THE TEXAS TAX LAWYER

Spring 2014
Vol. 41 No. 3
www.texastaxsection.org

All articles following "411 on Fundraising for Charitable Organizations" will appear in part II

<u>TO MOVE DIRECTLY TO AN ARTICLE CLICK ON THE TITLE</u>

TABLE OF CONTENTS

- The IRS: A Former Insider's View of How it is Organized and How it Works
  Richard L. Hunn, Norton Rose Fulbright
- IRS Collections – Liens, Levies, Trust Fund Recovery: What to Do?
  Dustin Whittenburg, The Law Offices of Dustin Whittenburg
- Employee Benefits – Basic Overview and Effect of Windsor
  Rob Fowler, Baker Botts
- A Rundown of the Top 10 International Tax Traps
  Deidra W. Hubenak and Austin C. Carlson, Gray Reed & McGraw, P.C.
- Partnership and Limited Liability Companies 101
  Chester Grudzinski, Jr., Kelly, Hart & Hallman

COMMITTEE ON GOVERNMENT SUBMISSIONS:

- State Bar of Texas, Section of Taxation, Comments on Proposed Treasury Regulations Section 1.704-3, May 5, 2014
  Brandon Bloom, Thompson & Knight LLP
- State Bar of Texas, Section of Taxation, Comments on Income, Gift and Estate Tax; OMB Number: 1545-1360; Regulation Project Number: PS-102-88 (T.D. 8612), March 19, 2014
  Catherine C. Scheid, Scheid Law
  Austin Carlson, Gray Reed & McGraw P.C.
- State Bar of Texas, Section of Taxation, Response to Texas Comptroller Request for Comments Pertaining to New Rule 3.11, April 4, 2014
  Ira A. Lipstet, Dubois, Bryant & Campbell, L.L.P.
  Sam Megally, K&L Gates LLP
  Charolette Noel, Jones Day
  Alyson Outenreath, Texas Tech University School of Law

A Word from the Chair
Elizabeth A. Copeland

This year has been another amazing year for the Tax Section. First and foremost, we officially changed our name to the "Tax Section" as opposed to the "Section of Taxation." The change comports with a longstanding history whereby we were often publicized as the Tax Section in official bar events and publications.

The Section's Leadership Academy completed its first CLE and networking event in San Antonio. It was very well received. The Leadership Academy assists young tax lawyers in the development of leadership skills and provides an opportunity to network with other tax lawyers throughout the state. The next event is scheduled for June 26, 2014 in Austin.

The Section's Committee on Government Submissions (COGS) prepared and submitted seven significant comment projects this year addressing the Affordable Care Act, material advisor penalty regulations, proposed innocent spouse regulations, proposed Treasury Regulations on basis adjustments for oil & gas properties, proposed Treasury Regulations on QDOTs, charitable remainder trusts and the net investment income tax, and a proposed rule change by the Texas Comptroller of Public Accounts regarding settlements on redeterminations. The tax attorneys participating in the COGS projects were Co-Chairs Stephanie Schroepfer and Robert (Bob) Probasco, with help from draftspersons Brandon Bloom, Sibyl Bogardus, Christopher Bourell, Wesley Bowers, Austin Carlson, David Colmenero, Lora Davis, David Gair, David Gilliland, Richard Hunn, Eleanor Kim, Celeste Lawton, Ira Lipstet, Sam Megally, Charolette Noel, Shawn O'Brien, Alyson Outenreath, Catherine Scheid, Michelle Spiegel, Henry Talavera, Rob Fowler, Susan Wetzel, Melissa Willms, and me. In addition to the COGS Chairs, reviewers were Tina Green, Riva Johnson, J.F. (Jack) Howell III, Mary McNulty, Dan Micciche, Jeffrey Myers, and Alyson Outenreath.

The Section continued its award winning pro bono program of assisting pro se litigants during U.S. Tax Court Calendar Calls throughout Texas. In addition, we provided lawyer assistance to the St. Mary's Low Income Taxpayer Clinic in its first-ever problem solving day, set up with the cooperation of the IRS. Its goal was to resolve cases in advance of the Tax Court's small case calendar in San Antonio set for March 12th. The new program was a huge success. Many thanks to Bob Probasco and Mel Meyers for assisting and Juan Vasquez, Jr. and Rachael Rubenstein for coordinating the event.

The Section also completed a new basics course in February, "Tax Law Survey in a Day." Many thanks to Course Directors Lora Davis and Amanda Traphagan. The program was very well received and is soon to be rebroadcast on the 24/7 CLE library available on the Section's website, texastaxsection.org. See also the many other valuable CLE programs available on our website. Michael Threet does a superior job keeping the CLE programing relevant and up to date.

The Section also continued its long-standing tradition of live CLE events, including the International Tax Symposium presented in Plano and in Houston; the Property Tax Conference and the State and Local Committee's program with the Texas Comptroller. This year Christi Mondrik has coordinated an outstanding lineup for the Tax Section Annual Meeting that will be held on June 27, 2014 at the Austin Convention Center. We will have a special joint session with the LGBT Law Section on the taxation and federal benefits for same-sex couples in light of the Supreme Court's *Windsor* decision. Other programs will include a Tax Court update, cross-border taxation, the ABA State Tax Tribunal Act, Lunch with Legend Ken Gideon, changes at the IRS, and tax considerations relating to operations in the Eagle Ford Shale. Finally, the 2014 Advanced Tax Law course is scheduled to be held August 28-29 at the Westin Galleria in Dallas; Course Directors are Amanda Traphagan and James Roberts.

The Section's Law School Outreach Program held luncheons this year at law schools throughout Texas, which this year included Southern Methodist University Dedman School of Law, University of Texas School of Law, University of Houston Law Center, and Texas Tech University School of Law. New this year, the Section is sponsoring up to three law student scholarships for demonstrated excellence and desire to practice in the field of tax law. The scholarships will be awarded at our Annual Meeting in June.

Finally, the Section selected United States Tax Court Judge Juan Vasquez as the recipient of the 2014 Outstanding Texas Tax Lawyer Award. The Honorable Judge Vasquez is the 11th lawyer selected to receive this prestigious award.

As a closing note, always be on the lookout for the Section's electronically published newsletter, The Texas Tax Lawyer, which contains current development articles and other articles of interest, as well as a practitioner's corner with forms and other useful information.

It has been wonderful serving as your Chair and I look forward to seeing all of you at our Annual Meeting on June 27, 2014.

SECTION OF TAXATION OF THE STATE BAR OF TEXAS
2013-2014
LEADERSHIP ROSTER

Officers

Elizabeth A. Copeland (Chair)
Strasburger Price Oppenheimer Blend
711 Navarro Street, Suite 600
San Antonio, Texas 78205
210-250-6121
210-258-2732 (fax)\
210.710.3517 (mobile)
elizabeth.copeland@strasburger.com

Andrius R. Kontrimas (Chair-Elect)
Norton Rose Fulbright
1301 McKinney, Suite 5100
Houston, Texas 77010-3095
713-651-5482
713-651-5246 (fax)
akontrimas@nortonrosefulbright.com

Alyson Outenreath (Secretary)
Texas Tech University
School of Law
1802 Hartford Ave.
Lubbock, Texas 79409-0004
806-742-3990 Ext. 238
806-742-1629 (fax)
alyson.outenreath@ttu.edu

David E. Colmenero (Treasurer)
Leadership Academy Program Director
Meadows, Collier, Reed, Cousins,
Crouch & Ungerman, LLP
901 Main Street, Suite 3700
Dallas, Texas 75202
214-744-3700
214-747-3732 (fax)
dcolmenero@meadowscollier.com

Appointed Council Members

Stephanie M. Schroepfer
COGS Chair
Norton Rose Fulbright
1301 McKinney, Suite 5100
Houston, Texas 77010-3095
713-651-5591
713-651-3246 (fax)
sschroepfer@fulbright.com

Robert C. Morris
Newsletter Editor
Norton Rose Fulbright
1301 McKinney Suite 5100
Houston, Texas 77010-3095
713-651-8404
713-651-5246 (fax)
robert.morris@nortonrosefulbright.com

Daniel G. Baucum
Leadership Academy
Shackelford, Melton & McKinley, LLP
3333 Lee Parkway, Tenth Floor
Dallas, Texas 75219
214-780-1470
214-889-9770 (fax)
dbaucum@shacklaw.net

J. Michael Threet
CLE Chair
Akin Gump Strauss Hauer & Feld, LLP
1700 Pacific Avenue, Suite 3900
Dallas, Texas 75201
214-969-2795
214-969-4343 (fax)
mthreet@akingump.com

Juan F. Vasquez, Jr.
Chamberlain, Hrdlicka, White, Williams & Aughtry, LLP
1200 Smith Street, 14th Floor
Houston, Texas 77002-4310
713.654.9679
713.658.2553 (fax)
juan.vasquez@chamberlainlaw.com

Return to Table of Contents

Elected Council Members

Matthew L. Larsen
Term expires 2014
Baker Botts, LLP
2001 Ross Avenue, Suite 600
Dallas, Texas 75201-2980
214-953-6673
214-661-4673 (fax)
matthew.larsen@bakerbotts.com

Robert D. Probasco
Term expires 2014
Thompson & Knight, LLP
One Arts Plaza
1722 Routh Street, Suite 1500
Dallas, Texas 75201-2533
214-969-1503
214-999-9113 (fax)
robert.probasco@tklaw.com

Catherine C. Scheid
Term expires 2014
4301 Yoakum Blvd.
Houston, Texas 77006
713-840-1840
713-840-1820 (fax)
ccs@scheidlaw.com

Jeffry M. Blair
Term expires 2015
Hunton & Williams, LLP
1445 Ross Avenue Suite 3700
Dallas, Texas 75202-2799
214-468-3306
214-468-3599 (fax)
jblair@hunton.com

Lisa Rossmiller
Term expires 2015
Norton Rose Fulbright
Fulbright Tower
1301 McKinney
Houston, Texas 77010-3095
713-651-8451
713-651-5246 (fax)
lisa.rossmiller@nortonrosefulbright.com

Susan A. Wetzel
Term expires 2015
Haynes & Boone
2323 Victory Avenue Suite 700
Dallas, Texas 75219
214-651-5389
214-200-0675 (fax)
Susan.wetzel@haynesboone.com

Ira Lipstet
Term expires 2016
DuBois, Bryant & Campbell, LLP
700 Lavaca, Suite 1300
Austin, Texas 78701
512-381-8040
512-457-8008 (fax)
ilipstet@dbcllp.com

Melissa Willms
Term expires 2016
Davis & Willms, PLLC
3555 Timmons Lane, Suite 1250
Houston, Texas 77027
281-786-4503
281-742-2600 (fax)
melissa@daviswillms.com

Henry Talavera
Term expires 2016
Polsinelli Shughart
2501 N. Harwood, Suite 1900
Dallas, Texas 75201
214-661-5538
htalavera@polsinelli.com

Ex Officio Council Members

Tina R. Green (Immediate Past Chair)
Capshaw Green, PLLC
2801 Richmond Road #46
Texarkana, Texas 75503
903-223-9544
888-371-7863 (fax)
tgreen@capshawgreen.com

Christopher H. Hanna
Law School Representative
SMU Dedman School of Law
3315 Daniel Avenue
Dallas, Texas 75205
214-768-4394
214-768-3142 (fax)
channa@mail.smu.edu

Kari Honea
Comptroller Representative
Comptroller of Public Accounts
Tax Policy Division
P.O. Box 13528
Austin, Texas 78711-3528
512-475-0221
512-475-0900 (fax)
Kari.Honea@cpa.state.tx.us

Abbey B. Garber
IRS Representative
Internal Revenue Service
MC 2000 NDAL
13th Floor
4050 Alpha Road
Dallas, Texas 75244
972-308-7913
abbey.b.garber@irscounsel.treas.gov

Return to Table of Contents

COMMITTEE CHAIRS AND VICE CHAIRS
2013 / 2014

	COMMITTEE	CHAIR	VICE CHAIR
1.	**Annual Meeting**	**Christi A. Mondrik** Mondrik & Associates 515 Congress Avenue, Suite 1850 Austin, Texas 78701 512-542-9300 512-542-9301 (fax) cmondrik@mondriklaw.com	**Matthew Larsen** Baker Botts, LLP 2001 Ross Avenue, Suite 600 Dallas, Texas 75201-2980 214-953-6673 214-661-4673 (fax) matthew.larsen@bakerbotts.com
2.	**Continuing Legal Education**	**J. Michael Threet** Akin Gump Strauss Hauer & Feld, LLP 1700 Pacific Avenue, Suite 4100 Dallas, Texas 75201 214-969-2795 214-969-4343 (fax) mthreet@akingump.com	**Amanda Traphagan** The Seay Law Firm, PLLC 807 Brazos Street, Suite 304 Austin, Texas 78701 512-582-0120 512-532-9882 (fax) atraphagan@seaytaxlaw.com **Jim Roberts** Glast, Phillips & Murray, PC 14801 Quorum Drive, Suite 500 Dallas, Texas 75254 972-419-7189 972-419-8329 jvroberts@gpm-law.com
3.	**Corporate Tax**	**David S. Peck** Vinson & Elkins LLP Trammell Crow Center 2001 Ross Avenue, Suite 3700 Dallas, Texas 75201 214-220-7937 214-999-7937 (fax) dpeck@velaw.com	**Sam Merrill** Thompson & Knight, LLP One Arts Plaza 1722 Routh Street, Suite 1500 Dallas, Texas 75201 214-969-1389 214-999-9244 (fax) Sam.Merrill@tklaw.com
4.	**Employee Benefit**	**Susan A. Wetzel** Haynes & Boone 2323 Victory Ave., Suite 700 Dallas, Texas 75219 214-651-5389 214-200-0675 (fax) susan.wetzel@haynesboone.com	**Rob Fowler** Baker Botts, LLP One Shell Plaza, 910 Louisiana St. Houston TX 77002 713-229-1229 713-229-2729 (fax) rob.fowler@bakerbotts.com
	Co-Chair:	**Henry Talavera** Polsinelli Shughart 2501 N. Harwood, Suite 1900 Dallas, Texas 75201 214-661-5538 htalavera@polsinelli.com	

Return to Table of Contents

	COMMITTEE	CHAIR	VICE CHAIR
5.	**Energy and Natural Resources Tax**	**Brandon Bloom** Thompson & Knight, LLP One Arts Plaza 1722 Routh Street, Suite 1500 Dallas, Texas 75201-2533 214-969-1106 214-880-3103 (fax) brandon.bloom@tklaw.com	**Michelle Spiegel** Mayer Brown, LLP 700 Louisiana Street Suite 3400 Houston, Texas 77002-2730 713-238-3000 713-238-4888 (fax) mspiegel@mayerbrown.com
6.	**Estate and Gift Tax**	**Lora G. Davis** The Blum Firm, P.C. 300 Crescent Court, Suite 1350 Dallas, Texas 75201 214-751-2130 214-751-2160(fax) ldavis@theblumfirm.com	**Melissa Willms** Davis & Willms, PLLC 3555 Timmons Lane, Suite 1250 Houston, Texas 77027 281-786-4503 281-742-2600 (fax) melissa@daviswillms.com **Celeste C. Lawton** Norton Rose Fulbright 1301 McKinney, Suite 5100 Houston, Texas 77010-3095 713-651-5591 713-651-5246 (fax) celeste.lawton@nortonrosefulbright.com **Wes Bowers** Fizer, Beck, Webster, Bently, Scroggins, P.C. 1330 Post Oak Blvd., Suite 2900 Houston, Texas 77056 713-840-7710 713-963-8469 (fax) wbowers@fizerbeck.com
7.	**General Tax Issues**	**David C. Cole** Vinson & Elkins, LLP First City Tower 1001 Fannin Street, Suite 2500 Houston, Texas 77002-6760 713-758-2543 713-615-5043 (fax) dcole@velaw.com	**Shawn R. O'Brien** Mayer Brown, LLP 700 Louisiana Street, Suite 3400 Houston, Texas 77002 713-238-2848 713-238-4602 (fax) sobrien@mayerbrown.com
8.	**International Tax**	**Austin Carlson** Looper Reed & McGraw, PC 1300 Post Oak Blvd. Suite 2000 Houston, Texas 77056 713.986.7188 713.986.7100 (fax) acarlson@lrmlaw.com	**E. Alan Tiller** E. Allan Tiller, PLLC Two Houston Center 909 Fannin, Suite 3250 Houston, Texas 77010 713-337-3774 713-481-8769 (fax) allan.tiller@tillertaxlaw.com VC – COGS

	COMMITTEE	CHAIR	VICE CHAIR
9.	**Partnership and Real Estate**	**J.F. (Jack) Howell III** Sprouse Shrader Smith, PC 701 S. Taylor, Suite 500 Amarillo, Texas 79101 806-468-3345 jack.howell@sprouselaw.com	**Chester W. Grudzinski, Jr.** Kelly Hart & Hallman LLP Wells Fargo Tower 201 Main Street, Suite 2500 Ft Worth, Texas 76102 817-878-3584 817-878-9280 (fax) chester.grudzinski@khh.com
10.	**Property Tax**	**Melinda Blackwell** Blackwell & Duncan, PLLC 15851 Dallas Parkway, Suite 600 Addison, Texas 75001 214-561-8660 214-561-8663 (fax) blackwell@txproptax.com	**Rick Duncan** Blackwell & Duncan, PLLC 15851 Dallas Parkway, Suite 600 Addison, Texas 75001 214-561-8660 214-561-8663 (fax) duncan@txproptax.com **Christopher S. Jackson** Perdue, Brandon, Fielder, Collins & Mott 3301 Northland Drive, Suite 505 Austin, Texas 78731 512-302-0190 512-323-6963 (fax) cjackson@pbfcm.com
11.	**Solo and Small Firm**	**Catherine C. Scheid** 4301 Yoakum Blvd. Houston, Texas 77006 713-840-1840 713-840-1820 (fax) ccs@scheidlaw.com	**Dustin Whittenberg** Law Office of Dustin Whittenburg 4040 Broadway, Suite 450 San Antonio, Texas 78209 (210) 826-1900 (210) 826-1917 (fax) dustin@whittenburgtax.com
12.	**State and Local Tax**	**Ira A. Lipstet** DuBois, Bryant & Campbell, LLP 700 Lavaca, Suite 1300 Austin, Texas 78701 512-381-8040 512-457-8008 (fax) ilipstet@dbcllp.com	**Charolette F. Noel** Jones Day 2727 North Harwood Street Dallas, Texas 75201-1515 214-969-4538 214-969-5100 (fax) cfnoel@jonesday.com **Sam Megally** K&L Gates, LLP 1717 Main Street, Suite 2800 Dallas, Texas 75201 214-939-5491 sam.megally@klgates.com

COMMITTEE	CHAIR	VICE CHAIR
		Matt Hunsaker Baker Botts, L.L.P 2001 Ross Avenue Dallas, Texas 75201-2980 214-953-6828 214-661-4828 (fax) matt.hunsaker@bakerbotts.com
13. Tax Controversy	**Richard L. Hunn** Norton Rose Fulbright 1301 McKinney, Suite 5100 Houston, Texas 77010-3095 713-651-5293 713-651-5246 (fax) richard.hunn@nortonrosefulbright.com	**Anthony P. Daddino** Meadows, Collier, Reed, Cousins, Crouch & Ungerman, LLP 901 Main Street, Suite 3700 Dallas, Texas 75202 214-744-3700 214-747-3732 (fax) adaddino@meadowscollier.com
		David Gair Looper Reid & McGraw, P.C. 1601 Elm Street, Suite 4600 Dallas, Texas 75201 dgair@lrmlaw.com
14. Tax-Exempt Finance	**Peter D. Smith** Norton Rose Fulbright 98 San Jacinto Blvd., Suite 1100 Austin, Texas 78701 512-536-3090 512-536-4598 (fax) peter.smith@nortonrosefulbright.com	
15. Tax-Exempt Organizations	**Terri Lynn Helge** Professor of Law Texas A&M University School of Law 1515 Commerce Street Fort Worth, Texas 76102-6509 817.212.3942 thelge@law.tamu.edu	**David M. Rosenberg** Thompson & Knight LLP One Arts Plaza 1722 Routh Street, Suite 1500 Dallas, Texas 75201 214.969.1508 214.880.3191 (fax) david.rosenberg@tklaw.com
		Shannon Guthrie Smith & Stephens 8330 Meadow Road, Suite 216 Dallas, Texas 75231 214.373.7195 214.373.7198 Esgg@smithstephenslaw.com

Return to Table of Contents

COMMITTEE		CHAIR	VICE CHAIR
			Frank Sommerville Weycer, Kaplan, Pulaski & Zuber, P.C. 3030 Matlock Rd., Suite 201 Arlington, Texas 76015 817-795-5046 fsommerville@wkpz.com
16.	**Governmental Submissions**	**Stephanie M. Schroepfer** Norton Rose Fulbright 1301 McKinney, Suite 5100 Houston, Texas 77010-3095 713-651-5591 713-651-5246 (fax) stephanie.schroepfer@nortonrosefulbright.com	**Henry Talavera** Polsinelli Shughart 2501 N. Harwood, Suite 1900 Dallas, Texas 75201 214-661-5538 htalavera@polsinelli.com
	Co-Chair:	**Robert D. Probasco** 214-335-7549 rbob.probasco@gmail.com	**Catherine C. Scheid** 4301 Yoakum Blvd. Houston, Texas 77006 713-840-1840 713-840-1820 (fax) ccs@scheidlaw.com
17.	**Communications:**		
	Newsletter Editor	**Robert C. Morris** Norton Rose Fulbright 1301 McKinney, Suite 5100 Houston, Texas 77010-3095 713-651-8404 713-651-5246 (fax) robert.morris@nortonrosefulbright.com	
	List Servs	**Brent Gardner** Gardere Wynne Sewell, LLP 1601 Elm Street, Suite 3000 Dallas, Texas 75201 214-999-4585 214-999-4667 (fax) bgardner@gardere.com	
	Tax App	**Ryan L. Morris** Baker Botts, LLP One Shell Plaza 910 Louisiana Street Houston, Texas 77002-4995 713-229-1567 ryan.morris@bakerbotts.com	**Janet Jardin** Ernst & Young, LLP 2323 Victory Avenue, Suite 2000 Dallas, Texas 75219 214-969-8000 janet.jardin@ey.com

COMMITTEE	CHAIR	VICE CHAIR
		Mark Maurer Ernst & Young, LLP 2323 Victory Avenue, Suite 2000 Dallas, Texas 75219 214-969-8000 mark.maurer@ey.com
18. Pro Bono	**Juan F. Vasquez, Jr.** Chamberlain, Hrdlicka, White, Williams & Aughtry LLP 1200 Smith Street 14th Floor Houston, Texas 77002-4310 San Antonio: 112 East Pecan Street Suite 1450 San Antonio, Texas 78205 713.654.9679 713.658.2553 (fax) juan.vasquez@chamberlainlaw.com	**Vicki L. Rees** Glenda Pittman & Associates, P.C. 4807 Spicewood Springs Road Bld. 1, Suite 1140 Austin, Texas 78759 512-499-0902 512-499-0952 (fax) vrees@pittmanfink.com VC – Vita **Derrick Mata** 2600 S. Gessner, Suite 220 Houston, Texas 77063 713-400-3701 713-588-8631 (fax) 713-501-0453 (mobile) dmatta@derekmattapc.com VC – Tax Court
19. Leadership Academy	**David E. Colmenero** Meadows, Collier, Reed, Cousins, Crouch & Ungerman, LLP 901 Main Street, Suite 3700 Dallas, Texas 75202 214-744-3700 214-747-3732 (fax) dcolmenero@meadowscollier.com	**Ryan Gardner** Woodgate I, Suite 217 1121 E.S.E. Loop 323 Tyler, Texas 75701 903-705-1101 903-508-2469 (fax) rg@ryangardnerlaw.com
Co-Chair:	**Daniel G. Baucum** Shackelford, Melton & McKinley, LLP 3333 Lee Parkway, Tenth Floor Dallas, Texas 75219 214-780-1470 214-889-9770 (fax) dbaucum@shacklaw.net	

SECTION OF TAXATION
OF
THE STATE BAR OF TEXAS

2013 / 2014
CALENDAR

June 2013	
1	Deadline for Student Paper Competition
6-7	29th Annual Texas Federal Tax Institute – Hyatt Regency Hill Country Resort, San Antonio
20-21	SBOT 2013 Annual Meeting – Dallas – Hilton Anatole
20	**Council Retreat** Hosted by: Thompson & Knight, LLP (Bob Probasco) 1722 Routh Street, Suite 1500, Dallas, Texas 75201 214-969-1700 1:00 pm – 5:00 pm
21	**Tax Section Annual Meeting** 8:00 am – 4:45 pm (post on website at least ***20 days in advance***; elect 3 new Council members)
July 2013	
26	**Bar Leaders Conference – New Chair and Treasurer Orientation** Westin Galleria – Houston 10:00 a.m. – 3:00 p.m.
23	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
August 2013	
14	**Tax Law 101 CLE** Norris Conference City Centre, 816 Town & Country Lane, Suite 210, Houston, Texas 77024 713-590-0950
15	**Officer's Retreat** Hosted by: Norton Rose Fulbright (Andrius Kontrimas) 1301 McKinney Street, Suite 5100, Houston, Texas 77010-3095 210-224-2000 11:00 a.m. – 3:00 p.m.
15-16	**31st Annual Advanced Tax Law Course** Norris Conference City Centre, 816 Town & Country Lane, Suite 210, Houston, Texas 77024 713-590-0950
20	**COGS Call** (2nd Last Tuesday) Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
30	**Council and Committee Chairs and Vice Chairs Meeting** **MANDATORY IN PERSON ATTENDANCE FOR CHAIRS AND COUNCIL** Hosted by: Meadows, Collier, Reed, Cousins, Crouch & Ungerman (David Colmenero) The City Club, 901 Main Street, Suite 6900 (Bank of America Bldg.), Dallas, Texas 75202 214-748-9525 10:30 a.m. – 12:30 p.m.
September 2013	
16	Pro Bono Committee Calendar Call Assistance (regular and small case) United States Tax Court El Paso, Texas
17	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
19	Deadline for appointing Nominating Committee (list in *Texas Tax Lawyer* and on website)

19-21	ABA Joint Fall CLE Meeting, San Francisco, CA
23	Pro Bono Committee Calendar Call Assistance (regular and small case) United States Tax Court – Lubbock, Texas
27	Article Deadline – Fall 2013 issue of the *Texas Tax Lawyer*
30	Pro Bono Committee Calendar Call Assistance (small case)\United States Tax Court San Antonio, Texas
October 2013	
7	Pro Bono Committee Calendar Call Assistance (regular case) United States Tax Court – Dallas, Texas
22	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
25	Publishing Deadline – Fall 2013 Issue of the *Texas Tax Lawyer*
November 2013	
7	16th Annual International Tax Symposium – Place to be determined, Houston, Texas
8	16th Annual International Tax Symposium – The Center for American and International Law 5201 Democracy Drive, Plano, Texas 75024
8	**Council Meeting** Hosted by: Strasburger Price (Elizabeth Copeland) 901 Main Street, Suite 4400, Dallas, Texas 75202 214-651-4300 10:30 a.m. – 12:30 p.m.
19	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
December 2013	
2	Pro Bono Committee Calendar Call Assistance (small case) United States Tax Court Houston, Texas
2 and 9	Pro Bono Committee Calendar Call Assistance (regular case) United States Tax Court Dallas, Texas
17	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
January 2014	
6	**Pro Bono Committee Calendar Call Assistance (regular case)** United States Tax Court Houston, Texas
10	**Council and Committee Chairs and Vice Chairs Meeting** Hosted by: Strasburger & Price, LLP 711 Navarro Street, Lower Level Conference Room, San Antonio, Texas 78205 210-224-2000 or 210-710.3517 10:30 am – 12:30 pm
13	**Pro Bono Committee Calendar Call Assistance (small case)** United States Tax Court Dallas, Texas
13	Deadline for annual meeting program agenda Nominations due for Outstanding Texas Tax Lawyer (Council vote follows January 10th meeting)
17	Leadership Academy Application deadline

Return to Table of Contents

21	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
23 – 25	ABA Tax Section Midyear Meeting
February 2014	
3	**Pro Bono Committee Calendar Call Assistance (regular case)** United States Tax Court Houston, Texas
7	Article Deadline – Winter 2014 issue of the *Texas Tax Lawyer*
10	**Pro Bono Committee Calendar Call Assistance (small case)** United States Tax Court Dallas, Texas
14	Tax Court Pro Bono Program Annual Renewal
18	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
28	Tax Law Survey in a Day CLE, Dallas Cityplace Center 8am – 4pm
March 2014	
3	Nominations due for Chair-Elect, Secretary, Treasurer, and 3 Elected Council Members
3	Publishing Deadline – Winter 2014 Issue of the *Texas Tax Lawyer*
3	**Pro Bono Committee Calendar Call Assistance (small case)** United States Tax Court Houston, Texas
3	**Pro Bono Committee Calendar Call Assistance (regular case)** United States Tax Court Dallas, Texas
17	**Pro Bono Committee Calendar Call Assistance (regular case)** United States Tax Court Houston, Texas
18	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
TBA	**Property Tax Conference**
20-21	**Leadership Academy Meeting** San Antonio, Texas Hosted by: Strasburger Price (Elizabeth Copeland) 2201 Broadway, San Antonio, Texas 78209 210-224-2000 or 210-250-6121
24	**Pro Bono Committee Calendar Call Assistance (regular case)** United States Tax Court San Antonio, Texas
April 2014	
4	Nominating Committee's Report due to Council
11	**Council Meeting** Hosted by: Strasburger & Price, LLP 2201 Broadway, San Antonio, Texas 78209 210-224-2000 or 210-250-6121 Election for Chair-Elect, Secretary, and Treasurer 10:30 a.m. – 12:30 p.m.
18	Article Deadline – Spring 2014 issue of the *Texas Tax Lawyer*
22	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
22	Pro Bono Tax Day – San Antonio
May 2014	
8-10	**ABA Section of Taxation 2014 May Meeting** – Grand Hyatt, Washington, DC

12	**Pro Bono Committee Calendar Call Assistance (small case)** United States Tax Court Houston, Texas
12	**Pro Bono Committee Calendar Call Assistance (small case)** United States Tax Court San Antonio, Texas
19	**Pro Bono Committee Calendar Call Assistance (regular case)** United States Tax Court Dallas, Texas
20	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
June 2014	
2	**Pro Bono Committee Calendar Call Assistance (regular case)** United States Tax Court Houston, Texas
6	Publishing Deadline – Summer 2014 issue of the *Texas Tax Lawyer*
17	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
26	Annual Meeting Speaker's Dinner and Leadership Academy Group Evening Event Max's Wine Dive, Austin TX
26	**Leadership Academy Meeting – A**ustin, Texas
27	**SBOT 2014 Annual Meeting** – Austin, Texas
27	**30th Annual Texas Federal Tax Institute –** Hyatt Regency Hill Country Resort, San Antonio
July 2014	
August 2014	
27 – 29	**32nd Annual Advanced Tax Law Course and Tax Law 101** Westin Galleria – Dallas, TX
September 2014	
25-26	**Leadership Academy Meeting –** Houston, Texas
January 2015	
15	**Leadership Academy Meeting –** Dallas, Texas

Annual Meeting

Don't forget to register for the Tax Section's 2014 Annual Member Meeting and CLE Program, which will be held as part of the State Bar of Texas Annual Meeting from June 26-27, 2014, at the Hilton Austin and the Austin Convention Center, in Austin, Texas. Registration is available online at http://www.texasbar.com/Content/NavigationMenu/Events/AnnualMeeting/default.htm. Our Annual Meeting will be held on **Friday, June 27, 2014**, at **8:00 a.m.** followed by the CLE Program which will begin at 8:30 a.m. This year's world-class program is headlined Faris Fink, Former IRS Commissioner; Doug Lindholm, President and Executive Director, Council on State Taxation and Hon. Juan F. Vasquez, U.S. Tax Court Judge. We have a variety of talented presenters joining us from around Texas and the U.S. The topics and presenters are:

- U.S. Tax Court Updates: Keeping up with the rules and practice tips for practitioners: Hon. Juan F. Vasquez, U.S. Tax Court Judge; T. Richard Sealy, Managing Counsel, IRS Office of Chief Counsel, U.S. Department of the Treasury; Robert E. Reetz, Jr., Partner, Haynes and Boone, LLP.

