interests in a partnership are readily tradeable on a secondary market or the substantial equivalent of a secondary market for purposes of § 7704(b).

9. Revenue Rulings.

(i) Revenue Ruling 2000-18 - In this ruling, the IRS addressed the tax consequences arising when there is a transfer of qualified replacement property to a partnership in exchange for a partnership interest by a taxpayer that has elected to defer the recognition of gain under § 1042(a). Although the contribution of property to a partnership in exchange for an interest in the partnership is ordinarily a non-recognition event under § 721, the IRS ruled that § 1042(e)(1) requires that any gain realized on the contribution be recognized to the extent of the gain that was deferred under § 1042(a).

(ii) Revenue Ruling 2000-44 - The IRS ruled that a corporation, which acquires the assets of another corporation in a tax-free transaction, succeeds to the status of the transferor corporation for purposes of applying the exception for reimbursements of preformation expenditures and determining whether a liability is a qualified liability under the disguised sale provisions of § 707(a)(2)(B). The IRS noted that when a corporation acquires assets in a transaction subject to § 381, the acquisition does not alter the circumstances under which the expenditures or indebtedness were originally incurred or otherwise raise concerns that justify not treating the acquiring corporation as having incurred the expenditures or debt at the time they were incurred by the transferor corporation.

10. Proposed & Final Regulations.

(i) Partnership Mergers and Divisions - The IRS issued proposed regulations addressing the tax consequences of partnership mergers and divisions. These regulations affect partnerships and their partners. These rules propose to respect, for Federal income tax purposes, the form of a partnership merger or division if the partnership undertakes either the Assets-Over Form and the Assets-Up Form. Generally, when partnerships merge, assets are transferred from one partnership to another at the entity level (the Assets-Over Form). However, if the assets are transferred to the partners (titled in the names of the partners) and then transferred to another partnership, the proposed regulations would treat the transaction as the Assets-Up Form. In addition, the regulations provide that if the partnerships use the Interest-Over Form (the partners transfer their interest in one partnership to second partnership in exchange for an interest in the second partnership, and as a result of the transaction the assets and liabilities of the first partnership become the assets and liabilities of the second partnership), the transaction will be treated as following the Assets-Over Form. The proposed regulations also address some of the adverse tax consequences that may occur for partnerships that merge in accordance with the Assets-Over Form such as § 752 liability shifts and buyouts of existing partners. See Regulations § 1.708-1, § 1.743-1 and § 1.752-1.

(ii) Amortization of Intangible Property - The IRS issued final regulations addressing the amortization of intangible property. The regulations provide that a partner may amortize a § 743 adjustment with respect to a § 197 intangible if the transaction giving rise to the adjustment is structured in a manner that under general principles of tax law is properly characterized as a sale. The regulations also permit a partnership to make curative allocations to its noncontributing partners of amortization relating to an asset that was amortizable (or a zero-basis intangible that otherwise would have been amortizable in the hands of the contributing partner). Lastly, the regulations provide that for purposes of the anti-churning rules, when a partner is treated as holding its proportionate share of partnership property under § 197(f)(9)(E), the continued or subsequent use of an intangible by a partner could cause the anti-churning rules to apply with respect to the partner's share of the intangible in situations where a basis step-up under § 732(d) or § 743(b) otherwise would be amortizable. See § 1.197-2

(iii) Partnership Asset Basis Allocation - The IRS issued proposed regulations coordinating the application of § 755 and § 1060. While the temporary regulations under § 755 apply only if the assets of a partnership comprise a trade of business within the meaning of § 1060(c), and the basis adjustments are made under § 743(b) or § 732(d), these proposed regulations apply to all transfers of partnership interests and partnership distributions to which § 755 applies. In dealing with a basis adjustment under § 743(b) or § 732(d), the proposed regulations determine the fair market value of the partnership assets in two steps. Generally, the partnership's gross value is determined first, and that gross value is allocated among five classes of partnership property. With respect to allocating value within the asset classes, the proposed regulations generally provide that if the value assigned to a class is less than the sum of the fair market values of the assets in that class, then the assigned value must be allocated among the individual assets in proportion to their fair market values. However, because the value assigned to an asset cannot exceed the fair market value of the asset on the date of the relevant transfer, the excess must be allocated entirely to the value of goodwill if the partnership gross value exceeds the aggregate value of the partnership's individual assets. See Regulations § 1.755-2.

(iv) Sales or Exchanges of Interests in Partnerships, S Corporations and Trusts - The IRS issued final regulations relating to the sales or exchanges of interests in partnerships, S corporations and trusts. The final regulations interpret the look-through provisions of § 1(h) added in the 1997 Taxpayers Relief Act as amended by the IRS Restructuring and Reform Act of 1998. These rules explain the rules relating to the division of the holding period of a partnership interests and applies to a partner who (i) acquires portions or an interest at different times or (ii) acquires interest in a single transaction that gives rise to different holding periods under § 1223. The proposed regulations provide that, when a taxpayer sells or exchanges an interest in a partnership, rules similar to the rules under § 751(a) apply to determine the capital gain that is attributable to certain unrealized gain in certain assets. Even though these rules do not contain an anti-abuse provision, the IRS stated that it may attack such situations under a variety of judicial doctrines including substance over form, the step-transaction doctrine, or under Regulation § 1.701-2. See Regulations § 1.1(h)-1 and § 1.1223-3.

(v) Partnership Nonrecourse Liabilities - The IRS issued final regulations addressing the allocation of nonrecourse liabilities by a partnership. These regulations revise tier three of a three-tiered allocation structure contained in Regulation § 1.752-3, and also provide guidance regarding the allocation of a single nonrecourse liability secured by multiple properties. The proposed regulations modify the third tier by allowing an additional method under which a partnership may allocate an excess nonrecourse liability based on the excess § 704(c) gain attributable to the properties that are subject to the liability. For purposes of determining § 704(c) minimum gain under the second tier, the regulations also provide that if a partnership holds multiple properties subject to a single liability, the liability may be allocated among the properties based on any reasonable method. However, a method is not reasonable under the regulations if it allocates to any property an amount that exceeds the fair market value of such property. See Regulations § 1.752-3 and § 1.752-5.

11. Other Partnership Issues. For more information on partnership procedural issues, see the cases cited under the code sections listed below.

(i) Section 6221 - Tax Treatment Determined at Partnership Level.
- (A) Rhone-Poulenc Surfactants and Specialties L.P. v. Commissioner, 114 T.C. No. 34 (June 29, 2000)
- (B) GAF Corp. v. Commissioner, 114 T.C. No. 33 (June 29, 2000)
- (C) Callaway v. Commissioner, 231 F3d 106 (2nd Cir. 2000)

(ii) Section 6223 - Notice to Partners of Proceeding.
- (A) Prochorenko v. United States, 48 FedCl 494 (January 13, 2000)
- (B) Crnkovich v. United States, 202 F3d 1325 (3rd Cir. 2000)
- (C) Wechsler v. United States, 2000-1 USTC 50,158 (CCH)

(iii) Section 6224 - Participation in Administrative Proceedings; Waivers, Agreements.
- (A) Gregory v. United States, 2000-2 USTC 50,631 (CCH)

(iv) Section 6226 - Judicial Review of Final Partnership Administrative Adjustments.
- (A) Davenport Recycling Associates v. Commissioner, 220 F3d 1255 (11th Cir. 2000)

(v) Section 6228 - Judicial Review Where Administrative Adjustment Request is Not Allowed in Full.
- (A) Monti v. United States, 223 F3d 76(2nd Cir. 2000)

(vi) Section 6229 - Period of Limitation for Making Assessments.
- (A) Addington v. Commissioner, 205 F3d 54 (2nd Cir. 2000)
- (B) Phillips v. Commissioner, 114 T.C. No. 7 (February 29, 2000)
- (C) Carroll v. United States, 2000-2 USTC 50,843

B. Real Estate Investment Trusts ("REITs").

1. Section 856 - Definition of REIT.

(i) PLR 200008036 - The IRS ruled that the transportation services rendered by a trucking contractor do not cause the REIT's income from self-storage facilities to be excluded from qualification as rents from real property under § 856(d), because tenants of the self-storage facilities will be an insubstantial portion of the tucking contractor's client base and will not be offered a discount by virtue of being a tenant of the self-storage facilities.

(ii) PLR 200013021 - The IRS ruled that certain promotional services for business tenants constitutes impermissible tenant service income under § 856(d)(7) despite the fact that the services are (i) performed by a third-party, (ii) separately negotiated for with the third-party and (iii) the tenants are not required to use the services. However, the designation of a tenant to receive such services will not disqualify the rental income under § 856(d) if the impermissible tenant service income is less than one percent (1%) of all amounts received.

(iii) PLR 200027034 - The IRS ruled that a REIT's cold storage warehouses and central refrigeration systems constitute real property for purposes of § 856(c) because the facilities were inherently permanent structures and structural components of permanent structures.

(iv) PLR 200028014 - The IRS ruled that the provision of ambulatory care planning, property management and development management services by a REIT's subsidiary will not cause the REIT's share of otherwise qualifying income to fail to be rents from real property under § 856(d)(2)(C) because such services will constitute a separate and independent business. In addition, the IRS found the facts in this PLR to be similar to those of Rev. Rul. 84-138 and ruled that the amounts collected by the REIT under a reimbursement arrangement for general and administrative overhead, shared personnel, and facilities between the REIT and its subsidiaries, will not constitute gross income for purposes of § 857(c).

(v) PLR 200039017 - The IRS ruled that a concession agreement with a municipality is analogous to a lease and therefore is an interest in real property for purposes of § 856(c)(5)(C) making it a real estate asset for purposes of § 856(c)(4)(A). In addition, the IRS ruled that the sublease of the concession agreement is also analogous to a lease and the income derived under the sublease will qualify as rents from real property under § 856(c).

(vi) PLR 200039027 - The IRS ruled that amounts received by a partnership in which a REIT is a limited partner as a result of litigation and settlement do not cause the REIT's share of such receipts to fail to qualify under the gross income tests of § 856(c)(2) and (3).

(vii) PLR 200041024 - The IRS ruled that a REIT's fee, leasehold, license and other interests in building rooftop sites that the REIT intends to lease, sublease or license to providers of wireless telecommunications, constitute interests in real property and real estate assets under § 856(c)(5)(B) and (C).

2. Regulations.

(i) Recharacterization of Financing Arrangements Involving Fast-Pay Stock. The IRS issued final regulations that recharacterize for tax purposes financial arrangements involving fast-pay stock. Under these regulations, if a corporation with outstanding fast-pay stock is a REIT, the fast-pay arrangement is automatically recharacterized, and the proposed regulations treat the fast-pay shareholders as acquiring instruments issued by the benefitted shareholders instead of acquiring interests in the assets of the corporation. See Regulation § 1.7701(l)-3 and § 1.1441-7.

C. Real Estate Taxation.

1. Section 121 - Exclusion of Gain From Sale of Principal Residence.

(i) PLR 200004022 - The IRS ruled that the transfer of a residence to a limited partnership that is wholly owned by the transferors, does not end the transferors' ownership of the residence. Thus, the transferors will continue to be treated as the owners of the residence for purposes of § 121(a) during the period in which the limited partnership holds title to the residence.

(ii) PLR 200018021 - The IRS ruled that because a trust's income beneficiary has never had the power to vest trust corpus or income in herself, the beneficiary is not considered to be the owner of the residence held by the trust for purposes of § 121.

(iii) Bankruptcy Estates Residence Exclusion - The IRS issued proposed regulations to clarify the exclusion of gain from the sale or exchange of a taxpayer's principal residence including the availability of the exclusion to the bankruptcy estate of an individual debtor. Under these proposed rules the IRS adopts the majority view that a Chapter 7 or Chapter 11 bankruptcy estate succeeds to the exclusion if the debtor otherwise satisfies the requirements under § 121.

2. Section 280A - Disallowance of Certain Expenses in Connection with Business Use of Home; Rental of Vacation Homes, Etc.

(i) Kurzet v. Comm'r, 222 F3d 830 (10th Cir. 2000) - The Court held that the taxpayers are not entitled to deductions for home office expenses associated with their Tahiti property because the taxpayers failed to show that the home was the principal place of business for any of their business activities and are not entitled to change the recovery period on a timber farm reservoir because the taxpayers failed to obtain the Commissioner's permission prior to the change.

3. Section 1031 - Exchange of Property Held for Productive Use or Investment.

(i) Notice 2000-4 - The IRS provided guidance on the depreciation of property that is subject to § 168 when the property is acquired in a like-kind exchange under § 1031 or from an involuntary conversion under § 1033. The Notice provides that the acquired MACRS property should be depreciated over the remaining recovery period of, and using the same depreciation method as, the exchanged or converted MACRS property.

(ii) PLR 200019014 through 200019019 - In six similar PLRs the IRS ruled that an exchange by means of a qualified intermediary does not cause receipt of cash proceeds of the sale for purposes of § 1031 because the rights of the limited partners to the proceeds held by the qualified intermediary are limited to the circumstances in Regulation § 1.1031(k)-1(g)(6). In addition, the IRS ruled that the exchange of a fee simple interest in a mobile home park for tenancy-in-common interests in other real and personal property of a like-kind or class qualifies under § 1031.

(iii) PLR 200027028 - The IRS ruled that a proposed amendment to a standard exchange agreement and standard qualified trust agreement, under which the qualified intermediary is allowed to distribute funds if the owner of the relinquished property, after negotiating in good faith with the seller of identified replacement property, is unable to reach an agreement with the seller provided all other replacement properties have been acquired, is beyond the scope of Regulation § 1.1031(k)-1(g)(6)(iii). The exchange agreement as amended does not qualify under the regulations because the owner of the relinquished property has not yet received all of the replacement property to which the owner is entitled under the exchange agreement prior to the time the funds can be distributed.

(iv) TAM 200035005 - The IRS ruled that the exchange of a FCC radio broadcast license for a FCC television broadcast station license qualifies as a like-kind exchange subject to the nonrecognition rules under § 1031.

(v) Rev. Proc. 2000-37 - The IRS, provided a safe harbor under which reverse-Starker exchanges can qualify for nonrecognition of gain under § 1031. This Procedure provides that if the property is held in a qualified exchange accommodation arrangement, the Service will not challenge the qualification of property as replacement property or relinquished property for purposes of § 1031 and the Treasury regulations thereunder, or the treatment of the exchange accommodation titleholder as the beneficial owner of such property for tax purposes.

(vi) TAM 200039005 - In reviewing a reverse-Starker transaction, the IRS ruled that the transaction in question lacked the required interdependence to be treated as an exchange, because the taxpayer could have terminated the transaction after acquiring the replacement property while keeping the relinquished property.

(vii) INFO 2000-0216 - The IRS explained that a rental unit acquired in a § 1031 exchange can be converted to a personal residence and sold under § 121 after five years.

(viii) PLR 200040017 - The IRS ruled that U.S. Virgin Islands real estate can qualify as replacement property if it produces income early enough to cause § 932 to apply to the taxpayer.

(ix) Rev. Proc. 2000-46 - The IRS announced that it will not issue PLRs for transactions involving exchanges of undivided fractional interests in real property. The IRS indicated that it intends to study whether an undivided fractional interest should be considered a partnership for federal tax purposes.

(x) PLR 200041027 - The IRS ruled that a taxpayer's signs meet the definition of "outdoor display property" found in § 1033(g)(3), and, as a result, the taxpayer may elect to treat the signs as real property thereby allowing the signs to constitute property of a like-kind with respect to certain replacement property. Furthermore, because the taxpayer represented that the other requirements of § 1031 were met, the proposed exchange qualifies as a like-kind exchange under § 1031.

(xi) DeCleene v. Comm'r, 115 T.C. No. 34 (November 17, 2000) - The Court held that a transaction whereby the taxpayer: (i) purchased a piece of unimproved real estate as a new location for his business, (ii) quitclaimed that property to a third party who was interested in the taxpayer's old business location and who constructed a building on the property with nonrecourse financing guaranteed by the taxpayer, and (iii) exchanged the old business location for the improved property, does not qualify as a tax-free like-kind exchange, because the taxpayer never divested himself of beneficial ownership of the replacement property.