- Cross Border Taxation Between the U.S. and Mexico: Robert Barnett, Partner, Cacheaux, Cavazos & Newton, L.L.P.

- Panel on State Tax Tribunals: Doug Lindholm, President and Executive Director, Council on State Taxation; Jaye A. Calhoun, McGlinchey Stafford, PLLC; E. Kendrick Smith, Partner, Jones Day.

- Presentation of Outstanding Texas Tax Lawyer Award

- Lunch with a Tax Legend: Moderator: Bill Elliott, Elliott, Thomason & Gibson, LLP, interviewing Kenneth W. Gideon Skadden, Arps, Slate, Meagher, & Flom LLP & Affiliates.

- Taxation and Federal Benefits for Unmarried and Same-Sex Couples: Grover Hartt III, Senior Litigation Counsel, U.S. Department of Justice; Patricia Cain, Professor of Law, Santa Clara Law, Aliber Family Chair in Law Emerita, University of Iowa; Charles D. Pulman, Meadows, Collier, Reed, Cousins, Crouch & Ungermann, LLP.

- Changes in the Internal Revenue Service and Best Practices: Moderator: Jaime Vasquez, Chamberlain Hrdlicka, White, Williams & Aughtry interviewing Faris Fink, Former IRS Commissioner, Small Business/Self-Employed Division.

- Eagle Ford Shale Development: Legal and Tax Aspects of Oil and Gas Leasing and Land/Water Usage: Stanley Blend, Partner, and Mike Maloney, Partner, Strasburger & Price, LLP.

Return to Table of Contents

2014 STATE BAR OF TEXAS TAX SECTION ANNUAL MEETING

2014 State Bar of Texas Tax Section Annual Meeting
June 27, 2014, Austin Convention Center, Austin, Texas

☐ $2,500 Platinum package
☐ $1,500 Gold package

SPONSORSHIP FORM

SPONSORSHIP NAME (AS YOU WOULD LIKE IT TO APPEAR)	CONTACT NAME
STREET ADDRESS	CITY, STATE, ZIP
PHONE	EMAIL

For $2,500 Platinum Sponsorship Only, please provide names and bar numbers of up to 3 registrants to attend the Annual Meeting free of charge and the names of those attending the Speakers' Dinner (note that names may be provided at a later date):

Name	Bar No.

Speakers Dinner Attendees (if different)

PAYMENT INFORMATION

Please submit this form and payment in form of a check by June 13, 2014, to:

David Colmenero
Meadows Collier Reed Cousins Crouch & Ungerman
901 Main Street, Suite 3700, Dallas, Texas 75202

*Checks should be made payable to State Bar of Texas Tax Section.

Return to Table of Contents

2014 STATE BAR OF TEXAS TAX SECTION ANNUAL MEETING

We are excited to announce the 2014 State Bar of Texas Tax Section Annual Meeting will take place on June 27 at the Austin Convention Center, Austin, Texas.

This year's world-class program will be headlined by the Honorable Judge Juan Vasquez, Judge of United States Tax Court. Other renowned speakers will include T. Richard Sealy, IRS Office of Chief Counsel, Faris Fink, Former IRS Commissioner SBSE, Grover Hart III, Counsel at DOJ, Robert Reetz, Jr., Robert Barnett, Jaye A. Calhoun, Doug Lindholm, E. Kendrick Smith, Kenneth W. Gideon, Bill Elliott, Patricia Crain, Charles Pulman, Jaime Vasquez, Stanley Blend and Mike Maloney.

We encourage you to take a greater part in this exceptional event by becoming a sponsor.

A $2,500 Platinum Sponsorship provides:

- Three seats to the Speakers' Dinner at Max's Wine Dive
- Three tickets to the Annual Meeting, which includes a joint session with the LGBT Committee on the impact of DOMA's partial repeal
- Recognition at the Tax Section Annual Meeting
- Recognition in Tax Section Chair introductory remarks
- Recognition on Tax Section Annual Meeting handouts
- Recognition on Annual Meeting e-blasts from Tax Section leadership to members of Tax Section

A $1,500 Gold Sponsorship provides:

- Recognition at the Tax Section Annual Meeting
- Recognition in Tax Section Chair introductory remarks
- Recognition on Tax Section Annual Meeting handouts
- Recognition on Annual Meeting e-blasts from Tax Section leadership to members of Tax Section

In addition to these valuable benefits, both sponsorships include publicity throughout the year at our program for outstanding young tax lawyers, the Tax Section Leadership Academy. Thus, the sponsorships also provide:

- Recognition at each separate Leadership Academy event, including course materials, posters, and in introductory remarks
- Recognition on Leadership Academy e-blasts and brochures

To discuss this opportunity further, or to reserve a sponsorship, please contact:
Matt Larsen, Vice-Chair, Tax Section Annual Meeting Committee

P: 214.953.6673
E: matt.larsen@bakerbotts.com

Return to Table of Contents

INCOME TAXATION OF TRUSTS AND ESTATES—
THINGS TAX PROFESSIONALS NEED TO KNOW

Mickey R. Davis
DAVIS & WILLMS, PLLC
3555 Timmons Lane, Suite 1250
Houston, Texas 77027
(281) 786-4500
mickey@daviswillms.com

Melissa J. Willms
DAVIS & WILLMS, PLLC
3555 Timmons Lane, Suite 1250
Houston, Texas 77027
(281) 786-4500
melissa@daviswillms.com

INCOME TAXATION OF TRUSTS AND ESTATES—
THINGS TAX PROFESSIONALS NEED TO KNOW

Return to Table of Contents

INCOME TAXATION OF TRUSTS AND ESTATES—THINGS TAX PROFESSIONALS NEED TO KNOW*

I. INTRODUCTION[1]

It is essential for estate planners to have a fundamental understanding of the income taxation of trusts and estates, and of the income tax issues that arise in relation to related-party transactions. The income tax arena presents a multitude of planning opportunities that arise, both during lifetime, and during the administration of a trust or a decedent's estate. The goal of this outline is to focus essential income tax planning issues that arise (i) as a result of intra-family transactions; (ii) immediately before death; and (iii) when administering the estate of a decedent. The outline addresses critical income tax reporting issues that arise for estates and trusts. An exhaustive examination of the issues would result in a book-length outline (or a semester-long course in law school). This outline is intended to hit some of the highlights in the area of income tax planning and reporting for family members, trusts and estates.

II. PRE-DEATH INCOME TAX PLANNING

Discussion of tax planning for an individual with a shortened life expectancy requires considerable diplomacy. Most people faced with their own imminent mortality have a number of issues that are more important to them then minimizing taxes. Nevertheless, under the right circumstances, there are a number of areas that might warrant consideration by persons who have a shortened life expectancy.

A. Capture Capital Losses. If an individual has incurred capital gains during the year, he or she may consider disposing of high basis assets at a loss during his or her lifetime, in order to recognize capital losses to shelter any gains already incurred during the year. As discussed below beginning at page 17, assets the basis of which exceed their fair market value receive a reduced basis at death, foreclosing recognition of these built-in capital losses after death. Moreover, losses recognized by the estate after death will not be available to shelter capital gains recognized by the individual before death. If, on the other hand, the individual has recognized net capital losses, he or she may sell appreciated assets with impunity. Net capital losses are not carried forward to the individual's estate after death, and as a result, they are simply lost. Rev. Rul. 74-175, 1974-1 C.B. 52.

B. Transfer Low Basis Assets to the Taxpayer. Since assets owned by an individual may receive a new cost basis at death, taxpayers may consider transferring low basis assets to a person with a shortened life expectancy, with the understanding that the person will return the property at death by will. This basis "gaming" may be easier in an environment with no estate tax or a substantial estate tax exemption. If the person to whom the assets are initially transferred does not have a taxable estate, substantial additional assets may be transferred, and a new basis obtained thereby, without exposure to estate tax.

1. Gifts Received Prior to Death. Congress is aware that someone could acquire an artificial step-up in basis by giving property to a terminally ill person, receiving it back with a new basis upon that person's death. As a result, the Internal Revenue Code prohibits a step-up in basis for appreciated property given to a decedent within one year of death, which passes from the decedent back to the donor (or to the spouse of the donor) as a result of the decedent's death. IRC § 1014(e). A new basis is achieved only if the taxpayer lives for at least one year after receipt of the property.[2]

---

* Mickey R. Davis and Melissa J. Willms are partners at Davis & Willms, PLLC in Houston, Texas.

[1] This article was derived in part from Theodore B. Atlass, Mickey R. Davis and Melissa J. Willms, "Planning and Administering Estates and Trusts: The Income Tax Consequences You Need to Consider," presented as an ACTEC-ALI Telephone Seminar, May 9, 2013.

[2] For the estate of a person dying in 2010 whose executor opted out of the federal estate tax, the modified carry-over basis rules of Section 1022 extended this look-back period to three years. For those estates, the denial of step-up applied regardless of whether the donor re-inherited the property. IRC § 1022(d)(1)(C)(i). An exception to the three year rule applied to gifts received from the decedent's spouse, unless the spouse acquired the property from another person by gift within the prior three years. IRC § 1022(d)(1)(C)(ii).

Return to Table of Contents

2. Granting a General Power. Rather than giving property to a terminally ill individual, suppose that you simply grant that person a general power of appointment over the property. For example, H could create a revocable trust, funded with low basis assets, and grant W a general power of appointment over the assets in the trust. The general power of appointment will cause the property in the trust to be included in W's estate under Section 2041(a)(2) of the Code. In that event, the property should receive a new cost basis upon W's death. IRC § 1014(b)(9). The IRS takes the position that the principles of Section 1014(e) apply in this circumstance if H reacquires the property, due either to the exercise or non-exercise of the power by W. See PLR 200101021 ("section 1014(e) will apply to any Trust property includible in the deceased Grantor's gross estate that is attributable to the surviving Grantor's contribution to Trust and that is acquired by the surviving Grantor, either directly or indirectly, pursuant to the deceased Grantor's exercise, or failure to exercise, the general power of appointment.", citing H.R. Rept. 97-201, 97th Cong., 1st Sess. (July 24, 1981)). If W were to actually exercise the power in favor of (or the taker in default was) another taxpayer, such as a bypass-style trust for H and their descendants, the result should be different.[3]

C. Transfer High Basis Assets to Grantor Trust. An intentionally defective grantor trust is one in which the grantor of the trust is treated as the owner of the trust property for federal income tax purposes, but not for gift or estate tax purposes. If the taxpayer created an intentionally defective grantor trust during his or her lifetime, he or she may consider transferring high basis assets to that trust, in exchange for low basis assets of the same value owned by the trust. The grantor trust status should prevent the exchange of these assets during the grantor's lifetime from being treated as a sale or exchange. Rev. Rul. 85-13, 1985-1 CB 184. The effect of the exchange, however, will be to place low basis assets into the grantor's estate, providing an opportunity to receive a step-up in basis at death. But for the exchange of these assets, the low basis assets formerly held by the trust would not have acquired a step-up in basis as a result of the grantor's death. At the same time, if the grantor transfers assets with a basis in excess of fair market value to the trust, those assets will avoid being subject to a step-down in basis at death. Since the grantor is treated for income tax purposes as the owner of all of the assets prior to death, the one-year look-back of Section 1014(e) of the Code should not apply to limit the step-up in basis of the exchanged assets.

D. Change Marital Property Characteristics. For married clients living in community property jurisdictions, and for clients living in common law jurisdictions that have otherwise acquired community property, the clients may consider a modification of the marital property character of assets, if consistent with their dispositive scheme.

1. Partition Depreciated Community Property. If a married couple owns community property that is worth less than its basis, both halves of the community property will receive a step-down in basis upon the death of the first spouse to die. IRC § 1014(b)(6).[4] Partitioning these assets into separate property will limit the loss of basis to only the deceased spouse's half of the assets. Additional basis could be preserved by having the terminally ill spouse transfer loss assets to his or her spouse in exchange for low-basis assets. No gain or loss should be recognized from the exchange of those assets. IRC § 1041(a).

2. Transmute Appreciated Separate Property. If local law permits the creation of community property by agreement, the couple should consider transmuting the healthy spouse's low-basis separate property into community property so that both halves of the property may receive a step-up in basis at death. IRC § 1014(b)(6).[5]

---

[3] For estates of persons dying in 2010 whose executors opted out of the federal estate tax, simply holding a general power of appointment over property would not be sufficient to cause the property to be treated as being "owned by the decedent" as required by the modified carry-over basis rules in Section 1022 of the Code. As a result, no part of the decedent's basis allocation could be used to increase the basis of these assets. IRC § 1022(d)(1)(B)(iii).

[4] For estates of decedents dying in 2010 whose executors opted out of the federal estate tax, this same result arose under Section 1022(a)(2)(B) because the decedent was deemed to own the spouse's half of the community property. IRC § 1022(d)(1)(B)(iv); Rev. Proc. 2011-41. 2011-35 IRB 188, § 4.05.

[5] For estates of decedents dying in 2010 whose executors elected out of the federal estate tax, the surviving

E. Dispose of Passive Loss Assets. If an individual has assets that have generated passive loss carry-overs, he or she may wish to dispose of those assets prior to death, so that the losses can be deducted. The losses may otherwise be lost at death to the extent of any increase in the asset's basis. IRC § 469(g). In addition, the IRS may take the position that the decedent's estate or trust does not materially participate in the activity after the client's death. See the discussion of this issue at page 9 below. Note, however, that the transfer of a passive-activity asset by lifetime gift does not trigger recognition of suspended passive activity losses for the donor. IRC § 469(j)(6). Rather, any suspended passive activity losses attributable to a gifted asset are added to the donee's adjusted cost basis. This addition to basis provides some benefit the donee, although to the extent it causes basis to exceed the fair market value of the property at the time of the gift, will not benefit the donee in a loss transaction. To illustrate this limitation, assume that a donor has an asset with a fair market value of $100, an adjusted cost basis of $70, and a suspended passive activity loss of $40. When the asset is gifted, the donee will have a $100 basis for loss purposes and a $110 basis for gain purposes. IRC § 1015(a).

F. Pay Medical Expenses. It is not unusual for persons with a terminal condition to incur substantial medical expenses in the year of their demise. These medical expenses may be deductible for federal income tax purposes if they exceed 7.5% of the taxpayer's adjusted gross income. IRC § 213(a). This threshold may be easier to meet in the year of the decedent's death, especially if the decedent dies early in the year before earning significant AGI, since there is no requirement to annualize income or make other adjustments to reflect a "short" year. Treas. Reg. § 1.443-1(a)(2). Expenses outstanding at the date of death, if paid within one year after the date of death, may be deducted on the decedent's final income tax return, or may be deducted as a debt on the decedent's estate tax return. IRC § 213(c)(1). A "double" deduction is disallowed. IRC § 213(c)(2). Note, however, that if the taxpayer actually pays outstanding medical expenses prior to death, they are eligible for deduction on his or her income tax return. At the same time, the individual's cash has decreased as a result of the payment, which has the same effect as deducting them on the estate tax return, since the decedent's estate is effectively decreased by the amount of the expenses paid. Even paying the medical expense by credit card prior to death should be sufficient to allow this double tax benefit. *See* Rev. Rul. 78-39, 1978-1 CB 73.

G. Accelerate Death Benefits. If a taxpayer is covered by a policy of life insurance, the taxpayer may seek to obtain a pre-payment of the death benefits available under the policy. If the payments are received at a time when the taxpayer is terminally ill or chronically ill, the payments may be excluded from gross income. IRC § 101(g). The exclusion for prepayment of death benefits applies only to payments received from the insurance company that issued the policy, or from certain licensed "viatical settlement providers." A "viatical settlement" is a transaction in which a third party purchases the policy from the insured.

1. Payments to Terminally Ill Taxpayers. If the insured is terminally ill, payments are tax-free. This exclusion from income applies to both accelerated death benefits and to payments made by a viatical settlement provider (but only if the provider meets licensing or other requirements). IRC § 101(g). For this purpose, a "terminally ill" individual is one who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 24 months or less. IRC § 101(g)(4)(A).

2. Payments to Chronically Ill Taxpayers. If the insured is chronically ill, payments are tax-free only if detailed requirements are met. For example, the payment must be for costs incurred for qualified long-term care services. These costs include both medical services and maintenance or personal care services provided under a prescribed plan of care. Also, the payment must not be for expenses reimbursable under Medicare, other than as a secondary payor. IRC § 101(g)(3). A person is considered "chronically ill" if he or she is unable to perform, without "substantial assistance," at least two activities of daily living for at least 90 days due to a loss of functional capacity. See IRC §§ 101(g)(4)(B);

---

spouse's share of the community property was deemed to be owned by and acquired from the decedent pursuant to Section 1022(d)(1)(B)(iv) of the Code, and as a result, was eligible for the $3 million spousal property basis increase. IRC § 1022(c); Rev. Proc. 2011-41. 2011-35 IRB 188, § 4.01.

7702(c)(2)(A). The exclusion for chronically ill taxpayers is subject to a per-diem cap ($300 per day, or $109,500 per year for 2011). IRC §§ 101(g)(3)(D); 7702B(d); Rev. Proc. 2010-40, 2010-46 IRB 663 § 3.29.

III. INCOME TAXATION OF DECEDENTS AND ESTATES

A. The Decedent's Prior Tax Returns. Upon the death of an individual, the personal representative should determine which income tax returns have or have not been filed by the decedent, and examine those returns, in order to ascertain whether all required returns have been properly filed.

1. Ascertaining What Tax Returns Have Been Filed. The IRS can provide information about whicht tax returns have been filed by the decedent. The executor should make a written request for a "Record of Account" from the appropriate region. The executor's letters of appointment (and a Form 2848 Power of Attorney if the executor's attorney is to get the information) should be included with the request. The IRS response will be supplied free of charge. Call 1-800-829-1040 for details.

2. Ascertaining the Amount of the Decedent's Income. The executor may not be certain that he or she has information concerning all of the decedent's income relating to years for which the executor will file income tax returns on behalf of the decedent. It may be necessary to request in writing "All Information Returns" (you should be as specific as possible) in writing from the appropriate region. Information is available after August 1st relating to the prior year, and six years' worth of information is kept in the IRS computers. Again, the executor's letters of appointment (and a Form 2848 Power of Attorney if the executor's attorney is to get the information) should be included with the request. The IRS response will be supplied free of charge. The executor can call 1-800-829-1040 for details.

3. Getting Copies of Prior Filed Tax Returns. The executor can obtain copies of prior income tax returns filed by the decedent from the IRS via Form 4506. Consider requesting at the same time copies of gift tax returns filed by the decedent. Be sure to make your request to the proper region or district, based upon where the decedent filed the returns in question. The executor's letters of appointment (and a Form 2848 Power of Attorney if the executor's attorney is to get the information) should be included with the request. The IRS response will require a fee ($57 per return the last time the authors checked).

4. Contact Area Disclosure Officer. Any questions concerning what information is available from the IRS, or procedurally how to get at that information, should be directed to the IRS Area Disclosure Officer. Personnel in this office are generally very knowledgeable and helpful with regard to these matters

B. The Decedent's Final Return. Upon the death of an individual, a final income tax return must be filed. In fact, depending upon the date of death, there may be two returns required for the decedent–one for the last full calendar year of the decedent's life, if that return was not yet filed as of the date of death, and one final return for the year of the decedent's death. Only this last return is the "final" return. The final return of the decedent includes items of income and deductions actually or constructively received or paid (assuming the decedent was on a cash basis) by the decedent prior to death. Treas. Reg. § 1.451-1(b). The responsibility for preparing and filing the decedent's final income tax return rests with the personal representative of the estate. Treas. Reg. § 1.6012(b)(1).

1. Due Date, Filing Responsibilities, and "Short Year" Issues. A decedent's final return is due on the regular return date, typically April 15th of the year following the date of death. Treas. Reg. § 1.6072-1(b). The executor need not make adjustments to reflect a "short" year. Treas. Reg. § 1.443-1(a)(2). Apparently, the personal representative need not make further estimated tax payments on behalf of the decedent. Although Code Section 6153, which formerly dealt with estimated payments, has been repealed and replaced by Code Section 6654, the IRS has privately ruled that the principles set forth in Treasury Regulation Section 1.6153-1(a)(4) (which exempted estates from making estimated payments) continue to apply to Section 6654 (for which there are no relevant regulations). PLR 9102010. Estates (and certain post-death revocable trusts) are exempt from the requirement to make estimated tax payments for two years. IRC § 6654(*l*)(2). While the surviving spouse must generally continue to make estimated payments, there is no longer any requirement to file an amended declaration of payments. *See* former

IRC § 6015. The executor of the estate is responsible for paying the decedent's income tax liability. The distributee may also be held liable. IRC § 6901. If no executor is appointed, the term "executor" means any person in actual or constructive possession of any property of the decedent. IRC § 2203. The executor faces personal liability if he distributes the estate prior to paying tax obligations of which he had notice, or with respect to which he failed to exercise due diligence. Treas. Reg. § 1.641(b)-2(a); IRC § 6012(b)(1).

2. "Fiduciary Liability". Pursuant to the concept of "fiduciary liability," the executor is personally liable for the income and gift tax liability of the decedent, at least to the extent that assets of the decedent come within the reach of such executor. 31 U.S.C. § 3713(b). Fiduciary liability may be personally imposed on every executor, administrator, assignee or "other person" who distributes the living or deceased debtor's property to other creditors before he satisfies a debt due to the United States.

a. Insolvency of Estate. Fiduciary liability is imposed only when, by virtue of the insolvency of a deceased debtor's estate or of the insolvency and collective creditor proceeding involving a living debtor, the priority of 31 USC § 3713(a) is applicable.

b. Limited to Distributions. The fiduciary's liability is limited to debts (or distributions) actually paid before the debt due to the United States is paid.

c. Knowledge Required. The fiduciary must know or have reason to know of the government's tax claim.

d. Deferring Distributions. Fiduciaries will frequently delay making distributions until they are no longer liable for the decedent's income tax and estate tax liabilities. Refunding agreements with beneficiaries and state law provisions allowing fiduciaries to get back prior distributions to settle estate liabilities are sometimes relied upon , but require that the beneficiary still have the funds to refund to the estate.

3. Transferee Liability. Transferee liability may make the transferee: (1) of property of a taxpayer personally liable for income taxes, (2) of property of a decedent personally liable for estate taxes, and (3) of property of a donor personally liable for gift taxes. IRC § 6901.

a. Transferee Liability at Law. Transferee liability at law exists under Section 6901 of the Code if the government can prove: (1) the taxpayer transferred property to another person; (2) at the time of the transfer and at the time transferee liability is asserted, the taxpayer was liable for a tax; (3) there is a valid contract between the taxpayer who is the transferor and the transferee; and (4) under the terms of that contract, the transferee assumed the liabilities of the taxpayer, including the obligation to pay the tax or specifically the obligation to pay the taxes of the transferor.

b. Transferee Liability in Equity. Transferee liability at equity exists under Code Section 6901 if the government can prove: (1) the taxpayer transferred property to another person; (2) at the time of the transfer and at the time transferee liability is asserted, the taxpayer was liable for the tax; (3) the transfer was made after liability for the tax accrued, whether or not the tax was actually assessed at the time of the transfer; (4) the transfer was made for less than full or adequate consideration; (5) the transferor was insolvent at the time of the transfer or the transfer left the transferor insolvent; and (6) the government has exhausted all reasonable efforts to collect the tax from the taxpayer transferor before proceeding against the transferee.

4. Priority of Tax Claims. In a probate setting, the state law rules relating to the time and place for filing claims do not apply to the tax claims of the United States. *Board of Comm'rs of Jackson County v. U.S.*, 308 US 343 (1939); *U.S. v. Summerlin*, 310 US 414 (1940). Federal law generally provides that a debt due to the United States be satisfied first whenever the estate of a deceased taxpayer/debtor is insufficient to pay all creditors. 31 USC § 3713(a). Although no exceptions are made in Section 3713(a) of the Revised Statutes for the payment of administration expenses, the IRS nevertheless appears to recognize exceptions for administration expenses, funeral expenses, and widow's allowance. GCM 22499, 1941-1 CB-272; Rev. Rul. 80-112. 1980-1 CB 306.

Return to Table of Contents

5. Claims for Refund.

a. Time for Filing. A tax refund claim must generally be filed within three years from the time the related return was filed or two years from the time the tax was paid, whichever of such periods expires later, or if no return was filed, within two years from the time the tax was paid. IRC § 6511(a). Special rules extend the time for filing a claim for refund in cases where the period for assessing tax has been extended and in other cases. IRC '§ 6511(c); 6511(d). Equitable mitigation provisions exist that may be useful in cases where a refund or credit would otherwise be barred by the applicable statute of limitations. See IRC '§ 1311-1314; 1341.

b. Informal Claims. In estates with no formal need for administration, a surviving spouse, heir, or another person agreeing to pay out the refund according to the laws of the state where the decedent was a legal resident may claim any refund owed to the decedent by filing IRS Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer.

6. Place for Filing Decedent's Final Return. The final Form 1040 should normally be filed in the Internal Revenue District in which the legal residence or principal place of business of the person making the return is located (i.e., based upon where the executor is located, which is *not* necessarily where the decedent filed his or her returns), or at the service center serving such internal revenue district. IRC § 6091(b)(1)(A); Treas. Reg. § 1.6091-1(a). If the person filing the return has no legal residence or principal place of business in any Internal Revenue District, the return should be filed with the District Director, Internal Revenue Service, Baltimore, Maryland, 21202, except as provided in the case of returns of taxpayers outside the United States. Treas. Reg. § 1.6091-2(a). The return made by a person outside the United States having no legal residence or principal place of business in any Internal Revenue District should be filed with the Director of International Operations, Internal Revenue Service, Washington, D.C. 20225, unless the legal residence or principal place of business of that person, or the principal place of business or principal office or agency of such corporation, is located in the Virgin Islands or Puerto Rico, in which case the return shall be filed with the Director of International Operations, U.S. Internal Revenue Service, Hato Rey, Puerto Rico 00917. Treas. Reg. § 31.6091-1(c).

7. Applicable Statute of Limitations. Income tax must normally be assessed within three years after the related return was filed, whether or not such return was timely filed. IRC § 6501(a). The normal three year income tax statute of limitations is extended to six years if the taxpayer makes a substantial omission (in excess of 25%) of the amount of gross income shown on the return. IRC § 6501(e)(1). There is no limit on the statute of limitations where a false return was filed, there is a willful attempt to evade tax, or no return was filed. IRC § 6501(c). The normally applicable statute of limitations is extended as to transferees–for one year in the case of the initial transferee, and as to transferees of transferees, for as much as three years after the expiration of the period of limitations for assessment against the initial transferor. IRC § 6901(c). The taxpayer and government can agree to indefinitely extend an income tax (but not estate tax) statute of limitations prior to the expiration of the statute. IRC § 6501(c)(4).

a. Requests for Prompt Assessment. The executor may shorten to 18 months the period of time for the IRS to assess additional taxes on returns previously filed by the decedent or the executor by separately filing Form 4810. Treas. Reg. § 301.6501(d)-1(b). It is not believed that this increases the audit exposure on such returns.

b. Requests for Discharge from Personal Liability. The executor may request a discharge from personal liability for estate, income and gift tax liabilities of the decedent (which gives the IRS nine months to collect such taxes from the executor) by making a request for such a discharge (Form 5495) pursuant to Code Sections 2204 (as to estate tax), or 6905 (as to income and gift tax). This request does not shorten the statute of limitations (i.e., the IRS could still assert the tax due by pursuing the assets, transferees, etc.), and it is not believed that this increases the audit exposure on such returns.

8. Filing Joint Returns. The personal representative has the option to file a separate return for the decedent, or to file a joint return with the surviving spouse, provided that the surviving spouse has not remarried prior to the end of the survivor's tax year. IRC § 6013. A joint return may not be filed if either

of the spouses is a nonresident alien at any time during the taxable year. IRC § 6013(a)(1). If no executor has been appointed by the due date of the decedent's final return, the surviving spouse may file the joint return alone. If an executor is subsequently appointed, however, the executor may revoke the surviving spouse's election to file a joint return by filing a separate return for the decedent's estate within one year from the due date of the return, including extensions. IRC § 6013(a)(3).

a. Apportionment of Tax. The joint return will report the decedent's income through the date of death, and the spouse's income for the entire year. The income tax liability between the executor and surviving spouse is apportioned as they agree, or if there is no agreement, as provided by local law. *See* Treas. Reg. § 20.2053-6(f).

b. Joint and Several Liability. The executor, when considering whether to file a joint return with a surviving spouse, must consider not only the possibility of saving income taxes, but also the liability associated with the election. By filing a joint return, the executor becomes jointly and severally liable with the surviving spouse for the taxes and penalties associated with the return. IRC § 6013(d)(3). The executor may thereby be adopting a significant risk of unknown tax liabilities. It is currently unsettled whether the "innocent spouse" rule applies in this context. Many wills expressly authorize the executor to file a joint return with the spouse on the theory that the benefits of any resulting tax reduction outweigh any detriment of joint and several liability.

c. Available AMT Exemption Amount. For the year of the decedent's death and the succeeding two tax years, a "surviving spouse," as defined in Section 2(a) of the Code, is entitled to an AMT exemption of $78,750, reduced by 25% of any excess of AM1 over $150,000 (rather than the normal AMT exemption applicable to single persons of $50,600, reduced by 25% of any excess AM1 over $112,500). IRC §§ 55(d); 55(d)(3).

9. Planning Opportunities on the Final Return. Prior to the end of the tax year of the surviving spouse, several planning opportunities are presented.

a. Using Expiring Losses. The decedent's portion of net operating losses and capital losses can offset income and capital gains of the surviving spouse arising after death. The surviving spouse should be advised to examine opportunities to accelerate recognition of income sheltered by these losses. If not used prior to the end of the year in which the decedent dies, the net operating losses and capital losses are lost. If an NOL arises from a net business loss appearing on the decedent's final return, the NOL may be carried back to previous years. IRC § 172(b)(1)(A)(i). Since the estate is a separate taxpayer, however, the decedent's estate cannot carry over the decedent's net operating losses and capital losses. Rev. Rul. 74-175, 1974-1 C.B. 52.

b. Reporting Savings Bond Interest. A taxpayer may elect to report all previously unreported Series E or EE Bond interest and thereafter report all Series E or EE Bond Interest as it is accrued. IRC § 454(a). The executor may make this election on behalf of the decedent on the final Form 1040. Rev. Rul. 68-145, 1968-1 C.B. 203. The executor may also make this election for bonds held in the decedent's revocable trust at the time of death. Rev. Rul. 79-409, 1979-2 C.B. 208. If the Section 454(a) election is not made, interest will be taxable as income in respect of a decedent ("IRD") to the ultimate recipient. If the interest is IRD, a deduction is available under Section 691(c) for any estate tax attributable to the interest. Rev. Rul. 64-104, 1964-1 C.B. 223. If the Section 454(a) election is made, no Section 691(c) deduction will be applicable, but a deduction for federal estate tax purposes will be generated for the amount of the income tax created on the decedent's final return. Ltr. Rul. 9232006. If federal estate tax is due, making the Section 454(a) election will generally lower the overall tax liability.

c. Partnership and S Corporation Income. If the decedent was a partner or S corporation shareholder, the method of determining the decedent' share of the entity's income may have a substantial effect on the final return. For example, if a substantial portion of partnership or S corporation income is received in a month of the entity's taxable year after the date of death, a portion of the disproportionately high post-mortem partnership income can be shifted to the decedent's final return by making an election to prorate the income on a daily basis. Conversely, if a disproportionately large portion of the partnership

Return to Table of Contents

or S corporation income was received prior to the date of the decedent's death, more income can be bunched into the decedent's final return by using a "closing of the books" method to allocate the income between the pre-death and post-death periods. The allocation of partnership income for a short year is made by an interim closing of the partnership's books unless the partners agree to allocate income on per diem or other reasonable basis. *See* Treas. Reg. § 1.706-1(c)(2)(ii). Conversely, an S corporation shareholder's final return must include the decedent's pro rata share of the S corporation's income for the year on a per diem basis. IRC § 1377(a)(1). If all the shareholders agree, the allocation for the short year is made by an interim closing of the books. IRC § 1377(a)(2). For a more complete discussion of issues that arise when estates hold interests in flow-through entities, see the material beginning at page 42 below.

d. Accelerating Installment Gain. If the decedent participated in an installment sale in the year of death, the executor may decide to elect out of the installment method. IRC § 453(d). Electing out of the installment method would cause the gain to be taxed on the decedent's final return (thereby creating an estate tax deduction for the resulting income tax liability). The election would preclude IRD recognition after death as the note is collected (or if the installment note is later cancelled or forgiven).

e. Passive Activity Losses. Congress enacted the passive activity loss ("PAL") rules to limit a taxpayer's ability to offset non-passive sources of income (active income, such as salary, and portfolio income, such as dividends and interest) with losses from passive sources (such as rental real estate). Generally, if an activity generates passive losses, the taxpayer owning the activity can only deduct those losses against income from other passive activities, or upon the disposition of the activity. IRC §§ 469(d), (f). The death of the owner of a passive activity does constitute a "disposition" of that activity for purposes of the loss recognition rules. IRC § 469(g). However, a deduction is allowable on the decedent's final Form 1040 only to the extent that the suspended passive activity loss exceeds the step-up in basis allocated to activity. IRC § 469(g)(2). To illustrate this rule, assume that the decedent had an asset having a fair market value at the death of $100, and adjusted basis before death of $60. Assume also that the decedent had a suspended passive activity loss of $50. The basis of the asset is stepped up by $40 to its $100 fair market value at the decedent's death. As a result, only a $10 loss (i.e., the $50 suspended loss, less the $40 basis step-up at death) is deductible on the decedent's final Form 1040.[6]

C. The Estate's Income Tax Return.

1. Obtaining an Employer Identification Number. The executor must obtain an employer identification number for the estate. Payers of interests, dividends and other income items should be notified of the estate's employer identification number so that these items of income can be accurately attributed to the estate. An executor may obtain a number by filing Form SS-4. Alternatively, the number may be obtained online at: https://sa1.www4.irs.gov/modiein/individual/index.jsp.

2. Notifying the IRS of Fiduciary Status. The executor (or if none, the testamentary trustee, residuary legatee(s), or distributee(s)) should file with the IRS a Notice Concerning Fiduciary Relationship (Form 56). This form puts the IRS on notice that the executor has been appointed to handle the decedent's affairs, and apprizes the IRS of the proper address to which correspondence regarding the decedent's tax matters may be directed. IRC § 6903; Treas. Reg. §§ 601.503; 301.6903.

a. A short-form certificate or authenticated copy of letters testamentary or letters of administration showing that the executor's authority is still in effect at the time the Form 56 is filed, otherwise an appropriate statement by the trustee, legatee, or distributee, should accompany the Form 56. *Id.*

b. The Form 56 must be signed by the fiduciary and must be filed with the IRS office where the return(s) of the person for whom the fiduciary is acting must be filed. Treas. Reg. §§ 301.6903-1(b).

c. Written notice of the termination of such fiduciary relationship (on Form 56) should also be filed with the same office of the IRS where the initial Form 56 was filed. The notice must state the name and

[6] This initial basis adjustment would not apply to estates of decedents dying in 2010 whose executors opted out of the estate tax and who elected not to allocate $40 of basis to the asset under Section 1022.

address of any substitute fiduciary and be accompanied by satisfactory evidence of termination of fiduciary relationship. *Id*.

3. Electing a Fiscal Year End. Unlike an individual or a trust, an estate may elect to adopt a year end other than December 31. The only requirements are that the fiscal year must end on the last day of a month, and that the first year does not exceed 12 months. IRC § 441(e); Treas. Reg. § 1.441-1(a).

a. Available to Estates and Electing Trusts. Although the option to elect a fiscal year end does not generally apply to trusts, a revocable trust may elect to be treated as part of the estate and not as a separate trust. If the election is duly made, it applies for all taxable years of the estate beginning the day after the date of decedent's death and ending (1) two years after the date of death if no estate tax return is required, or (2) six months after the date of final determination of estate tax liability if an estate tax return is required. IRC § 645.

b. Method of Election. The election is made on the first income tax return filed by the estate Although IRS Form SS-4 asks for the taxpayer's fiscal year end, as does an Application for Extension of Time to File, the filing of those forms does not establish the fiscal year end for the entity. The election must be made by the due date of the return. Therefore, the decision may be made several months after the end of the month selected. IRC §§ 441, 443(a)(2), 6072(a); Treas. Reg. § 1.441-(c)(1).

c. Reasons for Adopting Fiscal Year Ends. By adopting a non-calendar year end, an estate (or electing trust) can accomplish a number of objectives.

(1) Deferral, Income Splitting and Expense Matching. For example, adoption of a fiscal year end for the estate of a decedent who dies in November 2012 would permit deferral of any income tax due from April 15, 2013 until February 15, 2014 (if an October 31 fiscal year end were selected). By adopting a very short first fiscal year, the estate may be able to split substantial income arising immediately after death (such as the collection of IRD) into two separate years, thereby taking advantage of two uses of the estate's lower marginal brackets (although the compression of rate brackets for estates substantially reduces the benefit of this strategy). Selecting a long first fiscal year may serve to permit enough time to pass for the estate to generate deductions (e.g., the payment of fees) to offset estate income. Alternatively, selection of a fiscal year end may allow substantial excess deductions taken in a last short year to be taken by the estate's beneficiaries. IRC § 642(h).

(2) Deferral for Recipients of DNI. As discussed in the next section, when an estate makes a distribution, that distribution will generally carry out the estate's distributable net income to the distributee, causing the estate beneficiary to pay tax on any taxable income earned by the estate, to the extent of the distribution. If the tax year of the estate and the beneficiary differ, the beneficiary reports taxable DNI not when actually received, but as though it had been distributed on the last day of the estate's tax year. IRC § 662(c). Therefore, if an estate selects a fiscal year end other than December 31, its beneficiaries may defer reporting of income. For example, if an estate selects a January 31 year end, all distributions made from, say February 2013 through January 31, 2014 will be treated as being received by the beneficiary on January 31, 2014. Thus, a beneficiary who actually receives a distribution in February 2013 could defer paying the tax thereon until April 15, 2015 (the due date of the beneficiary's 2014 tax return), more than two years after receipt. Deferral in the first year may result in a bunching of income in the final year of the estate. If the estate in the foregoing example terminated on December 31, 2014, the beneficiary would include 23 months worth of estate income (February 2013 through December 2014) on the beneficiary's tax return for 2014. Bunching can be offset by deferring expenses into the last year of the estate, and by keeping the estate's last fiscal year as short as possible, to generate excess deductions for the beneficiary under Section 642(h)(2) of the Code.

4. Passive Activity Losses. A passive activity involves the conduct of a trade or business in which the taxpayer does not materially participate. IRC § 469(c)(1). While IRS regulations spell out seven ways in which an individual can materially participate, there are no regulations addressing how an estate or trust materially participates. The regulations suggest that the capacity in which one participates does not matter. Treas. Reg. § 1.469-5(a)(1). The legislative history, however, says that "an estate or trust is

materially participating in any activity . . . if an executor or fiduciary, *in his capacity as such*, is so participating." S. Rep. No. 99-313, 99th Cong., 2d Sess. 735 (1986) (emphasis added). In *Mattie K. Carter Trust V. U.S.*, 91 AFTR 2d 2003-1946 (N.D. Tex. 2003), a case of first impression that addresses what activities can qualify as material participation under the passive loss rules for trusts and estates, the IRS took the position that only the trustee's activities, in his capacity as trustee, could be used to test material participation. The taxpayer argued instead that because the trust (not the trustee) is the taxpayer, material participation in the ranch operations should be determined *by assessing the activities of the trust* through its fiduciaries, employees, and agents. The court agreed with the taxpayer's position, based on an interpretation of the statute itself. Section 469 states that a "taxpayer" is treated as materially participating in a business if "its" activities in pursuit of that business are regular, continuous, and substantial. IRC § 469(h)(1). Therefore, the court ruled that participation must be tested by the activities of the trust itself, which necessarily entails an assessment of the activities of those who labor on the ranch, or otherwise in furtherance of the ranch business, on behalf of the trust. Although the legislative history quoted above might have suggested otherwise, the court noted that legislative history has no application where the statutory language is clear. Furthermore, the court concluded that the activities of the trustee alone were also sufficient to constitute material participation. The IRS continues to advance its view that the actions of the trustee are controlling. For example, in Technical Advice Memorandum 200733023, the IRS, relying primarily on the legislative history, held that notwithstanding the decision in *Mattie K. Carter Trust*, the sole means for a trust to establish material participation was by its fiduciaries being involved in the operations. *See also* TAM 201317010 ("special" trustee of two trusts holding S corporation stock who also served as president of S corporation didn't materially participate on behalf of trust since trustee's non-fiduciary activities are excluded from consideration).

5. Allocating Depreciation. Like an individual, a trust or an estate is entitled to an income tax deduction for depreciation, depletion, and amortization. However, there are special rules in allocating the deduction between the estate (or trust) and the beneficiaries. IRC § 642(e). For an estate, the deductions for depreciation and depletion are apportioned between the estate and beneficiary based on the amount of state law accounting income allocable to each. IRC §§ 167(d), 611(b)(4). For a trust, the depreciation and depletion deductions are apportioned between the trust and beneficiaries in accordance with the terms of the trust agreement. Therefore, if the trust agreement or state law requires or permits the trustee to maintain a reserve for depreciation or depletion, the deduction is allocated first to the trust to the extent that income is set aside for the reserve. If the trust agreement (or local law) is silent on this issue, the deduction is apportioned between the trust and beneficiaries on the basis of "income" allocable to each. IRC §§ 167(d), 611(b)(3). The fiduciary allocates the depreciation, depletion, and amortization deductions using the allocation procedures described above. After those calculations have been made, the fiduciary computes taxable income of the trust or estate by deducting only the portion of the depreciation, depletion and amortization deductions that have not been allocated to the beneficiaries. IRC §§ 642(e), 642(f), 167(d), 611(b). If authorized by local law or under the terms of the governing instrument, a fiduciary may establish a reserve for depreciation or depletion. Doing so effectively reduces receipts that would otherwise be treated as income of the estate or trust, allocated them instead to corpus. Section 179 of the Code allows businesses to expense depreciable personal property within certain limits, which limits have become much more generous in recent years. *See* Stevens, "Section 179's Special Pass-Through Entity Rules," BUSINESS ENTITIES (July/August 2010). As Steve Gorin has noted, however, a trust cannot deduct this special Section 179 expense that flows through on its K-1 from a partnership or S corporation. IRC § 179(d)(4). The business entity does not reduce its basis in, and may depreciate, this depreciable property to the extent that this deduction is disallowed. Treas. Reg. § 1.179-1(f)(3). Because the regulation specifically refers to S corporations, presumably this regulation overrides the general rule that all S corporation shareholders are taxed the same; the only way to give effect to this regulation would appear to make a special allocation of depreciation expense to the trust or estate. Presumably, this complexity would be avoided by using a grantor trust. Rev. Rul. 85-13, 1985-1 CB 184; *see also* Rev. Rul. 2007–13, 2007-11 IRB 684.

D. Ten Things Estate Planners Need to Know About Subchapter J. With apologies to David Letterman, here is our own personal list of the top ten income tax issues that every estate planner should know. We

Return to Table of Contents

don't pretend to present them in order of importance (or, for that matter, in any particular order). There are certainly other income tax issues that merit consideration. Mastery of these ten, however, should give an estate planner a good background in fundamental income tax issues that arise in the estate planning and administration context. Most estate planners think of an inheritance as being free from income tax. IRC § 102(a). Nevertheless, We start our "top ten list" with four important income tax issues that arise when estate assets are distributed. These areas are the carry-out of estate income; the recognition of gain by the estate at the time of funding certain gifts; the impact upon beneficiaries of making unauthorized non-pro rata distributions of assets in kind; and the impact of distributing IRD assets. The income tax effect of estate distributions is an important area both in terms of language included in the governing instrument and the steps taken and elections made by the executor in the administration of the estate.

1. Estate Distributions Carry Out Distributable Net Income. The general rule is that any distribution from an estate will carry with it a portion of the estate's distributable net income ("DNI"). Estate distributions are generally treated as coming first from the estate's current income, with tax free distributions of "corpus" arising only if distributions exceed DNI. If distributions are made to multiple beneficiaries, DNI is generally allocated to them pro rata.

> **Example 1:** Assume that A and B are beneficiaries of an estate worth $1,000,000. During the year, the executor distributes $200,000 to A and $50,000 to B. During the same year, the estate earns income of $100,000. Unless the separate share rule discussed at page 12 below applies, the distributions are treated as coming first from estate income, and are treated as passing to the beneficiaries pro rata. Therefore, A will report income of $80,000 ($100,000 x ($200,000/$250,000)); B will report income of $20,000 ($100,000 x ($50,000/$250,000)). The estate will be entitled to a distribution deduction of $100,000. If the estate had instead distributed only $50,000 to A and $25,000 to B, each would have included the full amount received in income, the estate would have received a $75,000 distribution deduction, and would have reported the remaining $25,000 as income on the estate's income tax return.

If the tax year of the estate and the beneficiary differ, the beneficiary reports taxable DNI not when actually received, but as though it had been distributed on the last day of the estate's tax year. IRC § 662(c). Section 663(b) of the Code permits complex trusts to treat distributions made during the first 65 days of the trust's tax year as though they were made on the last day of the preceding tax year. This election enables trustees to take a second look at DNI after the trust's books have been closed for the year, to shift income out to beneficiaries. The Taxpayer Relief Act of 1997 extended the application of the 65 day rule to estates for tax years beginning after August 5, 1997. As a result, for example, the executor of an estate can make distributions during the first 65 days of Year 2, and elect to treat them as though they were made on the last day of the estate's fiscal Year 1. If the executor makes this election, the distributions carry out the estate's Year 1 DNI, and the beneficiaries include the distributions in income as though they were received on the last day of the estate's Year 1 fiscal year.

The general rule regarding DNI carry-out is subject to some important exceptions.

a. Specific Sums of Money and Specific Property. Section 663(a)(1) of the Code contains a special provision relating to gifts or bequests of "a specific sum of money" or "specific property." If the executor pays these gifts or bequests all at once, or in not more than three installments, the distributions will effectively be treated as coming from the "corpus" of the estate. As a result, the estate will not receive a distribution deduction for these distributions. By the same token, the estate's beneficiaries will not be taxed on the estate's DNI as a result of the distribution.

(1) Requirement of Ascertainability. In order to qualify as a gift or bequest of "a specific sum of money" under the Treasury Regulations, the amount of the bequest of money or the identity of the specific property must be ascertainable under the terms of the governing instrument as of the date of the decedent's death. In the case of the decedent's estate, the governing instrument is typically the decedent's Will or revocable trust agreement.

(2) Formula Bequests. Under the Treasury Regulations, a marital deduction or credit shelter formula bequest *does not* usually qualify as a gift of "a specific sum of money." The identity of the property and the exact sum of money specified are both dependent upon the exercise of the executor's discretion. For example, if the executor elects to deduct administration expenses on the estate's income tax return, the amount of the formula marital gift will be higher than if those expenses are deducted on the estate tax return. Since the issues relating to the final computation of the marital deduction or credit shelter bequest cannot be resolved on the date of the decedent's death, the IRS takes the position that these types of bequests will not be considered "a specific sum of money." Treas. Reg. § 1.663(a)-1(b)(1); Rev. Rul. 60-87, 1960-1 C.B. 286. Thus, funding of formula bequests whose amounts cannot be ascertained at the date of death *does* carry out distributable net income from the estate.

(3) Payments from Current Income. In addition, amounts that an executor can pay, under the express terms of the Will, only from current or accumulated income of the estate will carry out the estate's distributable net income. Treas. Reg. § 1.663(a)-1(b)(2)(i).

(4) Distributions of Real Estate Where Title has Vested. The transfer of real estate does not carry out DNI when conveyed to the devisee thereof if, under local law, title vests immediately in the distributee, even if subject to administration. Treas. Reg. § 1.661(a)-2(e); Rev. Rul. 68-49, 1968-1 C.B. 304. State law may provide for immediate vesting either by statute or by common law. *See, e.g,* Tex. Ests. Code § 101.001; *Welder v. Hitchcock,* 617 S.W.2d 294, 297 (Tex. Civ. App.– Corpus Christi 1981, writ ref'd n.r.e.). Therefore, a transfer by an executor of real property to the person or entity entitled thereto should not carry with it any of the estate's distributable net income. Presumably, this rule applies both to specific devisees of real estate and to devisees of the residue of the estate. Otherwise, the no-carry-out rule would be subsumed within the more general rule that specific bequests do not carry out DNI. Rev. Rul. 68-49, 1968-1 C.B. 304. Note, however, that the IRS Office of the Chief Counsel has released an IRS Service Center Advice Memorandum (SCA 1998-012) which purports to limit this rule to specifically devised real estate (not real estate passing as part of the residuary estate) if the executor has substantial power and control over the real property (including a power of sale).

b. The Separate Share Rule. Generally, in the context of estate distributions made to multiple beneficiaries, DNI is carried out pro rata among the distributees of the estate. For example, in a year in which the estate has $10,000 of DNI, if the executor distributes $15,000 to A and $5,000 to B, A will include $7,500 of DNI in his income, and B will include $2,500 in his income, since the distributions were made 75% to A and 25% to B. The Taxpayer Relief Act of 1997 has made a substantial modification to the pro rata rule by applying the "separate share rule" to estates. Under this rule, DNI is allocated among estate beneficiaries based upon distributions of their respective "share" of the estate's DNI. IRC § 663(c). The Committee Report describing this change provides that there are separate shares of an estate "when the governing instrument of the estate (e.g., the will and applicable local law) creates separate economic interests in one beneficiary or class of beneficiaries such that the economic interests of those beneficiaries (e.g., rights to income or gains from specific items of property) are not affected by economic interests accruing to another separate beneficiary or class of beneficiaries." The IRS has issued final regulations applying the separate share rules to estates. See T.D. 8849, 2000-2 IRB 245; Treas. Reg. § 1.663(c)-4. As a result of this change, the executor will have to determine whether the Will, revocable trust, or the intestate succession law creates separate economic interests in one beneficiary or class of beneficiaries.

> **Example 2:** A Will bequeaths all of the decedent's IBM stock to X and the balance of the estate to Y. During the year, the IBM stock pays $20,000 of post-death dividends to which X is entitled under local law. No other income is earned. The executor distributes $20,000 to X and $20,000 to Y. Prior to the adoption of the separate share rule, the total distributions to X and Y would have simply been aggregated and the total DNI of the estate in the year of distribution would have been carried out pro rata (i.e., $10,000 to X and $10,000 to Y). But X has an economic interest in all of the dividends; the distribution to Y must be from corpus. Under the separate share rules, the distribution of $20,000 to X carries out all of the DNI to X. No DNI is carried out to Y. Thus, application of the

separate share rule more accurately reflects the economic interests of the beneficiaries resulting from estate distributions.

Distributions to beneficiaries who don't have "separate shares" continue to be subject to the former pro-rata rules. Application of the separate share rule is mandatory. The executor doesn't elect separate share treatment, nor may it be elected out of. Application of the separate share rules to estates was one of a host of small statutory changes enacted in 1997 that sought to bring the taxation rules for trusts and estates in line with one another. In practice, application of the separate share rules to estates is often quite complex. Unlike separate share trusts, which are typically divided on simple fractional lines (e.g., "one-third for each of my children") the "shares" of estates may be hard to identify, let alone account for. Under the final Regulations, a revocable trust that elects to be treated as part of the decedent's estate is a separate share. The residuary estate (and each portion of a residuary estate) is a separate share. A share may be considered as separate even though more than one beneficiary has an interest in it. For example, two beneficiaries may have equal, disproportionate, or indeterminate interests in one share which is economically separate and independent from another share in which one or more beneficiaries have an interest. Moreover, the same person may be a beneficiary of more than one separate share. A bequests of a specific sum of money paid in more than three installments (or otherwise not qualifying as a specific bequest under Section 663(a)(1) of the Code) is a separate share. If the residuary estate is a separate share, than presumably pre-residuary pecuniary bequests (such as marital deduction formula bequests) are also separate shares. For a good discussion of some of the complexities associated with the application of the separate share rules to estates, see Cantrell, "Separate Share Regulations Propose Surprising Changes," TRUSTS & ESTATES, March 1999, p. 56.

c. Income From Property Specifically Bequeathed. Under the statutes or common law of most states, a beneficiary of an asset under a Will is entitled not only to the asset bequeathed, but also to the net income earned by that asset during the period of the administration of the estate. *See, e.g.,* Tex. Ests. Code § 310.004(b). Until the adoption of the separate share rules, DNI was distributed on a pro rata basis among all beneficiaries receiving distributions. The items of income were not specifically identified and traced. As a result, the beneficiary may well have been taxed not on the income item actually received, but on his or her pro rata share of all income distributed to beneficiaries. However, since the income earned on property specifically bequeathed appears to be a "separate economic interest . . .", the separate share rules should change this result. This change means that if an estate makes a current distribution of income from specifically bequeathed property to the devisee of the property, the distribution will carry the DNI associated with it out to that beneficiary, regardless of the amount of the estate's other DNI or distributions. If the estate accumulates the income past the end of its fiscal year, the estate itself will pay tax on the income. When the income is ultimately distributed in some later year, the beneficiary will be entitled to only the net (after tax) income. In addition, the later distribution should not carry out DNI under the separate share rules, since it is not a distribution of current income, and since the accumulation distribution throwback rules (which still apply to certain pre-1985 trusts) do not apply to estates. The separate share rules, while complex to administer, have the advantage of making the income tax treatment of estate distributions more closely follow economic reality.

d. Interest on Pecuniary Bequests. State law or the governing instrument may require that a devisee of a pecuniary bequest (that is, a gift of a fixed dollar amount) is entitled to interest on the bequest, beginning one year after the date of death. The provision for paying interest on pecuniary bequests does not limit itself to payments from estate income. Under UPIA, the executor must charge this "interest" expense to income in determining the estate's "net" income to be allocated to other beneficiaries. Unif. Prin. & Inc. Act § 201(3) (1997). Interest payments are not treated as distributions for the estate for DNI purposes, so they do not carry out estate income. Instead, they are treated as an interest expense to the estate. Rev. Rul. 73-322, 1973-2 CB 44. For a discussion of the income tax issues associated with the deductibility of this interest payment by the estate, see page 27 below.

2. An Estate May Recognize Gains and Losses When It Makes Distributions In Kind. Unless a specific exception applies, all estate distributions, whether in cash or in kind, carry out the estate's DNI. Generally, the amount of DNI carried out by an in-kind distribution to a beneficiary is the *lesser* of the

adjusted basis of the property prior to distribution, or the fair market value of the property at the time of the distribution. IRC § 643(e). The estate does not generally recognize gain or loss as a result of making a distribution to a beneficiary. This general rule is subject to some important exceptions.

a. Distributions Satisfying the Estate's Obligations. Distributions which satisfy an obligation of the estate are recognition events for the estate. The fair market value of the property is treated as being received by the estate as a result of the distribution, and the estate will recognize any gain or loss if the estate's basis in the property is different from its fair market value at the time of distribution. Rev. Rul. 74-178, 1974-1 C.B. 196. Thus, for example, if the estate owes a debt of $10,000, and transfers an asset worth $10,000 with a basis of $8,000 in satisfaction of the debt, the estate will recognize a $2,000 gain.

b. Distributions of Assets to Fund Pecuniary Gifts. A concept related to the "discharge of obligation" notion is a distribution of assets to fund a bequest of "a specific dollar amount," including a formula pecuniary bequest.

> **Example 3.** A formula gift requires an executor to distribute $400,000 worth of property. If the executor properly funds this bequest with assets worth $400,000 at the time of distribution, but with an adjusted cost basis of only $380,000 at the date of death, the estate will recognize a $20,000 gain.

The rules that apply this concept to formula bequests should not be confused with the "specific sum of money" rules which govern DNI carry outs. As noted above, unless the formula language is drawn very narrowly, most formula gifts do not constitute gifts of a "*specific sum of money*," exempt from DNI carryout, because they usually cannot be fixed exactly at the date of death (for example, most formula marital bequests must await the executor's determination of whether administration expenses will be deducted on the estate tax return or the estate's income tax return before they can be computed). Such gifts are nevertheless treated as bequests of "*a specific dollar amount*" for gain recognition purposes, regardless of whether they can be precisely computed at the date of death. As a result, gains or losses will be recognized by the estate if the formula gift describes a pecuniary amount to be satisfied with date-of-distribution values, as opposed to a fractional share of the residue of the estate. *Compare* Treas. Reg. § 1.663(a)-1(b) (to qualify as bequest of specific sum of money or specific bequest of property, and thereby avoid DNI carry-out, the amount of money or the identity of property must be ascertainable under the will as of the date of death) *with* Treas. Reg. § 1.661(a)-2(f)(1) (no gain or loss recognized unless distribution is in satisfaction of a right to receive a specific dollar amount or specific property other than that distributed). *See also* Treas. Reg. § 1.1014-4(a)(3); Rev. Rul. 60-87, 1960-1 C.B. 286. For fiscal years beginning on or before August 1, 1997, estates could recognize losses in transactions with beneficiaries. Although the Taxpayer Relief Act of 1997 repealed this rule for most purposes, an estate may still recognize a loss if it distributes an asset that has a basis in excess of its fair market value in satisfaction of a pecuniary bequest. IRC § 267(b)(13). Note, however, that loss recognition is denied to trusts used as estate surrogates by application of the related party rules of Section 267(b)(6) of the Code, except for qualified revocable trusts electing to be treated as estates under Section 645 of the Code.[7]

c. Pension and IRA Accounts Used to Fund Pecuniary Bequests. Some commentators have argued that if a pension asset is used to satisfy a pecuniary legacy, the use of that asset will be treated as a taxable sale or exchange, and this treatment will accelerate the income tax due. This analysis is based upon Treasury Regulation 1.661(a)-2(f)(1), which requires an estate to recognize gain when funding a pecuniary bequest with an asset whose fair market value exceeds its basis, as though the asset is sold for its fair market value at the date of funding. *See* Rev. Rul. 60-87, 1960-1 C.B. 286. If an estate uses an asset constituting income in respect of a decedent to satisfy a pecuniary bequest, application of this

[7] For decedents dying in 2010 whose executors elected out of the federal estate tax and into the modified carry-over basis rules of Section 1022, recognition of gain on the funding of a pecuniary bequest was limited to post-death appreciation. IRC § 1040. Note, however, that if the modified carryover basis rules were applicable, any transfer of property by a United States person (including a trust or estate) to a non-resident alien resulted in the recognition of all built-in gains. IRC § 684(a).

principle would cause the gain to be accelerated. In this author's opinion, however, it can be persuasively argued that this acceleration will not occur if the beneficiary is not the estate, but the trustee named in the participant's Will. Three lines of analysis confirm this result:

(1) No Receipt By Estate. The recognition rules under Treasury Regulation Section 1.661(a)-2(f)(1) apply only in the context of a distribution *by the estate* in satisfaction of a right to receive a specific dollar amount. When a "testamentary trustee" is named as the beneficiary of a pension plan or IRA, there is clearly no distribution by the estate, and no acceleration event should occur to the estate. The estate, after all, is subjected to taxation only on income *received by the estate* during the period of administration or settlement of the estate. IRC § 641(a)(3). Pension benefits payable directly to the trustee of the trust established under the Will of the plan participant are never "received by the estate." This fact remains true even if the Will contains instructions directing the testamentary trustee to use these funds in whole or in part to compute the amount of a pecuniary bequest. The fact that the executor takes these non-testamentary transfers into account in measuring the amount of *other* amounts needed to fund the pecuniary bequest should not change this result. Since the non-probate pension assets are not subject to administration, the estate cannot properly be said to be the taxpayer with respect to any transaction involving these benefits.

(2) No IRD Transfer by Estate. Separate and apart from the gain recognition rules of Treasury Regulation Section 1.661(a)-2(f)(1) is the IRD recognition rule of Section 691 of the Code. However, the recognition rules of Section 691(a)(2) of the Code, by their terms, apply only if the right to receive income in respect of a decedent is transferred "*by the estate of the decedent* or a person who receives such right by reason of the death of the decedent . . ." (emphasis added). If the testamentary trustee is the beneficiary, there is simply no transfer *by* the estate. Moreover, there is no transfer *by* any "person" who receives such right by reason of the decedent's death. The Code expressly excludes from the definition of "transfer" requiring IRD acceleration any "transmission at death . . . *to* a person pursuant to the right of such person to receive such amount by reason of the death of the decedent . . .". IRC § 691(a)(2) (emphasis added). In that event, the recipient (here, the trust) includes these amounts in gross income not when the right to the payment is received, but only when the payments themselves (i.e., the distributions from the retirement plan) are actually received. IRC § 691(a)(1)(B).

(3) Constructive Receipt Rules. The general rules which describe the timing of recognition for income attributable to an IRD asset are reinforced by the statutes expressly governing pension distributions. Amounts held in qualified plans and IRA's are taxable to the recipient only when actually distributed. IRC §§ 72, 402(a). The mere fact that benefits under the plan or IRA are made available, or that the participant or beneficiary has access to them, is not determinative, since the constructive receipt rules do not apply to these assets. IRC §§ 402(a)(1), 408.

(4) Proper Tax Treatment. Therefore, if the testamentary trustee receives, whether by a spouse's disclaimer or by direct designation by the participant, the right to receive plan distributions, no income tax should be payable until such time as distributions are actually made from the plan or IRA to the trust, even if the assignment of the right to receive plan assets otherwise reduces (or eliminates) the amount that the estate needs to distribute in satisfaction of a pecuniary bequest. Instead, the testamentary trust should be able to defer taxation on pension and IRA proceeds until such time as those accounts are distributed (which may be until they are required to be distributed in accordance with the minimum required distribution rules). See PLR 9630034 (pecuniary disclaimer by spouse of one-half interest in decedent's IRA does not cause recognition to spouse or estate).

d. Section 643(e)(3) Election. The executor may elect under Section 643(e)(3) of the Code to recognize gain and loss on the distribution of appreciated and depreciated property. If this election is made, the amount of the distribution for income tax purposes will be the fair market value of the property at the time of the distribution. The Section 643(e) election must be made on an "all or nothing" basis, so that the executor may not select certain assets and elect to recognize gain or loss on only those assets. Of course, if the executor wants to obtain the effect of having selected certain assets, he or she may actually "sell" the selected assets to the beneficiary for the fair market value of those assets, recognizing gain in the estate. The executor can thereafter distribute the sales proceeds received to the beneficiary who purchased the assets. Note that if an executor makes a Section 643(e)(3) election in a year that an IRD asset is distributed by the estate, gain would be accelerated, even if the distribution is otherwise subject to a Section 691(a)(2) exception, since the asset representing the IRD will be treated as having been sold by the estate in that year. For fiscal years beginning after August 1, 1997, the Section 643(e)(3) election (or an actual sale to a beneficiary) can cause the estate to recognize gains, but not losses, since under the principles of Section 267 of the Code, the estate and its beneficiary are now treated as related taxpayers. IRC § 267(b)(13).

3. Estate Beneficiaries May Recognize Gains and Losses If the Estate Makes Unauthorized Non Pro Rata Distributions In Kind. If an estate makes unauthorized non-pro rata distributions of property to its beneficiaries, the IRS has ruled that the distributions are equivalent to a pro rata distribution of undivided interests in the property, followed by an exchange of interests by the beneficiaries. This deemed exchange will presumably be taxable to both beneficiaries to the extent that values differ from basis. Rev. Rul. 69-486, 1969-2 C.B. 159.