4. Section 1033 - Involuntary Conversions.

(i) PLR 200011052, 200011053, 200011057, 200011059 through 200011060, 200013039, 200014042, 200038025, 200051033, and 200051035 - In eleven similar PLRs, the IRS ruled that the termination of a power purchase agreement constitutes a "compulsory or involuntary conversion" of both the power purchase agreement and the facility producing the power within the meaning of §§ 1033 and 1231.

(ii) PLR 200022029 and 200022034 - In two similar PLRs, the IRS ruled that where a noncontrolling interest in a utility or public utility is involuntarily converted into money within the meaning of § 1033(a)(2), the reinvestment of the proceeds in public utility mutual funds or utility stocks constitutes a reinvestment in property that is similar or related in service or use as described in § 1033(a)(2)(A).

D. Other Related Issues.

1. Section 108 - Discharge of Indebtedness.

(i) TAM 200014007 - The IRS ruled that the debt of a partnership was incurred "in connection with" real property used in the partnership's trade or business satisfying the requirements of § 108(c)(3)(A) because, at the time the debt was incurred, it was secured by real property used in the partnership's trade or business.

(ii) PLR 200021014 - The IRS granted a taxpayer an extension to file an election under § 108(c)(3) to reduce his tax basis in depreciable property.

(iii) FSA 200028019 - The IRS concluded that the indebtedness of a limited partner which has been reduced to judgement does not result in cancellation of indebtedness income for the limited partner in the tax year.

2. Section 162 - Trade or Business Expense.

(i) United Dairy Farmers Inc. v. United States, S.D. Ohio, No. C-1-97-1043 (May 22, 2000) - The Court held that expenditures made by the taxpayer to remediate contaminated soil resulted in an improvement of the properties as compared to the condition of the property at the time of acquisition, and, as a result, the taxpayer is required to capitalize the remediation costs.

3. Section 165 - Losses.

(i) Lund v. United States, 2000-1 USTC 50,234 (CCH) - The Court granted the government's motion for summary judgment holding that owners of a Utah vacation home are not entitled, in the year they experienced a second avalanche, to a casualty loss deduction because of the restricted use of their home in winter months and a lower appraisal value due to the avalanche risk.

(ii) Revenue Ruling 2000-15 - In this revenue ruling, the IRS provided that under the Disaster Relief and Emergency Assistance Act, residents of federally declared disaster areas can elect to claim deductions for losses related to the disaster, and such losses can be taken on the tax return for the taxable year immediately preceding the taxable year in which the disaster occurred.

4. Section 179 - Election to Expense Certain Depreciable Business Assets.

(i) Hayden v. Comm'r, 204 F3d 772 (7th Cir. 2000) - The Court held that a partnership that invested in business equipment and reported a loss for the taxable year may not, despite its election to expense the equipment cost under § 179, allocate a § 179 deduction to the partners. The Court based its holding on the limitation contained in § 179(b)(3)(A) which provides that the deduction may not exceed the taxpayer's aggregate amount of taxable income derived from the active conduct of all trades or businesses of the taxpayer.

5. Section 183 - Activities not Engaged in for Profit.

(i) Hill v. Comm'r, 204 F3d 1214 (9th Cir. 2000) - The Court held that the Tax Court was correct in holding that the partnerships involved in the case lacked a profit motive under § 183 because oil production never occurred in commercial quantities. The Court held that § 183 applies to partnerships despite the statute's failure to address them. The Court, citing other cases, reasoned that the IRS is well within granted regulatory authority to equate the violation of one code section with a violation of § 6621(c).

6. Section 263A - Capitalization.

(i) Proposed Regulations Addressing "Delay Rental" Costs - The IRS issued proposed guidance concerning when "delay rental" costs for leased mineral property can be expensed and when it must be capitalized.

(ii) Revenue Ruling 2000-7 - The IRS ruled that where a depreciable asset is removed and replaced, the removal costs are not required to be capitalized under §§ 263(a) or 263A as part of the cost of replacing the asset. The facts in this ruling involved the removal and replacement of telephone poles. The IRS stated that historically, costs involved in removing an asset have been deductible.

7. Section 453 - Installment Method.

(i) Notice 2000-26 - The IRS issued guidance in a question and answer format on the application of § 453(a)(2) to certain installment sale transactions. The notice provided that a partner is not precluded by § 453(a)(2) from reporting on the installment method the gain arising from the sale of a partnership interest if the sale otherwise qualifies for such treatment.

(ii) ASA Investerings Partnership v. Comm'r, U.S., cert. denied (October 2, 2000) - The U.S. Supreme Court declined to review the decisions of lower courts in ten tax cases, including a case involving a Merrill Lynch transaction aimed at sheltering capital gains. The Tax Court previously held that a tax shelter scheme proposed by Merrill Lynch which generated losses through contingent installment sales that would be used to offset capital gains lacked economic substance.

8. Section 465 - Deductions Limited to Amount At Risk.

(i) FSA 200025018 - The Chief Counsel's Office stated that a guarantor of a partnership liability is not at-risk to the extent that there is a right of reimbursement against any partner. However, to the extent that the member does not have a right of reimbursement against the remaining members, the member is at-risk under § 465.

(ii) FSA 200043004 - The National Office concluded that limited partners with adequate tax basis in their partnership interests are allowed their distributive share of ordinary loss to the extent of their distributive share of cancellation of indebtedness income under § 465. However, with no amount at-risk, any limited partner's § 465(d) loss in excess of the limited partner's cancellation of indebtedness income is not allowed, even with adequate tax basis.

9. Section 469 - Passive Activity Losses and Credits Limited.

(i) Pungot v. Comm'r, T.C. Memo. 2000-60 (February 24, 2000) - The Tax Court upheld as constitutional § 496(c)(7)(D), which distinguishes between an employee who is a five percent (5%) owner of the employer and one who is not for purposes of the exception that treats rental activities as non-passive if certain requirements are met.

(ii) TAM 200014010 - The IRS ruled that a taxpayer's activity of providing property to a convenience store operator is a rental activity, and the taxpayer may not group the rental activity with its trade or business activity of selling petroleum products.

(iii) Krukowski v. Comm'r, 114 T.C. No. 25 (May 22, 2000) - The Tax Court held that a taxpayer may not offset income realized on his rental of an office building to his subchapter C law firm by the loss he realized on his rental of a building to his subchapter C health club.

(iv) Connor v. Comm'r 218 F3d 733 (7th Cir. 2000) - The Court held that income generated by the lease of a dental office to the taxpayer's spouse is not passive income, and the taxpayer is not entitled to offset that income with passive losses from the rental of other properties.

(v) Sidell v. Comm'r 225 F3d 103 (1st Cir. 2000) - The Court held that rental income received by the controlling shareholder of a subchapter C corporation is not passive income under the self-rental and attribution rules, and the rental income may not be offset by rehabilitation tax credits claimed with respect to refurbished rental property.

ENDNOTE

1 Haynes and Boone, L.L.P., 901 Main Street, Suite 3100, Dallas, Texas 75202; Phone (214) 651-5000

TAX CONTROVERSY: RECENT DEVELOPMENTS

Compiled by Anthony E. Rebollo[1]

1. TAX CONTROVERSY CASES

[Criminal Cases]

1.1 Defendant in a tax evasion and false subscription case moved to dismiss the indictment for lack of venue and duplicity. Although the Court denied those motions, it transferred venue from the Southern District of New York to the Southern District of Florida. The Court described the standards applicable to venue challenges and ultimately determined that there were sufficient contacts with New York for proper venue. The Court, however, transferred the case to Florida based on the defendant's residence there, the fact that witnesses were located there and the fact that the securities deals which generated the alleged unreported income were solicited, negotiated and executed from Florida.

United States v. Martino, 87 A.F.T.R. 2d 328 (S.D.N.Y. Dec. 14, 2000)

1.2 The conviction and sentencing of a defendant under Section 7206 was reversed and remanded by the Ninth Circuit, which held that the individual's Sixth Amendment Right to counsel had been violated. While the district court had properly discussed the dangers and disadvantages of self-representation (including the possible penalties if convicted), the court did not adequately explain the nature of the charges against the defendant. United States v. Glessner, No. 00-30148 (9th Cir. January 5, 2001).

1.3 Reversing the district court, the Second Circuit held that "because tax evasion and mail fraud are substantially similar charges whose offense levels are determined by the total amount of harm or loss, the counts should have been grouped." As a result, the defendant's resulting offense level under the sentencing guidelines was 16 instead of 18.

United States v. Petrillo, 237 F.3d 119 (2nd Cir. December 29, 2000)

1.4 "[T]ax evasion, fraud and conversation should be grouped under U.S.S.G. § 3d1.2(d)." As a result, the defendant's resulting offense level under the sentencing guidelines was reduced from 20 to 19.

United States v. Fitzgerald, 232 F.2d 315 (2nd Cir. November 15, 2000).

[Trust Fund Cases (Responsible Persons)]

1.5 A corporate director was not a responsible person under Internal Revenue Code §6672. Even though the director knew about the company's failure to pay its withholding taxes for several years, the court found that the director did not participate in management decisions, had no authority to pay creditors, and could not make bank deposits, sign checks or make corporate disbursements.

Mark McLaughlin v. United States, No. 5-98-3918 (D. MD. Nov. 20, 2000), entering judgment based on facts set out in 2000-1 U.S.T.C ¶50,183 (2000).

["Hobby Loss" Win]

1.6 Despite a string of considerable losses and substantial amounts of income from taxpayer's employment as an executive, the Tax Court held that a couple operating a horse breeding and boarding activity was a for-profit business, entitling them to deduct expenses from that activity. The Court focused on the fact that the taxpayers operated their activity in a businesslike manner, because they (a) kept complete and accurate records, (b) understood the activity's profit potential, (c) advertised in a businesslike manner in the local newspaper and (d) offset some of their breeding losses with the boarding activity.

Strickland v. Commissioner, 80 T.C.M. 451 (September 28, 2000).

[Change in Accounting Method]

1.7 The Tax Court found that flooring materials used by a floor installation business were not merchandise and, consequently, held that the IRS abused its discretion in determining that the company was required to use the accrual method instead of the cash method. The Tax Court held that the taxpayer was not in the business of selling merchandise, but that its stock in trade was its expertise in installing flooring materials. The taxpayer, therefore, was not a merchandise manufacturer or a retail seller of flooring materials, which were merely incidental to the flooring services it provided.

Smith v. Commissioner 80 T.C.M. 701 (November 14, 2000).

[Worker Classification]

1.8 Despite §3121(d), which states that "the term 'employee' means … any officer of a corporation," the Service reasoned in a Legal Memorandum that a corporate officer could, under §530 of the Revenue Act of 1978, be properly treated as an independent contractor. The Legal Memorandum also concluded that the reduced employer liability rates of §3509 could be used where a corporate officer was misclassified as an independent contractor.

ILM 200038045 (August 9, 2000).

[Wages v. Reimbursements]

1.9 The Eleventh Circuit reversed the district court's finding that per diem payments – calculated on the basis of a flat percentage of the miles driven by truckers – failed to meet the three-pronged test under §62 that would enable the payments to qualify as non-taxable reimbursements made under an accountable plan. In reaching that conclusion, the Court reasoned that each of the three prongs ultimately rested on the question whether the employer reasonably anticipated and calculated the expenses in question before reimbursing them. Notwithstanding the fact that the payments in question were made without regard to whether a trucker actually incurred travel expenses, these questions of reasonableness and the employer's state of mind should have been decided by a jury, not the court. It was error, therefore, for the trial court to have ruled on its own that the payments in question were wages because of the "accountable plan" requirements of §62 had not been met.

Trucks, Inc. v. United States, 234 F3d 1340 (11th Cir. Dec. 11, 2000).

[Fraud Penalty]

1.10 Finding that the IRS had failed to carry its burden of proof, the Ninth Circuit reversed a Tax Court decision applying fraud penalties against a taxpayer under §6651(f). The Tax Court found that the taxpayer had continually failed to file returns even though her CPA had timely prepared them. Furthermore, the Tax Court noted that copies of those returns, which had been provided to the Revenue Agent during the examination, had been improperly signed and dated. Notwithstanding these facts, as well as the existence of explanations which the Tax Court found to be inconsistent and implausible, the Ninth Circuit disagreed with the conclusion that the Service had met its burden.

Christianson v. Commissioner, 87 A.F.T.R. 2d ¶ 2001-484 (January 11, 2001).

[Form 8300 Analysis]

1.11 In a Legal Memorandum, the Service addressed questions about whether certain "open account" payments in currency were reportable under §6050I. It determined that, in the final analysis, reporting will depend upon whether the payments are the result of one or more "related transactions," which would trigger a reporting requirement when the total exceeds $10,000. Information reporting would not be required, however, where there are monthly payments for separate, independent transactions. "The recipient's record keeping practices are not a factor in determining whether information reporting is required." Instead, the key is "the nature of the underlying event that precipitates these payments," which is a factual determination.

ILM 200102049 (January 12, 2001)

[Collections (Installment Agreements)]

1.12 In a legal memorandum, the Service examined an installment agreement which erroneously referenced a taxpayer prior year's liability, thereby permitting another year's liability to escape collection. In seeking to invalidate the agreement, questions were raised about the taxpayer's responsiveness to requests for financial information. The Service noted that, while the failure to provide financial information may constitute grounds for terminating an installment agreement, the request for financial information in the case under consideration was unclear. In addition, nothing in §6159 enables the Services to terminate an agreement because the agreement will not provide for full payment of the tax liability. Finally, the Service could not terminate an agreement simply because it failed to obtain an extension of the statute of limitations on collections.

ILM 200040007. (June 20, 2000)

[Useful Websites]

1.11 http://www.ustreas.gov/irs/ci/tax_fraud/docabusivetrustschemes.html (describing recent cases and investigative priorities of CID)

1.12 http://www.irs.gov/prod/news/efoia/ccbull.html (Criminal Tax Bulletin, published by Office of Chief Counsel, Criminal Tax Division)

1.13 http://www.irs.gov/prod/news/efoia/ccbull.html (Collection, Bankruptcy and Summonses Bulletin, published by Office of Chief Counsel)

ENDNOTES

1 Anthony E. Rebollo is a partner with the law firm of Strasburger & Price, LLP.

CURRENT DEVELOPMENTS IN ESTATE TAX

Alan K. Davis and Alan L. Stroud[1]

LETTER RULINGS

1. Valid Disclaimer of Interest in Pre-1977 Trust.

The IRS ruled that a minor's disclaimer, made within nine months of attaining the age of majority, of the disclaimant's interest in a pre-1977 trust will not constitute a transfer subject to the federal gift tax. The disclaimer made within nine months after reaching age 18 is considered to be within the time period prescribed in Reg. Section 25.2511-1(c). PLR 200047027.

2. Status of Grandfathered GST Trusts Unaffected.

In numerous letter rulings, the IRS held that trusts which were exempt from the generation-skipping transfer tax pursuant to the grandfather provisions of Section 1433(b)(2)(A) of the Tax Reform Act of 1986 and Reg. Section 26.2601-1(b)(1)(i), were not deprived of that exemption as a result of certain modifications to the trusts, or the consolidation, merger or division of the trusts under certain circumstances. PLRs 200037009; 200037010; 200037011; 200037012; 200037013; 200037014; 200037015; 200037016; 200037017; 200046002; 200046003; 200047001; 200047002; 200047003; 200047004; 200047005; 200047006; 200047007; 200047008; 200047009; 200047011; 200047018; 200049011; 200050016; 200050041; 200052007; 200052009; 200051004; 200102039; 200102040; 200103001; 200103002; 200103003; 200103007; 200103049; 200104023; 200105039; 200105044; 200107003.

3. Extensions of Time for Reverse QTIP Elections.

In multiple separate letter rulings, the IRS dealt with issues relating to the reverse QTIP election. In four of those rulings the IRS granted extensions of time for making reverse QTIP elections under Section 2652(a)(3) because the executor had failed to make the election on Schedule R of the estate tax return. In two of the rulings, the IRS also granted an extension of time to sever a marital trust for purposes of making the reverse QTIP election. PLRs 200037008; 200047013; 200050027; 200050030; 200050037.

4. Valid Disclaimer of CRT Interest.

The IRS held in a letter ruling that a disclaimer by a beneficiary was a qualified disclaimer under Section 2518 and resulted in an estate tax charitable deduction. The decedent established a trust to be funded by the decedent's residuary estate. The trust was drafted as a charitable remainder unitrust and the beneficiary was to receive the unitrust amount for her lifetime. The beneficiary was also named as the beneficiary of several individual retirement accounts and commercial annuity contracts. The beneficiary disclaimed her interest in the individual retirement accounts and commercial annuities. As no alternative beneficiary was designated, the IRA accounts and annuities passed pursuant to the decedent's residuary estate to the trust. The beneficiary also disclaimed her entire interest in the trust. The IRS concluded that because the beneficiary disclaimed all of her interest in the trust, which included any interest in the IRAs and annuities that passed to the trust, the trust corpus passed immediately to the remainder beneficiary and qualified for the estate tax charitable deduction. *PLR 200052006.*

5. Tax-Free Rollover of IRAs.

The IRS ruled that a widow may rollover the proceeds of her deceased husband's IRA to her own IRA on a tax-free basis. Husband had designated his estate as the beneficiary. The IRS ruled that because the widow had control over the estate, she could roll the proceeds from the husband's IRA into her own IRA tax-free. *LTR 200106047.*

In two more letter rulings, the surviving spouse of a participant was allowed to rollover the participant's IRA into her own IRA on a tax-free basis. The participant had designated the estate as the beneficiary of the IRA. The participant's Will distributed his estate to a trust. As the result of an election to take against the Will, the spouse was entitled to 50% of the decedent's estate. Accordingly, as her 50% distribution, she elected to take the IRA proceeds and roll them over to her own IRA. *LTR 200052040 and LTR 200052041.*

6. State Court Reformation Saves Marital Deduction.

The IRS ruled that a surviving spouse had a qualifying income interest for life in a marital trust, following a state court reformation of a decedent's Will. The decedent's Will provided for a marital deduction trust. However, the trust provided that the trustee had the power to distribute marital trust assets to persons other than the surviving spouse. The spouse petitioned the state court to reform the trust due to a scrivener's error to exclude the provision regarding the distribution of marital trust assets to descendants. The state court reformed the trust to correct the scrivener's error and, accordingly, the IRS concluded that the marital trust qualified for the marital deduction. *LTR 200106008.*

7. Beneficiaries of IRAs May Use Life Expectancy for RMDs.

The IRS ruled that the designated beneficiaries of an IRA may take required minimum distributions over the life expectancy of the oldest designated beneficiary despite the fact that the participant had elected to receive distributions following her required beginning date over her single life expectancy using the recalculation method. *LTRs 200105063* and *200105065.*

In another letter ruling, the IRS ruled that a beneficiary may take required minimum distributions from a deceased participant's IRA over the beneficiary's life expectancy even though the participant was receiving her required minimum distributions over her single life expectancy. In this ruling, the participant had rolled over the IRA from the IRA of her deceased husband. She designated her son, the taxpayer, as of the date the rollover IRA was established. The IRS ruled that even though this date was beyond the decedent's required beginning date, because the IRA was new as of the date it was established, the son is considered as being the designated beneficiary on the required beginning date. *LTR 200104033.*

In a series of letter rulings, the decedent named her three children as the beneficiaries of her IRA. Following her required beginning date, she elected to take distributions over her life expectancy and her life expectancy was being recalculated. Following her death, the three children proposed to divide the IRA into three equal accounts and respectively take required distributions over their respective life expectancies. The IRS ruled that each beneficiary would be allowed to take the required distributions from the child's respective account over the child's life expectancy. *LTR 200052042, LTR 200052043, LTR 200052044.*

8. Charitable Trust Reformation.

The IRS ruled that a proposed judicial reformation of a charitable remainder trust to conform with Section 2055(e)(2) was a reformable interest as defined in Section 2055(e)(3) and that an estate tax charitable deduction would be allowable for the remainder interest passing to charity. *LTR 200105059.*

9. Time for Disclaimer.

The IRS ruled that a beneficiary's disclaimer of his interest in a trust established while he was a minor will not be subject to gift tax. A taxpayer was 14 years old when the trust was created and was unaware that he was a remainder beneficiary. The trust terminated upon the death of all the beneficiaries of the trust and was to be distributed to the taxpayer presumably well after nine months of the creation of the remainder interest. The IRS ruled that an interest must be disclaimed within a reasonable time after the disclaimant obtains knowledge of the transfer creating the interest to be disclaimed rather than a reasonable time after the distribution or vesting of the interest. *LTR 200105049.*

REVENUE PROCEDURES, REGULATIONS AND OTHER ANNOUNCEMENTS

10. IRS Issues Publication 559.

The IRS released Publication 559, "Survivors, Executors, and Administrators," for use in preparing returns for the year 2000. Pub. 559 discusses the decedent's final income tax return, the Federal income tax return of the estate and the Federal estate tax return.

11. IRS Issues Announcement to Correct Proposed Regulations Under § 679.

On November 28, 2000, the IRS issued Announcement 2000-96 under Section 679 that published corrections to the proposed regulations on transfers of property by U.S. persons to foreign trusts having one or more U.S. beneficiaries. The corrections changed the effective dates listed in the proposed regulations' preamble from November 6, 2000, to August 7, 2000. [REG-209038-89].

12. Correction to Final Regulations on Valuing Partial Interests in Trusts.

On December 18, 2000, the IRS issued Announcement 2000-100 under Section 2702 that published corrections to final regulations (T.D. 8899, 2000-38 I.R.B. 288) on valuing partial interests in trusts. The corrections relate to the period for payment of the annuity amount and the unitrust amount under Reg. Section 25.2702-3.

13. Proposed Regulations on Electing to Treat a Trust as Part of an Estate.

On December 18, 2000, the IRS issued proposed regulations [REG-106542-98] under Section 645 relating to certain revocable trusts for which an election is made to be treated and taxed as part of an estate. Under Section 645, if both the executor of an estate and the trustee of a qualified revocable trust (QRT) elect the treatment provided in Section 645, the trust shall be treated and taxed for income tax purposes as part of the estate. A QRT is any trust that on the date of death of the decedent was treated as owned by the decedent under Section 676 by reason of a power held by the decedent. The Section 645 election may be made whether or not a personal representative is appointed for the decedent's estate. Under the proposed regulations, if a personal representative is appointed for the decedent's estate, the personal representative and the trustee of the QRT make the Section 645 election by attaching a statement to the Form 1041, U.S. Income Tax Return for Estates and Trusts, filed for the first taxable year of the decedent's estate. If a personal representative is not appointed for the decedent's estate, the trustee makes a Section 645 election for the QRT by attaching a statement to the Form 1041 filed for the first taxable year of the trust treating the trust as an estate. [Rev. Proc. 98-13 (1998-1 C.B. 370) currently sets forth the procedures for making the Section 645 election.]

During the election period, the personal representative files one Form 1041 for the combined electing trust and related estate under the name and TIN of the related estate. Thus, the electing trust must furnish payors of the trust with the TIN of the related estate. If there is no personal representative, the trustee of the electing trust must file a Form 1041 treating the trust as an estate under Section 645 during the election period. The trustee of the trust must obtain a TIN to be used by the trust during the election period to file as an estate and must furnish this TIN to payors of the trust.

The electing trust and related estate are treated as separate shares under Section 663(c) for purposes of computing distributable net income (DNI) and applying the distribution provisions of Sections 661 and 662. The proposed regulations provide rules for adjusting the DNI of the separate shares with respect to distributions made from one share to another share of the combined electing trust and related estate to which Sections 661 and 662 would apply had the distribution been made to a beneficiary other than another share.

The proposed regulations provide that the election period begins on the date of the decedent's death and terminates on the day before the applicable date. If a Form 706 is not required to be filed for the decedent's estate, the applicable date is the day which is two years after the date of the decedent's death. If a Form 706 is required to be filed, the applicable date is the day that is 6 months after the date of final determination of liability for estate tax. The proposed regulations provide that the final determination of liability for estate tax is the earliest day on which any of the following has occurred: (A) The issuance of an estate tax closing letter, unless a claim for refund with respect to the estate tax is filed within six months after the issuance of the letter; (B) the final disposition of a claim for refund that resolves the liability for the estate tax, unless suit is instituted within six months of the disposition of the claim; (C) the execution of a settlement agreement that resolves the liability for estate tax; (D) the issuance of a decision, judgment, decree, or other order by a court of competent jurisdiction resolving the liability for estate tax unless a notice of appeal or petition for certiorari is filed within 90 days after the issuance of the decision, judgment, decree, or other order of a court; or (E) the expiration of the period of limitations for assessment of the estate tax provided in Section 6501.

At the close of the last day of the election period, the combined related estate and electing trust, if there is a personal representative, or the electing trust, if there is no personal representative, is deemed to distribute all the assets and liabilities of the share (or shares) comprising the electing trust to a new trust in a distribution to which Sections 661 and 662 apply. Thus, the combined related estate and electing trust, or the electing trust, as appropriate, is entitled to a distribution deduction to the extent permitted under Section 661 in the taxable year in which the election period terminates as a result of the deemed distribution. The new trust must include the deemed distribution in gross income to the extent required under Section 662.

14. Final Regulations Issued Concerning Effects of Changes to GSTT Exempt Trusts.

On December 20, 2000, final regulations were issued (T.D. 8912) which adopted the proposed regulations [REG-103841-99] that were initially published on November 18, 1999. These regulations relate to the application of the GST tax provisions where the terms of a trust that was irrevocable before the effective date of the statute are changed or modified after that date.

Several clarifications were made in the final regulations in response to the comments received. First, retention of property in a continuing exempt trust, as well as the distribution of property to a new trust, will not cause loss of exempt status, assuming the requirements of the regulations are met. Second, if state law permits distribution to a new trust or retention in a continuing trust, exempt status will not be affected even if the governing instrument does not specifically authorize such distribution or retention. Third, the perpetuities period for a new trust should be the date the original trust became irrevocable (not necessarily the date the original trust was created). Fourth, a settlement of a bona fide issue regarding administration of the trust or the construction of terms of the trust will not cause the trust to lose exempt status if the settlement is, among other requirements, within the range of reasonable outcomes under the governing instrument and applicable state law. Language was added to the final regulations to emphasize the point that the settlement need not resolve the issue in the same manner as a court decision on the merits, thus giving the parties a greater degree of latitude to settle a case than would be available if a court had to decide the issue. Fifth, changes that are administrative in nature (such as a change in the number of trustees) will not cause the trust to lose exempt status (an example was added to illustrate this point). Sixth, a modification to an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in an increase in a GST transfer or create a new GST transfer. In conjunction with this point, the final regulations remove Example 7 contained in Reg. Section 26.2601-1(b)(2)(vii)(B). Finally, two examples have been added to the final regulations illustrating circumstances under which a trust will not lose exempt status where an income interest is converted to an interest that pays the greater of trust income or a unitrust amount, and a trust is modified to allow allocation of capital gain income. The effective date of these final regulations is December 20, 2000.

15. IRS Issues Notice on Equity Split-Dollar.

In Notice 2001-10, the IRS revised and clarified taxation of split-dollar arrangements. The Notice attempts to clarify prior rulings issued by the IRS regarding the taxation of split-dollar arrangements and provides taxpayers with interim guidance on the tax treatment of split-dollar arrangements pending further guidance. The Notice discusses Rev. Rul. 64-328, 1964-2 C.B. 11 and Rev. Rul. 66-110, 1966-1 C.B. 12, which address the income tax treatment of split-dollar arrangements. These rulings conclude that the economic benefits conferred on an employee under the endorsement method or collateral assignment method are included in the employee's gross income, less any economic benefits attributable to the employee's own premium payments. Rev. Rul. 64-328 rejected the loan characterization of such an arrangement and provided that the table of one-year premium rates set forth in Rev. Rul. 55-747, 1955-2 C.B. 228, commonly referred to as the "P.S. 58" rates, may be used to determine the value of the current life insurance protection provided to the employee. Rev. Rul. 66-110 held that in addition to the P.S. 58 rates, the insurer's published premium rates for one-year term insurance may be used to measure the value of the current insurance protection if those rates were lower than the P.S. 58 rates.

In proposing the guidance provided in Notice 2001-10, the IRS noted that none of the published rulings directly addressed forms of equity split-dollar arrangements in common use today. Under so-called equity split-dollar arrangements, the employer's interest in the cash surrender value of the contract is limited to its premium payments. Accordingly, the employee derives the entire economic benefit of any positive return on the employer's investment during the life of the contract. In the Notice, the IRS contends that the benefits derived by the employee under these arrangements exceed the insurance protection addressed in the prior rulings. Accordingly, the IRS proposes that the characterization of income tax treatment of equity and other split-dollar arrangements will generally be determined under one of two methods.

First, the IRS will permit an employer's payment under a split-dollar arrangement to be characterized as a loan for tax purposes to be treated under Section 7872. In other words, the employee will be taxed on the imputed interest under Section 7872, but will not be taxed either on the value of the insurance protection or on the equity buildup of the policy.

Second, to the extent that the loan characterization is not followed, the parties must fully account for all economic benefits that the employee derives from the arrangement, including the value of the life insurance protection, any dividends or other distributions made to the employee or used to provide additional policy benefits, and any vested interest in the equity buildup of the policy, reduced by any consideration paid by the employee for such benefits.

The IRS states that it will generally accept a party's characterization of the employer's payments under the split-dollar arrangement, provided it is consistent and fully accounts for all economic benefits conferred upon the employee

Finally, the Notice also provides that after December 31, 2001, a new table is published in the Notice which replaces the P.S. 58 table. The new published rates are lower than the prior P.S. 58 rates. The Notice, however, still allows taxpayers to rely on the published premium rates of the insurer if available to all standard risks. Notice 2001-10, 2001-5 I.R.B. _ _ _.

16. IRS Issues New Proposed Regulations for Required Minimum Distributions.

The IRS issued new proposed regulations under Section 401(a)(9) which replace the former proposed regulations issued in 1987. The new proposed regulations revise the method to determine the required minimum distributions (RMDs) for IRAs and qualified plans. The regulations address the required payout during the participant's life, the required payout following the participant's death, and change the rules relating to a participant dying without a designated beneficiary. Under the new proposed regulations, the rules applicable to distributions during the life of the participant are significantly simplified. Distributions after the required beginning date (RBD) are based upon a single table for everybody. The table applicable during a lifetime is the table used for the minimum distribution incidental benefit table under the former proposed regulations. Note, that if the beneficiary is a spouse that is younger than ten years, you are able to use the actual joint life expectancy of the participant and the spouse in determining your lifetime payout amounts. The rules for determining payouts following the death of the participant are also significantly simplified. If there is a designated beneficiary, the remaining account balance is paid out over the remaining life expectancy of the beneficiary. If the IRA does not have a designated beneficiary and the participant dies prior to the RBD, the balance is paid out over the remaining life expectancy of the participant. If the IRA does not have a designated beneficiary and the account owner dies before the required beginning date, the account balance must be paid out within five years of the participant's death.

The new rules will apply for calendar years beginning after 2001, but for 2001, taxpayers may use either the old proposed Regulations or the new proposed Regulations to determine their RMDs.

The new proposed regulations were issued on January 17, 2001. The IRS issued corrections to these proposed regulations on February 21, 2001. (REG-130477-00; REG-130481-00).