> **Example 4:** A decedent's estate passes equally to A and B, and contains two assets, stock and a farm. At the date of death, the stock was worth $100,000 and the farm worth $110,000. At the date of distribution, each are worth $120,000. If the executor gives the stock to A and the farm to B *and if the will or local law fails to authorize non-pro rata distributions*, the IRS takes the view that A and B each received one-half of each asset from the estate. A then "sold" his interest in the farm (with a basis of $55,000) for stock worth $60,000, resulting in a $5,000 gain to A. Likewise, B "sold" his interest in the stock (with a basis of $50,000) for a one-half interest in the farm worth $60,000, resulting in a $10,000 gain to B. To avoid this result, the governing instrument should expressly authorize non-pro rata distributions.

See page 28 for a discussion of an analogous issue in the context of non-pro rata divisions of community property between the estate and the surviving spouse.

4. Income in Respect of a Decedent is Taxed to the Recipient. A major exception to the rule that an inheritance is income tax free applies to beneficiaries who receive payments that constitute income in respect of a decedent. IRC § 691.

a. IRD Defined. Income in respect of a decedent ("IRD") is not defined by statute, and the definition in the Treasury Regulations is not particularly helpful. Generally, however, IRD is comprised of items which would have been taxable income to the decedent if he or she had lived, but because of the decedent's death and tax reporting method, is not includible in the decedent's final Form 1040. Examples of IRD include accrued interest; dividends declared but not payable; unrecognized gain on installment obligations; bonuses and other compensation or commissions paid or payable following the decedent's death; and amounts in IRAs and qualified benefit plans upon which the decedent has not been taxed. A helpful test for determining whether an estate must treat an asset as IRD is set forth in *Estate of Peterson v. Comm'r*, 667 F.2d 675 (8th Cir. 1981). The estate's basis in an IRD asset is equal to its basis in the hands of the decedent. No step-up is provided. IRC § 1014(c).

b. Recognizing IRD. If the executor distributes an IRD asset in a manner which will cause the estate to recognize gain on the distribution, or if a Section 643(e)(3) election is made and the asset is distributed in the year of the election, the result will be to tax the income inherent in the item to the decedent's estate. Absent one of these recognition events, if the estate of the decedent transmits the right to an IRD asset to another person who would be entitled to report that income when received, the transferee, and not the estate, will recognize the income. Thus, if a right to IRD is transferred by an estate to a specific or residuary legatee, only the legatee must include the amounts in income when received. Treas. Reg. § 1.691(a)-4(b)(2). If IRD is to be recognized by the estate, the tax costs may be substantial. In a setting where a substantial IRD asset is distributed from the estate in a manner causing recognition, a material decrease in the amount passing to other heirs might result.

> **Example 5:** In 2013, X dies with an $8.25 million estate. The Will makes a formula marital gift of $3,000,000 to the spouse, leaving the rest of the estate to a bypass trust. If an IRD asset worth $3,000,000 but with a basis of $0 is used to fund this marital gift, the estate will recognize a $3,000,000 gain. The spouse will receive the $3,000,000 worth of property, but the estate will owe income tax of some $1,186,000, presumably paid from the residue of the estate passing to the bypass trust. Payment of this tax would leave only $4,064,000 to fund the bypass trust.

Under these circumstances, the testator may wish to consider making a specific bequest of the IRD asset to insure that the income will be taxed to the ultimate beneficiary as received, and will not be accelerated to the estate.

c. <u>Deductions in Respect of a Decedent</u>. A concept analogous to income in respect of a decedent is applied to certain deductible expenses accrued at the date of the decedent's death but paid after death. These "deductions in respect of a decedent" ("DRD") are allowable under Code Section 2053(a)(3) for estate tax purposes as claims against the estate, and are also allowed as deductions in respect of a decedent for income tax purposes to the person or entity paying those expenses. IRC § 691(b). The general rule disallowing both income and estate tax deductions for administration expenses, discussed below at page 19 does not apply to DRD. The theory behind allowing this "double" deduction is that had the decedent actually paid this accrued expense prior to death, he could have claimed an income tax deduction, and the cash on hand in his estate would be reduced, thereby effecting an estate tax savings as well. Of course, interest, administration expenses, and other items not accrued at the date of the decedent's death are subject to the normal election rules of Section 642(g) of the Code discussed below.

5. <u>Impact of Death Upon Basis</u>. Most practitioners describing the impact of death upon basis have traditionally used a kind of short-hand by saying that assets get a "step-up" in basis at death. In inflationary times, this oversimplification is often accurate. However, it is important to remember that the basis of an asset may step up or down. For most assets, the original cost basis in the hands of the decedent is simply irrelevant. It is equally important to remember that the basis adjustment rule is subject to some important exceptions. In addition, for estates of persons dying in 2010 whose executors elected not to have the federal estate tax apply, the basis adjustment rules of Section 1014 did not apply. Instead, the "modified carry-over basis" rules of Section 1022, were used.

a. <u>General Rule</u>. In general, the estate of a decedent receives a new cost basis in its assets equal to the fair market value of the property at the appropriate valuation date. IRC § 1014. In most cases, the basis is the date-of-death value of the property. However, if the alternate valuation date for estate property has been validly elected, that value fixes the cost basis of the estate's assets. IRC § 1014(a)(3). The basis adjustment rule also applies to a decedent's assets held by a revocable trust used as an estate surrogate, since they are deemed to pass from the decedent pursuant to Sections 2036 and 2038 of the Code. Although often called a "step up" in basis, various assets may be stepped up *or down* as of the date of death. The adjustment to the basis of a decedent's assets occurs regardless of whether the estate is large enough to be subject to federal estate tax. Original basis is simply ignored and federal estate tax values are substituted. Note that the new cost basis applies not only to the decedent's separate property but also to *both halves* of the community property owned by a married decedent. IRC § 1014(b)(6).

b. <u>Exceptions</u>. There are two important exceptions to the basis adjustment rules of Section 1014.

(1) <u>No New Basis for IRD.</u> Items which constitute IRD receive a carryover basis. IRC § 1014(c). This rule is necessary to prevent recipients of income in respect of a decedent from avoiding federal income tax with respect to items in which the income receivable by a decedent was being measured against his basis in the asset (such as gain being reported on the installment basis).

(2) <u>No New Basis for Deathbed Transfers to Decedent.</u> Section 1014(e) of the Code provides a special exception for appreciated property given to a decedent within one year of death, which passes from the decedent back to the donor or the donor's spouse as a result of the decedent's death. As noted

earlier, this rule is presumably designed to prevent avaricious taxpayers from transferring property to dying individuals, only to have the property bequeathed back to them with a new cost basis.

c. Holding Period. A person acquiring property from a decedent whose basis is determined under Section 1014 is considered as being held by the person for more than one year. IRS § 1223(9). Therefore, any post-death gains will be treated as long-term capital gain, even if the property is sold within one year of the decedent's death.

d. Persons Dying in 2010. For estates of decedents dying in 2010 whose executors elected not to have the federal estate tax apply, property acquired from these decedents was treated as transferred by gift. As a result, the basis of that property was the lesser of (i) the adjusted basis of the decedent; or (ii) the fair market value of the property as of the date of the decedent's death. IRC § 1022(a). There were two important adjustments to this basis.

(1) The $1.3 Million Adjustment. First, a general basis adjustment equal to $1.3 million was available for property that was "owned by the decedent" and "acquired from a decedent." IRC § 1022(b). The $1.3 million amount was increased by the sum of (i) any capital loss carryover determined under Section 1212(b); and (ii) the amount of any net operating loss carryover determined under Section 172, which would (but for the decedent's death) be carried from the decedent's last taxable year to a later taxable year of the decedent. The $1.3 million amount was further increased by the sum of the amount of any losses that would have been allowable under Code Section 165 if the property acquired from the decedent had been sold at fair market value immediately before the decedent's death. In the case of a decedent nonresident not a citizen of the United States, the general basis increase was limited to $60,000.

(2) The $3 Million Adjustment for Qualified Spousal Property. Second, there was a spousal basis adjustment equal to $3 million for "qualified spousal property." IRC § 1022(c). Qualified spousal property means either: (i) property that would not be treated as nonqualified terminable interest property under the federal estate tax marital deductions rules ("Outright transfer property"); or (ii) property that would be treated as qualified terminable interest property (QTIP) under those rules ("Qualified terminable interest property").

(3) The "Owned-by-the-Decedent" Requirement. Basis increases were available only for property that was "owned" by the decedent at the time of death. IRC § 1022(d)(1). For purposes of this rule, property that was owned with the surviving spouse either jointly with right of survivorship or as tenants by the entirety, was treated as being owned 50% by the decedent. IRC § 1022(d)(1)(B(i). Other survivorship property was treated as being owned in the proportion that the decedent furnished consideration, unless acquired by gift, bequest, or inheritance, in which case the decedent was treated as owning a fractional part of the property determined by dividing the value of the property by the number of joint tenants with rights of survivorship. *Id.* In addition, the decedent was treated as owning property in a revocable trust for which the election under Section 645(b)(1) was available to treat the trust as part of a decedent's estate (essentially, a trust that was revocable by the decedent immediately before death). IRC § 1022(d)(1)(B)(ii). Finally, a surviving spouse's interest in community property was treated as owned by, and acquired from, the decedent if at least one-half of the whole of the community interest in that property was treated as owned by, and acquired from, the decedent. IRC § 1022(d)(1)(B(iv). A decedent was not treated as owning any property by reason of having a limited or general power of appointment with respect to such property. IRC § 1022(d)(1)(B)(iii). In addition, property acquired by the decedent from any one except the surviving spouse during the three-year period ending on the decedent's death for less than adequate and full consideration in money or money's worth was not treated as owned by the decedent. IRC § 1022(d)(1)(C). Property acquired from the surviving spouse during such period was, however, treated as owned by the decedent unless the spouse acquired the property by gift or inter vivos transfer for less than adequate and full consideration in money or money's worth. *Id*.

(4) "Property Acquired from the Decedent". For purposes of the modified carryover basis rules, property acquired from the decedent included: (i) property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent; (ii) property transferred by the decedent during his lifetime to a qualified revocable trust as defined in Code Section 645; (iii) property transferred by the decedent to

any other trust with respect to which the decedent reserved the right to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust; and (iv) any other property passing from the decedent by reason of death to the extent that such property passed without consideration. IRC § 1022(e).

(5) Ineligible Property. Certain property was not eligible for any basis adjustment. The carryover basis rules did not apply to items of income in respect of a decedent. IRC § 1022(f). In addition, no basis adjustment was permitted for stock or securities in a foreign personal holding company; a DISC (domestic international sales company); a foreign investment company; and a passive foreign investment company (unless it is a qualified electing fund as described in Section 1295 with respect to the decedent). IRC § 1022(d)(1)(D).

(6) Limited to Fair Market Value. The basis adjustments did not increase the basis of any asset above its fair market value as of the date of the decedent's death. IRC § 1022(d)(2). The executor must have made the allocation of the basis adjustments on the return required by Section 6018 (IRS Form 8939, due January 17, 2012). Once basis was allocated, changes in the allocation could be made only as provided by the Secretary of Treasury. IRC § 1022(d)(3). Notice 2011-66, § I.D.2, Notice 2011-76.

(7) Certain Liabilities in Excess of Basis. In determining whether gain was recognized on the acquisition of property (i) from a decedent by a decedent's estate or any beneficiary other than a tax exempt organization; and (ii) from the decedent's estate by any beneficiary other than a tax exempt organization, and in determining the basis of such property, liabilities in excess of basis were disregarded. IRC § 1022(g).

(8) Holding Period. The automatic one-year holding period of Section 1223(9) did not apply to estates of persons dying in 2010 whose executors opted out of the federal estate tax and into the modified carryover basis rules. Instead, the holding period of inherited property was likely determined under Section 1223(2), which is the rule generally applicable to property acquired by gift. The IRS has ruled that to the extent the recipient's basis in property acquired from the decedent is determined under Section 1022, the recipient's holding period of that property will include the period during which the decedent held the property, whether or not the executor allocates any Basis Increase to that property. Rev. Proc. 2011-41, 2011-35 IRB 188, § 4.06(1).

6. The Executor Can Elect to Deduct Many Expenses for Either Income or Estate Tax Purposes (but not Both). An executor is often confronted with a choice of deducting estate administration expenses on the estate tax return, or the estate's income tax return. In most instances, double deductions are disallowed. IRC § 642(g). Between 1986 and 1992, the decision about where to deduct an expense was simplified by the fact that the lowest effective federal estate tax bracket (37%) was always higher than the highest marginal income tax bracket applied to estates (typically 31%). If estate tax was due, a greater tax benefit was always obtained by deducting expenses on the estate tax return. Between 1993 and 2001, the analysis was more difficult since income tax rates might or might not exceed effective estate tax rates in those years. For decedents dying between 2002 and 2009, the decision about where to deduct an expense was simplified by the fact that the lowest effective federal estate tax bracket (45%) was always higher than the highest marginal income tax bracket applied to estates (35%). In 2013, with a top income tax rate of 39.6% and a possible Medicare surtax of 3.8%, executors are once again faced with deciding whether the deduction on the estate's income tax return (with a top combined tax bracket of 43.4%) may be of greater benefit than deducting expenses on the estate tax return, where the top bracket is effectively 40%.

a. Section 642(g) Expenses. The executor must make an election to take administration expenses as a deduction for income tax purposes by virtue of Section 212 of the Code, or to deduct those same expenses as an estate tax deduction under Section 2053 of the Code. No double deduction is permitted. Expenses to which this election applies include executors' fees, attorneys' fees, accountants' fees, appraisal fees, court costs, and other administration expenses, provided that they are ordinary and necessary in collection, preservation, and management of the estate. There is no requirement that the estate be engaged in a trade or business or that the expenses be applicable to the production of income.

Treas. Reg. § 1.212-1(i). Note, however, that expenses attributable to the production of tax-exempt income are denied as an income-tax deduction to estates, just as they are to individuals, under Section 265(1) of the Code. Interest on estate taxes deferred under Section 6166 of the Code, which now accrues at only 45% of the regular rate for interest on under payments, is no longer allowed as an estate tax <u>or</u> on income tax deduction. IRC §§ 2053(c)(1)(D); 163(k).

b. <u>Method of Election</u>. Technically, the Code and Treasury Regulations require the executor to file with the estate's income tax return a statement, in duplicate, to the effect that the items have not been allowed as deductions from the gross estate of the decedent under Section 2053 or 2054 and that all rights to have such items allowed at any time as deductions under Section 2053 or 2054 are waived. Treas. Reg. § 1.642(g)-1. Some executors tentatively claim expenses on both returns, filing the income tax return waiver statement only after the estate has received a closing letter and deductions on the estate tax return have proven unnecessary. This approach can be dangerous, however, if deductions are taken on the estate tax return, and the estate receives a closing letter without examination of or adjustment to the return. Under these circumstances, presumably, the income tax waiver statement could not lawfully be filed, since the deductions in question will have been "allowed" as deductions from the gross estate.

c. <u>Payments From Income</u>. Increased attention has been focused on the interaction of state law and tax rules in determining whether estate administration expenses are chargeable to principal or income, particularly in estates seeking an estate tax marital or charitable deduction. The importance of this issue is illustrated by *Commissioner v. Estate of Hubert*, 117 S. Ct. 1124 (1997) where the executor charged administration expense to estate income for both state law and tax law purposes. The IRS held that such an allocation constituted a "material limitation" on the rights to income otherwise afforded recipients of marital and charitable gifts, and denied estate tax deductions for the gifts to which these expenses were allocated. The Supreme Court disagreed, holding that the Treasury Regulations in place at the time justified the tax court's finding that the marital deduction was not jeopardized.

(1) <u>Regulatory Guidance</u>. In response to the *Hubert* decision, the IRS announced new regulations providing guidance on this issue. Treas. Reg. §§ 20.2013-4(b)(3), 20.2055-3; 20.2056(b)-4(d). Unlike the "material limitation" rules under the prior regulations, the new regulations permit deductions depending upon the nature of the expenses in question. The regulation provides that "estate management expenses" may be deducted as an income tax deduction (but not as an administrative expense for estate tax purposes) without reducing the marital or charitable deduction. Expenses that constitute "estate transmission expenses" will require a dollar for dollar reduction in the amount of marital or charitable deduction.

(2) <u>Estate Management Expenses</u>. Estate management expenses are "expenses incurred in connection with the investment of the estate assets and their preservation and maintenance during a reasonable period of administration. Examples of these expenses include investment advisory fees, stock brokerage commissions, custodial fees and interest." Treas. Reg. §§ 20.2055-3(b)(1)(i); 20.2056(b)-4(d)(1)(i).

(3) <u>Estate Transmission Expenses</u>. Estate transmission expenses are all estate administration expenses that are not estate management expenses. These expenses reduce the amount of the marital or charitable deduction if they are paid out of assets that would otherwise pass to the surviving spouse or to charity. Estate transmission expenses include expenses incurred as a result of the "consequent necessity of collecting the decedent's assets, paying the decedent's debts and death taxes, and distributing the decedent's property to those who are entitled to receive it." Examples of these expenses could include executor commissions and attorney fees (except to the extent of commissions or fees specifically related to investment, preservation, and maintenance of assets), probate fees, expenses incurred in construction proceedings and defending against Will contests, and appraisal fees. Treas. Reg. §§ 20.2055-3(b)(1)(ii); 20.2056(b)-4(d)(1)(ii).

(4) <u>Reduction for Unrelated Estate Management Expenses</u>. In addition to reductions for estate transmission expenses, the final regulations require that the marital deduction be reduced by the amount of any estate management expenses that are "paid from the marital share but attributable to a property

interest not included in the marital share." Treas. Reg. § 20.2056(b)-4(d)(1)(iii)(4). Similar language is applied to charitable gifts. Treas. Reg. § 20.2055-3(b)(4).

(5) Special Rule for Estate Management Expenses Deducted on Estate Tax Return. If estate management expenses are deducted on the estate tax return, the marital or charitable deduction must be reduced by the amount of any estate management expenses "that are deducted under section 2053 on the decedent's Federal estate tax return." Treas. Reg. §§ 20.2055-3(b)(3); 20.2056(b)-4(d)(3). The justification for this position is the language in Section 2056(b)(9) of the Code, which provides that nothing in section 2056 or any other estate tax provision shall allow the value of any interest in property to be deducted for federal estate tax purposes more than once with respect to the same decedent.

> **Example 6:** $150,000 of life insurance proceeds pass to the decedent's child, and the balance of the estate passes to the surviving spouse. The decedent's applicable credit amount had been fully utilized prior to death. If estate management expenses of $150,000 were deducted for estate tax purposes, the marital deduction would have to be reduced by $150,000. Otherwise, the estate "would be taking a deduction for the same $150,000 in property under both sections 2053 and 2056." As a result, the deduction would have the effect of sheltering from estate tax $150,000 of the insurance proceeds passing to the decedent's child. Treas. Reg. § 20.2056(b)-4(d)(5), Ex.4.

(6) Effective Date. The regulations apply to estates of decedents dying on or after December 3, 1999. Treas. Reg. §§ 20.2055-3(b)(7); 20.2056(b)-4(d)(6).

d. Summary of Deductible Expenses.

(1) Deductible ONLY on the Decedent's Final Income Tax Return:

(a) Iitemized deductions paid prior to date of death. IRC §§ 161-223.

(b) Capital loss carry-forward of the decedent. IRC § 212(b).

(c) Charitable contributions carry-forward of the decedent. IRC § 170(d)(1).

(d) Net operating loss carry-forward of the decedent. IRC § 172(b).

(e) Disallowed investment interest carry-forward of the decedent. IRC § 163(d)(2).

(f) Disallowed S Corporation carry-forward of the decedent. IRC § 1366(d)(2).

(g) Investment tax credit carry-forward of the decedent. IRC § 46(b).

(2) Deductible on EITHER the Decedent's Final Income Tax Return or the Estate Tax Return:

(a) Medical expenses of the decedent paid out of his estate within one year after date of death. IRC § 213(c).

(3) Items Deductible ONLY on the Estate Tax Return:

(a) Funeral expenses. IRC § 2053(a)(1); Treas. Reg. § 20.2053-2.

(b) Claims against the estate of a personal non-deductible nature (e.g., federal income and gift taxes unpaid at date of death). IRC § 2053(a)(3).

(c) Administration expenses attributable to tax-exempt income. Rev. Rul. 59-32, 1959-1 CB 245.

(4) Items Deductible ONLY on the Estate's Income Tax Return:

(a) State, local and windfall profit taxes on estate income. IRC §§ 164(a); 2053(c)(1)(B).

(b) Real estate taxes not accrued prior to death. IRC §§ 164(a); 2053(c)(1)(B).

(c) Interest accruing after date of death on indebtedness incurred by the decedent or the estate which are not allowable as expenses of administration under local law. IRC §§ 163(a); 2053(c)(1)(B).

(5) Items Deductible on EITHER the Estate's Income Tax Return or the Estate Tax Return:

(a) Administration expenses, except administration expenses attributable to tax-exempt income, may be taken on the Form 1041 or the Form 706. Any administration expenses, including those attributable to tax-exempt income, not claimed on the Form 1041 can be claimed on the Form 706. IRC §§ 212; 642(g); 2053(a). *See* Rev. Rul. 59-32, 1959-1 CB 245.

(b) Casualty and theft losses. IRC §§ 165; 642(g); 2054.

(6) Items (called "Deductions in Respect of a Decedent") Deductible BOTH on the Estate's Income Tax Return and on the Estate's Death Tax Return:

(a) Business expenses accrued prior to death. IRC §§ 163; 2053(a).

(b) Interest expenses accrued prior to death. IRC §§ 163; 2053(a).

(c) Taxes accrued prior to death. IRC §§ 164, 2053(a); 2053(c)(1)(B).

(d) Expenses incurred for the management, conservation, or maintenance of property held for the production of income, or in connection with the determination, collection or refund of any tax accrued prior to death. IRC §§ 212; 2053(a).

(e) Alimony or separate maintenance payments accrued prior to death. §§ 215; 2053(a). *See* Rev. Rul. 67-304. 1967-2 CB 224.

7. Post-Death Revocable Trusts May Be Separate Taxpayers or Part of the Estate. Revocable trusts typically provide for the creation of sub-trusts (i.e., marital trusts, credit shelter trusts, trusts for descendants, etc.) after the grantor's death. It is important to remember that the revocable trust becomes a separate taxpayer at the grantor's death, and that it is a separate taxpayer from the sub-trusts that will later be funded by it. Trusts used as estate surrogates face issues similar to estates in the context of post-death income taxation. In the words of one author,

> A postmortem successor trust does not spring, Minerva-like, full-blown from the Jovian brow of the grantor trust *eo instante* upon the grantor's death. In most instances, and unless the governing instrument provides otherwise, the postmortem successor trusts (marital deduction, credit shelter or other) will be treated as separate trusts for income tax purposes only when funded. Funding occurs only when the trustee has assigned assets to the trust after careful exploration and prudent exercise of post-mortem tax options and elections available under the Internal Revenue Code of 1986. In the interim, the grantor trust normally functions like an estate pending distribution to its beneficiaries (including successor trusts) and, as such, in a separate taxable entity for income tax purposes.

Becker, "Wills vs. Revocable Trusts - Tax Inequality Persists," 3 PROB. & PROP. No. 4 at 17, 18 (1989). Trust termination rules are governed by paragraph (b) of Treasury Regulation Section 1.641(b)-3, as opposed to paragraph (a). The rules, however, are similar and should give rise to no real substantive difference in timing or treatment.

a. Effect of Grantor's Death. A revocable living trust typically allows the grantor, but no one else, to revoke it and thus becomes irrevocable at the grantor's death. The income, deductions and credits attributable to such a grantor-type trust prior to the grantor's death will be reflected on the deceased grantor's final Form 1040. A revocable living trust becomes a different taxpayer after the grantor dies. Rev. Rul. 57-51, 1957-1 C.B. 171. It must obtain a new taxpayer identification number and start filing Form 1041 trust income tax returns under such new number on income earned after the grantor's death. If a grantor-type revocable living trust was not exempt from filing trust income tax returns or obtaining a taxpayer identification number during the grantor's lifetime, then such trust should file a final grantor-type trust income tax return under its old taxpayer identification number relating to items of income, deductions, and credits attributable to such trust for the period ending on the grantor's date of death.

b. Post-Differences Between Trusts and Estates. Post-death revocable trusts suffer several minor disadvantages when contrasted with an estate for income tax purposes. These included, for example:

(1) The revocable living trust becomes a separate taxpaying entity after the grantor's death; if no 645 election (described below) is made to treat it as part of the probate estate, it gets an added run up the tax bracket ladder (i.e., on the estate's return as well as the trust's tax return) and the advantage of separate exemptions ($600 for the estate, and either $100 or $300 for the trust). IRC §§ 1(e); 642(b). xxx

(2) After TRA '97, an estate is still allowed to recognize some losses for income tax purposes (i.e., losses resulting from the funding of a pecuniary gift), but losses in other taxable transactions between an estate or trust and its beneficiaries are not allowed to be recognized for tax purposes. IRC § 267(b)(5).

(3) An estate is allowed to choose a fiscal year for income tax reporting purposes, but a revocable living trust must utilize a calendar year for reporting its income after the grantor's death. IRC § 645(a).

(4) Estates are not subject to the throwback rules with respect to accumulated income from prior tax years, but post-TRA '97, some domestic trusts and all foreign trusts are still subject to throwback rules. IRC §§ 665-669.

(5) Estates and (since TAMRA) revocable trusts are not required to make estimated income tax payments during their first two taxable years. IRC §6654(k). However, estates have less flexibility than trusts, as trusts can elect to have estimated income tax payments deemed distributed to the beneficiary in any year, but estates can only do so in their last year. IRC § 643(g).

(6) Estates having a charitable residuary beneficiary can deduct amounts which are set aside for ultimate distribution to charity. IRC § 642(c). Post 1969-Act trusts are not entitled to the IRC §642(c) deduction, which makes it difficult for trusts to avoid income tax on capital gains realized unless a current year distribution of such gains can be made to charity.

(7) Estates have a potentially unlimited charitable income tax deduction. IRC §642(c). But trusts having unrelated business income that is contributed to charity are subject to the percentage limitations on deductibility applicable to individuals. IRC § 681(a).

(8) An estate (but not a trust) in its first two taxable years after death may deduct up to $25,000 of losses with respect to rental real estate against other income if the decedent was an active participant with respect to such real estate at the time of death. IRC § 469(i)(4).

(9) An estate qualifies to hold to hold S corporation stock for a reasonable period of time, but a revocable trust can continue as an S corporation shareholder for only two years after the grantor's death. IRC §§ 1361(b)(1)(B); 1361(c)(2)(A)(ii).

(10) The executor (or personal representative) and a trustee may have personal liability for a decedent's income and gift tax returns, but only an "executor" (as specially defined in IRC § 6905(b), which does not include a trustee) is entitled to a written discharge for personal liability for such taxes. IRC § 6905.

(11) Medical expenses of the decedent paid out of the estate within one year after date of death may be deducted if so elected. IRC §§ 213(c); 642(g).

(12) Estates qualify for IRC § 194 amortization of reforestation expenditures, but trusts do not.

c. Election to Unify. For decedents dying after August 5, 1997, the trustee and the executor (if any) may irrevocably elect to treat a "qualified revocable trust" as part of the estate for income tax purposes. IRC § 645(a). A "qualified revocable trust" is a trust that, during the life of the grantor, was treated as a grantor trust because of his or her right of revocation under Section 676 of the Code. IRC § 645(b). The election must be made on the estate's first timely income tax return (including extensions), and, once made, is irrevocable. IRC § 645(c); Treas. Reg. § 1.645-1(e)(1). The election applies until "the date which is 6 months after the date of the final determination of the liability for tax imposed by chapter 11," or if no estate tax return is due, two years after the date of death. The final regulations provide that the date of final determination of liability is the date that is six months after the date the closing letter is issued. Therefore, the section 645 election will terminate twelve months after issuance of the closing letter. The regulations further provide that the election period terminates earlier if both the electing trust and the related estate, if any, have distributed all their assets. Treas. Reg. § 1.645-1 (f)(1). The procedures for making the election for decedents who die on or after December 24, 2002 are governed by final Treasury Regulations. Treas. Reg. § 1.645-1(j). If an executor has been appointed, the executor and trustee of the trust make the election by signing and filing Form 8855, "Election to Treat a Qualified Revocable Trust as Part of an Estate." If there is no executor, the trustee of the trust files the election form. Treas. Reg. § 1.645-1(c)(2).

d. Advantages of the Election. If the estate (if any) and the revocable trust make the election, a number of tax benefits may result to the trust, including:

(1) availability of a fiscal year under Section 644. Treas. Reg. § 1.645-1(e)(3)(i).

(2) avoiding the need to make estimated tax payments for two years after the decedent's death. Treas. Reg. § 1.645-1(e)(4).

(3) the ability to obtain a charitable deduction for amounts permanently set aside for charity under section 642(c)(2). Treas. Reg. § 1.645-1(e)(2)(iv) & (e)(3)(i).

(4) the ability to hold S corporation stock for the duration of the administration of the estate, without meeting special trust rules Treas. Reg. § 1.645-1(e)(3)(i); see Rev. Rul. 76-23, 1976-1 C.B. 264 (estate exception applies for the reasonable period of estate administration and applies for entire section 6166 deferral period).

(5) avoidance of the passive loss active participation requirement under Section 469 of the Code for rental real estate for two years after death. Treas. Reg. § 1.645-1(e)(3)(i).

(6) use of the $600 personal exemption available to an estate rather than either a $300 or $100 exemption available to trusts (depending on whether the trust is required to distribute all of its income annually). Treas. Reg. § 1.645-1(e)(2)(ii)(A).

(7) allowing losses in funding pecuniary bequests under section 267(b)(13).

(8) simplifying the number of tax returns.

(9) deferral of payment of income tax on income earned after the date of death until the due date of the estate's fiduciary return (which could result in up to eleven months of additional deferral).

8. When An Estate or Trust Allocates "Income," That Means Fiduciary Accounting Income, Not Taxable Income. Estate planning attorneys that spend too much of their time studying tax rules sometimes forget that not every situation is governed by the Internal Revenue Code. Nowhere is this failure more prevalent than in the area of allocating and distributing estate and trust "income." In general, when a trust (or the income tax rules applicable to estates and trusts) speaks of "income" without any modifier, it means fiduciary accounting income, and not taxable income. IRC § 643(b). In measuring fiduciary accounting income, the governing instrument and local law, not the Internal Revenue Code, control. Therefore, estate planners should have a basic understanding of these state law rules. Allocations are generally made pursuant to directions set forth in the governing instrument, or in the absence of those directions, pursuant to the provisions of local law. As of this writing, forty-two states and the District of Columbia have adopted the 1997 Uniform Principal and Income Act ("UPIA"). Most other jurisdictions utilize a version of the prior Uniform Principal and Income Act, primarily the 1962 version of that Act ("RUPIA 62"). Despite the benefits of “uniform” acts, many states have chosen to modify specific sections to their principal and income rules. (For example, Section 116.174 of the Texas Trust Code effectively provides that income from mineral royalties for most trusts will be allocated 85% to income instead of the 10% specified in Section 411 of the Uniform Act.) Therefore, it is essential that the actual language of the applicable local law be reviewed.

a. Allocation of Income.

(1) General Rules. UPIA provides that a trustee must make allocations between trust income and principal in accordance with the specific provisions of the governing instrument, notwithstanding contrary provisions of the Act. Unif. Prin. & Inc. Act § 103(a)(1) (1997). Provisions in the Will or trust agreement should therefore control allocations of estate and trust income and expense, so long as they are specific enough to show that the testator chose to define a specific method of apportionment. See *InterFirst Bank v. King*, 722 S.W.2d 18 (Tex. App.–Tyler 1986, no writ). In the absence of specific provisions in the instrument, the provisions of the Act control allocations between income and principal.

(2) Allocations Under UPIA. Under UPIA, a more uniform approach is directed for distributions from entities than was applied under prior law. The cash basis is expressly used to characterize income from entities.

(a) Distributions from "Entities". Section 401(d) of the 1997 UPIA provides a direct answer to the question of how to characterize distributions from "entities," which the Act defines to include corporations, partnerships, LLCs, regulated investment companies (i.e., mutual funds), real estate investment trusts, and common trust funds. The general rule under UPIA is that all distributions received from these entities are income, subject to four exceptions. First, the Act treats long term capital gain distributions from mutual funds or real estate investment trusts as principal. Second, a distribution or series of distributions received in exchange for the trust's interest in the entity are principal. Third, distributions in kind (as opposed to distributions of money) from entities are treated as principal. Fourth, distributions of money received as a partial liquidation are principal. In this regard, money is treated as a partial liquidation if (i) they are designated by the entity as a liquidating distribution; or (ii) to the extent they exceed 20% of the entity's gross assets prior to distribution (ignoring money that does not exceed the income tax that the trustee or beneficiary must pay on the entity's income). Of note, reinvested corporate dividends are treated as principal (but presumably only if they are reinvested pursuant to the trustee's power under the Act to adjust between income and principal to comply with the duty of impartiality between income and remainder beneficiaries).

(b) Mutual Fund Distributions. Section 401(c)(4) of UPIA provides that principal includes money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes. The official comment to the Uniform Act states: "Under the Internal Revenue Code and the Income Tax Regulations, a 'capital gain dividend' from a mutual fund or real estate investment trust is the excess of the fund's or trust's net long-term capital gain over its net short-term capital loss. As a result, a capital gain dividend does not include any net short-term capital gain, and cash received by a trust because of a net short-term capital gain is income under this Act."

(c) Business and Farming Operations. UPIA permits a trustee to aggregate assets used in a business or farming operation and to account separately for the business or activity (instead of accounting separately for its various components) if the trustee "determines that it is in the best interest of all of the beneficiaries" to do so. Unif. Prin. & Inc. Act § 403(a) (1997). The trustee is permitted to maintain a reserve from its net cash receipts to the extent needed for working capital, the acquisition or replacement of fixed assets, and other reasonably foreseeable needs of the business. Unif. Prin. & Inc. Act § 402(b) (1997).

b. Allocation of Expenses.

(1) General Rule. Like income, expenses may be allocated between fiduciary accounting income and principal based upon the terms of the governing instrument. If the instrument fails to specify how expenses are to be allocated, state law provides guidance.

(2) Allocations Under UPIA. Section 501 and 502 of UPIA make allocations against income and principal similar to those made under prior law.

(a) Charges Against Income. Under the statute, charges against income include one-half of all trustee fees and commission, (including investment advisor fees) and one-half of expenses for accountings and judicial proceedings that involve both the income and principal beneficiaries. All of the ordinary expenses of administration, management and preservation of property, and the distribution of income, including recurring taxes assessed against principal, insurance, interest and repairs are charged against income. Also charged to income are all court costs and attorney fees for other matters concerning income. Unif. Prin. & Inc. Act § 501 (1997).

(b) Charges Against Principal. Charges against principal are all those not charged to income, including one-half of trustee fees, accountings and judicial proceedings not charged to income, trustee compensation based on acceptance, distribution or termination, of for making property ready for sale, and payments on the principal portion of debt. Also charged to principal are estate, inheritance and other transfer taxes. Unif. Prin. & Inc. Act § 502 (1997).

(c) Income Taxes. UPIA Section 505 general charges taxes based upon income receipts to income, and charging taxes on principal receipts to principal, even if denominated as an "income" tax (such as capital gain taxes). The Section then goes on to allocate "tax required to be paid by a trustee on a trust's share of an entity's taxable income," which would presumably include income from partnerships, LLCs and S corporations. The Act requires that these taxes be paid proportionally from income, to the extent that receipts from the entity are allocated to income, and to principal to the extent (i) receipts are allocate to principal; or (2) the entity's taxable income exceeds the total receipts from the entity. Unif. Prin. & Inc. Act § 505(c) (1997). These allocations may be reduced by the amount distributed to a beneficiary for which a distribution deduction is allowed. Unif. Prin. & Inc. Act § 505(d) (1997). In 2008, the Uniform Laws Commission made important changes to Section 505 of UPIA to deal with income tax issues associated with pass-though entities owned by trusts and estates. These changes are discussed below beginning at page 45.

c. "Power to Adjust".

(1) Breadth of the Power. The framers and advocates of UPIA make much of its provision granting the trustee the power to adjust between principal and income "to the extent the trustee considers necessary if the trustee invests and manages trust assets as a prudent investor, the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee determines . . . that the trustee is unable to comply with" the general requirement to administer the trust "impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries." Unif. Prin. & Inc. Act §§ 103(b), 104 (1997). The power to adjust includes the power to allocate all or part of a capital gain to trust income. This power is seen as many as a panacea to cure all of the ills of trust administration. Unfortunately, however, its application is limited.

(2) Limitations on the Power to Adjust. The power to adjust is not available to all trustees. In particular, the power may not be used to make an adjustment: (1) that diminishes the income interest in a trust that requires all of the income to be paid at least annually to a spouse and for which an estate tax or gift tax marital deduction would be allowed, in whole or in part, if the trustee did not have the power to make the adjustment; (2) that reduces the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion; (3) that changes the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets; (4) from any amount that is permanently set aside for charitable purposes under a will or the terms of a trust unless both income and principal are so set aside; (5) if possessing or exercising the power to make an adjustment causes an individual to be treated as the owner of all or part of the trust for income tax purposes, and the individual would not be treated as the owner if the trustee did not possess the power to make an adjustment; (6) if possessing or exercising the power to make an adjustment causes all or part of the trust assets to be included for estate tax purposes in the estate of an individual who has the power to remove a trustee or appoint a trustee, or both, and the assets would not be included in the estate of the individual if the trustee did not possess the power to make an adjustment; (7) if the trustee is a beneficiary

of the trust; or (8) if the trustee is not a beneficiary, but the adjustment would benefit the trustee directly or indirectly. Unif. Prin. & Inc. Act § 104(c) (1997). Many of the trusts with which estate planners struggle fall within category (1) (intended to qualify for the estate tax marital deduction) or (7) (the trustee is a beneficiary). As a result, the power to adjust is simply unavailable in many cases.

d. Equitable Adjustments. UPIA Section 506 permits a fiduciary to make adjustments between principal and income to offset the shifting economic interests or tax benefits between income beneficiaries and remainder beneficiaries that arise from (i) elections that the fiduciary makes from time to time regarding tax matters; (ii) an income tax imposed upon the fiduciary or a beneficiary as a result of a distribution; or (iii) the ownership by an estate or trust of an entity whose taxable income, whether or not distributable, is includible in the taxable income of the estate, trust or a beneficiary. This sort of adjustment, often referred to as an "equitable adjustment," has been the subject of common law decisions in a variety of jurisdictions.

> **Example 7:** Equitable adjustments can be illustrated by *Estate of Bixby*, 140 Cal. App. 2d 326, 295 P.2d 68 (1956). There, the executor elected under Section 642(g) to take deductions for income tax purposes, which reduced income taxes by $100,000.00, at the cost of $60,000.00 in estate tax savings. Based upon the terms of the Will, the income tax savings inured to the benefit of the income beneficiary, while the loss of estate tax savings came at the expense of the remainder beneficiaries. The court required the benefitted estate to pay $60,000.00 in damages to the remainder beneficiaries as an "equitable adjustment." As a result, the remainder beneficiaries were unharmed, and the income beneficiaries received the net $40,000.00 tax savings.

9. Deduction of Interest Paid on Pecuniary Bequests. State law or the governing instrument may provide that at some point in time, the devisee of a pecuniary bequest is entitled to interest on the bequest. Many jurisdictions provide that interest begins to accrue one year after the date of death. See, e.g., Tex. Prop. Code § 116.051(3). UPIA provides that this interest is charges against income to the extent that it is sufficient, and thereafter from principal. Unif. Prin. & Inc. Act § 201(3) (1997). For tax purposes, however, payment of this interest is treated not as a distribution of income, but as an interest expense to the estate and interest income to the beneficiary. Rev. Rul. 73-322, 1973-2 C.B. 44. Under Section 163(h) of the Code, interest is non-deductible "personal interest" unless it comes within an exception, none of which expressly relates to interest on a pecuniary bequest. Some practitioners have sought to characterize this interest as deductible "investment interest." Section 163(d)(3) of the Code defines "investment interest" as interest paid or accrued on indebtedness properly allocable to property held for investment, and capital gains attributable to that property. Property held for investment is described by reference to Section 469(e)(1) of the Code, and includes property that produces interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business. IRS Notice 89-35, 1989-13 IRB 4, provides temporary guidance on allocating interest expense on a debt incurred with respect to certain pass-through entities. Under the Notice, the debt and associated interest expense must be allocated among the assets of the entity using a reasonable method. Reasonable methods of allocating debt among assets ordinarily include pro rata allocation based upon fair market value, book value, or adjusted basis of the assets. Although this Notice does not apply by its terms to indebtedness incurred by an estate in funding a bequest, perhaps these principles can be applied by analogy to estates. This analysis would probably require the executor to examine the activities of the estate. One could argue that a "debt" to the beneficiary was incurred because the estate failed to distribute its assets to fund the pecuniary bequest promptly. As a result, the estate was able to retain assets, including assets that generate portfolio income, as a result of its delay in funding the bequest. In effect, the estate could be said to have "borrowed" these assets from the beneficiary during the period that the distribution was delayed, and it is as a result of this borrowing that the interest is owed under the provisions of the Will or local law. This analysis would mean that to the extent that the assets ultimately distributed to the beneficiary (or sold to pay the beneficiary) were assets of a nature that produced interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business, the interest expense would be deductible to the estate as "investment interest." It should be noted, however, that in an example contained in the Treasury

Return to Table of Contents

Regulations relating to the separate share rules, the IRS states (without explanation) that interest paid on a spouse's elective share that is entitled to no estate income, but only statutory interest, is income to the spouse under Section 61 of the Code, but non-deductible to the estate under Section 163(h). Treas. Reg. § 1.663(c)-5, Ex. 7. The focus of this regulation is on the amount of DNI that will be carried out by the distribution; it properly rules that no DNI is carried out. Its characterization of the interest expense as nondeductible under Section 163(h) is gratuitous, and in this author's view, erroneous. It appears that the only case to consider this matter is *Schwan v. United States*, 264 F. Supp. 887 (DSD 2003). In *Schwan*, the court rejected the executors' argument that the interest was incurred to prevent the forced liquidation of stock held by the estate, noting that the stock had already been transferred to the estate's beneficiary when the interest obligation began to run. The estate, therefore, did not even own the stock when the interest was imposed, and had no interest in preventing its forced liquidation. On these facts, the investment interest question was not squarely before the court.

10. Non-Pro Rata Divisions of Community Property. Can an executor and the surviving spouse make tax free non-pro rata divisions of community property, so that the beneficiaries of the estate own 100% of a community property asset while the surviving spouse succeeds to 100% of other community property assets of equal value? Two 1980 technical advice memoranda suggest that such a tax-free division is permissible. Both rely on Revenue Ruling 76-83, 1976-1 C.B. 213, a ruling involving similar issues in the divorce context, which has since been rendered obsolete by the enactment of Section 1041 of the Code (which expressly provides for non-recognition in the divorce context). Tech. Adv. Mem. 8016050; Tech. Adv. Mem. 8037124. A more recent ruling seems to confirm this analysis, so long as the division is permitted by the governing instrument or by local law. Tech. Adv. Mem. 9422052. Does local law permit such a non-pro rata division? In Texas, at least, there is no direct authority on point. One can construct a reasonable, if complex, argument. Under Section 453.009 of the Texas Estates Code, the executor of an estate takes possession of both halves of the community property of the decedent and the decedent's spouse. Section 360.253 of the Texas Estates Code provides that when a husband or wife die leaving community property, the surviving spouse may, at any time after the grant of letters testamentary and the filing of an inventory, make application to the court for a "partition" of the community property into "two equal moieties, one to be delivered to the surviving spouse and the other to be delivered to the executor or administrator of the deceased spouse's estate. . . . The provisions of this title relating to the partition and distribution of an estate apply to a partition under this section to the extent applicable." Tex. Ests. Code § 360.252(c), (e). At least one court has described equal moieties in this circumstance to be either two groups alike in magnitude, quantity, number or degree, or two groups alike in value or quality. *Estate of Furr*, 553 S.W.2d 676, 679 (Tex. Civ. App.–Amarillo, 1977, writ ref'd n.r.e.). Chapter 360 of the Estates Code deals with partitions and distributions of estate assets generally. The chapter does not require the court to make a pro rata partition of each and every asset of the estate, but permits the court to allocate assets among beneficiaries to achieve a "fair, just and impartial" distribution of estate assets. Similar powers perhaps apply to independent executors acting without court supervision. For example, in the context of a community administrator, there appears to be no requirement to account for specific assets upon the conclusion of the administration. Rather, the responsibility of the survivor is only in the aggregate. *See Leatherwood v. Arnold*, 66 Tex. 414, 416, 1 S.W. 173, 174 (1886). *Cf. Gonzalez v. Gonzalez*, 469 S.W.2d 624, 630 (Tex. Civ. App.–Corpus Christi 1971, writ ref'd n.r.e.) (power of an executor to distribute an estate does not include the right to partition undivided interests, absent express grant of authority in the Will). As to partitions generally, Texas courts in establishing the rights of co-owners of property subject to partition have adopted the concept of "owelty." The classic definition of "owelty" is an amount paid or secured by one co-tenant to another for the purpose of equalizing a partition. Although originally designed to address minor variations in value, the concept has been expanded to the situation where one co-tenant acquires all of the commonly owned property, and the other takes only cash. *See, e.g., McGoodwin v. McGoodwin*, 671 S.W. 2d 880 (Tex. 1984).

IV. ADDITIONAL INCOME TAX ON ESTATES AND TRUSTS

A. Health Care and Education Reconciliation Act of 2010, P.L. 111-152. The year 2013 brought a new income tax to estates and trusts. The Health Care and Education Reconciliation Act of 2010 ("HCA

Return to Table of Contents

2010") imposes an additional 3.8% income tax on individuals, trusts, and estates. Although the tax is similar between individuals on the one hand and trusts and estates on the other, there are some differences.

B. IRC § 1411. The new income tax is found in new Chapter 2A of the Internal Revenue Code entitled "Unearned Income Medicare Contribution." Chapter 2A is comprised only of Section 1411. Although commonly referred to as a Medicare tax (which is understandable based on the name of the Chapter), the funds will not be placed in the Medicare Fund but will go to the General Fund of the Treasury.

For individuals, the 3.8% tax applies to the lesser of net investment income or the excess of a taxpayer's modified adjusted gross income over certain defined thresholds. For estates and trusts, the 3.8% tax applies to the lesser of undistributed net investment income or the excess of adjusted gross income over a threshold determined based on the highest income tax bracket for estates and trusts ($11,950 for 2013 and $12,150 for 2014). For ease of reference, for individuals who are married filing jointly, the threshold is $250,000 (for married filing separately, $125,000 each) and for single individuals, the filing threshold is $200,000. Because the threshold for trusts and estates is based on the highest income tax bracket for each, the threshold is indexed each year to some extent for these entities, whereas there is no indexing for individuals.

The statute as it applies to estates and trusts is as follows:

§ 1411(a) In general. Except as provided in (e) –

(2) Application to estates and trusts. In the case of an estate or trust, there is hereby imposed (in addition to any other tax imposed by this subtitle) for each taxable year a tax of 3.8 percent of the lesser of –

(A) the undistributed net investment income for such taxable year, or

(B) the excess (if any) of –

(i) the adjusted gross income (as defined in section 67(e)) for such taxable year, over

(ii) the dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year.

C. Regulations.

1. Proposed Regulations. On December 5, 2012, the IRS issued a Notice of Proposed Rulemaking ("Notice") seeking comments to proposed Treasury regulations related to Section 1411 (77 FR 72611). As stated in the Notice, the purpose of Section 1411 is to impose a tax on "unearned income or investments." The Notice provides that for the most part, the principles of chapter 1 of subtitle A of the Internal Revenue Code are to be applied in determining the tax to be imposed. In addition, the statute introduces terms that are not defined and makes cross references to various other sections of the Internal Revenue Code; however, as pointed out in the Notice, nothing in the legislative history indicates that a term used in the statute is meant to have the same meaning as it would for other income tax purposes. The proposed regulations are intended to provide additional definitions of terms and guidance for the imposition of the tax. The proposed regulations are "designed to promote the fair administration of section 1411 while preventing circumvention of the purposes of the statute."

2. Final Regulations. On December 2, 2013, the IRS and Treasury Department issued final regulations under Section 1411 ("Final Regulations"). For the most part, the Final Regulations are effective for tax years beginning after December 31, 2013. Section 1.1411-3(d)(3), which applies to charitable remainder trusts, is effective for tax years beginning after December 31, 2012. Interestingly, amendments to the Final Regulations should be issued at some point. Contemporaneously with the Final Regulations, the IRS and Treasury Department issued a new set of proposed regulations (78 FR 72451) to further study specific items under Section 1411.

D. Net Investment Income vs. Undistributed Net Investment Income. Individuals, trusts, and estates now have to calculate their "net investment income." Net investment income consists of the sum of three categories of income. IRC § 1411(c)(1). Keep in mind that in each of the three categories of income, when the term "trade or business" is used, it is in reference to that term as defined in Section 1411(c)(2) and as further defined in Treasury Regulation Section 1.1411-4(b).

The first category of income includes gross income from interest, dividends, annuities, royalties, and rents, other than those that are derived in the ordinary course of a trade or business. Note that each of these types of income may be included in the first category even though they may be earned through an activity that may otherwise be thought of as a trade or business. In order to be excluded from this category, the income must meet the ordinary course of a trade or business exception as set out in Treasury Regulation Section 1.1411-4(b). To meet the exception, the trade or business must be one to which the tax will not apply. The second category of income includes other gross income derived from a trade or business. The third category of income includes net gain from the disposition of property held in a trade or business. From the total of these three categories, deductions that are properly allocable are taken. IRC § 1411(c)(1)(B).

For estates and trusts, the first component of income taken into account is "undistributed" net investment income, a term that is unique to Section 1411. Although the statute does not define what is meant by "undistributed," the proposed regulations apply rules similar to those in Sections 651 and 661 regarding the carry out of distributable net income ("DNI") to beneficiaries. Treas. Reg. § 1.1411-3(e).

Whereas for other income, DNI carries out to beneficiaries to the extent of a trust or estate's taxable income, for purposes of Section 1411, net investment income will carry out to beneficiaries (and the trust will receive a deduction) in an amount equal to the lesser of the trust's DNI or its net investment income. In other words, if a trust has both net investment income and other income, distributions will carry out each class of income pro rata to the beneficiaries. In turn, each beneficiary will pick up the respective classes of income for purposes of computing their income, including net investment income, and the trust will receive corresponding deductions. With the vast difference between the threshold for estates and trusts and individuals, the distribution of net investment income will frequently impact the overall amount of the tax paid.

The interrelation between taxable income, fiduciary accounting income, and DNI can be difficult to understand. When determining a trust's DNI, any amounts that the fiduciary allocates to principal or income for purposes of fiduciary accounting income are irrelevant. Rather, when determining a trust's DNI, the *taxable* income of the trust is what is important. DNI not only determines how much taxable income will be income taxed to a beneficiary, it also determines the amount that will be taxed to a trust or a beneficiary for purposes of Section 1411. Therefore, it is important that these concepts be understood.[8]

E. Trade or Business. The phrase "trade or business" is part of each of the categories of net investment income. Therefore, a fiduciary must evaluate this phrase to determine whether items of income or gain constitute net investment income. Although Treasury Regulation Section 1.1411-1(d)(12) clarifies that a trade or business is one that is defined in Section 162, the term is subject to further limitations of Section 1411. Section 1411(c)(2) limits the application of the tax to a trade or business that is (i) a passive activity or (ii) a trade or business of trading in financial instruments or commodities. IRC § 1411(c)(2); Treas. Reg. § 1.1411-5.. Note that trading in financial instruments or commodities is included regardless of whether or not it is a passive activity. Because income from passive activities comprise the largest portion of what constitutes net investment income, determining what activities are passive is key.

F. Trusts. Although the statute indicates that the tax applies to "trusts," it does not specify which trusts are included. Treasury Regulation Section 1.1411-3(a)(1)(i) specifies that the statute applies to trusts that

[8] The examples in Proposed Treasury Regulation Section 1.1411-3(f) proposed to illustrate the calculation of undistributed net investment income, but Examples 1 and 2 contained a fundamental mistake in excluding a distribution from an individual retirement account when calculating DNI. The calculations were corrected in the Final Regulations. *See* Treas. Reg. § 1.1411-3(e)(5), Exs. 1 and 2.

are subject to part I of subchapter J of chapter 1 of subtitle A of the Internal Revenue Code unless otherwise exempted – in other words, the statute applies to ordinary trusts as defined in Treasury Regulation Section 301.7701-4(a), but not to certain other trusts, including charitable trusts, grantor trusts, foreign trusts, and business trusts. See Treas. Reg. § 1.1411-3(b). Certain charitable estates and foreign estates were also included in the exceptions from the tax pursuant to the Final Regulations. Treas. Reg. §§ 1.1411-3((b)(i), (ix). In addition, because subtitle A does not include tax exempt trusts, the statute does not apply to tax exempt trusts. After receiving comments to the proposed regulations, the Final Regulations also provide that the tax does not apply to certain Alaska Native Settlement Trusts and Cemetery Perpetual Care Funds. Treas. Reg. §§ 1.1411-3((b)(vi), (vii).

G. <u>Grantor Trusts</u>. The grantor trust rules for income tax purposes are to be applied for purposes of Section 1411. Therefore, the 3.8% tax is not imposed on a grantor trust, but items of income or deductions that are attributable to the grantor (or to someone treated as the grantor) are to be treated as if the items had been paid or received by the grantor for calculating his or her own net investment income. Treas. Reg. § 1.1411-3(b)(1)(v).

H. <u>Special Problem Areas</u>. Although the statute uses terms such as "net investment income," "adjusted gross income," "ordinary course of a trade or business," "passive activity" and "disposition," the terms do not necessarily correspond to the same terms as used in other parts of the Internal Revenue Code. Following is a discussion of some net investment income problem areas, but this is in no way meant to be an exhaustive list.

1. <u>Capital Gains</u>. A review of the statute and proposed regulations raises a concern for existing trusts and estates with regard to the treatment of capital gains. As mentioned above, trust and estate income is taxed to the trust or estate unless the income (or more specifically unless the trust's or estate's DNI) is carried out to the beneficiaries. As a general rule, capital gains are not treated as part of DNI. This general rule applies as long as those gains are allocated to corpus and are not "paid, credited, or required to be distributed to any beneficiary during the taxable year." IRC § 643(a)(3). However, pursuant to Section 643 and the related Treasury regulations, capital gains may be included in DNI under certain conditions and if done pursuant to local law, the trust agreement, or "a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law)." Treas. Reg. § 1.643(a)-3(b).

Two of the three conditions which allow a fiduciary to allocate capital gains to DNI can invoke a consistency requirement by the fiduciary for all future years. Id. Most commentators and practitioners believe that in the first year that a trust or estate incurs capital gains, once a fiduciary decides to allocate the capital gains to DNI or not to do so, the fiduciary has in effect made an election that remains in place for all future years of the trust or estate. Unfortunately, there is no authority or guidance in this area to suggest otherwise. A trust or an estate may have the ability to allocate capital gains to corpus on a case-by-case basis under a narrow condition provided by Treasury Regulation Section 1.643(a)-3(b)(3), but there is no clear guidance for fiduciaries as to how to meet the condition under this so-called "deeming rule." Since many capital gains are included in net investment income under Section 1411, trusts and estates that do not include capital gains in DNI (which are most trusts and estates), or cannot "deem" capital gains to be part of DNI under the narrow condition provided in the regulations, will have this component of net investment income trapped as undistributed net investment income, taxable to the trust or estate. Section 1411 does not (and the related proposed Treasury regulations did not) address this issue for existing trusts or estates, although for other similar elections, an entity is given a fresh start to make a new election. The IRS and Treasury received comments requesting that existing trusts and estates that incur capital gains after December 31, 2012 be given the option to reconsider how capital gains are to be allocated. The Final Regulations, however, did not adopt the request, reasoning that a fiduciary's decision in this regard is similar to other elections "that only indirectly impact the computation of net investment income" and that potential changes in the capital gains rate is something foreseeable to a fiduciary when making the election. See Final Regulations, Summary of Comments and Explanation of Provisions, § 4.E.

2. Passive Activities, Passive Income, and the Passive Loss Rules. The statute does not define to what extent the passive loss rules for "ordinary" income taxes will apply. For purposes of Section 1411, however, passive activities are those that are included within the meaning of Section 469. IRC § 1411(c)(2)(A). To determine if an activity is a passive activity, a two-step determination is needed. First, the activity must be a trade or business within Section 162. Second, the activity must be passive within the meaning of Section 469, which means the taxpayer must not materially participate in the trade or business. Treas. Reg. §§ 1.1411-1(d)(12), 1.1411-5(b). Section 469 further provides that in order for a taxpayer to materially participate in an activity, the taxpayer must be involved in the operations of the activity on a regular, continuous and substantial basis. IRC § 469(h)(1). It appears that for the most part, the majority of passive income will be included in the calculation of the tax under Section 1411. However, there are certain exceptions where items that are generally thought of as passive are not included and vice versa, such as in the case of actively managed real estate investments. As a result, practitioners will need to not only have a good understanding of Section 469 and its related Treasury regulations to know what constitutes a passive activity but will also need to master the exceptions under Section 1411 when computing net investment income.

a. Material Participation. Because Section 1411 defers to Section 469 to define a passive activity, we must look to Section 469. For determining the disallowance of passive activity losses and credits, Section 469 applies to individuals, trusts[9], estates, closely held C corporations, and personal service corporations. IRC § 469(a). Although Section 469 applies to trusts and estates, what amounts to material participation by a trust or estate has not been defined beyond the requirement that the taxpayer's involvement in the operations of the business must be regular, continuous and substantial. The temporary regulations outline seven separate tests that an individual may satisfy in order to meet the definition of material participation and avoid the passive loss disallowance rules. Since the statute was enacted in 1986, however, no such regulations have been issued for trusts and estates. Temp. Treas. Reg. § 1.469-5T(a), 1.469-5T(g), 1.469-8.

From Section 469 we can glean that the taxpayer's involvement in the operations is what is important. However, for trusts and estates, who the taxpayer is continues to be an issue. Until March of this year, only one federal case had addressed this issue. In *Mattie K. Carter Trust v. U.S.*, 256 F.Supp.2d 536 (N.D. Tex. 2003), a testamentary trust owned a cattle ranching operation as a proprietorship and not through an LLC or other entity. In addition to work done by the trustee himself, the trust employed a ranch manager and other employees. The work done by the trustee, the ranch manager, and the other employees was performed on behalf of the trust. The IRS argued that the trustee is the taxpayer and only his activities should be considered to determine whether the trustee materially participated in the operations. The trust argued that the trust, as a legal entity, is the taxpayer and the activities of the fiduciaries, employees and agents of the trust should be considered. The court looked to the plain language of Section 469 which states that a trust is the taxpayer, and in agreeing with the trust, held that the material participation of the trust should be determined by looking at the activities of all persons acting on behalf of the trust, not solely the trustee. The court noted that common sense says that in order to determine material participation by a trust, one must look to the activities of all of those who work on behalf of the trust.[10]

In the decade since the holding in the Mattie K. Carter Trust case, and with no regulations having being issued, the IRS has continued to maintain its position that only the activities of the trustee should be considered. See, PLR 201029014; TAM 201317010; TAM 200733023. The only source that the IRS cites for its position is language in the legislative history of Section 469 that states that "an estate or trust is treated as materially participating in an activity . . . if an executor or fiduciary, in his capacity as such,

[9] Like with Section 469, the trusts at issue are non grantor trusts because the passive activity loss rules do not apply to grantor trusts and instead are applied at the grantor level. Temp. Treas. Reg. § 1.469-1T(b)(2).

[10] In criticizing the IRS, the court went as far as to say that the IRS's position that only the activities of the trustee himself should be considered is "arbitrary, subverts common sense, and attempts to create an ambiguity where there is none." *Id*. Zowie!

Return to Table of Contents

is so participating." S. Rep. No. 99-313, 99th Cong., 2d Sess. 735 (1986). It is important to note, however, that nothing in the legislative history indicates that looking to the actions of an executor or trustee is the exclusive way to determine material participation by a trust or an estate. In the most recent Technical Advice Memorandum, the IRS again found that the language in the legislative history is the standard to apply to trusts for determining material participation. In so finding, the IRS inexplicably comes to the conclusion that the sole means for making such determination is to find that in the operation of the activity, the activities of fiduciaries, in their capacities as fiduciaries, are conducted on a regular, continuous, and substantial basis. TAM 201317010.

In relying on limited language in legislative history for its reasoning in these decisions, the IRS appears to ignore the ability to consider activities of employees when determining material participation by other categories of taxpayers in Section 469. See, Temp. Treas. Reg. § 1.469-1T(g) (allowing activities of employees of corporation to be taken into account by virtue of the rules of Section 465(c)(7)) and Temp. Treas. Reg. § 1.469-5T(k) (Examples 1 and 2 where activity as employee of owner of entity counts toward whether entity materially participates in a business). Although it may be understandable to disregard the activities of employees of the underlying operation who are not trustees, employees of the trust itself are not the same, and their activities should be taken into account. Unless and until the IRS reverses its narrow view of these rules, commentators suggest for trusts that own an interest in an entity such as a limited liability company, the entity might be structured to be member-managed so that the activities of the trustee (owner) count toward material participation. Of course, in this case, the trustee would owe fiduciary obligations to the company as well as to the trust beneficiaries and would need to explore how best to deal with any potential division of loyalties in exercising its fiduciary duties. For other thoughts and potential planning alternatives when a trust owns an interest in a business entity, see Gorin, Structuring Ownership of Privately-Owned Business: Tax and Estate Planning Implications (available by emailing the author at sgorin@thompsoncoburn.com to request a copy or request to subscribe to his newsletter "Gorin's Business Succession Solutions").

The recent Tax Court decision in Frank Aragona Trust v. Comm'r., 142 T.C. No. 9, may give some comfort for individual trustees. Although the case is very fact-specific, it does give some guidance as to the attitude of the Tax Court. The case involved the issues of whether a trustee can qualify for a certain exception under Section 469 for real estate activities for real estate professionals and whether a trust can materially participate in a rental real estate business. The issues arose because the trust had claimed losses from rental activities as non-passive activity losses. Because the Section 469 exception involves a determination of material participation by a taxpayer, the court's ruling may have an impact on interpreting a trustee's material participation for other purposes of Section 469. In Frank Aragona Trust, five siblings served as co-trustees together with one independent trustee of a trust that was the sole owner of a limited liability company that was in the rental real estate business. Three of the siblings were also employed by the LLC. Disregarding the IRS's arguments that a trust can never satisfy the real estate professional exception and that activities of a trustee-employee should not be considered in determining material participation, the court held that (1) if a trustee is an individual and works in a trade or business as part of its trustee duties, the trustee's work may be considered personal services of an individual in order to determine if the real estate professional exception under Section 469(c)(7) is met, and (2) because of duties set out in applicable state law (which seem to be the duties arising under the common law of every state), the activities of a trustee, both in its capacity as a trustee and as an employee, are to be considered in determining whether the trust materially participates in the business.

Section 1411 and the Final Regulations require taxpayers to look to Section 469 for the passive activity loss rules. It seems evident that the IRS and Treasury Department did not want to add anything new to the passive activity loss rules through Section 1411. With no regulations being issued for Section 469 to deal with passive activities and material participation for trust and estates, as expected the Final Regulations declined to address the issue and practitioners continue to struggle in giving guidance to give their clients. Although recognizing that commentators to the proposed regulations raised valid concerns regarding this issue, the IRS and Treasury Department deferred to Section 469 and a separate study of the issue being conducted from which separate guidance may come. Comments were welcomed for consideration and several groups have indicated plans to respond. See Final Regulations, Summary of Comments and Explanation of Provisions, § 4.F.