17. Final Regulations Issued For Charitable Lead Trusts.

The IRS issued final regulations designed to curb abuses regarding charitable lead trusts. Under the final Regulations, only one or more of the following individuals may be used as measuring lives for a charitable lead trust: (1) the donor; (2) the donor's spouse; or (3) an individual who, with respect to all non-charitable remainder beneficiaries, is either a lineal ancestor or the spouse of a lineal ancestor of those beneficiaries. A trust will satisfy the third criteria if there is less than a 15% probability that individuals who are not lineal descendants will receive any trust corpus. The Regulations apply to transfers to inter vivos charitable lead trusts made after April 3, 2000. The Regulations contain grandfather and reformation provisions for existing charitable lead trusts. *T.D. 8923.*

18. Final Regulations Issued For Charitable Remainder Trusts.

The IRS issued a new regulation to address certain abusive transactions involving charitable remainder trusts. New Reg. Section 1.643(a)-8 provides that a deemed sale will apply to a CRT in the year in which a distribution of an annuity or unitrust amount is made from the CRT. This treatment forces the trust to be treated as having sold a pro rata portion of its assets. In addition, two exceptions were added under the final regulations to decrease the likelihood that a non-abusive trust would violate the rule requiring the annuity amount to be paid by the end of the year. First, a distribution made within a reasonable time after the close of the year may be characterized as corpus to the extent it was attributable to a contribution of cash to the trust with respect to which a deduction was allowable; and a distribution may be characterized as corpus if it was attributable to a return as basis in any asset contributed to the trust with respect to which a deduction was allowed and then sold by the trust during the year the annuity was due. *T.D. 8926.*

CASES

19. Refund Allowed On Reformation of Split Interest Trust.

A U.S. District Court held that the IRS must pay a refund to the estate where the lower court previously denied the charitable deduction. Decedent's will established a life estate in trust for Decedent's brother. Upon termination of the life estate, the remaining estate would be given to certain individuals and to eight designated charities. Decedent's brother died a few weeks after Decedent's date of death. An estate tax return was filed, after a timely-filed extension, and the return did not include a charitable deduction. Before the return was filed, Decedent's granddaughters filed a will contest contending that Decedent lacked testamentary capacity to execute her will. The executors and the granddaughters later resolved their objections to the will by agreeing to reform the will and terminate the litigation. The reformation included the removal of any reference to a life estate or trust in favor of Decedent's brother and provided for a specific bequest to him of a certain amount. Granddaughters then filed an amended return claiming a charitable deduction for the bequests to the charities. The will, as originally drafted, provided for a split-interest trust which was not allowed as a charitable deduction under Section 2055(e)(2). However, if an income beneficiary noted in a will died before the estate files an estate tax return, the split-interest trust will be reformed as if the split-interest trust had met the requirements of a valid charitable trust under Section 2055(e). Section 2055(e)(3)(F). Thus, the District Court decided that Decedent's brother's death retroactively reformed the original will from the date of Decedent's death and the estate was allowed to petition for a charitable deduction. *Harbison v. U.S., 86 AFTR 2d 2000-7135 (N.D. Ga., 2000).*

20. The Tax Court Determines That Gifts From Joint Account Were Taxable Gifts.

The Tax Court held that gifts from a joint bank account should be treated as taxable gifts. Decedent died on January 10, 1996 at the age of 102. Since the mid-1980's until her death, decedent maintained a joint bank account with her two children. All of the funds deposited in the joint account belonged to decedent. In 1984, decedent executed a durable power of attorney which appointed her two children as her attorneys in fact. The power of attorney did not specifically include the power to transfer decedent's property by gift. In November 1995 and December 1996, before decedent's date of death, decedent's children wrote several checks to make gifts totaling $205,000. The value of the joint bank account listed on decedent's federal estate tax return did not include the $205,000. First, the estate argued that the checks written by decedent's children, as joint account holders, constituted gifts made by the decedent because those checks were "authorized and proper disbursements" under applicable state law. The Tax Court disagreed and held that applicable state law does not grant authority to a person named on a joint bank account who does not own the funds in such account to make a gift of all or a portion of those funds on behalf of the actual owner of those funds.

The estate also argued that Reg. Section 25.2511-1(g)(1) provided that decedent did not have to possess donative intent at the time of the gifts to have made a gift. Furthermore, the estate asserted that the example found in Reg. Section 25.2511-1(h)(4) "impliedly recognizes" that, regardless of donative intent on the part of the transferor, checks properly drawn on a joint account to others constitutes gifts. The Tax Court disagreed with the estate's position and held that the gift tax regulations on which the estate relied do not establish that the payees of the checks were recipients of gifts from decedent.

Decedent also was the beneficiary of a trust established for her benefit upon the death of her predeceasing spouse. Decedent had the annual power to withdraw an amount not exceeding the greater of $5,000 or 5 percent of the value of such principal. The value of the trust upon decedent's date of death was $1,535,950.58. Decedent's federal estate tax return did not include any amount with respect to decedent's power of withdraw. The Tax Court found that the savings clause of the state statute (Washington) imposing an ascertainable standard did not apply to decedent's power of withdraw and, therefore, such power constitutes a general power of appointment. Thus, the withdraw power should be includable in decedent's gross estate. *Estate of Christensen v. Commissioner, TC Memo 2000-368.*

21. The Tax Court Invalidates Example 5 In 2702 Regulations.

The Tax Court held that Example 5 of Reg. Section 25.2702-3(e) is an unreasonable interpretation and invalid extension of Section 2702. In this case, the taxpayer established two identical Grantor Retained Annuity Trusts ("GRATs") and transferred to each Wal-Mart Stores, Inc. stock with a value of $100,000,023. The grantor retained an annuity interest for a two-year period and provided that if the grantor died within the two-year term, the annuity would continue to be paid to grantor's estate. The remaining assets at the end of the two-year term were to be distributed to grantor's children. The GRATs specified an annuity rate which would approximately zero-out the initial gift if the retained interest were a two-year specified term. By the end of the trust term, the value of the stock had decreased to the extent that all of the stock had been distributed to grantor in satisfaction of the annuity payments. The IRS took the position, following Example 5 of the Regulations, that the only qualified interest retained by the grantor was an annuity for the shorter of two years or until grantor's death. Calculated under the shorter-of-method, the resulting initial gift to each GRAT was $3,821,000. In the opinion, the Court determined that the interest retained by the grantor and her estate is a single non-contingent annuity interest payable for a specified term of years, rejecting the IRS's contention that the retained interest consisted of the shorter of the specified term or the grantor's life. As a result, the Tax Court held that Example 5 of Reg. Section 25.2702-3(e) was an unreasonable and invalid interpretation of Section 2702. *Audrey J. Walton v. Commissioner*, 115 T.C. No. 41 (December 22, 2000).

22. Reciprocal Transfer Doctrine Results In Taxable Gifts.

The Tax Court applied the reciprocal transfer doctrine and found that a decedent's pre-death transfers of closely held company stock to his brother's family were indirect, taxable gifts to his own children and their children when it was found that the brother made approximately equal transfers to the decedent's children and their families. The transfers involved two closely held companies co-owned by the brothers and their respective family members. The decedent and the decedent's spouse and the brother and the brother's spouse each made transfers to their own children and grandchildren and to the children and grandchildren of the sibling under their applicable annual gift tax exclusion. The Tax Court citing *United States v. Estate of Grace*, 395 U.S. 316 (1969) and invoking the reciprocal trust doctrine found that the transfers at issue were reciprocal, interrelated, and left the transferors in approximately the same economic position as they would have been had they made the transfers themselves. *Estate of Robert V. Schuler, et al. v. Commissioner*, T.C. Memo 2000-392.

23. Estate Collaterally Estopped From Litigating Ownership Interest.

The IRS was granted partial summary judgment to the effect that certain ranch property was included in the decedent's estate. The estate claimed that the ranch property had been previously sold to the decedent's daughter prior to the decedent's death and was, therefore, not includable in the estate. However, at least two state court proceedings instituted by individuals against the estate as to the ownership of the property concluded that the decedent had not sold or gifted the ranch to his daughter prior to his death. Accordingly, the daughter, as the personal representative of the estate, was collaterally estopped from re-litigating the ownership issue. *Theodore C. Chemodurow v. Commissioner*, T.C. Memo 2001-14 (2001).

24. No Marital Deduction for Settlement Proceeds.

The United States District Court for the district of Maine denied marital deduction treatment for a lump sum payment received by a surviving wife in settlement of her elective share case. The decedent's Will established a trust and provided payments to the decedent's wife of $3,333 per month until she reached the age of 65 and $2,500 thereafter for life with remainder to the decedent's children. The wife filed a petition in the probate court to receive an elective share of the estate pursuant to state law. As a result of the elective share case, the spouse and children executed a settlement and release agreement which provided a lump sum payment of $260,000 in lieu of the wife's interest in the trust and her elective share. The court points out that had the spouse been successful in her elective share case, she would have been entitled to the fixed annuities from the trust and an additional elective share amount offset by the value of the annuities. Because the annuities were a terminable non-deductible interest, the court found that by virtue of the transmutation of the annuity into a settlement amount it did not become a deductible interest. The court then held that the property acquired in recognition of the non-deductible annuity component does not qualify for the marital deduction. *Davies v. U.S.*, 87 AFTR2d 2001-614.

25. Court Determines 40% Combined Marketability and Control Discount on Closely Held Bank Holding Company Stock.

In a Federal gift tax case, the Tax Court redetermined the fair market value of a closely held bank holding company stock gifted to the taxpayers' children. In 1992, the taxpayers made gifts of shares of stock in the bank holding company to their children. Each transferred block of stock constituted a 5.27% interest in the company. The taxpayers filed Federal gift tax returns reporting the gifts at a 65.77% lack of marketability and lack of control discount determined by the petitioners' accounting firm. The court expressed doubt that the quantitative marketability discount model as applied by the taxpayers' expert produced a reliable discount. Along the same lines, the Tax Court also refused to accept the IRS's expert opinion that a 20% lack of marketability was appropriate. The Tax Court then determined that a 40% discount for lack of marketability and control was appropriate to value the bank shares. *Donald Janda, et ux v. Commissioner, T.C. Memo 2001-24.*

26. Tax Court Concludes No Gift on Formation of Limited Partnership But Reduces Discounts.

As the line of family limited partnership cases continues to roll out from the United States Tax Court, the latest installment is *Estate of W.W. Jones, II v. Commissioner*. In *Jones*, Mr. Jones (the "Donor") formed a family limited partnership with his son and transferred assets, including real property, in exchange for a 95.5% limited partner interest. The Donor also formed a family limited partnership with his daughters and transferred real property to the partnership in exchange for an 88.178% limited partner interest. The Donor's son contributed real property in exchange for a general and limited partner interest in the first partnership, and the daughters contributed real property in exchange for general and limited partner interests in the second partnership. Immediately after formation, the Donor gifted an 83.08% limited partner interest in the first partnership to his son and a 16.915% limited partner interest in the second partnership to each of his four daughters.

The Tax Court held that the initial transfers of the property to the partnerships were not taxable gifts because the transferred property was properly reflected in the capital accounts of the Donor and the Donor received continuing limited partner interests in return for the transfers. Accordingly, the Tax Court found against the IRS's position that there was an initial gift on formation of the partnerships. Secondly, the Tax Court determined that Section 2704(b) was not applicable to the transactions.

With respect to the gift to the son, the Tax Court determined that no lack of control discount was applicable due to the power of a holder of the transferred interest to remove the General Partner. Regarding this issue, the Tax Court acknowledged that the partnership agreements required written approval by the general partners and 75% of the limited partners before an assignee could become an actual limited partner, but concluded that the evidence showed that the Donor intended for the transfers to be of limited partner interests as opposed to assignee interests. In determining the amount of the lack of marketability discount, the Tax Court stated that self-imposed limitations on the interest, created with the purpose of minimizing value for transfer tax purposes, are likely to be waived or disregarded and applied a mere 8% discount. Nevertheless, with respect to the four gifts to the Donor's daughters, the Tax Court concluded that a secondary market discount of 40% should be applied and a lack of marketability discount of 8% should be applied.

Finally, the Tax Court found that gifts of limited partner interests are not subject to additional discounts for built-in capital gain due to the availability of a Section 754 election through which a hypothetical buyer would benefit. In arriving at this conclusion, the Tax court held that a hypothetical buyer would negotiate a 754 election at the time of purchase and the remaining partners would agree to such an election as the cost of compliance with such an election was held to be immaterial. *Estate of W.W. Jones, II v. Commissioner*, 116 T.C. No. 11 (2001).

ENDNOTE

1 Alan K. Davis and Alan L. Stroud, Meadows, Owens, Collier, Reed, Cousins & Blau, L.L.P., 901 Main Street, Suite 3700, Dallas, Texas 75202, **adavis@meadowowens.com**, **astroud@meadowsowens.com**

TEXAS FRANCHISE TAX NEXUS UPDATE

Steven D. Moore[1]

In *Rylander v. Bandag Licensing Corp*, 18 S.W.3d 296, 301 (Tex. App.–Austin 2000, *writ denied*), the Austin Court of Appeals held, based on the federal Commerce Clause standard and the federal Due Process Clause standard, that the State of Texas may not impose its franchise tax on an out-of-state taxpayer whose only contact in Texas is a passive registration to do business.

A similar decision was recently reached in Tennessee, and the United States Supreme Court declined to review the case. In *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn.Ct. App. 1999), the Tennessee appellate court held something more than the Due Process Clause nexus standard is required for a state to impose an income tax. The court found that an out-of-state bank making credit card solicitations in Tennessee was not subject to Tennessee franchise tax.

Although *Bandag's* factual background is different from *J.C. Penney Bank*,[2] the Austin Court of Appeals addressed the core nexus issue in *J.C. Penney Bank*. Bandag Licensing Corp. was a company whose only contacts with Texas were a registration to do business and receipt of certain royalties from the license of intangible patent rights in Texas.[3]

The Texas Comptroller argued that the Commerce Clause requirement for physical presence and substantial nexus did not apply to the Texas franchise tax, but the Court rejected the argument:

> "While the decisions in *Quill Corp.*[4] … involved sales and use taxes, we see no principled distinction [between sales and use taxes and the Texas franchise tax] when the basic issue remains whether the state can tax the corporation at all under the Commerce Clause. … we conclude that … *Quill* … dictated the judgement reached by the trial court [that Texas lacked jurisdiction to impose its franhise tax] in order to comply with the Commerce Clause."[5]

The most controversial portion of the *Bandag* opinion is its position that the taxpayer's certificate of authority did not establish nexus under the federal Due Process Clause, which is generally thought to be a minimum threshold. The Austin Court of Appeals reasoned, however:

> "Because identical policies underlie the Due Process Clause in the context of both in personam jurisdiction and the jurisdiction to tax, we conclude the Comptroller could not constitutionally impose the [Texas] franchise tax against [the taxpayer] solely on the ground that is possessed a certificate of authority to transact business in Texas, such a contact being insufficient, standing alone, under the Due Process Clause as construed in *Quill Corp*."

The *Bandag* Court did not make any distinction between the income tax component and the net worth component of the Texas franchise tax.

ENDNOTES

1 Jackson Walker L.L.P., 100 Congress Avenue, Suite 1100, Austin, Texas 78701; 512-238-2000; 512-236-2002 (fax).

2 *Bandag*, 18 S.W.3d at 298.

3 The facts are similar to *Geoffrey Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993), *cert denied*, 510 U.S. 992 (1993), where South Carolina successfully imposed an income tax where the taxpayer only contact with South Carolina was intellectual property licensed for use in South Carolina. During the period from 1992 to 1996, however, the Comptroller's policy provided that the licensing of intangibles did not create franchise tax nexus with Texas. *Bandag*, 18 S.W.3d at 298.

4 *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

5 *Bandag*, 18 S.W.3d at 300.

A BRIEF LOOK AT THE NEW 2000 PROPOSED ANTI-MORRIS TRUST REGULATIONS

by Jennifer Graff and Stuart Miller[1]

Internal Revenue Code (IRC) § 355 generally provides that, if a corporation distributes to its shareholders stock of a corporation that it controls immediately before the distribution and certain other conditions are met, neither the distributing corporation (Distributing) nor its shareholders recognize gain or loss. Several requirements for tax-free treatment operate to limit the circumstances under which Distributing or the controlled corporation (Controlled) can undergo an acquisition of their stock directly or indirectly of a fifty percent or greater interest in conjunction with a distribution that qualifies for corporate and shareholder-level nonrecognition per IRC §355. The catalyst for change was the *Commissioner v. Mary Archer W. Morris Trust* case [2] which allowed a change of control to occur while still qualifying the transaction for tax-free treatment.

Enactment of IRC §355(e).

In 1997, Congress added IRC §355(e) to the Code in order to prevent what it viewed as the abusive use of these so-called Morris Trust transactions, i.e., abusive spinoff transactions.[3] The law requires corporations to recognize gain on certain stock or securities distributed as part of a plan or arrangement in the course of acquisitions that otherwise would be tax-free under IRC § 355. IRC § 355(e) applies to a distribution if stock representing a 50% or greater interest [4] in Distributing or Controlled is acquired pursuant to a plan or series of related transactions.

Where either Distributing or Controlled have an acquisition of more than a fifty percent interest in their stock and if the distribution and the change in control are part of a plan or series of related transactions, then Distributing (but not its shareholders) will recognize gain on the distribution. Any change in control of Distributing or Controlled during the four-year period beginning two years before the date of the distribution will be treated as pursuant to a plan unless it is established that the distribution and the change in control are not pursuant to a plan. Both the distribution and acquisition are tested to determine whether or not they are part of a plan or series of transactions.

Issuance of 1999 Proposed Regulations.

On August 24, 1999, the IRS and Treasury issued proposed regulations that provided the exclusive means by which a taxpayer could show that a distribution and an acquisition were not part of a plan. These rules were heavily criticized by practitioners who felt the rules made it too difficult to prove that taxpayers' transactions were *not* part of a plan. Taxpayers were required to establish the *absence* of a plan by clear and convincing evidence. Practitioners felt it was unreasonable for taxpayers to have to prove a negative circumstance by such a heavy standard of proof. In response to this criticism, the IRS and Treasury withdrew the 1999 proposed regulations and issued new proposed regulations in their place on December 29, 2000 (the 2000 Proposed Regulations).

Issuance of 2000 Proposed Regulations.

The 2000 Proposed Regulations adopt a broader view of rebutting the statutory presumption that a distribution of controlled stock followed by an acquisition within two years are part of the same plan. Because practitioners felt that the previous clear and convincing evidence standard for rebutting the presumption was too high, the standard of proof normally used in civil cases, a preponderance of the evidence is applied by the 2000 Proposed Regulations.

The 2000 Proposed Regulations take a facts and circumstances approach providing a much more flexible standard for taxpayers to show their transactions are not part of a plan or arrangement. It should be noted that under the 2000 Proposed Regulations, the weight to be accorded many of the factors will vary, depending upon the context. The 2000 Proposed Regulations provide further guidance in determining whether a plan or arrangement exists by examining timing and intent factors. For example, the timing of discussions pertaining to related transactions and the intent of the various parties to the transactions, although the intent of third parties is not relevant. Ultimately, the decision depends on the intentions and expectations of the relevant parties.

The following is a nonexclusive list of additional factors that, if present, will tend to add weight to an argument that a distribution and acquisition are part of a plan:

- Discussions with outside parties before the first transaction occurred;
- Evidence that the distribution was motivated by a business purpose to facilitate the acquisition of Distributing or Controlled;
- The fact that both transactions (i.e., the acquisition and the distribution) occurred within six months of each other or there was an agreement, understanding, arrangement; or substantial negotiations regarding the second transaction within six months after the first transaction;
- Evidence that Distributing distributed Controlled stock with the intention of decreasing the likelihood of the acquisition of Distributing or Controlled by separating it from another corporation that is likely to be acquired.
- Evidence that the debt allocation between Distributing and Controlled made it likely that an acquisition would occur in order to service the debt.

The 2000 Proposed Regulations also contain a nonexclusive list of factors indicating that a plan was not in place. These include:

- Absence of discussions with outside parties before the first transaction occurred;
- Existence of a corporate business purpose (other than a purpose to facilitate the acquisition);
- Identifiable, unexpected changes in market or business conditions after the first of the two transactions;
- Evidence that the distribution would have occurred at the same time and in the same form regardless of the acquisition or a previously proposed similar transaction.

The 2000 Proposed Regulations not only expand methods to rebut the presumption, but also include six safe harbor provisions under which a distribution and an acquisition will not be viewed as part of a plan. The provisions of the safe harbors are more specifically set out below:

Safe Harbor I: An acquisition made more than six months after a distribution will receive safe harbor treatment if no agreement, understanding, arrangement or substantial negotiations concerning the acquisition occurred prior to six months after the distribution and the distribution was motivated by a substantial corporate business purpose to facilitate an acquisition.

Safe Harbor II: Certain acquisitions made more than six months after a distribution for which there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition within six months after the distribution will receive safe harbor treatment. In contrast to Safe Harbor I, Safe Harbor II applies to situations in which the distribution was motivated by a business purpose to facilitate an acquisition of no more than 33% of the stock of Distributing or Controlled. In addition, less than 20% of the stock of the corporation whose stock was acquired in the acquisition or acquisitions was either acquired or the subject of an agreement, understanding, arrangement, or substantial negotiations prior to six months after the distribution.

Safe Harbor III: Acquisitions more than two years after a distribution receive safe harbor treatment so long as there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition at the time of the distribution or within six months thereafter.

Safe Harbor IV: Acquisitions more than two years before a distribution receive safe harbor treatment if there was no agreement, understanding, arrangement or substantial negotiations concerning the distribution at the time of the acquisition or within six months thereafter.

Safe Harbor V: An acquisition of Distributing or Controlled stock that is listed on an established market will receive safe harbor treatment if the stock is transferred between shareholders of Distributing or Controlled who are less than five-percent shareholders.

Safe Harbor VI: An acquisition of stock in a IRC §83 transaction by an employee or director of Distributing or Controlled in connection with the performance of services will receive safe harbor.

The 2000 Proposed Regulations will apply to distributions made after they are published as final. It is interesting to note that IRC §355(e) would not have affected the result in the *Morris Trust* case because in that case, the shareholders of Distributing held stock representing approximately 54% of the acquiring corporation subsequent to the combining transaction. IRC §355(e) is not applicable if shareholders of Distributing, as a result of their ownership of shares of Distributing, own 50% or more of the Controlled and acquiring corporation subsequent to a merger. In most recent *Morris Trust* transactions, the shareholders of Distributing ended up with a less than 50% interest in the combined entity.

While most tax practitioners will conclude that the safest approach to these types of transactions are to fall within one of the safe harbors, even with the most careful of planning, circumstances may occur that remove a taxpayer from within the safe harbor. If this happens, practitioners should explain to the client that safe harbors are a nonexclusive route to tax-free treatment. Moreover, when suggesting an arrangement that is outside the scope of a safe harbor, practitioners must also make it clear to the client that there is a significant risk that the Service may challenge the tax-free nature of the arrangement.

ENDNOTES

1 Jennifer Graff and Stuart Miller, Associates, Haynes and Boone, L.L.P., 1000 Louisiana, Suite 4300, Houston, Texas 77002, Phone (713) 547-2000, Fax (713) 547-2600, E-mail: graffj@haynesboone.com, millers@haynesboone.com

2 See *Commissioner v. Mary Archer W. Morris Trust*, 367 F.2d 794 (4th Cir. 1966).

3 1997 TRA, P.L. 105-34, §1012(a) and (b)(1), generally effective for transactions occurring after April 16, 1997.

4 A 50% or greater interest means stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote or at least 50% of the total value of shares of all classes of stock.

REVENUE PROCEDURE 2001-17 THE ABCS OF EPCRS

Rosemary T. Shepard[1]

The IRS issued Revenue Procedure 2001-17 to reorganize and expand the correction programs it offers in lieu of plan disqualification. All programs are now part of one procedure known as the Employee Plans Compliance Resolution System, “EPCRS”. EPCRS is divided into three parts: VCP (correction with IRS involvement), SCP (correction without IRS involvement) and Audit CAP (correction after audit begins).

Although the IRS left intact most concepts from prior guidance, they changed the names of existing programs making the procedure difficult to read and digest. On the positive side, the IRS added two new correction programs and offered a few welcome improvements. The IRS promises more changes to come and asks for ongoing comments.

The effective date of Rev. Proc. 2001-17 is generally May 1, 2001. For SCP (correction with no IRS involvement) the rules apply to corrections not completed before that date. For VCP (corrections with IRS involvement), the rules apply to filings submitted on or after that date. For Audit CAP, the rules apply to examinations begun on or after that date. A plan sponsor or Eligible Organization can choose to substitute January 19, 2001 for May 1, 2001. (An “Eligible Organization” is an entity filing under the new VCGroup correction program.)

This article summarizes the major changes announced in the revenue procedure. Then it outlines the rules for each program within EPCRS. Finally it lists the operational failures which appear in Appendices A and B to the revenue procedure. Those appendices provide examples of approved (standardized) methods of correcting certain failures. The examples offer important insight into the IRS’s thinking on correction principles, particularly on earnings/interest adjustments. As painful as it may be, the appendices should be on every benefits practitioner's required reading list.

At the end of this article is a chart, which may help readers keep straight the new terminology.

MAJOR CHANGES

1. The most notable improvement is the addition of an Anonymous Procedure, available only in 2001 and 2002. A plan sponsor using VCO (the successor to VCR), the VCP general procedures (the successor to Walk-in CAP) or VCT [403(b) plans] can file anonymously provided the failure is not one described in Appendix A or B. This John/Jane Doe submission procedure is not available if the sponsor has filed the same error anonymously within the preceding two years. (How will the IRS know if the previous filing was withdrawn before identification?)

   If the anonymous sponsor and the IRS cannot reach agreement on correction, the sponsor can drop the matter and not have to fear referral for audit, although the sponsor does lose the filing fee. If the sponsor reaches agreement on correction, the sponsor must identify itself within 21 days after the compliance statement is issued. A disadvantage to filing anonymously is that the filing does not keep the IRS from initiating an examination. By contrast, a VCO or VCP general procedures filing which is not anonymous will generally prevent the IRS from initiating an examination until the filing has been brought to a conclusion.

2. Also important is a clarification that a plan sponsor can use SCP (the self-correction program with no IRS involvement) to correct insignificant failures during a plan or plan sponsor examination. That is true even if the IRS found the failure during the examination. Thus the sponsor does not have to go to the expensive Audit CAP program for insignificant failures found on audit. Instead it can correct the errors with no penalty. Hats off to the IRS for a fair and reasonable approach!

3. There are some new, more lenient rules for plan sponsors correcting errors relating to assets transferred from another plan in a transfer subject to section 414(l). The assets must have been transferred from outside the recipient's controlled group in connection with a corporate acquisition, merger or like transaction between the sponsor of the transferor plan and the sponsor of the receiving plan. (Question: what about divestitures?) These leniency rules appear in the outline with the words "Transferred Assets" underlined. The new rules provide welcome relief, but the risk of taking on operational failures in an asset transfer is still a big problem.

   Question: to correct pre transfer operational failures, do both the sending plan and the receiving plan need to use EPCRS to get absolution?

4. The IRS now permits three types of operational failures to be corrected by amending the plan. The three failures are hardship withdrawals without supporting plan provisions, section 401(a)(17) violations in a defined contribution plan (an employer contribution is required as well as a plan amendment), and inclusion of ineligible employees. These corrections by plan amendment are available under SCP (self-correction of significant and insignificant failures without Service involvement),VCO (formerly VCR) and VCS (standardized correction). See the examples in Section 2.07 of Appendix B. The correction must be done as described in those examples.

5. There is a new correction procedure by which a third party administrator, an issuer of master or prototype plans or an insurance company (called "Eligible Organization") can file for correction on behalf of 20 or more plans which have the same failure(s). The new procedure is VCGroup. If fewer than 20 plans are affected, VCGroup is not available; and each plan sponsor must file individually. The correction follows the rules applicable to the type of plan and failure involved.

6. There is also a new correction procedure for SEPs. Insignificant errors can be corrected under SCP (self-correction without Service involvement). Other errors can be corrected under the new VCSEP.

7. There is now a way for tax-exempt employers to correct their adoption of a 401(k) plan at a time when such adoption was prohibited.

8. The meaning of having a "Favorable Determination Letter" is changed to take into account GUST. Terminated plans have a favorable determination letter if they have been amended to comply with GUST before termination. Plans adopted or effective after December 7, 1994 must represent that a determination letter request will be timely filed. Other plans have a favorable determination letter if they have a TRA '86 letter.

Outline of EPCRS

VCP

Voluntary Correction Program / IRS Involvement

General Procedures	The revenue procedure confuses the reader by calling these rules "general procedures" for VCP. That terminology gives the false impression that the rules apply generally to all programs within VCP. The general rules, however, have no application to the major VCP programs — VCO (formerly VCR) and VCP (formerly the standardized correction program). The most important role of the general procedures is to replace Walk-in CAP. The general procedures do have application for some of the lesser programs within VCP. For example an Eligible Organization using VCGroup might use the general procedures to correct a Plan Document Failure.
Types of plans	401(a) and 403(b)
Types of failures	The following types of failures can be corrected under VCP general procedures: operational, plan document, demographic and employer eligibility. An "Operational Failure" is a "Qualification Failure (other than an

	Employer Eligibility Failure) that arises solely from the failure to follow plan provisions, including failure to comply with 401(k) and 401(m) requirements." A "Plan Document Failure" is a failure to amend the plan to comply with new qualification requirements within the applicable remedial amendment period. A "Demographic Failure" is a "failure to satisfy the requirements of 401(a)(4), 401(a)(26), or 410(b) that is not an Operation Failure or an Employer Eligibility Failure." An "Employer Eligibility Failure" is the adoption of a 401(k) plan by a tax-exempt organization between 1987 and 1996 (inclusive) when such adoption was prohibited. Note that there is a special definition of "Employer Eligibility Failure" for 403(b) plans. Definitions appear in section 5 of the revenue procedure.
Egregious failures	Really bad, bad, bad errors can be corrected under the general procedures, but higher penalties apply. The maximum penalty is 40% of the "Maximum Payment Amount" (total tax impact of plan disqualification), and there is no presumptive penalty. See section 12.01(4) of the revenue procedure.
Misuse of plan assets	Violation of the exclusive benefit rule by misuse or diversion of plan assets cannot be corrected under the VCP general procedures or under any other EPCRS program for that matter. Question: What if the diversion was an accident due to an accounting or human error, but not a deliberate attempt to misuse plan assets?
Anonymous	The new anonymous submission procedure (section 10.12 of the revenue procedure) is available under the VCP general procedures (and under VCO and VCT) but not for failures listed in Appendix A or B. Failures submitted anonymously within the preceding two years cannot be submitted anonymously. If the sponsor and the IRS cannot reach agreement on correction, the case is closed, and the fee is not returned. If they do reach agreement, the IRS sends a compliance statement; and the sponsor has 21 days to identify itself. The procedure is a temporary program for submissions in 2001 and 2002.
Effect of examination	The correction program is not available if the plan or plan sponsor is under examination.
Determination letter	A sponsor does not need a favorable determination letter to be able to use the general procedures.
Time frames	Rigid time frames apply. The punishment for not meeting the deadlines is harsh — the plan can be referred for audit. Also the compliance fee is not returned. 21 days to provide additional information requested by the Service 30 days to sign the compliance statement 150 days after date of compliance statement to complete corrections There are also rigid time frames for applying for an extension of the above deadlines. The IRS should be encouraged to loosen up on time frames. If a large plan sponsor has a failure that will require complicated calculations for many participants for numerous years, it may not want to risk being unable to complete the corrections on time. Although an extension of time may be granted, the sponsor does not have any way of knowing at the time it files whether the extension will be granted. An anonymous filing would help, in that the sponsor could do the calculations ahead of time based on its proposed correction method. If the IRS did not approve the correction method, the sponsor could drop the matter without fear of being referred for audit. But then what? Why would the IRS want to discourage plan sponsors from using the correction programs by setting rigid deadlines?
Plan Amendment	Operational Failures can be corrected by plan amendments conforming the plan to the past operation, provided the amendment does not violate 401(a)(4), 410(b), and 411(d)(6). Correction by plan amendment under the general procedures is not limited to three types of failures as is the case with VCO and SCP. A determination letter application regarding the amendment must be submitted along with the VCP application (to the same address). See sections 4.06 and 10.05 of the revenue procedure.
Penalties	The general procedures continue the minimum/maxim/presumptive scheme of the former Walk-in CAP.