3. Qualified Subchapter S Trusts ("QSSTs"). In most cases, when a trust owns stock in an S corporation and the income beneficiary makes an election to have the trust treated as a QSST, because the beneficiary is treated as the owner of the stock for income tax purposes, all income from the S corporation which is attributable to the QSST will be taxed to the beneficiary.[11] Treas. Reg. § 1.1361-1(j)(7). An exception to this rule is when a disposition of the S stock occurs. In that case, the beneficiary is not treated as the owner and any resulting gain or loss that is recognized will be reported by the trust. Treas. Reg. § 1.1361-1(j)(8). For Section 1411 purposes, neither the statute nor the original proposed regulations provide any special rules that would change these results. Rather than issuing final regulations regarding QSSTs, the IRS and Treasury Department issued a new set of proposed regulations at the same time as the Final Regulations. Under the new proposed regulations, these same rules will apply with regard to allocating income and gain for QSSTs. As a result, a QSST's share of an S corporation's net investment income will be taxed to the beneficiary, but net investment income arising from a sale of S corporation stock will be taxed to the trust. Prop. Treas. Reg. § 1.1411-7(a)(4)(iii)(C). Moreover, the passive nature of any gains or loss on the disposition will be determined at the trust level, and will not be based on the material participation of the beneficiary. *Id*. In determining the amount of net investment income that results from a sale of S corporation stock, the new proposed regulations set out complex rules for entities that have activities that are passive only in part as to the transferor. *See*, Prop. Treas. Reg. §§ 1.1411-7(b)-(c).

As a reminder, income for trust and estate purposes is not always the same as income for income tax purposes. Section 643(b) provides that for trusts and estates, if the general term "income" is used, it means fiduciary accounting income as determined pursuant to the governing instrument and local law, and *not* taxable income. IRC § 643(b). Because a beneficiary will have to report taxable income as part of DNI but will receive only a distribution of fiduciary accounting income (if any), the distinction between fiduciary accounting income and taxable income is important when considering a QSST election. Accordingly, it raises the question as to whether a beneficiary should try to obtain some assurance or guarantee from the trustee regarding sufficient cash distributions, whether of income or principal, in order to pay any income tax liability that arises from the QSST election. For additional discussion regarding the income characterization issues, see Davis, *Funding Testamentary Trusts: Tax and Non-Tax Issues*, State Bar of Texas Adv. Est. Pl. Strat. Course (2013).

4. Electing Small Business Trusts ("ESBTs"). In contrast to a QSST, when a trust holds S corporation stock and the trustee makes an election to have the trust treated as an ESBT, all income from the S corporation is taxed to the trust at the highest income tax bracket, regardless of whether any income is distributed to a beneficiary and without regard to any threshold. IRC § 641(c). The portion of the trust that holds the S corporation stock is treated as if it were a separate trust. Id. If all or any portion of an ESBT is a grantor trust, the income attributable to such portion is taxable to the grantor. Treas. Reg. § 1.641(c)-1(c). As with other S corporation shareholders, in making an ESBT election, a trustee would want some assurance from the S corporation that sufficient cash distributions will be made from the corporation to allow the trustee to pay any income tax liability. An ESBT will have to pay income tax on its share of S corporation income at the highest marginal rate. The trustee of an ESBT, therefore, must make careful consideration before making any distributions to beneficiaries, since the trust will need to retain sufficient funds to pay any income tax liability and will not have the advantage of reducing the trust's taxable income since it will not receive a distribution deduction for these distributions.

Also in contrast to QSSTs, Section 1411 provides special rules for ESBTs. In Treasury Regulation Section 1.1411-3(c), two separate computations are made to determine whether income of an ESBT is subject to the net investment income tax. In line with the stated attempt to preserve as much Chapter 1

[11] Remember that because a QSST is treated as a grantor trust that is deemed to be owned by the beneficiary, the character of income is determined and the test for material participation occurs at the deemed owner level instead of at the trust level.

treatment as possible, the first calculation requires that the amount of the undistributed net investment income be calculated for each of the separate S and non S portions of the trust. The separate treatment is disregarded, however, for the second calculation because the Final Regulations require the ESBT to then calculate its adjusted gross income by combining the adjusted gross income of the non S portion of the trust with the net income or net loss of the S portion of the trust. Id. In other words, the trust is treated as a single trust for determining whether the trust's adjusted gross income exceeds the Section 1411 threshold. The trust is then to pay tax on the lesser of the trust's total undistributed net investment income or the excess of the trust's adjusted gross income over the trust's threshold. Treas. Reg. § 1.1411-3(c)(2)(iii). Treasury Regulation Section 1.1411-3(c)(3) provides a detailed example of the calculation. Again, as discussed above, these calculations can be avoided if the trustee's involvement in the S corporation constitutes material participation which would prevent treatment as a passive activity and imposition of the net investment income tax.

5. Charitable Remainder Trusts. Although charitable remainder trusts are not themselves subject to Section 1411, distributions that are made to non-charitable beneficiaries may be. The first set of proposed regulations provided what was termed by the IRS and Treasury Department to be a simplified method of reporting for charitable remainder trusts. After receiving comments requesting that net investment income of a charitable remainder trust be treated as a subset of the income earned by the trust, the Final Regulations adopted this approach. Therefore, for a charitable remainder trust, net investment income is assigned to the related tier or class of income set forth in Section 664 of the Code and is distributed to a beneficiary as that class of income is distributed. Treas. Reg. § 1.1411-3(d). The Final Regulations require that the trustee keep track of accumulated net investment income (i.e., net investment income accrued but not distributed after December 31, 2012). Treas. Reg. § 1.1411-3(d)(1)(iii). Any non-accumulated net investment income is also to be tracked but will be treated as excluded income for purposes of Section 1411 of the Code. Treas. Reg. § 1.1411-3(d)(2). In issuing the new set of proposed regulations, the IRS and Treasury Department requested comments as to whether the alternate simplified approach should be retained and a section of the Final Regulations was reserved for this purpose, just in case. Pursuant to the alternative method, the net investment income of a non-charitable beneficiary would include an amount equal to the lesser of the distributions made for the year or the trust's current and accumulated net investment income. Prop. Treas. Reg. § 1.1411-3(d)(2)(ii). In addition, certain character and ordering rules would be imposed in order to first distribute net investment income proportionately among the non-charitable beneficiaries before any amounts of non-net investment income. Id. For many non-charitable beneficiaries of charitable remainder trusts, the alternative method appears to be a WIFO ("worst in – first out") approach, thereby imposing another layer of tax on these beneficiaries. However, for some charitable remainder trusts, such as those that never accumulate net investment income, the simplified approach may be preferred. Availability of the simplified approach will not be known until the IRS and Treasury Department review requested comments and determines whether to amend the Final Regulations.

6. Allowable Losses and Properly Allocable Deductions. The only deductions allowed in computing net investment income are those that are allowed by subtitle A of Chapter 1 of the Internal Revenue Code and that are properly allocated to the gross income or net gain that is part of net investment income. IRC § 1411(c)(1)(B). The key is that the deductions must be allocable to the related gross income or net gain. In addition, in general, allowable losses may not exceed net gain such that net gain will be less than zero.[12] Treas. Reg. § 1.1411-4(d)(2). Treasury Regulation Section 1.1411-4 places further limitations on the amount and timing of deductions. In the Notice, the IRS asked for comments regarding the treatment of certain deductions, such as suspended passive losses and net operating losses.

[12] An exception to this general rule is found in Treasury Regulation Section 1.1411-4(f)(4). If a loss is described in Section 165 of the Code, any excess loss may be deducted against unrelated net investment income if it is not used in computing net gain under Section 1.1411-4(d). In other words, a loss will first offset a related net gain down to zero, and if any excess loss remains, the loss can offset any unrelated net investment income.

Of particular note, the Final Regulations specify deductions that are considered property allocable. Some of these deductions are: a deduction for unrecovered basis in an annuity in a decedent's final year; a deduction to beneficiaries of a trust or estate for any net operating losses, capital loss carryovers, and other excess deductions passing to them in the final year of the trust or estate as provided in Section 642(h) of the Code; deductions in respect of a decedent as provided in Section 691(b) of the Code; a deduction for estate taxes paid on IRD items as provided in Section 691(c) of the Code; and a deduction for ordinary and necessary expenses related to the determination, refund, or collection of tax, to be allocated to net investment income using any reasonable method. Treas. Reg. §§ 1.1411-4(f)(3)(iv), (f)(3)(v), (f)(3) (vi), (g)(3), (g)(4). If an IRD item is an ordinary income item, the deduction for the related estate tax pursuant to Section 691(c) of the Code is treated as an itemized deduction not subject to the 2% floor, whereas if the IRD item is a capital gain, the deduction is used in calculating net gain. Treas. Reg. §§ 1.1411-4(f)(3)(v), (7).

I. <u>Special Notes</u>. A few additional items of note:

1. <u>Tax Does Not Apply to Distributions from Qualified Plans</u>. You will recall that there are two components of income used to measure whether the tax will apply. One type of income is net investment income and the other is adjusted gross income (modified adjusted gross income for individuals and adjusted gross income as defined in Section 67(e) of the Code for trusts and estates). Section 1411(c)(5) provides that net investment income does not include distributions from qualified plans. However, there is no exception for distributions from qualified plans for purposes of computing adjusted gross income. As a result, distributions from qualified plans may push the trust or estate into the top income tax bracket, exposing its net investment income to the 3.8% tax.

2. <u>Nonresident Aliens</u>. The tax does not apply to nonresident aliens. IRC § 1411(e)(1).

J. <u>Planning for the Tax</u>. The additional 3.8% income tax on trusts and estates can be considered an additional cost of forming a trust or administering an estate. Items to consider include:

- Planners will need to advise clients that certain investments may subject estates and trusts to additional income tax. For example, when funding testamentary trusts, it may be more desirable to transfer the homestead to the surviving spouse and make a non pro rata distribution of other assets to fund the trust so that if the homestead is later sold, any appreciation will not be subject to the tax imposed under Section 1411.

- There may be even more reason for clients to take a team approach with the attorney, accountant and financial planner to adequately plan to minimize the additional tax burden.

- Fiduciaries have a greater burden with the additional recordkeeping necessary to track assets that may be subject to the 3.8% tax, and most likely will need even more assistance than before from accountants.

- When evaluating whether to make a distribution, fiduciaries may desire additional cooperation between themselves and beneficiaries in order to better evaluate the tax brackets of each as they relate not only to income taxes, but also the tax on net investment income.

- There may be more incentive to speed up the administration of estates to minimize the potential of the additional tax that may not apply once the assets which produce net investment income are transferred to beneficiaries.

- Fiduciaries will need to weigh whether it is better to invest more in assets that are not subject to the tax, such as those that produce tax-exempt income vs. those assets that may produce a higher after-tax return regardless of this additional tax.

- There may be more incentive to take a buy-and-hold approach to investing in order to put off the additional tax burden that may arise from recognizing capital gains.

V. STATE INCOME TAXATION OF TRUSTS

In considering income tax consequences of trust administration, it is important to consider not only federal income tax issues, but also issues relating to state income taxes. Trusts can present unique multi-jurisdictional problems when the trust is established by a grantor in one state, administered by a trustee residing in another state, for the benefit of beneficiaries in one or more other states. Moreover, the trust may hold income-producing property situated in yet another state. Although many states have statutes designed to limit the taxation of trust income in multiple states, no state imposing an income tax wishes to lose tax revenue to another state. Therefore, these double-tax prevention measures are imperfect at best. A detailed, if somewhat dated, discussion of the state tax regime attributable to trusts, together with a helpful summary of state tax rules and rates in each state, is set forth in Gutierrez and Keydel, "Study 6: State Taxation on Income of Trusts with Multi-State Contacts," ACTEC STUDIES (2001). An updated table is found in the current ACTEC State Survey (formerly ACTEC STUDIES) Neno, "Bases of State Income Taxation of Nongrantor Trusts".

A. Constitutional Issues. In order to pass constitutional muster, a state seeking to impose tax on a trust's income must establish some nexus to the trust. In the words of the Supreme Court, "due process requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Miller Bros. V. Maryland*, 347 U.S. 340, 344-45 (1953). In general, states may impose a tax on nonresidents with respect to income derived within the state, so long as the tax is no more onerous than the tax imposed under like circumstances on residents of the taxing state. *Shaffer v. Carter*, 252 U.S. 37, 50 (1919).

1. The Nexus Requirement. For most states, "contacts" with the state are described in terms of "residency." A state may constitutionally tax all of the income of its residents, regardless of the source of that income. *Oklahoma Tax Comm'n v. Chickasaw Nation*, 515 U.S. 450, 462-63 (1995). If a trust is determined to be a resident of a state, the state may tax the trust's undistributed income. *New York ex rel. Cohn v. Graves*, 300 U.S. 308 (1937). The due process clause of the United States Constitution required that residency be based upon a sufficient nexus between the trust and the taxing state.

2. Contacts Supporting State Taxation. The seminal case in the area of establishing a trust's "residency" for income tax purposes points to six factors to consider in fixing this nexus. *Swift Trust v. Director of Revenue*, 727 S.W.2d 880 (Mo. 1987). These factors are (1) the domicile of the grantor; (2) the state in which the trust is created; (3) the location of the trust property; (4) the domicile of the beneficiaries; (5) the domicile of the trustee; and (6) the location of the administration of the trust. Moreover, the nexus must be tested not at the inception of the trust, but at the time that the tax is being imposed. The *Swift Trust* court held that of these six factors, the first two are irrelevant for years following the inception of the trust, and the domicile of the beneficiaries was not a sufficiently important nexus. Therefore, the other three factors (location of trust property, domicile of the trustee and location of administration) were determinative.

3. Broader Views of Contacts. Some states take a much broader view of which contacts support taxation than did the *Swift Trust* court. For example, the Connecticut Supreme Court found that the domicile of the grantor at the time of death is sufficient to establish the residence of the trust for state income tax purposes. *Chase Manhattan Bank v. Gavin*, 733 A.2d 780, 782 (Conn. 1999). The court in *Chase* distinguished the much earlier United States Supreme Court case of *Safe Deposit & Trust Co. v. Virginia*, 280 U.S. 83 (1929) on the somewhat dubious basis that the court there applied the due process clause to avoid the taxation of intangibles in multiple jurisdictions, noting that this tax issue was not now a part of the due process jurisprudence. The *Swift Trust* line of cases has also been called into question by the U.S. Supreme Court's decision in *Quill v. North Dakota*, 504 U.S. 298, 307-08 (1992), which extended the nexus test to cases in which an entity has an "economic presence" in a state, even though it does not have a physical presence there.

4. Interstate Commerce Issues. While the *Quill* decision extended the notion of nexus for due process purposes, it added new requirements for state taxation to pass muster under the Constitution's commerce clause. First, the tax must be fairly apportioned among all jurisdictions with which the entity has a nexus. Second, the tax must not discriminate against interstate commerce. Finally, the tax must be fair relative to

the benefits provided to the entity by the state. 504 U.S. 298, 311. Application of these principles to the multi-state income taxation of trusts awaits further analysis by the courts.

B. State Tax Regimes.

1. Resident vs. Non-Resident Trusts. Most states implement their tax regimes by differentiating between "resident" and "nonresident" trusts. Therefore, a preliminary matter in determining state income tax issues is to identify the "residence" of the trust. States do not, however, apply a uniform test in determining which trust is classified as a "resident" trust. *See* Gutierrez, "Oops! The State Income Taxation of Multi-jurisdictional Trusts," 25 U. MIAMI HECKERLING INST ON EST. PL. 12 (1991). States typically impose an income tax on all income of resident trusts, regardless of where it is earned. On the other hand, for nonresident trusts, states generally impose tax only on income derived from sources located within the taxing state. For most states, in-state revenue sources are limited to income derived from real estate located within the state, or from closely held businesses situated within the state.

2. Determining Trust Residency.

a. Residence of the Grantor. Most states use the residency of the grantor as the starting point for fixing the residency of the trust. For example, Missouri, New York, Virginia, and the District of Columbia impose an income tax on the trust where the only contact with the state is the residency of the grantor at the time the trust is created (or in the case of an revocable trust, the time that the trust becomes irrevocable). Other states add a requirement that at least some trust property is situated in the state.

b. Residence of the Trustee. The trustee is the legal owner of the assets of the trust. As a result, many states (e.g., Arkansas and California) use the residence of the trustee as the main criterion for fixing the trust's residence. Some states take other factors into consideration. For example, Indiana does not treat a trust as a resident trust if half or less of the trustees are resident there and the trust situs is in another state.

c. Place of Administration. Some states, such as Colorado, Utah and West Virginia, look primarily or exclusively to the place of administration as the basis of determining a trust's residence. Other states have found that the place of administration alone is not a sufficient nexus to a state to support state income taxation. See *Bayfield County v. Pishon*, 162 Wis. 466, 156 N.W. 463 (1916).

d. Residency of the Beneficiary. Most states do not look to the residence of the beneficiary to determine trust residence. A beneficiary resident in the state may be taxed on income distributed to that beneficiary, but the trust is generally not taxed by virtue of the beneficiary's residence alone. *Mauire v. Tefery*, 253 U.S. 12 (1938); *Guaranty Trust Co. v. Virginia*, 305 U.S. 19 (1938). Eight states, however, do look to the residence of the beneficiary. For example, Georgia imposes a tax on trusts with beneficiaries residing in Georgia, or more precisely, a resident trustee may avoid taxation on income that is distributed to, or accumulated for later distribution to, a non-resident of Georgia, if the income is received from business done outside of Georgia or from property outside of Georgia. O.C.G.A. § 48-7-22(a)(3)(A).

3. Income Derived from Within the State. Almost all states imposing an income tax do so on income derived from sources derived within the state, regardless of the residency of the trust. The benefit that the state provides to enable the production of income generally provides a sufficient nexus to permit the state to tax locally derived income of nonresident trusts. *Shaffer v. Carter*, 252 U.S. 37 (1920). Domestic income typically includes income from real or tangible property located within the state, the conduct of a business located within the state, or to intangible property which has acquired a business situs within the state.

C. Selecting a Trust Situs to Avoid State Tax. State income taxation is one of several factors that a grantor may consider in selecting the situs to establish a trust. Moreover, if permitted, a trustee may seek to move the situs of a trust to a state that offers a favorable state income tax environment. For a discussion of these issue, see Warnick and Pareja, "Selecting a Trust Situs in the 21st Century," PROB. &

Return to Table of Contents

PROP. 53 (Mar/Apr 2002); Sligar, "Changing Trust Situs: The Legal Considerations of 'Forum Shopping'," TR. & EST., July 1996 at 40.

VI. OVERVIEW OF INCOME TAXATION OF FLOW-THROUGH ENTITIES

A. Partnerships.

1. Entity Not Taxed. Partnerships are subject to a unique set of rules under the Internal Revenue Code. On the one hand, a partnership may be viewed for some purposes as entity. In other contexts, a partnership is viewed as an aggregate of individual partners. Congress chose the latter approach in taxing income derived through a partnership. In other words, unlike an individual, trust or corporation, a partnership itself is not subject to income tax. Instead, the partnership serves only as a reporting vehicle for the partners. The partners themselves must pay tax on the income generated by partnership operations. This conduit theory of taxation is sometimes difficult to apply. Most taxpayers operate on a cash basis, and pay tax based upon their own realization events (and cash flow). The partnership, however, does not pay tax. It simply records realization events at the partnership level and reports them to the partners (and the IRS). The cash flow between the partnership and its partners is largely irrelevant.

2. Taxation of Partners. The partners in a partnership are the taxpayers with respect to partnership income, losses, deductions and credits. These items, as they arise at the partnership level, are treated as having occurred at the partner level, and are allocated among the partners in accordance with the terms of the partnership agreement. Note that the partners are taxed on partnership activities, regardless of whether the partnership makes distributions to the partners. In that regard, a partner in a partnership is not taxed based upon the cash flow rules that most individual taxpayers are otherwise accustomed. Partners need not apportion individual items of income, loss, deduction or credit among them equally or in the ratio of their contributions. They may agree to any form of allocation. In order to ensure that the allocation of these items is not manipulated by the partners to artificially minimize taxation, the allocations are given effect only if they have a substantial basis in economic reality as among the partners themselves. IRC § 704.

3. Basis Issues. As with other taxpayers, partnership basis plays a key role in measuring gains and losses. Partnerships present an unusual layering of these rules, however, since a partner may sell not only his or her interest in the partnership's assets, but also his or her partnership interest itself. Thus, separate measures must be made of the partnership's basis in its assets, and the partners' respective bases in their partnership interests.

a. Inside Basis. The partnership's basis in the assets held by the partnership is figured much like a corporation's basis in its assets. Thus, for example, assets contributed by the partners to the partnership generally have a carry-over of the contributing partner's basis. Assets acquired by the partnership have a basis equal to cost. Depreciation may be taken at the partnership level (and passed through to the partners), thereby decreasing the partnership's basis in the depreciated assets.

b. Outside Basis. The partners themselves also have a basis in their partnership interest. Partners who enter the partnership by contributing assets generally begin with a basis equal to the basis of the assets contributed. Partners who acquire their interest by purchase from another partner begin with a basis equal to the purchase price. In either event, each partner's basis in the partnership is thereafter increased by his or her share of partnership income, and the basis of assets later contributed to the partnership, and is decreased by his or her share of partnership losses, and the basis of property distributed to him or her by the partnership. If a partnership makes distributions to its partners in excess of their unrecovered basis in the partnership, those distributions are generally taxed to the partners.

B. S Corporations.

Most corporations are taxed upon the income earned by the corporation. If income is later distributed to the corporation's shareholders, that income is again taxed at the shareholder level as a dividend. This regime of double taxation can make operation as a corporation unattractive for many businesses. At the same time, however, the limited liability afforded to corporate operations under state law makes operating as a corporation extremely attractive for businesses. To address this dilemma, Congress permits certain qualified corporations and their shareholders to opt out of the usual tax system for corporations (described in Subchapter C of the Internal Revenue Code) and instead elect to be taxed much as a partnership (under Subchapter S of the Code).

1. Qualification. Only eligible small business corporations may elect to avoid the double tax regime applied to most corporate taxpayers. An eligible small business is one which does not have more than 100 shareholders, all of whom are individuals (or estates or certain eligible trusts), and none of whom are nonresident aliens. In addition, the corporation must not have more than one class of stock. If the corporation meets these threshold requirements, and if the corporation and each shareholder makes an election to be taxed as an "S Corporation," then the corporation itself is generally not taxed.

2. Entity Not Taxed. An S corporation is not itself subject to tax (except in very rare instances which are beyond the scope of this overview). Instead, the entity is treated for most purposes like a partnership. The shareholders are subjected to tax on the S corporation's items of income, losses, deductions and credits, much like the partners of a partnership. Since S corporations must have only one class of stock, these items cannot be specially allocated among the shareholders. Instead, they are generally passed out to the shareholders pro rata, based upon their respective shareholdings.

3. Basis Issues. S corporation basis issues are similar to those arising with partnerships. The corporation must keep track of its basis in the assets owned by the corporation. At the same time, the shareholders themselves must keep track of their "outside" basis in their stock, which is adjusted to reflect income and losses of the corporation, as well as contributions by and distributions to shareholders.

4. Ownership By Trusts and Estates. In adopting the S corporation rules, Congress sought to limit their application to those entities that have identifiable domestic individuals as shareholders. Since an individual is mortal, the rule was extended to permit estates of decedents to remain as shareholders of S corporations during a reasonable period of administration. Congress apparently viewed trusts with somewhat more suspicion, as potential vehicles to shift income away from domestic individuals, or at least to complicate identification of the appropriate taxpayers. As a result, only a limited class of trusts are permitted to be S corporation shareholders. Ownership of S corporation stock by prohibited trusts terminates the S corporation election. Code Section 1361(c)(2)(A) limits trust ownership of S corporation stock to:

- Trusts that qualify as grantor trusts (the grantor is treated as the taxpayer);
- Trusts receiving stock pursuant to the terms of a Will, for a period of two years, beginning on the date that the stock is transferred to the trust, not the date of death (the trust is treated as the taxpayer);
- A Qualified Subchapter S Trust ("QSST"), which is a trust with a single income beneficiary who is entitled to receive all income annually, and which requires that any principal distributions during the beneficiary's lifetime be made only to that beneficiary (the electing beneficiary is treated as the taxpayer);
- An Electing Small Business Trust ("ESBT"), which is a trust which has only eligible individuals, estates or certain charities as beneficiaries, and for which the trustee makes an election to have the S stock treated as a separate trust, (the trust is treated as the taxpayer, taxed at the highest marginal federal income tax rate, regardless of whether its income is distributed).

C. Limited Liability Companies. A limited liability company is in large measure a hybrid entity under state law. It typically operates much as partnership under applicable state statutes, but has the uniquely corporate characteristic of limited liability. That is, unlike a general partnership (or the general partners of a limited partnership) the owners of a limited liability company have no personal liability to the creditors of the entity. Members of an LLC are in that respect very much like the shareholders of a corporation. The Internal Revenue Code does not set forth separate treatment for limited liability companies. Instead, unless the entity elects otherwise, it is taxed as a partnership for federal income tax purposes. Theoretically, the LLC could elect to be taxed as a corporation, and then if it met the eligibility requirements, it could make an S election. Most LLCs, however, simply accept partnership tax treatment.

In that regard, they may adopt special allocation rules to apportion profits and losses among members and obtain flow-through tax treatment (like a partnership), while retaining limited liability under state law (like a corporation).

VII. INCOME TAX ISSUES ASSOCIATED WITH FLOW-THROUGH ASSETS

A. Issues Unique to Estates.

1. Basis and the Section 754 Election.

a. Rationale for the Election. Upon the death of a partner, the partner's partnership interest is revalued based on date of death value or the value on the alternate valuation date. IRC § 1014(a). Unfortunately, however, this step-up affects only the partner's "outside" basis in the partnership interest. It has no direct effect on the partnership's "inside" basis in its assets. If the partnership sells an appreciated asset after the death of the deceased partner, the successor partner generally must report gain as if no step-up in basis of the asset had occurred. To alleviate this harsh result, the Code offers a unique tax advantage to a successor of a decedent's partnership interest. If the partnership makes a Section 754 election, the successor partner (but not the other partners) can increase his or her share of the "inside" basis of partnership assets by the difference between the stepped-up "outside basis" and the decedent's old inside share of the partnership assets. This increase in inside basis allows the inheriting partner to recognize less gain or more loss when assets are later sold by the partnership. If there is depreciable property, the inheriting partner can claim higher depreciation deductions than the other partners based on the higher inside depreciable basis. Conventional wisdom usually suggests making the Section 754 election on the death of a partner. However, a Section 754 can be a two-edged sword. It has several disadvantages. As one might imagine, a Section 754 election can dramatically increase the partnership's record keeping requirements, especially if several partners die (or sell their interests). Second, the election may cause a *step-down* as well as a step-up in basis if the fair market value of the deceased partner's interest is less than the partnership's inside basis of its assets. Unfortunately, once made, the Section 754 election is irrevocable without the consent of the IRS and forevermore affects all the other partners when any other partner dies, or a distribution of property to any partner is made in later years. Finally, changes made by The Taxpayer Relief Act of 1997 to the basis allocation rules on liquidation of a partner's interest in a partnership and new proposed regulations under Sections 754, 755, 743, 734, and 732 have caused advisors to reconsider the benefits of a Section 754 election. In some cases, a liquidation might offer preferential tax treatment over a Section 754 election. For a detailed discussion of these issues, see Cantrell, "Practical Income Tax Guidance on Forming, Operating, and Liquidating Your Family Limited Partnership," State Bar of Texas 22nd Annual Advanced Estate Planning and Probate Course (1998).

b. Manner and Timing of Election. A Section 754 election is made by the partnership by attaching a written statement, signed by any one of the partners, to the partnership's timely filed (including extensions) tax return for the year in which the death of the partner occurred. Once made, the election is effective until revoked with the approval of the district director for the district in which the partnership return is required to be filed. Treas. Reg. §§ 1.754-1(b) and (c). If the partnership determines that a Section 754 election is desirable after the due date has passed, an automatic extension of twelve months from the original due date may be granted provided the partnership files an original or amended partnership tax return attaching the required election statement and prints: "FILED PURSUANT TO TREAS. REG. 301.9100-2T" at the top of Form 1065 or the attached election statement. No user fees apply. If a partnership has other partnership interests as part of its portfolio, each partnership must make a separate election. Rev. Rul. 87-115, 1987-2 CB 163.

c. Application to Both Halves of the Community. Section 743(b) of the Code permits an adjustment to the basis of partnership property "in the case of a transfer of an interest in a partnership . . . upon the death of a partner." However, in community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington), the surviving spouse's interest in the partnership is not "transferred" upon the death of the decedent. Nevertheless, the IRS has ruled that the Section 754 optional basis adjustment applies to the entire partnership interest owned as community property, including the surviving spouse's share. The ruling also states that the same result would apply if the non-partner spouse predeceased the partner spouse. Rev. Rul. 79-124, 1979-1 CB 224.

d. Tax Effects of Election. A step-up (or step-down) in the partner's "outside" basis of the partnership interest may occur when a partner dies, regardless of whether a Section 754 election is made. A step-up eventually provides a tax savings for the successor-in-interest when the partnership interest is sold or liquidated. The effect of the Section 754 election is to accelerate the benefit of the step-up by immediately passing it through to the "inside basis" of the individual assets as to the decedent partner's interest only. As a result, if partnership assets are sold or depreciated after death, the successor partner will benefit immediately, due to the higher basis of the decedent's share of assets inside the partnership. The method by which the partner's increased (or decreased) basis is allocated among specific partnership assets is complex, involving first a separation of the partnership's ordinary income from its capital assets, followed by an allocation among specific assets within each class. This system yields rough justice, but does not truly put the transferee in the position of a purchaser of an undivided interest in partnership assets if some of the partnership's assets have appreciated and others depreciated.

2. Fiscal Year End Issues. As indicated above, an estate may select a fiscal year end. If the fiscal-year-end estate holds a majority interest in a partnership, the partnership must convert to the estate's fiscal year end. A partnership's tax year is not dictated by the terms of the partnership agreement. Instead, a Section 706(a) of the Code requires that the partnership's tax year be determined by reference to the partners. IRC § 706(b)(1)(B). Once a partnership's tax year is selected, it ordinarily does not change. However, there are some exceptions to that rule.

a. Mandatory Change in Partnership Year Based on Majority Partner. A partnership's tax year must conform to that of the majority interest partners. A majority interest partner is any one or more partners with the same tax year whose interest(s) in the capital and profits of the partnership constitute more than 50% on the first day of the partnership taxable year (the "testing date"). IRC § 706(b)(4)(A)(ii). When a partner of a calendar year partnership dies and his or her estate owns a majority interest and selects a tax year other than the calendar year, the partnership will be required to change its tax year to conform to the majority partner in the partnership's next tax year. The partnership does not "annualize" its income for the short period. Treas. Reg. § 1.706-1(b)(5)(ii)(a). If a change is required under the provisions of Section 706(b)(1)(B)(i) due to a change in the majority interest partner's tax year, no further change will be required of the partnership for the two years following the year of change. IRC § 706(b)(4)(B). This required tax year change can result in some rather interesting planning opportunities for the executor in selecting the estate's tax year. Invariably, one or more beneficiaries of the estate's partnership interest will be a trust or an individual required to use a calendar year. If the beneficiary receives the partnership interest following the "testing date," then the recipient partner may obtain a deferral on reporting his or her share of partnership income for as many as two tax years before the partnership is again required to change tax years.

b. Selection of Estate's Tax Year for Maximum Deferral. An estate or electing trust with partnership interests should carefully examine the effects of its chosen tax year on the deferral opportunities afforded by virtue of the ownership of calendar year partnership interests. If the estate is a majority partner, the partnership will be required to change to the estate's tax year. If the estate chooses a November 30 tax year, the estate's beneficiaries may obtain up to an eleven month deferral of income each year for two years following the partner's death. If the estate is not a majority partner, so the partnership stays on the calendar year, and the estate chooses a November 30 tax year, the estate may obtain this eleven month deferral for as long as it holds the partnership interest.