	See section 12.01 of the revenue procedure. One factor taken into account regarding the sanction is the extent to which the failure relates to Transferred Assets and occurred before the transfer. This new leniency rule acknowledges the reality that the receiving plan sponsor is likely to find operational errors only after it accepts the transfer. There is seldom (never?) time to do a compliance audit of the sending plan before the corporate transaction closes. But how lenient will the IRS be?
VCO	Formerly VCR
Type of plan	401(a)
Type of failure	VCO applies to operational failures only, not egregious failures and not misuse of plan assets
Anonymous	VCO offers anonymous filing. See discussion above under VCP general procedures.
Effect of examination	VCO is not available if the plan or plan sponsor is under examination.
Determination letter	The plan must have a favorable determination letter.
Time frames	The rigid time frames of the VCP general procedures apply.
Plan amendment	Three types of failures can be corrected by plan amendment: hardship withdrawals without supporting plan provisions, 401(a)(17) failures in defined contribution plans and inclusion of ineligible employee(s). A determination letter request regarding the amendment must be submitted with the VCO application (to same address). See Appendix B, section 2.07.
Fee	The plan sponsor pays a flat fee depending on the number of plan participants and, in some cases, the amount of plan assets. See section 12.02 of the revenue procedure. The largest fee is $10,000; the smallest fee is $500.
VCS	Formerly SVP - for standardized corrections. The revenue procedure appears to make VCS a subset of VCO. That may not be intended. Who cares?
Type of plan	Section 401(a)
Type of failure	VCS is for only operational failures listed in Appendix A or B.
Corrections	Standardized corrections are standardized. They must be exactly as described in the appendix, construed narrowly. If a standard correction creates an operational failure, that failure must be corrected.
Anonymous	VCS cannot be filed anonymously. It is doubtful that anyone would want to file anonymously since there is no mystery in VCS.
Effect of examination	VCS is not available if the plan or plan sponsor is under examination.
Determination letter	VCS can be used even if the plan is not the subject of a favorable determination letter.
Time frame	The Service will process the application within 120 days if it is complete. Although the rigid time frames of the general procedures apply, time is not a problem because the sponsor can do any calculations before filing.
Limitations	If the sponsor has identified more than 2 failures (whether or not they can be corrected by VCS), VCS is not available. The word “failure” refers to a particular violation of applicable law, not the number of individuals impacted. VCS is not necessarily available under the following circumstances: (1) the sponsor files under VCS, and while the application is still being considered, the sponsor files a second VCS application, or (2) the sponsor files under VCS, receives a compliance statement and files under VCS again within 12 months after the statement was issued. In the first case, the Service can shift both applications to VCO. In the second case, the Service can shift the second application to VCO. Question: Why is the IRS so stingy with VCS? Is it trying to raise revenue by shifting plan sponsors into the higher fee VCO? VCS is the most efficient correction program for all concerned.
Fee	Flat fee of $350.
VCT	Formerly TVC
Type of plan	Section 403(b)
Anonymous	VCT can be filed anonymously.

Fee	It's complicated. See section 12.05 of the Revenue Procedure.
Details	Section 10.13 of the Rev. Proc. says that VCT is subject to the rules of sections 10 and 11 of the revenue procedure. Note, however, that there are special definitions for 403(b) plans in section 5.02 of the revenue procedure.
VSEP	New
Type of plan	SEP maintained under a plan document
Egregious	No
Fee	See section 12.07 of the Rev. Proc.
Details	See section 10.15 of the Rev. Proc.
VCGroup	New
Types of Plans	Master or prototype plan, plan administered by third party administrator, and plan with annuities issued by insurance company. The Eligible Organization (plan issuer, third party administrator or insurance company) files the application on behalf of the plans. At least 20 plans must be affected by the failure. Otherwise an application must be filed for each plan under the appropriate EPCRS program. See section 10.14(2) of the revenue procedure.
Types of failures	VCGroup applies to operational and plan document failures. Only sponsors of master or prototype plans, however, can correct plan document failures using VCGroup. Egregious failures and misuse of plan assets cannot be corrected.
Anonymous	The anonymous procedure is available.
Fee	See section 12.06 of the revenue procedure.
Determination letter	A sponsor of master or prototype plans must have a TRA '86 letter and must have applied for a GUST letter by the end of 2000.
Details	See section 10.14 of the revenue procedure. VCGroup does not have its own correction rules. Rather, the filing organization follows the correction program appropriate for the type of plan and type of failure - VCO, VCS or VCT.

SCP

Self Correction Program / No IRS involvement

General rules	In contrast to VCP, the general rules for SCP apply to both subsets of SCP - correction of insignificant failures and correction of significant failures. Rules unique to significant or insignificant errors appear in this outline following the general rules.
Types of failures	SCP is available for operational failures only, not for egregious failures and not misuse of plan assets
Adequate Procedures	SCP is available only if "the plan sponsor or administrator of the plan had in place and routinely followed practices and procedures reasonably designed to promote and facilitate overall compliance with applicable Code requirements. The procedures must have been in place and routinely followed, and an operational failure must have occurred through an oversight or mistake in applying them because of the inadequacy of the procedures [meaning?]." <u>Transferred Assets</u>: The second sentence of the adequate procedures rule described above does not apply if the failure relates to Transferred Assets and did not occur after the end of the second plan year that begins after the corporate merger, acquisition or other similar transaction. This transferred asset rule allows a plan sponsor to use SCP even though at the time of the failure, there were not adequate procedures in place. It recognizes that the recipient of transferred assets had no control over the procedures in place before the transfer and that the recipient will need time to get adequate procedures in place after the transfer.
Fee	None
Insignificant Failures	See section 8.02 and 8.03 of revenue procedure for the meaning of insignificant/significant. There are no bright lines, causing great uncertainty in the gray area between obviously significant and obviously insignificant failures. Would the IRS consider an anonymous program for guidance on a particular set of facts? No doubt informal guidance is already available by phone, but it is not binding in a subsequent audit.

Types of plans	401(a), 403(b), and SEP
Effect of examination–	Insignificant failures can be corrected **even after examination begins and even if the IRS finds the failure**.
Determination letter	A favorable determination letter is not required.
Time frame	There are no time requirements for completing corrections.
Plan amendment	Three types of errors can be fixed by amending the plan to make the failure go away: hardship withdrawals without supporting plan provision, 401(a)(17) violations in defined contribution plans, and inclusion of ineligible employees. See section 4.06 of the revenue procedure. The plan sponsor must submit a determination letter request for the amendment (when?).

Significant Failures

Types of plans	401(a), 403(b) but not SEP
Effect of examination	Significant failures can be corrected after examination begins but only if the correction was substantially completed before the examination began. See below for meaning of substantially completed.
Determination letter	The plan must be the subject of a favorable determination letter.
Time frame	Correction must be completed or substantially completed by the end of the "Correction Period". Generally, the Correction Period begins on the date of the failure and ends on the last day of the second plan year following the plan year in which the operational error occurred. There is a longer Correction Period for corrections described under sections 401(k)(8) or 401(m)(6). There is a new, extended Correction Period for an operational failure that relates **only** to "Transferred Assets". The Correction Period extends to the last day of the first plan year which begins after the corporate event. The assumption behind this leniency rule is that the receiving plan sponsor can find and correct significant failures within a year to two years after the corporate transaction. Two years may be realistic, but one year is generally not enough time especially if the corporate transaction was a big one. In any event the Correction Period ends on the date the plan or plan sponsor is subject to examination. Substantially completed Corrections are substantially completed if (1) the plan sponsor has acted promptly, and corrections are completed within 90 days after the end of the Correction Period; or (2) Corrections have been completed within the Correction Period with respect to 85% of the affected participants, and the sponsor is diligent in completing the corrections for other participants.
Plan Amendment	Certain errors can be fixed simply by amending the plan document (hardship withdrawals with out supporting plan provisions, 401(a)(17) violation, and inclusion of non-eligible employee). A determination letter application related to the amendment must be filed before the end of the Correction Period. See section 4.06 of Rev. Proc.

Audit CAP

Types of plans	Section 401(a), 403(b) and SEP.
Types of failures	Audit CAP applies to all types of failures found on audit which have not been corrected under any other part of EPCRS.
Egregious	Audit CAP is available for egregious failures.
Misuse of plan assets	Audit CAP is not available for misuse or diversion of plan assets.
Determination letter	The plan does not need to have a favorable determination letter.
Penalty	The CAP sanction is negotiated. It will be no higher than the total tax impact of plan disqualification (Maximum Tax Amount). However, the penalty must be proportional to the nature of the failure(s). If the examination involves a plan with Transferred Assets, and the Service determines that the failures did not occur after the end of the second plan year that begins after the corporate merger, acquisition, or similar employer transaction occurred, the sanction will not exceed the sanction that would apply if the transferred assets were maintained as a separate

plan. This new rule implies that smaller plans get smaller sanctions under Audit CAP. It limits the impact of merging assets with qualification failures into an otherwise clean plan provided the receiving plan sponsor takes quick action to stop any qualification failures.

FAILURES LISTED IN APPENDIX A

Failure to provide minimum top heavy benefits to non-key employees
ADP/ACP/ multiple use test failures
Failure to distribute 402(g) excess
Exclusion of eligible employees from all contributions/accruals for a plan year
Minimum distribution failure
Failure to obtain participant or spousal consent
Section 415(c) failure

FAILURES LISTED IN APPENDIX B

THIS APPENDIX CANNOT BE USED FOR 403(b) PLANS OR SEPS

ACP/ADP/multiple use test failures
Exclusion of eligible employees for only part of a plan year
Exclusion of eligible employees from a profit sharing plan
Vesting failures
Section 415(b) and (c) failures
Other overpayments
Section 401(a)(17) failures in defined contribution plans, corrected by plan amendment and employer contribution
Hardship withdrawals allowed without proper plan provisions, corrected by plan amendment
Inclusion of ineligible employees, corrected by plan amendment

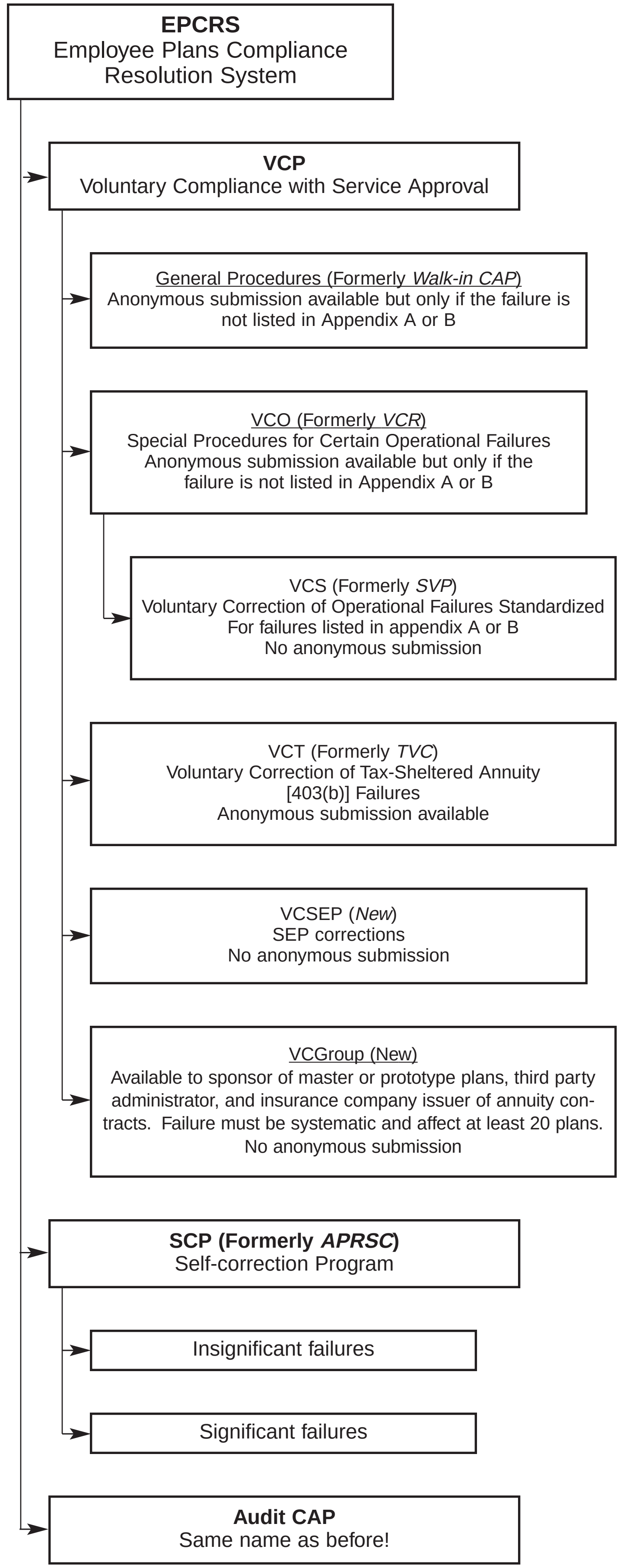
Section 3 of Appendix B gives detailed information about how to make earnings/interest adjustments. The Service places great emphasis on this aspect of correction.

CONCLUSION

The IRS is steadily making the correction programs more realistic and less threatening. As EPCRS is a work in progress, practitioners have an opportunity to impact the future of self-correction by providing comments and suggestions to the Service.

ENDNOTE

1 Conoco, Inc., 600 N. Dairy Ashford, P.O. Box 4783, Houston, Texas 77210; (281) 293-1939; (281) 293-2127 (fax).



POST-MORTEM ESTATE PLANNING AND ESTATE ADMINISTRATION

Stefnee D. Ashlock[1]

I. INTRODUCTION

One area of estate planning that is often overlooked by planners is that of post-mortem estate planning. We are given the chance to do additional estate planning, even after a decedent's death. There are a variety of tools to be utilized and elections to be made by both beneficiaries and executors after a death for estate tax and income tax planning. The purpose of this article is to provide a partial checklist of elections and actions to consider after someone had died. This article is designed to give the practitioner an overview of areas which must be considered in post-mortem planning. It is in no way intended to serve as a comprehensive guide.

II. BENEFICIARIES' ELECTIONS

A. Disclaimers

1. What is a disclaimer? No beneficiary is compelled to accept a gift or inheritance against his will. By disclaiming, the beneficiary foregoes the gift or inheritance which would otherwise pass to him. In disclaiming a bequest, the beneficiary is basically restructuring how the decedent's assets will pass upon death. The effect of a disclaimer for Federal transfer tax purposes is to bypass a beneficiary with no additional tax consequence. The person disclaiming is treated as never having owned the property. For example, if Father leaves a $600,000 bequest to his descendants, per stirpes, Father's only daughter is entitled to receive the bequest. However, if Daughter does not want or need the money and the money would only add to her taxable estate someday, she may wish to consider disclaiming the $600,000 bequest to the contingent beneficiaries. Consequently, the money would pass equally to Daughters' two children as if Daughter predeceased Father. There is no transfer from Daughter to her two children in this scenario.

2. Federal requirements of a qualified disclaimer. Internal Revenue Code (hereafter "IRC") § 2518 provides that a "qualified disclaimer" means an irrevocable and unqualified refusal by a person to accept an interest in property when:

   (a) the refusal is in writing;

   (b) the refusal is delivered within 9 months of the interest being created, unless the disclaimant is younger than 21 years old, in which case the period is extended until nine months after the disclaimant attains 21;

   (c) none of the benefits which are being disclaimed have been accepted in any way; and

   (d) as a result of the disclaimer, the property passes without any direction on the part of the disclaimant to the surviving spouse or someone other than the disclaimant.

   (e) if all of the above requirements are not met, then the disclaimer is treated as a gift by the disclaimant.

3. Additional Texas requirements of a disclaimer. Texas Probate Code §37A further requires that a disclaimer be a written memorandum acknowledged by a notary (or other person authorized to take an acknowledgment) and shall be filed not later than nine months after date of death in the Texas probate proceeding. In addition, notice of the disclaimer must be delivered to the legal representative of the transferor of the interest or the holder of legal title to the property to which the disclaimer relates within 9 months as well.

4. Time period. A disclaimer must be received nine months from the later of the date of transfer or the date the disclaimant reaches age 21. Reg. § 25.2518-2(c(1)). For gift tax purposes, this means when the transfer is complete during lifetime. Reg. § 2518-2(c)(3). For estate tax purposes, the "transfer" occurs at death or when the transfer becomes effective at death.

5. Creditors' claims. In Texas, disclaimers may generally be used to defeat creditors' claims under state law. Thus, a potential beneficiary of an inheritance which would immediately be attached by his creditors upon receipt may wish to forego his inheritance and disclaim the assets. However, the Supreme Court recently ruled that a disclaimer cannot defeat a federal tax lien. *Rohn F. Drye, Jr. et al v. United States*, 528 U.S. 49; 120 S. Ct. 474 (1999).

6. Uses of disclaimers. The use of the disclaimer in post-mortem estate planning is one of the most important and effective post-mortem estate planning techniques. One can basically rewrite an estate plan after the decedent's death. The following are some common scenarios in which a disclaimer may be used as an effective device:

   (a) Joint tenancy with right of survivorship assets. Example: Bill and Joan have a testamentary plan with a Bypass Trust in place. If they have a significant amount of their wealth in one JTWROS account and Bill dies, the account would automatically pass to Joan through her right of survivorship. Thus, the account would be unavailable to fund the Bypass Trust created under Bill's Will. Joan can disclaim Bill's interest in the JTWROS account so that his interest in the account will pass to his estate and be available to be placed into the Bypass Trust.

   (b) Under-utilization of the applicable exemption amount. Example: If Bill and Joan have a $10 million community estate and very simple "I Love You" wills, leaving all assets outright to the survivor and then down to the children, the survivor may wish to disclaim to take advantage of the decedent's applicable exemption amount. If Bill dies and Joan receives the entire community estate, only her exempt amount will pass to the children estate tax free someday. Instead, if Joan disclaims Bill's exempt amount ($675,000 in 2000, but increasing to $1 million by 2006) upon Bill's death, the children will receive Bill's exemption estate tax free. They will also receive Joan's exemption estate tax free upon her subsequent death.

(c) Increasing or decreasing the marital deduction bequest. When a formula marital bequest is greater or less than the optimal amount, a disclaimer may be used to cure the problem. In addition, the use of disclaimers and/or the partial QTIP election can be used to equalize estates and result in less overall estate tax being due.

(d) Avoidance or triggering of generation-skipping transfer tax. Disclaimers may be used to either (i) shift assets away from skip persons or (ii) deliberately send assets to skip persons to utilize the decedent's generation-skipping transfer ("GST") tax exemption.

(e) Other uses.
A. Disclaiming particular powers to cure a defective or non-qualifying trust.
B. Restructuring beneficiary designations on retirement plans.
C. Qualifying for the estate tax charitable deduction by disclaiming rights given to beneficiaries which would cause the denial of the deduction.
D. Keeping assets in the hands of "qualifying heirs" for a IRC § 2032A valuation.
E. Disclaiming powers which would cause a trust to not qualify as a Qualified Subchapter S Trust (QSST).

B. Retirement Benefits. – Once retirement elections are in place, they are generally locked in and cannot be changed after a decedent's death. However, if the spouse is the beneficiary of a retirement benefit, he or she has two options. The first is keeping the account (IRA, profit sharing, etc.) in the decedent's name. The second option is rolling the account into an IRA in his or her name. Too often advisors simply advise their clients to roll the IRA into a new IRA in the surviving spouse's name without exploring the other option. Example: Bill and Joan have a $2 million IRA of which Bill is the participant and a $400,000 home. Bill is 68 when he dies. Joan is 57 and is the beneficiary of his IRA. If Joan immediately rolls the IRA over into her own IRA, she will not have access to the IRA funds without the 10% early withdrawal penalty until she reaches age 59 _. IRC § 72(t). Instead, if she keeps the account in Bill's name, she can continue to withdraw the account based on the minimum distribution plan in place at the time of Bill's death.

III. EXECUTOR'S ELECTIONS

A. Decedent's Final Individual Income Tax Return.

1. Filing. A final individual income tax return (Form 1040) must be filed for the year of the decedent's death. The final return includes all income received by the decedent through his date of death and is due April 15 of the year following death. IRC §6012

2. Separate or joint return. A decedent's executor may file a separate return for the decedent or may file a joint return with the decedent's spouse. IRC §6013(a)(3). The joint filing is not available if the surviving spouse remarries before the end of the year in which the decedent dies. If a joint return is filed, it includes the decedent's income through his date of death and the surviving spouse's income for the entire year. Reg. §1.6013-1(a)(1).

3. Advantages and disadvantages of filing separately or jointly.
a. Allows matching of income and deductions.
b. Surviving spouse has tax planning options.
c. Ability to use decedent's losses (capital, net operating, passive activity) to offset income of surviving spouse; any of decedent's losses not used on the final return (separate or joint) cannot be carried forward and will be lost.
d. Joint and several liability of executor and surviving spouse.

4. Medical expenses. Medical expenses paid in the final taxable year prior to death and medical expenses paid after, but within one year of, death may be deducted on the decedent's final income tax return. IRC §213 (a) and (c). However, medical expenses deducted on the final income tax return are subject to the 7.5% AGI limitation of IRC §213(a). Medical expenses may not be deducted on the estate's income tax return. Reg.§1.642(g)-2. Medical expenses may be deducted on the estate tax return as a claim against the estate. IRC §2053(a)(3). Medical expenses may not be taken on both the final income tax return for the decedent and the estate tax return. An election statement should be filed on the return on which the deduction is taken. Reg. §1.213-1(d)(2).

5. Interest on Series E and EE bonds. Pursuant to IRC § 454, a taxpayer (i) may elect to accrue the interest on Series E or EE bonds and only report the interest upon redemption and (ii) may irrevocably elect in any year to report the interest income for that year and all prior years. The executor of an estate may elect to report all of the accrued interest on the decedent's final income tax return. Rev. Rul 68-145. This may be a great income planning opportunity, as the income tax due will be a deduction on the estate tax return as well. If the election to report all accrued income on the final income tax return is not made, then the interest earned through date of death is income in respect of a decedent which will not be included on the decedent's final return, but will be reportable when the bonds are redeemed. This will result in an offsetting deduction in respect of a decedent under IRC§ 691(c) for the estate tax paid on the accrued interest.

B. Estate Income Tax Return (Form 1041).

1. Treatment of revocable trust as part of probate estate. The Taxpayer Relief Act of 1997 introduced the IRC § 645 election. This election allows the executor of an estate and the trustee of a "qualified revocable trust" to elect to treat the trust as part of the estate for income tax purposes. Once made, this election is irrevocable. For purposes of this Section, the term "qualified revocable trust" is a grantor trust with a retained revocation power.

2. Selection of estate's year end. An estate can choose either a calendar year end or a fiscal year end. If a fiscal year end is chosen, the year can end on the last day of any month, but not in excess of a 12 month period. That is, the longest year would end on the last day of the month preceding the date of death. If a decedent died on July 15, the last possible fiscal year end would be June 30 of the next calendar year. Significant income tax deferral may occur with the careful selection of the estate's fiscal year end. For example, assume our dece-

dent died on October 23, 2000 and a January 31, 2001 fiscal year end is chosen. If a distribution to beneficiaries is made on February 15, 2001, the distribution is made during the fiscal year ending January 31, 2002 and reported on our beneficiaries' 2002 income tax returns. The beneficiaries' income tax returns are not due until April 15, 2003, deferring the tax on income received in February of 2001 until April of 2003, over two years later.

3. Income in respect of a decedent. "IRD" is income earned or accrued through a cash basis taxpayer's date of death but not collected until after death. IRC §691. These items are not reported on the decedent's final income tax return. Instead, they are included in the income of the recipient (the estate or beneficiary) when received. IRD items do not receive a step up in basis. Examples of IRD items include a decedent's final salary check, IRA distributions, and accrued interest or dividends not actually received. Care must be taken by the executor when distributing assets. If an executor distributes an IRD item in satisfaction of a pecuniary bequest, it is treated as a sale of the IRD item and will trigger the recognition of income. See *Keenan v. Commissioner*, 114 F.2d 217 (2d. Cir. 1940).

4. IRC §691(c) deduction. The amount of federal estate taxes attributable to net IRD items are deductible from income on the tax return of the recipient of the IRD item.

5. Deductions in respect of a decedent. "DRD" items are expenses accrued as of date of death but unpaid. IRC §691(b). If the decedent had paid these expenses, they would have qualified as income tax deductions for him. DRD items are actually desirable (as compared to IRD items) because they are double deductions: they may be deducted on the decedent's federal estate tax return (Form 706) as a debt of the decedent and they may also be deducted on the estate's Form 1041. DRD items are limited to deductions for business and other expenses related to the production of income under IRC §§ 162 and 2122, deductions for interest and taxes under IRC §§ 163 and 164 and depletion allowances under IRC §611.

6. Administration expenses. An estate may deduct the administration expenses which are paid or incurred in connection with the administration of the estate or revocable trust and which would not have been incurred if the property were not held in such trust or estate. IRC §67(e). Some expenses are only deductible on the estate tax return; others are only deductible on the estate's income tax return. However, many expenses may be deducted on either return (either in whole or in part) but not entirely on both. See IRC §§ 642, 2053(a)(2) and 2054, and IRC 642(g) A significant aspect of post-mortem estate planning involves where to take these deductions. Deductions regarding executor's fees, attorney's fees, accountant's fees, trustee fees, appraisal fees and probate fees (among others) are allowed in full and are not subject to the 2% AGI floor on miscellaneous itemized deductions.

7. Where to take the administration expenses - Form 706 or Form 1041.

   (a) Single decedent – When a single decedent dies, the decision regarding where to take the deductions is simply made by analyzing the marginal tax brackets and deciding where the deduction will be the most tax advantageous. If no estate tax is due, then the deductions will be taken on the estate's income tax return. If estate tax is due, then the deductions will most likely be taken on the estate tax return if the estate's marginal tax bracket exceeds the estate's income tax bracket.

   (b) Married decedent with a "reduce to zero" residual marital bequest – (Although I refer to the "marital bequest in this section and the next, this discussion is also applicable to a "reduce to zero" charitable bequest.) When the will or revocable trust is drafted to provide that the residue of the decedent's estate passes to the spouse or to a trust for the spouse qualifying for the unlimited marital deduction, then the decision as to where the deductions are to be taken becomes more complicated. In this scenario, the deductions would be "wasted" if they were taken on the estate tax return because no estate tax will be due as a result of the unlimited marital deduction. On the contrary, if the deductions were taken on the estate's income tax return, they would be utilized. Until recently, the issue of where the deductions must be taken when the Will provides for a residual marital bequest was an issue of great controversy. The taxpayer wanted to take the deductions on the income tax return and have no reduction in the marital deduction on the estate tax return, while the IRS took the position that taking all of the deductions against income would cause a reduction in the marital deduction on the estate tax return, thereby creating an estate tax. The result of the IRS' position was that the taxpayer was forced to take some of the deductions on the estate tax return in order to avoid reducing the marital deduction and causing estate tax to be due. This issue was the subject of much litigation and culminated in *Estate of Hubert v. Commissioner*, 520 U.S. 93, 117 S.Ct. 1124 (1997). The decision reached by the Supreme Court in Hubert was very complicated and difficult to apply. In response, the Treasury issued regulations which became final for estates of decedents dying on or after December 3, 1999.

   (c) Estate transmission expenses v. estate management expenses. The final regulations create two classes of expenses, "estate transmission expenses" and "estate management expenses." Estate transmission expenses are expenses that would not have been incurred but for the decedent's death and the estate administration. These include executor commissions, attorney and accountant fees, fees in conjunction with the preservation of the estate, probate fees, expenses incurred in Will construction proceedings and defending against Will contests, and appraisal fees. "Estate management expenses" are expenses incurred in the investment of estate assets or with maintenance of assets during a reasonable period of administration. Examples include investment advisory fees, stock brokerage commissions, custodial fees and interest. The regulations provide that estate transmission expenses include any administration expense that is not a management expense. The regulations provide that estate transmission expenses paid from either the principal or income of the marital bequest would reduce the marital deduction dollar-for-dollar. This means that estate transmission expenses must be taken on the federal estate tax return or will result in estate tax being due. Estate management expenses attributable to the marital bequest and paid from either principal or income will not cause a reduction in the marital deduction. Accordingly, these estate management expenses may be taken on the estate's income tax return without causing an offsetting reduction in the marital deduction. Finally , estate management expenses attributable to other property but paid from the marital bequest would reduce the marital deduction dollar-for-dollar. Thus, these management expenses must be taken on the estate tax return or result in estate tax being due.

C. Estate Tax Return (Form 706)

1. Alternate valuation. IRC §2032 allows the executor to elect to value the assets of an estate six months after the decedent's date of death if the total value of the estate is less than the date of death value. This is an "all or none" election. That is, all assets must be valued as of either the date of death or the alternate valuation date. The executor may not pick and choose assets. If an asset is sold or distributed within the six month period, the alternate valuation date of such asset is the date of disposition. Also, the election is only available if both the value of the estate and the amount of tax are reduced. If there is no estate tax due, the alternate valuation date election is not available.

2. QTIP election. IRC §2056(b)(7) provides that a QTIP (qualified terminable interest property) election may be made for property passing to a spouse in a qualifying manner. This election results in estate tax deferral for assets passing to the spouse until the spouse's subsequent death. In order to obtain the QTIP election, the spouse must have a qualifying income interest for life in the QTIP property. This means that the spouse must have a right to all of the income for life. In addition, the spouse must be the only beneficiary of the QTIP trust.

3. Special use valuation election. IRC §2032A allows a reduction in the value of real property if it is used in farming or in connection with another closely held business. The maximum reduction in value is $750,000, indexed for inflation ($770,000 in 2000). The requirements are stringent, resulting in very few §2032A elections. The value of the real property and related personal property used for the “qualified use” must constitute 50% or more of the adjusted gross estate (the gross estate less §2053 deductions). Further, the value of the real property used for the qualified use must be at least 25% of the adjusted gross estate. To qualify as a “qualified use,” the real property must have been used for a qualified farm or business use on the decedent’s date of death and must have been owned and used by the decedent or a member of his family for the qualified use for a period comprised of a total of five of the eight years immediately before his death. IRC §§2032A(b)(1)(C)(i) and 2032A(b)(2). The real property must pass from the decedent to a “qualified heir.” A “qualified heir” is defined as a member of the decedent’s family, including the decedent’s ancestor, surviving spouse or lineal descendant, a lineal descendant of the decedent’s parent or spouse or the spouse of any lineal descendant. IRC §§2032A(e)(1) and (2). In addition, there must be “material participation” by the decedent or a member of his family in the operation of the farm or business in five out of the eight years ending before the earliest of (i) the decedent’s date of death, (ii) the date on which the decedent became disabled, or (iii) the date on which the decedent began to receive Social Security retirement benefits (if received until death). IRC §§2032A(b)(1)(C)(ii) and 2032A(b)(4)(A). Treasury Regulation § 20.2032A-3(e)(1) states that "material participation" generally means actual full-time employment in the management of the farm or business. Finally, a “recapture agreement” must be signed by all persons receiving an interest in the property which would provide that additional tax is imposed in the event that (i) the property is disposed of to a non-family member within 10 years of date of death or (ii) the qualified use ends within specified periods. IRC §2032A(c).