3. Requirement to Close Partnership and S Corporation Tax Years. When a partner or S corporation shareholder dies, the decedent must report his or her share of the entity's income for the year of death. The allocation of partnership income for a short year is made by an interim closing of the partnership's books unless the partners agree to allocate income on per diem or other reasonable basis. *See* Treas. Reg. § 1.706 1(c)(2)(ii). Conversely, an S corporation shareholder's final return must include the decedent's pro rata share of the S corporation's income for the year on a per diem basis. IRC § 1377(a)(1). If all the

shareholders agree, the allocation for the short year is made by an interim closing of the books. IRC § 1377(a)(2).

4. Special Problems for Estates Holding Interests in S Corporations.

a. Eligibility Issues. A decedent's estate qualifies as an S corporation shareholder for the entire period of administration. IRC § 1361(b)(1)(B). For purposes of ensuring that the corporation has no more than 100 shareholders, the estate counts as only one shareholder. Treas. Reg. § 1.1361-1(e)(1). In addition, the fact that an estate has one or more beneficiaries who are not eligible to be S corporation shareholders does not disqualify the S election so long as the estate retains the stock and does not distribute it to the ineligible shareholder. These rules give an executor time to analyze the consequences of a distribution of stock, and to take necessary actions to ensure that the beneficiaries who receive the stock are eligible shareholders. These actions might include reforming a recipient trust to ensure that it is eligible to hold S corporation stock. Note, however, that the administration of an estate for tax purposes cannot be prolonged beyond the period necessary for its administration under state law. If an estate is unduly prolonged, the IRS might assert that the estate has in effect become a trust, and therefore is no longer an eligible shareholder. *See Old Virginia Brick Co.*, 367 F2d 276, 66-2 USTC & 9708 (4th Cir. 1966); *see also* Tenney and Belkap, "Postmortem Planning for Interests in Pass-Through Entities," 27 EST. PLAN. J.,No. 6, p. 250 (July 2000).

b. Avoiding Mismatches on Sale of S Corporation Assets. If the business of the S corporation will be discontinued after the death of the decedent, the executor (or remaining officers) may choose to sell the company. Most buyers of operating concerns prefer to purchase assets, and not stock (to avoid liability for past actions of the business and to facilitate an increased basis for acquired assets). Note, however, that the assets of the corporation do not receive a new cost basis at death. Only the stock held by the decedent receives a new basis. Unlike a partnership no Section 754 election is permitted for S corporations to transfer their shareholders' stepped up basis through to the corporation's underlying assets. As a result, any gain realized by the corporation will be passed through to its shareholders, further increasing basis, which can then enable an offset upon liquidation. Timing here, however, is critical. For example, suppose the estate holds all of the stock of an S corporation, whose fair market value on the date of death is $1,000,000. The executor thus has a basis in the stock of $1,000,000. The corporation holds assets with a fair market value of $1,000,000, and a basis of $100,000. If the corporation sells its assets, the corporation recognizes a gain of $900,000, which is passed through to the estate. The estate reports a capital gain of $900,000, and adds $900,000 to the basis of its stock, for a total basis of $1,900,000. If the corporation liquidates, transferring the $1,000,000 sales proceeds to the estate, it will apply its basis of $1,900,000, resulting in a $900,000 loss (which exactly offsets its gain). Note, however, that if the sale takes place in the estate's first fiscal year, and the liquidation occurs in the second, the estate will have to report, and pay tax on, the $900,000 gain in year one. The $900,000 loss in year two can be carried forward, but cannot be carried back to offset the prior year's gain.

5. Income Tax Consequences of Funding Bequests with Partnership Interests and S Corporation Stock.

a. Satisfactions of Specific Bequests. If an estate make a distribution of property in kind, including a distribution of a partnership interest or S corporation stock, to satisfy a gift of a "specific dollar amount" or a gift of specific property with property other than that specified in the governing instrument, then the estate will recognize gain or loss, based on the difference between the fair market value of the asset on the date of the distribution and the date of death basis of the property. Treas. Reg. § 1.661(a)-2(f)(1). This rule applies whether the gift is fixed dollar amount or a formula fixed dollar amount. *See* Rev Rul. 60-87, 1960-1 CB 286. Thus, if an appreciated partnership interest is used to fund a pecuniary bequest, gain may be required to be recognized by the estate upon the funding of the bequest. Of course, a partnership interest or S corporation stock can decline in value as well as appreciate between date of death and date of funding. Generally, any losses realized from date of death values will be subject to the related party rules and be denied to non-electing trusts. However, an estate may recognize losses incurred in funding pecuniary bequests. IRC § 267(b)(13).

Return to Table of Contents

b. Basis Issues. Except for estates of decedents dying in 2010 whose executors opt out of the federal estate tax, the basis to the decedent's estate of a partnership interest or S corporation stock will be its fair market value on the decedent's date of death (or on the alternate valuation date, if the decedent's executor so elects). Treas. Reg. § 1.1014-1(a). When the estate distributes an asset to an individual or a trust, the basis is generally a carryover basis of the adjusted basis in the hands of the estate prior to distribution, adjusted by the income or losses recognized by the estate during the administration, and any gain or loss triggered on the distribution. IRC § 643(e)(1). If the distribution does not trigger gain or loss to the estate, then the beneficiary would expect to receive a carryover basis in the interest distributed. If, however, the distribution occurs pursuant to a will clause or other situation that triggers gain or loss recognition, the beneficiary will obtain an additional step-up or step-down in basis equal to the gain or loss recognized upon the distribution. In addition, since the distribution constitutes a sale or exchange, the beneficiary will be afforded the opportunity to adjust the inside basis of assets as to the beneficiary if the partnership has made a Section 754 election. IRC § 743(b). In situations where the discounts and potential step-down indicate that a Section 754 election might not have been desirable in the year of death, the potential benefit of a Section 754 election should be revisited in the year of distribution.

B. Trust Issues.

1. Distribution of "All Income". As noted above, a simple trust is one which must distribute all of its "income" annually. "Income" for this purpose means *fiduciary accounting income* determined under local lawBnot taxable income. IRC § 643(b). In most states, "fiduciary accounting income" is determined under some version of the Uniform Principal and Income Act or the Revised Uniform Principal and Income Act and the relevant provisions of the governing instrument. The trust need not distribute all of its taxable or distributable net income. Naturally, in the context of stocks, bonds and most other assets, the trustee can look to the governing instrument or local law to determine which items constitute principal or income.

2. Trapping Distributions.

a. Description of Trapping Distributions. A "trapping distribution" may arise when one fiduciary (e.g., an estate) distributes property to a trust (e.g., a marital deduction trust), if the distribution carries with it taxable income in the form of the distributing entity's distributable net income. If the transferee fiduciary characterizes the receipt as corpus under principles of local law or the governing instrument, the recipient will not distribute that amount as "income" to the beneficiary. As a result, the DNI carried out by the distributing entity is "trapped" inside the transferee entity. This trapping of income presents an opportunity to use an otherwise simple trust as a taxpayer in the year it is funded. Naturally, since the trust's tax rates may be as high as 43.4% at only $11,950.00 in income (applying 2013 rules), the tax savings generated by this technique are limited. A simple trust with $12,250.00 in income ($300.00 of which would be excluded by the trust's allowance in lieu of personal exemption) would pay a tax of $3,090.00 instead of $4,851 if the entire $12,250.00 were taxed to a beneficiary in the 39.6% bracket–a savings of only $1,761. If the beneficiary were subject to the 3..8% tax on net investment income, the savings would be $2,226.50. Under UPIA, income accrued at the date of death is principal, but funds received by a trustee from an estate that constitute the estate's income is treated as trust income. Accordingly, this post-death income passing from the estate to the trust will not be "trapped." Although trapping distributions may arise without regard to whether the estate owns an interest in a pass-through entity, their application in this context can be more insidious.

Assume, for example, that the estate of a decedent who dies in 2011 holds as its only asset a limited partnership interest worth $6,000,000 at the date of death. The will makes a formula bequest of $1,000,000 (one-sixth of the estate) to a QTIP trust, with the residue (five-sixths of the estate) passing to a bypass trust. Suppose the estate funds these bequests on November 30, 2011. Upon funding, the partnership closes its books and determines that the estate's share of partnership taxable income is $180,000. No distributions are made by the partnership to the estate. The estate would report taxable income and DNI of $180,000, and increase its basis in the partnership by this amount. The estate would then distribute one-sixth of its limited partnership interest to the marital trust, and five-sixths of its interest to the bypass trust. These distributions would entitle the estate to a distribution deduction of $180,000 (since all of the estate's taxable DNI was distributed) and the estate's taxable income would be zero. The estate would issue K-1s to the QTIP trust showing $30,000 of income, and to the bypass trust showing $150,000 of income. The trusts would also receive a K-1 from the partnership for income earned by the partnership from December 1 to December 31, 2011. Assume for this example that partnership expenses offset income for the month of December and so no amounts are reportable on the K-1s issued by the partnership to the trusts. The QTIP trust, which has a mandatory income distribution requirement, calculates its fiduciary accounting income to be zero. (Even though post-death taxable income has been attributed to the estate, presumably no post-death fiduciary accounting income has been received by the estate or distributed to the trust.) The trust's only asset is a limited partnership interest which it held for one month during 2011. The partnership made no distributions to the trust in 2011. Therefore, the QTIP trust is not required to make any income distributions to the surviving spouse beneficiary in 2011. However, the marital trust has taxable income of $30,000 on which it must pay tax at fiduciary rates. The income is "trapped" in the trust (unless the trust agreement allows for, and the fiduciary actually makes, corpus distributions during December 2011 or within 65 days after the QTIP trust's year end under the 65 day rule).

3. Cash Flow Difficulties.

a. If the Entity Makes No Distributions. Note that in the above example, the QTIP trust and bypass trust both have serious liquidity problems. Their only assets are limited partnership interests from which they cannot demand a cash distribution. Perhaps the trusts could carve out and distribute partnership interests with a basis or value equal to their DNI (if the distributions are deemed to be necessary under the standards set forth in the trusts, and if the partnership agreement permits such an assignment). The effect of those distributions would be to shift the tax liability (and the liquidity problem) to the beneficiaries receiving the distributions. Query whether the trustee's fiduciary duty to the beneficiaries is violated by making in-kind distributions which carry out taxable income, without distributing sufficient cash to pay the resulting tax. If the trusts do not make any distributions, they are each faced with a significant federal income tax liability and no cash with which to pay it. Although the IRS now accepts credit cards payments, it has not yet approved payment by way of partnership interests. Presumably, the trustees will be required to sell sufficient limited partnership interests to raise the required cash, or to borrow funds to pay taxes.

b. If the Entity Distributes "Enough to Pay Taxes".

(1) Partnerships. If a partnership owned by a simple trust makes a distribution during the year, but doesn't distribute all of its taxable income, a new cash flow problem arises. Suppose that a QTIP trust owns a 25% interest in a partnership which earns $1,000,000 in income $250,000 of which is allocated to the trust. The managing partner decides to distribute $400,000 ($100,000 of which passes to the trust) to the partners so that they have funds with which to pay any resulting tax liability. The partnership sends the trust a K-1 for $250,000. For fiduciary accounting purposes, though, the income of the trust (if income is based upon receipts) is only $100,000. UPIA § 401(b). As a result, the trust distributes $100,000, leaving taxable income of $150,000 in the trust. The trust owes tax on that income of about $51,464.50 (using 2011 rates). Under Section 505 of UPIA as originally enacted, a tax required to be paid by a trustee on the trust's share of an entity's taxable income must be paid proportionally (i) from income to the extent that receipts from the entity are allocated to income; and (ii) from principal to the extent that receipts from the entity are allocated to principal, *or to the extent that the trust's share of the entity's taxable income exceeds receipts from the entity*. For this purpose receipts must be reduced by the amount distributed to a beneficiary that generates a distribution deduction. Since the trust's share of taxable income exceeds the receipts from the entity, this tax is charged to principal. UPIA § 505(c) (1997). Applying this rule, the trust owes tax not on proceeds, but on phantom income from the partnership, all of which is charged to principal on the trust's books. As a result, the trust may have a $51,464.50 cash shortfall. If the trustee ignores the statute and reduces fiduciary accounting income by *all* income taxes (or if the governing instrument permits or requires all taxes to be allocated to income), a rather curious set of inter-related computations arise: the distributable amount is reduced by taxes, which

reduces that distribution (and the distribution deduction). This reduced deduction further increases taxes, etc. until the tax bill on almost the entire $250,000 is owed by the trust, generating a tax of about $80,769, leaving $19,231 of income to be distributed by the trust (using a flat 35% income tax rate). In other words, for tax purposes, the trust would have $250,000 of K-1 income, less a distribution deduction of $19,231, leaving taxable income of $230,769, yielding a tax of $80,769. From a fiduciary accounting income point of view (ignoring UPIA), the trust would have $100,000 of gross accounting income, less $80,769 in taxes, for net accounting income of $19,231 (equal to the imputed distribution deduction). As noted below, this is exactly the result in those jurisdictions that have adopted the 2008 changes to UPIA or have comparably amended their principal and income rules. The same result occurs if the governing instrument charges these income taxes to income.

(2) ESBTs. A similar problem arises if the entity involved is an S corporation and the trust has made an ESBT election. The trust will receive a K-1 from the S corporation showing taxable income of $250,000. The trust will owe tax of $87,500 ($250,000 x 35%). As with the preceding example, actual *proceeds* have been received by the trust, which should be characterized as income. UPIA Section 505 allocates taxes to the income account to the extent receipts are treated as income. Subsection 505(d) provides that receipts allocated to income are reduced only for distributions yielding a distribution deduction, but an ESBT receives no distribution deduction. Therefore, the tax, to the extent it relates to income, should reduce fiduciary accounting income. If the trustee reduces fiduciary accounting income by the taxes attributable to income, the fiduciary accounting income will be $100,000, less the tax on that income ($35,000) or $65,000. The trust has only $100,000 of cash, but must write a check for $87,500 in tax, and make a distribution of $65,000. Thus, the trust will have a cash shortfall of $52,500 ($100,000-$87,500-$65,000) when it comes time to make its required distribution.

(3) QSSTs. If S corporation stock is held in a QSST, the S corporation should send the K-1 to the trust beneficiary, and not the trust. IRC § 1361(d)(1)(B); Treas. Reg. § 1.1361-1(j)(7). In that event, the $100,000 received by the trust is all fiduciary accounting income distributable to the beneficiary, who then has the cash flow with which to pay the tax.

(4) UPIA Power to Adjust Taxes. Section 506 of UPIA grants a fiduciary a power to adjust between principal and income to offset the shifting of economic interests or tax benefits between income and remainder beneficiaries which arise from tax elections, distributions or ownership of interests in flow-through entities. This section is essentially a codification of the doctrine of equitable adjustment. The commentary on Section 505 of UPIA notes that the power to adjust, together with the more general power to adjust between principal and income in Section 104 of UPIA (when available) "are probably sufficient to enable a trustee to correct inequities that may arise because of technical problems." This Pollyannaish view of the complex issues presented does little to solve the cash flow problems encountered by the trust. For example, for an ESBT to pay its taxes when the S corporation distributes only enough to pay taxes, the commissioners must expect the trustee to ignore UPIA Section 401, allocate all ESBT distributions to principal, and make no distributions to the income beneficiary, so that corporate dividends may be used to pay the trust's tax. Perhaps this is the best result one can hope for under the current state of the law, but it is probably contrary to the expectation of most income beneficiaries.

(5) 2008 UPIA Changes. In 2008, the Uniform Laws Commission finalized an amendment to Section 505 of UPIA to address the problem associated with trusts and estates holding interests in pass-through entities. The revised statute deletes the requirement that taxes be charged to principal to the extent that the trust's share of the entity's taxable income exceeds receipts from the entity. It then adds a provision requiring the trustee to adjust income or principal receipts to the extent that the trust's taxes are reduced because the trust receives a deduction for payments made to a beneficiary. The rewritten statute requires the trust to pay the taxes on its share of an entity's taxable income from income or principal receipts to the extent that receipts from the entity are allocable to each. This treatment assures the trust a source of cash to pay some or all of the taxes on its share of the entity's taxable income. Subsection 505(d) recognizes that, except in the case of an Electing Small Business Trust (ESBT), a trust normally receives a deduction for amounts distributed to a beneficiary. Accordingly, subsection 505(d) requires the trust to increase receipts payable to a beneficiary as determined under subsection (c) to the extent the

trust's taxes are reduced by distributing those receipts to the beneficiary. Because the trust's taxes and amounts distributed to a beneficiary are interrelated, the rewritten rule effectively requires the trustee to apply the formula approach outlined below to determine the correct amount payable to a beneficiary. This formula must take into account that each time a distribution is made to a beneficiary, the trust taxes are reduced and amounts distributable to a beneficiary are increased. The formula assures that after deducting distributions to a beneficiary, the trust has enough to satisfy its taxes on its share of the entity's taxable income as reduced by distributions to beneficiaries. The comments to the revised statute provide two examples to illustrate these tax allocations. In the first example, Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of $1 million. Partnership P distributes $100,000 to T. The trustee allocates the receipts to income. Both Trust T and income Beneficiary B are in the 35 percent tax bracket. Trust T's tax on $1 million of taxable income is $350,000. Under Subsection (c) T's tax must be paid from income receipts because receipts from the entity are allocated only to income. Therefore, T must apply the entire $100,000 of income receipts to pay its tax. In this case, Beneficiary B receives nothing. In the second example, Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of $1 million. Partnership P distributes $500,000 to T. Again, the trustee allocates the receipts to income. As in the first example, Trust T's tax on $1 million of taxable income is $350,000. Under Subsection (c), T's tax must be paid from income receipts because receipts from P are allocated only to income. Therefore, T uses $350,000 of the $500,000 to pay its taxes and distributes the remaining $150,000 to B. However, the $150,000 payment to B reduces T's taxes by $52,500, which it must pay to B. But the $52,500 further reduces T's taxes by $18,375, which it also must pay to B. In fact, each time T makes a distribution to B, its taxes are further reduced, causing another payment to be due B. The total amount due to B could be solved by multiple iterations. Alternatively, the trustee can apply the following algebraic formula to determine the amount payable to B:

> D = (C-(R*K))/(1-R), where D = Distribution to income beneficiary; C = Cash paid by the entity to the trust; R = tax rate on income; and K = entity's K-1 taxable income

Applying this formula (still using 2011 income tax rates), the distribution (D) would equal ($500,000-(.35*1,000,000))/(1-.35)= 230,769. The trust would thus report $1,000,000 of K-1 income less a $230,769 distribution deduction for a taxable income of $769,231. The tax on that income would be $269,231 (at a flat 35%). As a result, the $500,000 distributed to the trust would pass $230,769 to the beneficiary and $269,231 to the IRS. As of the date of this writing, the amended version of Section 505 has been adopted in the District of Columbia and 27 states: Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Idaho, Kansas, Kentucky, Maine, Missouri, Montana, Nebraska, Nevada, New Mexico, North Carolina, North Dakota, Oklahoma, Oregon, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, and West Virginia.

VIII. CONCLUSION

The income taxation of trusts and estates involves a myriad of sophisticated tax issues. Armed with a working knowledge of these issues, however, professionals who advise executors and trustees, and those that prepare their tax returns, can feel comfortable in administering and reporting these esoteric events. With proper attention and planning, the family can often recognize significant tax savings.

Joint Ventures of Nonprofits and For-Profits
by
Terri Lynn Helge

I. Introduction.[1] This article summarizes special tax considerations that should be taken into account when for-profit parties seek to engage in joint ventures with charitable organizations. In particular, there are two areas of concern unique to charitable organizations with respect to joint ventures with for-profit parties. First, certain rules restrict or prohibit a charitable organization's ability to enter into transactions with its insiders. Second, a charitable organization's participation in a joint venture with a taxable party may cause the charitable organization to incur unrelated business taxable income or lose its tax-exempt status. Underlying both of these areas of concern is the overriding concern that a charitable organization be organized primarily for the conduct of its charitable purposes and not engage in any activity that results in private inurement or private benefit.

A. Private Inurement. Section 501(c)(3) of the Code[2] provides that no part of the net earnings of an organization described therein may inure to the benefit of any private shareholder or individual. The Internal Revenue Service ("IRS") takes the position that any element of private inurement can cause an organization to lose or be deprived of tax exemption, and that there is no de minimis exception.[3] The private inurement prohibition contemplates a transaction between a charitable organization and an individual in the nature of an "insider," who is able to cause application of the organization's assets for private purposes because of his or her position.[4] In general, an organization's directors, officers, members, founders and substantial contributors are insiders. The meaning of the term "net earnings" in the private inurement context has been largely framed by the courts. Most decisions reflect a pragmatic approach, rather than a literal construction of the phrase "net earnings."[5] Common transactions that may involve private inurement include (i) excessive compensation for services; (ii) inflated or unreasonable rental prices; (iii) certain loan arrangements involving the assets of a charitable organization; (iv) purchases of assets for more than fair market value; and (v) certain joint ventures with commercial entities.

---

[1] As required by United States Treasury Regulations, this article is not intended or written to be used, and cannot be used, by any person for the purpose of avoiding penalties that may be imposed under the United States federal tax laws.

[2] All references to the "Code" are to the Internal Revenue Code of 1986, as amended.

[3] Gen. Couns. Mem. 35855 (June 17, 1974). The U.S. Tax Court has also adopted this approach. McGahen v. Comm'r, 76 T.C. 468, 482 (1981), *aff'd*, 720 F.2d 664 (3d Cir. 1983); Unitary Mission Church of Long Island v. Comm'r, 74 T.C. 507 (1980), *aff'd*, 647 F.2d 163 (2d Cir. 1981).

[4] *See* Treas. Reg. § 1.501(a)-1(c); *see, e.g,* South Health Ass'n v. Comm'r, 71 T.C. 158, 188 (1978) (stating that the private inurement prohibition has generally been applied to an organization's founders or those in control of the organization).

[5] *See, e.g.*, Texas Trade Sch. v. Comm'r, 30 T.C. 642 (1958) (holding that net earnings inured to insiders' benefit when the insiders leased property to an organization and caused it to make expensive improvements that would remain after the lease expired); Rev. Rul. 67-4, 1967-1 C.B. 123 (holding that an organization did not qualify for tax exemption because private inurement occurred when (i) the organization's principal asset was stock in the insiders' family-owned corporation, and (ii) the organization's trustees failed to vote against the corporation's issuance of a new class of preferred stock, diluting the organization's holdings); Tech. Adv. Mem. 9130002 (Mar. 19, 1991) (concluding that private inurement occurred when a hospital sold a facility to a private entity controlled by insiders for less than the fair market value).

B. Private Benefit. A charitable organization may not confer a "private benefit" on persons who are not within the charitable class of persons who are intended to benefit from the organization's operations, unless the private benefit is purely incidental. The purpose of the private benefit limitation is to ensure that charitable organizations are operated for public purposes because of their special tax status.[6] The determination of whether the private benefit is more than incidental is based on a "balancing test" set forth in a 1987 General Counsel Memorandum:

> A private benefit is considered incidental only if it is incidental in both a qualitative and a quantitative sense. In order to be incidental in a qualitative sense, the benefit must be a necessary concomitant of the activity which benefits the public at large, i.e., the activity can be accomplished only by benefiting certain private individuals. To be incidental in a quantitative sense, the private benefit must not be substantial after considering the overall public benefit conferred by the activity.[7]

If an organization provides more than incidental private benefit, the organization's tax-exempt status may be revoked.[8]

The "private benefit doctrine" subsumes, and is technically distinct from, the private inurement doctrine, and is not limited to situations where benefits accrue to an organization's insiders.[9] The IRS has been more willing to accept the contention that incidental private benefit, as opposed to incidental private inurement, will not preclude or defeat tax exemption.[10]

II. Joint Ventures with Insiders.

A. Private Foundations. In general, a "private foundation" is a charitable organization that is funded by contributions from only a few sources (usually a single family or company) and that typically accomplishes its charitable purposes by making grants to other charitable organizations. Section 4941 of the Code imposes a tax on "disqualified persons" who participate in acts of self-dealing with a private foundation. In particular, Section 4941 of the Code prohibits direct or indirect acts of "self dealing" between a private foundation and those individuals or entities who are "disqualified persons" with respect to the foundation. For this purpose, the term "disqualified person" includes:

(1) a substantial contributor (one who contributes more than $5,000 to the foundation, if such contribution is more than 2% of the total contributions received before the end of the foundation's taxable year);
(2) a foundation manager;
(3) the owner of more than 20% of a business or trust which is a substantial contributor;

---

6 *See* Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii). According to the Treasury Regulations, an organization does not qualify for exemption

> unless it serves a public rather than a private interest. Thus . . . it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Id.

7 I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987) (citations omitted). The Internal Revenue Service's balancing test was adopted by the Tax Court in *American Campaign Academy v. Commissioner*, 92 T.C. 1053 (1989).

8 For example, the Internal Revenue Service ruled that an organization formed to promote interest in classical music was not exempt because its only method of achieving its goal was to support a commercial radio station that was in financial difficulty. Rev. Rul. 76-206, 1976-1 C.B. 154.

9 *See* Gen. Couns. Mem. 39876 (Aug. 10, 1992).

10 *See, e.g.,* Priv. Ltr. Rul. 200044039 (Nov. 6, 2000) (ruling that a contract would not defeat an organization's tax-exempt status because it resulted in no private inurement and no more than incidental private benefit).

(4) a member of the family of any of the preceding;
(5) a corporation, trust, estate, or partnership more than 35% of which is owned or held by any of the preceding; or
(6) a government official.[11]

A "foundation manager" includes officers and directors of a private foundation and any employee who has the authority or responsibility with respect to an act that constitutes self-dealing.[12] A person is considered a "member of the family" if such person is the spouse, ancestor, child, grandchild or great grandchild of the individual who is a disqualified person.[13]

The prohibited acts of self-dealing, direct or indirect, between a disqualified person and a private foundation include the following:

(1) The sale, exchange or lease (other than a rent-free lease to a private foundation) of property between a private foundation and a disqualified person.
(2) The lending of money or other extension of credit between a private foundation and a disqualified person. An interest-free loan by a disqualified person to a private foundation is excepted from this prohibition, provided that the loan proceeds are used exclusively for exempt purposes.
(3) The furnishing of goods, services or facilities between a private foundation and a disqualified person (other than those furnished by a disqualified person to a private foundation without charge and for use exclusively for exempt purposes).
(4) The payment of compensation to a disqualified person for services unrelated to carrying out the foundation' s exempt purposes and the payment of excessive compensation (or payment or reimbursement of excessive expenses) by a private foundation to a disqualified person, except a government official, to whom the payment of compensation is even more severely proscribed.
(5) The transfer to or use by a disqualified person of the income or assets of a private foundation.
(6) The agreement by a private foundation to make any payment of money or other property to a government official, other than an agreement to employ such official for a period after termination from government employment and certain other limited types of payments.[14]

In considering whether a transaction between a private foundation and a disqualified person is an act of self-dealing, it is immaterial whether the transaction results in a benefit or detriment to the foundation.[15]

The initial tax on a disqualified person who participates in self-dealing is 10% of the amount involved.[16] In addition, the initial excise tax on a foundation manager who knowingly participates in an act of self-dealing between a disqualified person and a private foundation is 5% of the amount involved, unless such participation is not willful and is due to reasonable cause.[17] The initial excise tax on foundation managers is capped at $20,000.[18] If a disqualified person engages in an act of self-dealing with a private foundation, corrective action must be

11 I.R.C. § 4946(a)(1). The term "government official" is defined in Code Section 4946(c).
12 I.R.C. § 4946(b).
13 I.R.C. § 4946(d).
14 I.R.C. § 4941(d)(1), (2).
15 Treas. Reg. § 53.4941(d)-1(a).
16 I.R.C. § 4941(a)(1). The "amount involved" means the greater of the amount of money or fair market value of other property given by the private foundation or the amount of money or fair market value of other property received by the private foundation. I.R.C. § 4941(e)(2).
17 I.R.C. § 4941(a)(2).
18 *Id*.

taken to essentially undo the act of self-dealing to the extent possible and put the private foundation in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards.[19] The self-dealing excise tax is imposed each calendar year until the act of self-dealing is corrected.[20]

B. Public Charities. In general, a charitable organization is presumed to be a private foundation unless it can establish that it qualifies as a public charity under Sections 509(a)(1)–(3) of the Code. Types of public charities described under Section 509(a)(1) of the Code include churches, schools, hospitals, government entities and university endowment funds.[21] In addition, an organization which normally receives more than one-third of its total support from contributions from the general public is considered a public charity under Section 509(a)(1) of the Code.[22] An organization which receives more than one-third of its total support from exempt function revenues, such as admission fees to a museum or patient revenues for a hospital, is considered a public charity under Section 509(a)(2) of the Code, provided the organization does not normally receive more than one-third of its support from gross investment income. An organization which does not meet either of these tests may still qualify as a public charity under Section 509(a)(3) of the Code as a "supporting organization" of another public charity by virtue of the relationship between the first organization and the second public charity.

Section 4958 of the Code imposes an excise tax on disqualified persons who engage in excess benefit transactions with public charities. An "excess benefit transaction" is any transaction in which an economic benefit is provided by the public charity directly or indirectly to or for the use of any disqualified person, if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received in exchange for such benefit.[23] The term "transaction" is used very generally and includes a disqualified person's use of a charitable organization's property and services provided to a disqualified person without adequate payment. Prototypical examples of excess benefit transactions include paying excessive compensation to a director or officer or overpaying a director or officer for property the director or officer sells to the charitable organization. However, any direct or indirect benefit to a disqualified person may result in a violation of Section 4958 if the disqualified person does not provide adequate consideration for the benefit.

The term "disqualified person" includes any person who was, at any time during the 5-year period ending on the date of the transaction, in a position to exercise substantial influence over the affairs of the organization.[24] Some persons, including (but not limited to) board members, the president or chief executive officer, the treasurer or chief financial officer, family members of such individuals, and entities in which such individuals own 35% of the interests, are automatically considered "disqualified."[25] Where a person is not automatically disqualified, all of the facts and circumstances will generally be considered to determine if the person has substantial influence over the affairs of the organization.[26] Being a substantial contributor to the organization is a fact tending to show that the person has

[19] I.R.C. § 4941(e)(3). The Treasury Regulations contain specific procedures to correct certain acts of self-dealing between a private foundation and a disqualified person. *See* Treas. Reg. § 53.4941(e)-1(c).

[20] I.R.C. § 4941(a), (e)(1).

[21] I.R.C. §§ 509(a)(1), 170(b)(1)(A)(i)-(v).

[22] I.R.C. §§ 509(a)(1), 170(b)(1)(A)(vi); Treas. Reg. § 1.170A-9(e)(2).

[23] I.R.C. § 4958(c)(1).

[24] I.R.C. § 4958(f)(1).

[25] Treas. Reg. § 53.4958-3(c).