4. Qualified family owned business interest (QFOBI) election. IRC §2057 allows an estate tax deduction if a “qualifying business” is owned. The combination of the maximum QFOBI deduction and the applicable exclusion amount allows a taxable estate of $1.3 million to be sheltered from estate tax. For example, if the value of the QFOBI interest is greater than $675,000, the QFOBI deduction is limited to $675,000 and the applicable exclusion amount is limited to $625,000. IRC §2057 defines a “qualifying business” as a trade or business, the ownership of which is owned at least 50% by one family, 70% by two families or 90% by three families. The decedent’s family must own at least 30% if two or more families own the business. The stock may not have been publically traded within three years of death. The definition of family members who qualify include: (i) ancestors of decedent, (ii) spouse of decedent, (iii) lineal descendant of (a) decedent, (b) parent of decedent, and (c) spouse of decedent, and (iv) spouses of any of the lineal descendant in (iii). In order to receive the QFOBI deduction, the decedent or the decedent’s family members must have owned the business and must have materially participated in the business for 5 out of the 8 years prior to death. In addition, the QFOBI interests passing to the heirs must be greater than 50% of the adjusted gross estate. Adjusted gross estate is based on a complex calculation set forth in IRC §2057. Further, the heirs must continue to operate the business for 10 years following the decedent’s date of death.

5. Generation-skipping transfer tax exemption allocation. Each individual has a $1 million generation-skipping transfer (GST) tax exemption, indexed for inflation ($1,030,000 for 2000). IRC §2631. This exemption may be allocated during lifetime on gift tax returns or at death on the decedent’s estate tax return. There are deemed allocations of the GST exemption under IRC §2632 if the individual or the decedent’s executor do not affirmatively control the allocation. An executor may also make a “reverse QTIP election” on the decedent’s estate tax return to ensure the full usage of the decedent’s GST exemption. If a QTIP election is made, the surviving spouse becomes the transferor of such trust because the QTIP trust will be included in the survivor’s estate. However, in order to be able to fully use the decedent’s GST exemption, the decedent will be deemed to be the transferor of the QTIP trust only for purposes of GST allocation by the usage of the reverse QTIP election. A partial reverse QTIP election is not allowed. Thus, if the QTIP trust is too large to be fully covered by the decedent’s remaining GST exemption, the executor should divide the QTIP trust into two separate QTIP trusts, one which will be a GST exempt QTIP trust and the other which will be a non-GST exempt QTIP trust.

ENDNOTE

1 Fizer, Beck, Webster, Bentley & Scroggins, P.C., 1360 Post Oak Blvd., Suite 1600 Houston, Texas 77056; Phone: (713) 840-7710; Fax: (713) 963-8469; e-mail: sashlock@fizerbeck.com. Education: Rice University (B.A., 1990); University of Texas (J.D., 1993). Member: Houston (Member, Sections on: Real Property, Probate and Trust Law; Taxation) and American (Member, Sections on: Real Property, Probate and Trust Law; Taxation) Bar Associations; State Bar of Texas (Former, Probate Editor of the Newsletter of the Real Property, Probate and Trust Law Section: Vice-Chair, Estate and Inheritance Tax Committee); Texas Young Lawyers+ Association. (Board Certified, Estate Planning and Probate Law, Texas Board of Legal Specialization). PRACTICE AREAS: Estate Planning Law; Probate Law; Taxation Law.

2000 - 2001
Tax Section Leadership Roster

Officers

Cynthia M. Ohlenforst (Chair)
Hughes & Luce, LLP
1717 Main Street, Suite 2800
Dallas, Texas 75201-7342
214-939-5512
214-939-6100 (fax)
ohlenfc@hughesluce.com

William H. Hornberger (Vice Chair)
Jackson Walker, L.L.P.
901 Main Street, Suite 6000
Dallas, Texas 75202
214-953-5857
214-953-5822 (fax)
whornberger@jw.com

Robert V. Gibson (Secretary)
Krafsur Gordon Mott P.C.
P.O. Box 1322
El Paso, Texas 79947-1322
915-545-1133
915-545-4433 (fax)
rgibson2@elp.rr.com (home)
rgibson@krafsur.com (work)

Jasper G. Taylor, III (Treasurer)
Fulbright & Jaworski
1301 McKinney Street, Suite 5100
Houston, Texas 77010
713-651-5670
713-651-5246 (fax)
jtaylor@fulbright.com

Gene Wolf (Newsletter Editor)
Kemp Smith, P.C.
221 North Kansas, Suite 1700
El Paso, Texas 79901
915-533-4424
915-546-5360 (fax)
gwolf@kempsmith.com

John Brusniak, Jr. (Immediate Past Chair)
Brusniak, Clement & Harrison, P.C.
17400 Dallas Parkway, Suite 212
Dallas, Texas 75287-7306
972-250-6363
972-250-3599 (fax)
brusniak@txtax.com

Council Members

Martin Van Brauman Term expires 2001
Grant Thornton LLP
1717 Main Street, Suite 500
Dallas, Texas 75201
214-561-2466
214-561-2371 (fax)
mvanbrauman@gt.net

R. David Wheat Term Expires 2001
Thompson & Knight, P.C.
1700 Pacific Avenue, Suite 3300
Dallas, Texas 75201
214-969-1468
214-969-1751 (fax)
dwheat@tklaw.com

William P. Bowers Term expires 2002
Jenkens & Gilchrist, P.C.
1445 Ross Avenue, Suite 3200
Dallas, Texas 75202
214-855-4340
214-855-4300 (fax)
bbowers@jenkens.com

Anthony Rebollo Term expires 2003
Strasburger & Price, L.L.P.
300 Convent, Suite 900
Bank of America Plaza
San Antonio, Texas 78205
210-212-4100
210-212-5700 (fax)
arebollo@strasburger.com

Rosemary Shepard Term expires 2003
Conoco, Inc.
600 N. Dairy Ashford
P.O. Box 4783
Houston, Texas 77210
281-293-1939
281-293-2127 (fax)
rosemary.t.shepard@usa.conoco.com

Patrick R. Gordon Term expires 2001
Krafsur Gordon Mott P.C.
P.O. Box 1322
El Paso, Texas 79947-1322
915-545-1133
915-545-4433 (fax)
pgordon@krafsur.com

Susan Burnette Term expires 2002
Conant, Whittenburg, French, Schachter, P.C.
P.O. Box 31718
Amarillo, Texas 79120
806-345-5403
806-372-5757 (fax)
sburnette@whittenburglaw.com

John Christian Term expires 2002
Vinson & Elkins, L.L.P.
600 Congress Avenue, Suite 2700
Austin, Texas 78701-3200
512-495-8623
512-236-3224 (fax)
jchristian@velaw.com

Jimmy Martens Term expires 2003
Stahl, Martens & Bernal, L.L.P.
7320 N. MoPac, Suite 210
Austin, Texas 78731
512-346-5558
512-346-2712 (fax)
512-633-2735 (cell)
jfmartens@aol.com

2000 - 2001
Tax Section Leadership Roster

COMMITTEE	CHAIR	VICE CHAIR
1. CONTINUING LEGAL EDUCATION Council Liaison: Jimmy Martens 512-346-5558 jfmartens@aol.com	Jimmy Martens Stahl, Martens & Bernal, L.L.P. 7320 N. MoPac, Suite 210 Austin, Texas 78731 512-346-5558 512-346-2712 (fax) 512-633-2735 (cell) jfmartens@aol.com	Larry Jones Townsend & Jones 8100 Lomo Alto, Suite 238 Dallas, Texas 75225 214-696-2661 214-696-9979 (fax) larry@tjtaxlaw.com
3. CORPORATE TAX Council Liaison: David Wheat 214-969-1468 dwheat@tklaw.com	Allen B. Craig, III Gardere Wynne Sewell & Riggs, L.L.P. 1000 Louisiana, Suite 3400 Houston, Texas 77002 713-276-6680 713-276-5555 (fax) craal@gardere.com	Kenneth K. Bezozo Haynes and Boone, L.L.P. 901 Main street, Suite 3100 Dallas, Texas 75202 214-651-5568 214-200-0365 (direct fax) 214-651-5940 (fax) bezozok@haynesboone.com
2. EMPLOYEE BENEFITS Council Liaison: Rosemary Shepard 281-293-1939 rosemary.t.shepard@usa. conoco.com	Felicia F. Finston Vinson & Elkins LLP 2001 Ross Avenue, Suite 3700 Dallas, Texas 75201-2975 214-220-7990 214-220-7716 (fax) ffinston@velaw.com	Randy Fickel Gardere Wynne Sewell LLP Thanksgiving Tower 1601 Elm Street, Suite 3000 Dallas, Texas 75201 214-999-3000 214-999-4667 (fax) rfickel@gardere.com
4. ESTATE AND INHERITANCE TAX Council Liaison: Robert Gibson 915-545-1133 rgibson@krafsur.com	G. Edward Deery Fulbright & Jaworski, LLP 1301 McKinney, Suite 5100 Houston, Texas 77010-5151 713-651-3752 713-651-5246 (fax) gdeery@fulbright.com	Stefnee Ashlock Fizer, Beck, Webster, Bentley & Scroggins 1360 Post Oak Blvd., Suite 1600 Houston, Texas 77056 713-840-7710 713-963-8469 (fax) sashlock@fizerbeck.com
5. EXTERNAL RELATIONS	Vacant	
6. GENERAL INCOME TAX Council Liaison: Pat Gordon 915-545-1133 pgordon@krafsur.com	Alfonso Soto Attorney at Law 1220 Montana Avenue El Paso, Texas 79902 915-533-1906 877-332-1258 (fax) sotolaw@prodigy.net	Guy N. Fields, III Fields & Bagley, P.C. 601 Montana Avenue El Paso, Texas 79902 915-532-6997 915-532-7046 (fax) fb@elp.rr.com
7. INTERNATIONAL TAX Council Liaison: Martin Van Brauman 214-651-2466 mvanbrauman@gt.com	Carol Peters Exxon 5959 Las Colinas Blvd. Irving, Texas 75039 972-444-1614 972-444-1640 (fax) carol.l.peters@exxon.com	Alexander G. McGeoch Worsham Forsythe Wooldridge, LLP 1601 Bryan Street, 30th Floor Dallas, Texas 75201 214-979-3041 214-880-0011 (fax) amcgeoch@worsham.net
8. Partnership and Real Estate Council Liaison: Bill Powers 214-855-4340 bbowers@jenkens.com	Richard M. Fijolek Haynes & Boone, L.L.P. 901 Main Street, Suite 3100 Dallas, Texas 75202-3789 214-651-5570 214-200-0378 fax fijolekr@haynesboone.com	Mitchell A. Tiras Locke, Liddell & Sapp, LLP 600 Travis Street, Suite 3400 Houston, Texas 77002-3095 713-226-1144 713-223-3717 (fax) mtiras@lockeliddell.com

9. Property Tax

Council Liaison:
Tony Rebollo
210-212-4100
arebollo@strasburger.com

Walt McCool
Morgan & McCool, P.C.
1930 Thanksgiving Tower.
1601 Elm Street
Dallas, Texas 75201
214-740-9944
214-740-9977 (fax)
mccool@morganmccool.com

Greg Dalton
Of Counsel
Cordray & Goodrich, P.C.
3306 Sul Ross
Houston, Texas 77098
713-630-0600
713-630-0017 (fax)
gdalton@cgpc-law.com

10. State Tax

Council Liaison:
Cynthia Ohlenforst
214-939-5512
ohlenfc@hughesluce.com

Steven D. Moore
Jackson Walker L.L.P.
100 Congress Avenue, Suite 1100
Austin, Texas 78701
512-236-2074
512-236-2002 (fax)
smoore@jw.com

Daniel J. Micciche
Akin, Gump, Strauss, Hauer & Feld, L.L.P.
1700 Pacific Avenue, Suite 4100
Dallas, Texas 75201-4675
214-969-2800
214-969-4343 (fax)
dmicciche@akingump.com

11. Tax Controversy

Council Liaison:
Tony Rebollo
210-212-4100
arebollo@strasburger.com

Anthony E. Rebollo
Strasburger & Price, L.L.P.
300 Convent Street, Suite 900
Bank of America Plaza
San Antonio, Texas 78205
210-250-6008
210-250-6100 (fax)
arebollo@strasburger.com

Josh O. Ungerman
Meadows, Owens, Collier, Reed,
Cousins & Blau, L.L.P.
901 Main Street, Suite 3700
Dallas, Texas 75202-3725
214-744-3700
214-747-3732 (fax)
jungerman@meadowsowens.com

12. Tax-Exempt Finance

Council Liaison:
Rosemary Shepard
281-293-1939
rosemary.t.shepard@usa.
conoco.com

Kathryn Garner
Mayor Day Caldwell & Keeton, LLP
700 Louisiana, Suite 1900
Houston, Texas 77002
713-225-7032
713-225-7047 (fax)
kgarner@mdck.com

Bob Griffo
Winstead Sechrest & Minick, PC
1201 Elm Street, Suite 5400
Dallas, Texas 75270
214-745-5400
214-745-5390 (fax)
bgriffo@winstead.com

13. Tax-Exempt Organizations

Council Liaison:
Susan Burnette
806-345-5403
sburnete@whittenburglaw.com

Jeffrey Edward Sher
Fizer, Beck, Webster, Bentley &
Scroggins
1360 Post Oak Blvd., Suite 1600
Houston, Texas 77056-3022
713-840-7710
713-963-8469 (fax)
jsher@fizerbeck.com

Tyree Collier
Jenkens & Gilchrist
1445 Ross Avenue, Suite 3200
Dallas, Texas 75202-2799
214-855-4342
214-855-4300 (fax)
tcollier@jenkens.com

14. Newsletter Editor

Gene Wolf
Kemp Smith, P.C.
221 North Kansas, Suite 1700
El Paso, Texas 79901
915-533-4424
915-546-5360 (fax)
gwolf@kempsmith.com

Tina R. Green
Patton, Haltom, Roberts, McWilliams,
& Greer, LLP
Century Bank Plaza, Suite 400
29000 St. Michael Drive
P.O. Box 6128
Texarkana, Texas 75505-6128
903-334-7000
903-334-7007 (fax)
tgreen@pattonhaltom.com

15. Website

Council Liaison:
Robert Gibson
915-545-1133
rgibson@krafsur.com

Steven D. Erdahl
Director of E-Communications
Verizon Communications, Inc.
600 Hidden Ridge
MC: HQE02H44
Irving, Texas 75038
972-718-2197
972-719-0028 (fax)
steve.erdahl@verizon.com

Board Advisors

JoAl Cannon-Sheridan, Esq.
Moak & Sheridan, LLP
211 East Commerce Street
Jacksonville, Texas 75766
(903) 586-7555
moak21@iamerica.net

Jerry R. Selinger, Esq.
Jenkens & Gilchrist
1445 Ross Avenue, Suite 3200
Dallas, Texas 75202
(214) 855-4500
jselinger@jenkens.com

COMMITTEE SELECTION FORM
Section of Taxation
State Bar of Texas

[Please do not complete if you have already completed a selection form in the last nine months.]

NAME: ______________________________ DATE: ______________

FIRM: ____

ADDRESS: ____

CITY STATE ZIP CODE

TELEPHONE NO: (______)______________________

BAR CARD NO.: ______________________

COMMITTEE:

You may become a member of more than one committee.

I request appointment to the committees specified below: [Check each that you want to join.]

______ Compensation and Employee Benefits

______ Continuing Legal Education

______ Corporate Tax

______ Estate and Inheritance Tax

______ External Relations

______ General Income

______ International Tax

______ Partnership and Real Estate Tax

______ Property Tax

______ State Tax

______ Tax Controversy

______ Tax-Exempt Financing

______ Tax-Exempt Organizations

______ Newsletter

Return completed form to: Robert Gibson
P.O. Box 1322
El Paso, Texas 79947-1322
(915) 545-1133

NOTES