[26] Treas. Reg. § 53.4958-3(e).

substantial influence and is therefore disqualified.[27]

When it applies, Section 4958 imposes an initial tax equal to 25% of the excess benefit on any disqualified person. [28] A tax of 10% of the excess benefit is imposed on any organization manager, i.e., any officer, director, or trustee of the organization, who knowingly participates in the transaction.[29] The initial excise tax on organization managers is capped at $20,000.[30] If a disqualified person engages in an excess benefit transaction with a public charity, corrective action must be taken to essentially undo the excess benefit to the extent possible and to take any additional measures to put the public charity in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards.[31]

The Treasury regulations provide for a procedure, which if followed, creates a rebuttable presumption that a transaction between a public charity and a disqualified person will not constitute an excess benefit transaction within the meaning of Section 4958 of the Code. These procedures apply to fixed payments and, with minor additional requirements, to non-fixed payments subject to a cap.[32] Legislative history indicates that compensation arrangement or other financial transactions will be presumed to be reasonable if the transaction arrangement was approved in advance by an independent board (or an independent committee of the board) that (1) was composed entirely of individuals unrelated to and not subject to the control of the disqualified person, (2) obtained and relied upon appropriate data as to comparability, and (3) adequately documented the basis for its determination.[33] The Treasury Regulations read into the legislative history three distinct requirements: (1) approval by an authorized body, (2) the appropriate data as to comparability, and (3) the documentation.[34]

1. Approval by an Authorized Body. The authorized body may be the Board of Directors or a committee duly authorized under state law to act on behalf of the Board of Directors.[35] A person is not considered part of the authorized body if he merely meets to provide information to the board and then recuses himself.[36] No person voting on the matter may have a conflict of interest with respect to the transaction.[37] A member of the authorized body does not have a conflict of interest if the member:

i. is not the disqualified person or related to any disqualified person who benefits from the transaction;
ii. is not employed by or controlled by any disqualified person benefiting from the transaction;
iii. is not receiving compensation or other payments from a disqualified person benefiting from the transaction;
iv. has no material financial interest affected by the compensation arrangement or transaction; and
v. does not approve a transaction providing economic benefits to any disqualified person participating in the compensation arrangement or transaction, who in turn has approved or will approve a transaction providing economic benefits to the member.[38]

[27] Treas. Reg. § 53.4958-3(e)(2).
[28] I.R.C. § 4958(f)(1).
[29] I.R.C. § 4958(a)(2).
[30] I.R.C. § 4958 (d)(2).
[31] I.R.C. § 4958(f)(6). The Treasury Regulations contain specific procedures to correct certain excess benefit transactions between a public charity and a disqualified person. See Treas. Reg. § 53.4958-7.
[32] Non-fixed payments to a disqualified person not subject to a cap are generally not advisable.
[33] H.R. Rep. No. 104-506, at 56-57.
[34] Treas. Reg. § 53.4958-6(a)(1)-(3).
[35] Treas. Reg. § 53.4958-6(c)(1)(i)(A)-(C).
[36] Treas. Reg. § 53.4958-6(c)(1)(ii).
[37] Treas. Reg. § 53.4958-6(a)(1).
[38] Treas. Reg. § 53.4958-6(c)(1)(iii)(A)-(E).

2. Appropriate Data as to Comparability. The authorized body must have sufficient information to determine whether a compensation arrangement or other transaction will result in the payment of reasonable compensation or a transaction for fair value. Relevant information includes, but is not limited to:

i. compensation levels paid by other similarly-situated organizations (taxable or tax-exempt);
ii. availability of similar services in the applicable geographic area;
iii. independent compensation surveys;
iv. written offers from similar institutions competing for the services of the person;
v. independent appraisals of all property to be transferred; or
vi. offers for property received as part of an open and competitive bidding process.[39]

3. Documentation. For the decision to be adequately documented, the records of the authorized body must note:

i. the terms of the transaction and the date it was approved;
ii. the members of the authorized body who were present during the debate on the transaction or arrangement and those who voted on it;
iii. the comparability data obtained and relied upon and how the data was obtained;
iv. the actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the transaction; and
v. the basis for any deviation from the range of comparable data obtained.[40]

III. Joint Ventures with Third Parties. Participation in joint ventures affords charitable organizations with numerous opportunities, such as to (1) further their exempt purposes, (2) diversify their revenue source, and (3) obtain needed capital or expertise in an increasingly competitive economic environment.[41] While these types of business arrangements can be highly profitable and truly beneficial to both the charitable and for-profit organizations involved, there is a serious risk for the participating charitable organization. The failure of the charitable organization to protect its charitable assets can lead the loss its federal tax exemption.

Prior to 1982, a charitable organization automatically ceased to qualify as tax exempt under Code Section 501(c)(3) when it served as a general partner in a partnership that included private investors as limited partners. The IRS's reasoning was that the obligations of the charitable general partner to its for-profit limited partners were incompatible with its requirement to operate exclusively for charitable purposes. The IRS's per se opposition to charitable organizations' involvement in joint ventures with for-profit investors was abandoned, however, in 1982, with the issuance of the *Plumstead Theatre Society* decision.

A. Plumstead Theatre Society v. Commissioner. In *Plumstead*, the Ninth Circuit Court of Appeals held that a charitable organization's participation as a general partner in a limited partnership involving private investors did not

---

[39] Treas. Reg. § 53.4958-6(c)(2)(i).

[40] Treas. Reg. § 53.4958-6(c)(3)(i)(A)-(D), (ii). Moreover, such records must be prepared by the next meeting of the authorized body (or within 60 days after the final action of the authorized body, if later than the next meeting) and must be reviewed and approved as reasonable, accurate and complete within a reasonable time period thereafter. Treas. Reg. § 53.4958-6(c)(3)(ii).

[41] *See generally* Nicholas A. Mirkay, *Relinquish Control! Why the IRS Should Change Its Stance on Exempt Organizations in Ancillary Joint Ventures*, 6 NEV. L. J. 21 (2005).

jeopardize its tax exempt status.[42] The theatre company at question co-produced a play as one of its charitable activities. Prior to the opening of the play, the theatre company encountered financial difficulties in raising its share of costs.[43] In order to meet its funding obligations, the theatre company formed a limited partnership in which it served as general partner, and two individuals and a for-profit corporation were the limited partners. The IRS denied tax-exempt status to the theatre company on the grounds that it was not operated exclusively for charitable purposes. Based on the safeguards contained in the limited partnership agreement, which served to insulate the theatre company from potential conflicts with its exempt purposes, the Ninth Circuit Court of Appeals disagreed with the IRS, holding that the theatre company *was* operated exclusively for charitable (and educational) purposes, and therefore was entitled to tax exemption. One of the significant factors supporting the court's holding was its finding that the limited partners had no control over the theatre company's operations or over the management of the partnership.[44] Another significant factor was that the theatre company was not obligated for the return of any capital contribution made by the limited partners from the theatre company's own funds.[45]

Following its defeat in this landmark court decision, the IRS abandoned its prior per se opposition and formulated the basis on which charitable organizations could become general partners in joint ventures without violating the terms of their exemption.

B. The IRS's Two-Part Test for Joint Ventures. Soon after *Plumstead*, the IRS issued General Counsel Memoranda 39005 in which it set forth the required analysis in testing a charitable organization's participation as a general partner in a limited partnership involving private investors. The IRS used a two-prong "close scrutiny" test to determine the permissibility of joint venture arrangements between charitable and for-profit organizations. The IRS reiterated that participation by a charitable organization as a general partner in a limited partnership with private investors would not per se endanger its tax exempt status.[46] However, close scrutiny would be necessary to ensure that the obligations of the charitable organization as general partner do not conflict with its ability to pursue exclusively charitable goals.[47]

> Thus, in all partnership cases, the initial focus should be on whether the joint venture organization furthers a charitable purpose. Once charitability is established, the partnership agreement itself should be examined to see whether the arrangement permits the exempt party to act exclusively in furtherance of the purposes for which exemption is granted, and not for the benefit of the limited partners.[48]

The foregoing required a finding that the benefits received by the limited partners are incidental to the public purposes served by the partnership.[49]

In other words, the two-pronged "close scrutiny" test requires that: (1) the activities of the joint venture further the charitable purposes of the charitable organization; and (2) the structure of the venture insulate the charitable organization from potential conflicts between its charitable purposes and its joint venture obligations, and minimizes the likelihood that the arrangement will generate private benefit. If the charitable organization fails to satisfy either test and the activities of the joint venture are

[42] Plumstead Theatre Society v. Comm'r, 675 F.2d 244 (9th Cir. 1982) *aff'g* 74 T.C. 1324 (1980).
[43] *Id*.
[44] Priv. Ltr. Rul. 200502046 (Oct. 18, 2004).
[45] *Id*.

[46] Gen. Couns. Mem. 39005 (June 28, 1983).
[47] *Id*.
[48] *Id*.
[49] *Id*.

substantial, the IRS may seek to revoke the charitable organization's tax exemption.

C. Control by the Charitable Organization is a Key Factor. In evaluating joint ventures between charitable organizations and for-profit organizations, the focus of the IRS in applying the two-pronged close scrutiny test eventually evolved into a "facts-and-circumstances" determination. This determination focused on whether the charitable organization retained sufficient control over the joint venture activities, thereby ensuring that the organization's own charitable purposes were furthered or accomplished through its participation in the joint venture and no more than incidental benefit, financial or otherwise, was conferred on the for-profit participants.

1. Revenue Ruling 98-15. Revenue Ruling 98-15 was the first guidance with precedential value promulgated by the IRS with respect to joint ventures between charitable organizations and for-profit entities.[50] The ruling incorporates the two-part close scrutiny test set forth in General Counsel Memorandum 39005 with a focus on whether charitable organizations "control" the ventures in which they participate.[51] The IRS saw the charitable organization's control of the venture as crucial because it provided the charitable organization with an ability to ensure that the venture's activities were exclusively in furtherance of the charitable organization's exempt purposes and served as a safeguard against too much benefit, financial or otherwise, being conferred on the for-profit participants.

Revenue Ruling 98-15 describes two scenarios: one "good" and one "bad" joint venture involving nonprofit and for-profit healthcare organizations.[52] The IRS scrutinizes a variety of factors that determine whether the nonprofit has sufficient control over the venture.[53] Although Revenue Ruling 98-15 lists a number of relevant factors, four factors appear to be most significant: (1) governance control of the joint venture; (2) control of day-to-day operations of the joint venture; (3) management of conflicts of interest between the tax-exempt and for-profit participants; and (4) priority of charitable purposes over profit motives in the joint venture operations.

Based on substantial scrutiny of Revenue Ruling 98-15 after its release, several conclusions can be drawn. First, charitable organizations may participate in a joint venture with private investors and not automatically jeopardize their tax-exempt status. Second, in such situations, the joint venture agreement should clearly provide that the charitable partner's charitable purposes supersede any financial or private concerns in the event of a conflict between those goals. In addition, all contracts and agreements between the joint venture and another for-profit entity, such as a management agreement, must be entered into at arm's length and reflect commercially reasonable terms. Finally, Revenue Ruling 98-15 clearly favors the control of the joint venture's governing body by the charitable organization and elevates this component to unprecedented importance.[54]

2. Redlands Surgical Services v. Commissioner. In *Redlands*, the Tax Court upheld the IRS's denial of tax exempt status to a charitable organization which formed a joint venture with for-profit organizations.[55] In arriving at its decision that private, rather than charitable, interests were being served, the court examined various factors similar to the factors the IRS enunciated in Revenue Ruling 98-15.[56] The court noted, most

---

50 Rev. Rul. 98-15, 1998-1 C.B. 17.
51 *Id*.
52 Rev. Rul. 98-15, 1998-1 C.B. 17.

53 *Id*.
54 *See generally* Mirkay, *supra* note 41.
55 Redlands Surgical Services v. Comm'r, 113 T.C. 47 (1999), *aff'd*, 242 F.3d 904 (9th Cir. 2001).
56 *Id*.

significantly, that there was a lack of any express or implied obligation of the for-profit parties to place charitable objectives ahead of for-profit objectives.[57] Moreover, the relevant organizational documents did not include an overriding charitable purpose.[58] The Tax Court held that the requirement that a charitable organization operate exclusively for charitable purposes is not satisfied merely by establishing "whatever charitable benefits [the partnership] may produce," finding that the charitable partner lacked "formal or informal control sufficient to ensure furtherance of charitable purposes."[59] Affirming the Tax Court, the Ninth Circuit Court of Appeals held that ceding "effective control" of partnership activities impermissibly serves private interests.[60] *Redlands* provides that a charitable organization may form partnerships, or enter into contracts, with private parties to further its charitable purposes on mutually beneficial terms, "so long as the charitable organization does not thereby impermissibly serve private interests."[61]

3. St. David's Health Care System v. United States. The issue of whether a charitable organization's participation in a joint venture with for-profit participants would cause loss of the charitable organization's tax exempt status was revisited in *St. David's,* a case tried right here in Austin. Relying on Revenue Ruling 98-15 and *Redlands*, the Fifth Circuit Court of Appeals focused on the issue of the charitable organization's control over the joint venture, ultimately concluding that genuine issues of material fact existed with respect to whether the charitable organization "ceded control" of its tax-exempt hospital.[62] The court held that the determination of whether a charitable organization that enters into a partnership with for-profit partners operates exclusively for exempt purposes is not limited to "whether the partnership provides some (or even an extensive amount of) charitable services."[63] The charitable partner also must have the "capacity to ensure that the partnership's operations further charitable purposes."[64] Thus, "the [charity] should lose its tax-exempt status if it cedes control to the for-profit entity."[65] The Fifth Circuit ultimately wanted to see majority control by the charitable organization. The IRS continues to view its position on control of the joint venture by the charitable organization, as supported by the *St. David's* decision, as the "proper framework" for analyzing joint ventures between charitable organizations and for-profit entities.[66]

4. Revenue Ruling 2004-51. Revenue Ruling 2004-51 is the first instance in which the IRS acknowledges and supports equal ownership by charitable and for-profit participants in a joint venture, provided some protections are in place to ensure the furtherance of the charitable organization's exempt purposes.[67] The ruling pointedly looks at which partner controls the exempt activities. If the charitable partner controls the exempt activities, the joint venture presumably will not endanger the tax exemption of the charitable organization. Specifically, Revenue Ruling 2004-51 involved an exempt university that formed a limited liability company with a for-profit entity to provide distance learning via interactive video. Ownership of the joint venture was split equally between the university and the for-profit partner, but the university controlled the academic portion

[57] *Id*.
[58] *Id*.
[59] *Id*.
[60] 242 F.3d 904 (9th Cir. 2001).
[61] Rev. Rul. 2004-51, 2004-1 C.B. 974 (quoting Redlands Surgical Services v. Comm'r, 113 T.C. 47 (1999))
[62] St. David's Health Care System v. United States, 349 F.3d 232 (5th Cir. 2003).
[63] *Id*. at 243.
[64] *Id*.
[65] *Id*. at 239.
[66] *Id*.
[67] Rev. Rul. 2004-51, 2004-1 C.B. 974.

of the joint venture's activities, while the for-profit partner provided and controlled production expertise. The ruling concluded that the university's exempt status was not affected by the joint venture because the activities constituted an insubstantial part of the university's activities.[68] The ruling also implies that fifty-fifty control of the joint venture is acceptable as long as the charitable partner controls the charitable aspects of the joint venture.[69]

Even though Revenue Ruling 2004-51 marks an indisputable movement forward in the IRS's stance regarding the proper federal income tax treatment of joint ventures between charitable organizations and for-profit organizations, the ruling stops short of answering all of the questions and issues raised by venturers. In particular, Revenue Ruling 2004-51 does not modify Revenue Ruling 98-15. Therefore, the control requirement set forth in Revenue Ruling 98-15 is still viewed as essential by the IRS, continuing to raise questions as to how and when it may be applied.

IV. Unrelated Business Income Tax ("UBIT"): General Rules.[70]

A. <u>Definition of Unrelated Business</u>. Since the 1950s, the unrelated business income tax has been imposed on a charity's net income from a regularly carried on trade or business that is unrelated to the charity's tax-exempt purposes. Often times, the justification for imposing this tax on a charity's net income from unrelated business activities is that such activities involve unfair competition with the charity's for-profit counterparts.[71] Organizations described in Section 501(c)(3) of the Code are generally subject to income tax on the net income produced from engaging in an unrelated trade or business activity.[72] The term "unrelated trade or business" means an activity conducted by a tax-exempt organization which is regularly carried on[73] for the production of income from the sale of goods or performance of services[74] and which is not substantially related to the performance of the organization's charitable, educational or other exempt functions.[75]

1. <u>Activity is a "Trade or Business."</u> For purposes of the unrelated business income tax regime, "the term 'trade or business' has the same meaning it has in Section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services."[76] Section 162 of the Code governs the deductibility of trade or business expenses. In that context, the U.S. Supreme Court has declared that "to be engaged in a trade or business, the taxpayer must be involved in

---

[68] *Id*.

[69] *Id*. Revenue Ruling 2004-51 further stated that the limited liability company's activities would not generate unrelated business income for the university because (1) the university had exclusive control over the educational content, (2) all contracts entered into by the limited liability company were at arms length and for fair market value, (3) allocations and distributions were proportional to each member's ownership interest, (4) the video courses covered the same content as the university's traditional classes, and (5) the video courses increased access to the university's educational programs. *Id*.

[70] Portions of this discussion on unrelated business income are extracted from the author's previously published article, *The Taxation of Cause-Related Marketing*, 85 CHI-KENT L. REV. 883 (2010).

[71] *See* Treas. Reg. § 1.513-1(b) ("The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete.").

[72] *See* I.R.C. § 511.

[73] Treas. Reg. § 1.513-1(a).

[74] I.R.C. § 513(c); Treas. Reg. § 1.513-1(b).

[75] I.R.C. § 513(a).

[76] Treas. Reg. § 1.513-1(b).

the activity with continuity and regularity and . . . the taxpayer's primary purpose for engaging in the activity must be for income or profit."[77] When applying this test, the IRS may take into account a key purpose of the unrelated business income tax: to prevent unfair competition between taxable and tax-exempt entities. "[W]here an activity does not possess the characteristics of a trade or business within the meaning of section 162, such as when an organization sends out low cost articles incidental to the solicitation of charitable contributions, the unrelated business income tax does not apply since the organization is not in competition with taxable organizations."[78]

The most important element as to whether the activity is a trade or business is the presence of a profit motive. In the context of a tax-exempt organization, the U.S. Supreme Court declared that the inquiry should be whether the activity "'was entered into with the dominant hope and intent of realizing a profit.'"[79] Significant weight is given to objective factors such as whether the activity is similar to profit-making activities conducted by commercial enterprises.[80] When the activity involved is highly profitable and involves little risk, courts generally infer the presence of a profit motive.[81] The mere fact that the activity is conducted as a fund-raising activity of the charity is not sufficient to conclude that the activity is not a trade or business.[82]

2. Regularly Carried On Requirement. In general, in determining whether a trade or business is "regularly carried on," one must consider the frequency and continuity with which the activities productive of income are conducted, and the manner in which they are pursued. Business activities are deemed to be "'regularly carried on' if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations."[83] For example, "[w]here income producing activities are of a kind normally conducted by nonexempt commercial organizations on a year-round basis, the conduct of such activities by an exempt organization over a period of only a few weeks does not constitute the regular carrying on of trade or business *[sic]*."[84] Similarly, "income producing or fund raising activities lasting only a short period of time will not ordinarily be treated as regularly carried on if they recur only occasionally or sporadically."[85] However, "[w]here income producing activities are of a kind normally undertaken by nonexempt

[77] Comm'r v. Groetzinger, 480 U.S. 23, 35 (1987).

[78] Treas. Reg. § 1.513-1(b). *But see* La. Credit Union League v. United States, 693 F.2d 525, 542 (5th Cir. 1982) ("[T]he presence or absence of competition between exempt and nonexempt organizations does not determine whether an unrelated trade or business is to be taxed.").

[79] United States v. Am. Bar Endowment, 477 U.S. 105, 110, n. 1 (1986) (quoting Brannen v. Comm'r, 722 F.2d 695, 704 (11th Cir. 1984).

[80] Ill. Ass'n of Prof'l Ins. Agents v. Comm'r, 801 F.2d 987, 992 (7th Cir. 1986).

[81] *See, e.g.*, Carolinas Farm & Power Equip. Dealers Ass'n, Inc. v. United States, 699 F.2d 167, 170 (4th Cir. 1983) ("[T]here is no better objective measure of an organization's motive for conducting an activity than the ends it achieves."); La. Credit Union League v. United States, 693 F.2d 525, 533 (5th Cir. 1982) (finding that a profit motive existed based on the fact that the organization was extensively involved in endorsing and administering an insurance program that proved highly profitable); Fraternal Order of Police Ill. State Troopers Lodge No. 41 v. Comm'r, 87 T.C. 747, 756 (1986), *aff'd*, 833 F.2d 717 (7th Cir. 1987) (reasoning that the organization's advertising activities were "obviously conducted with a profit motive" because the activities were highly lucrative and with no risk or expense to the organization).

[82] *See Am. Bar Endowment*, 477 U.S. at 115 (stating that a charity cannot escape taxation by characterizing an activity as fundraising, because otherwise "any exempt organization could engage in a tax-free business by 'giving away' its product in return for a 'contribution' equal to the market value of the product").

[83] Treas. Reg. § 1.513-1(c)(1).

[84] Treas. Reg. § 1.513-1(c)(2)(i).

[85] Treas. Reg. § 1.513-1(c)(2)(iii).

commercial organizations only on a seasonal basis, the conduct of such activities by an exempt organization during a significant portion of the season ordinarily constitutes the regular conduct of trade or business."[86]

In making this determination, it is essential to identify the appropriate nonexempt commercial counterpart to the exempt organization's activity, because the manner in which the nonexempt commercial counterpart conducts its similar activities has an important bearing on whether the activity is considered to be carried on year-round, on a seasonal basis or intermittently. For example, a tax-exempt organization's annual Christmas card sales program was determined to be regularly carried on when conducted over several months during the holiday season because, although nonexempt organizations normally conduct the sale of greeting cards year-round, the Christmas card portion of the nonexempt organizations' sales was conducted over the same seasonal period.[87] By contrast, when an exempt organization's fundraising activities are conducted on an intermittent basis, such activities are generally considered not to be regularly carried on.[88]

Furthermore, in determining whether an exempt organization's business activities are "regularly carried on," the activities of the organization's agents may be taken into account.[89] Courts disagree as to whether an exempt organization's preparation time in organizing and developing an income-producing activity may be taken into account.[90]

3. Unrelated to the Charity's Exempt Purpose. In the event the charity's activities are determined to be regularly carried on, the next inquiry is whether such activities are related to the charity's purposes which constitute the basis for its exemption.[91] This in an inherently factual determination. To determine whether the business activity is "related," the relationship between the conduct of the business activities that generate the income and the accomplishment of the organization's exempt purposes must be examined to determine whether a causal relationship exists.[92] The activity will not be substantially related merely because the income produced from the activity is used to further the organization's exempt purposes.[93] Rather, the inquiry focuses on the manner in which the income is earned. Thus, a substantial causal relationship exists

[86] Treas. Reg. § 1.513-1(c)(2)(i).

[87] Veterans of Foreign Wars, Dept. of Mich. v. Comm'r, 89 T.C. 7, 32-37 (1987).

[88] *See* Treas. Reg. § 1.513-1(c)(2)(iii) (stating fundraising activities lasting only a short period of time will generally not be regarded as regularly carried on, despite their recurrence or their manner of conduct); Suffolk County Patrolmen's Benevolent Ass'n, Inc. v. Comm'r, 77 T.C. 1314 (1981), *acq.*, 1984-2 C.B. 2 (determining that the conduct of an annual vaudeville show one weekend per year and the solicitation and publication of advertising in the related program guide which lasted eight to sixteen weeks per year was intermittent and not regularly carried on). *Cf.* Treas. Reg. § 1.513-1(c)(2)(ii) ("[E]xempt organization business activities which are engaged in only discontinuously or periodically will not be considered regularly carried on if they are conducted without the competitive and promotional efforts typical of commercial endeavors.")

[89] State Police Ass'n of Mass. v. Comm'r, 72 T.C.M. (CCH) 582 (1996), *aff'd*, 125 F.3d 1 (1st Cir. 1997).

[90] *See* Nat'l Collegiate Athletic Ass'n v. Comm'r, 92 T.C. 456 (1989) (finding that NCAA's sale of advertisements for annual championship program was "regularly carried on," in part because of the amount of preliminary time spent to solicit advertisements and prepare them for publication), *rev'd*, 914 F.2d 1417 (10th Cir. 1990) (holding that this activity was not regularly carried on, because only the time spent conducting the activity, not the time spent in preparations, is relevant to that determination); A.O.D. 1991-015 (indicating that the IRS will continue to litigate the issue).

[91] *See* Treas. Reg. § 1.513-1(d)(1).

[92] Treas. Reg. § 1.513-1(d)(1).

[93] I.R.C. § 513(a); Treas. Reg. § 1.513-1(d)(1).

if the distribution of the goods from which the income is derived contributes importantly to the accomplishment of the organization's exempt purposes.[94] In each case, the determination of whether this relationship exists depends on the facts and circumstances involved. In making this determination, the size and extent of the activities involved are considered in relation to the nature and extent of the exempt functions they are serving.[95] If the activities are conducted on a scale larger than is reasonably necessary to accomplish the exempt purposes, the income attributed to the excess activities constitutes unrelated business income.[96]

B. Exceptions and Modifications. The term "unrelated trade or business" is subject to several exceptions under which certain businesses that may otherwise constitute unrelated businesses are removed from the scope of the tax. In particular, the term "unrelated trade or business" does not include a trade or business in which substantially all the work in carrying on the trade or business is performed for an organization without compensation.[97] Unlike the other exceptions, the "volunteer exception" is not restricted as to the nature of the businesses to which it pertains. In addition, the term "unrelated trade or business" does not include the trade or business of selling merchandise, substantially all of which has been received by the organization as gifts or contributions.[98] Finally, an exception from the unrelated business income tax is also provided for income derived from the distribution of low cost articles incident to the solicitation of charitable contributions.[99]

1. Passive Activities Generally. The purpose of the unrelated business income tax is to eliminate the conduct of unrelated businesses by tax exempt organizations as a source of unfair competition with for-profit companies. To the extent that income of a tax exempt organization is derived from investment and other passive activities, the taxation of such income is not necessary to accomplish this goal. Accordingly, the modifications to the unrelated business income tax exclude most passive income, as well as the deductions associated with such passive income, from the scope of the tax.[100] In particular, the following types of passive income are excluded from unrelated business taxable income:

i. dividends;[101]
ii. interest;[102]
iii. annuities;[103]
iv. payments with respect to securities loans;[104]
v. amounts received or accrued as consideration for entering into agreements to make loans;[105]
vi. royalties;[106]

---

94 Treas. Reg. § 1.513-1(d)(2).

95 *See* I.R.C. § 511.

96 *Id*.

97 I.R.C. § 513(a)(1).

98 I.R.C. § 513(a)(3).

99 I.R.C. § 513(h). For tax years beginning in 2012, a low-cost article is one which has a cost to the organization of $9.90 or less. Rev. Proc. 2011-52, 2011-45 I.R.B.

100 *See generally* Trinidad v. Sagrada Orden de Predicadores, 263 U.S. 578 (1924).

101 I.R.C. § 512(b)(1).

102 I.R.C. § 512(b)(1).

103 I.R.C. § 512(b)(1).

104 I.R.C. § 512(b)(1). The term "payments with respect to securities loans," refers to income derived from a securities lending transaction in which an exempt organization loans securities from its portfolio to a broker in exchange for collateral. I.R.C. § 512(a)(5). Payments derived from a securities lending transaction typically include interest earned on the collateral and dividends or interest paid on the loaned securities while in the possession of the broker.

105 I.R.C. § 512(b)(1).

106 I.R.C. § 512(b)(2). A royalty is defined as a payment that relates to the use of a valuable right, such as a name, trademark, trade name or copyright. Rev. Rul. 81-178, 1981-2 C.B. 135. By contrast, the payment for personal services does not constitute a royalty. *Id.*

vii. gains or losses from the sale, exchange, or other disposition of property other than inventory;[107] and

viii. gains or losses recognized in connection with a charitable organization's investment activities from the lapse or termination of options to buy or sell securities or real property.[108]

2. Rents. In addition, certain rents are excluded from unrelated business taxable income.[109] The exclusion applies to rents from real property and rents from personal property leased with such real property, provided that the rents attributable to the personal property are an incidental amount of the total rents received or accrued under the lease.[110] Three principal exceptions limit the ability of a charitable organization to exclude the eligible rents described above from unrelated business taxable income. The exceptions apply when there are excessive personal property rents, when rent is determined by net profits from the property, and when certain services are rendered to the lessee. Under the first exception, the rental exclusion does not apply if more than 50% of the total rent received or accrued under the lease is attributable to personal property, determined at the time the personal property is first placed in service.[111] Under the second exception, the rental exclusion is not available if the determination of the amount of rent depends in whole or in part on the income or profits derived by any person from the leased property, other than an amount based on a fixed percentage or percentages of receipts or sales.[112] Under the third exception, payments for the use or occupancy of rooms or other space where services are also rendered to the occupant do not constitute rent from real property.[113] As a general rule, services are considered to be rendered to the occupant if the services are (a) primarily for the convenience of the occupant, and (2) other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only.[114]

3. Royalties. Because royalties are passive in nature, the receipt of royalty income by a tax-exempt organization does not result in unfair competition with taxable entities.[115] Accordingly, section 512 of the Code provides that a charity's UBTI generally does not include royalties.[116] A royalty is defined as a payment that relates to the use of a valuable right, such as a name, trademark, trade name, or copyright.[117] The royalty may be in the form of a fixed fee or a percentage of sales of the products bearing the charity's name and logo. In addition, the tax-exempt organization may retain the right to approve the use of its name or logo without changing the determination that the income from the transaction is a royalty.

Of particular importance in the royalty context is the amount of services the charity performs in exchange for the payment received. In order to maintain the royalty exemption for the payments received, the charity may not perform more than *de minimis* services in connection with the arrangement.[118] If the charity performs more than insubstantial services, then the income received is considered compensation for personal services, the royalty exception would not apply, and

107 I.R.C. § 512(b)(5).
108 I.R.C. § 512(b)(5).
109 I.R.C. § 512(b)(3).
110 I.R.C. § 512(b)(3)(A).
111 I.R.C. § 512(b)(3)(B)(i).
112 I.R.C. § 512(b)(3)(B)(ii).
113 Treas. Reg. § 1.512(b)-1(c)(5).
114 *Id.*
115 *See* Sierra Club Inc. v. Comm'r, 86 F.3d 1526, 1533 (9th Cir. 1996).
116 I.R.C. § 512(b)(2); Treas. Reg. § 1.512(b)-1(b). A charity's UBTI would include royalties derived from debt-financed property. Treas. Reg. § 1.512(b)-1(b).
117 Rev. Rul. 81-178, 1981-2 C.B. 135.
118 *Sierra Club*, 86 F.3d at 1533–35.

the income would most likely be subject to tax as UBTI.[119]

For example, the Internal Revenue Service privately ruled that royalties received by a charity from the license of the charity's intellectual property to a for-profit company for use in the company's commercial activities were excluded from the charity's UBTI under the royalty exception.[120] Under the license agreement, the charity retained the right to review the designs and proposed uses of the charity's intellectual property, inspect the commercial counterpart's facilities where the product was manufactured, and inspect the commercial counterpart's books and records annually. The Internal Revenue Service determined that these services performed by the charity in connection with the licensing arrangement were *de minimis*. Moreover, the licensing agreement was narrowly tailored to protect the charity's ownership of its intellectual property by giving the charity absolute discretion to reject proposed uses of the property, providing notice on every unit displaying the charity's mark that it was used with the charity's permission, and allowing the charity to approve and limit mass media advertising of the product. The Internal Revenue Service concluded that the income that the charity would receive from the arrangement was "vastly out of proportion with the time and effort" the charity would expend. Therefore, it could only be compensation for the use of the charity's intellectual property.

The determination of the permissible amount of "insubstantial services" is uncertain, however, especially in connection with the charitable organization's exercise of quality control over the use of its name, logo, and trademarks. As is prudent business practice, a charity would want to maintain quality control over the use of its name, logo, and trademark by the corporate partner under the licensing agreement. In some cases, the Internal Revenue Service has determined that "mere" quality control does not constitute more than insubstantial services related to the royalty income.[121] In other cases, a charity's "quality control" was recharacterized as services, resulting in the income from the arrangement being taxed as compensation from services rather than exempted as royalty income.[122] Therefore, charities are left to struggle with the determination of the permissible types of "quality control" they can include in their licensing agreements without crossing the boundary between *de minimis* and substantial services.

Furthermore, caution should be taken in relying on the royalty exception for income received from the licensing of a charity's name or logo for placement on a corporate sponsor's product. In evaluating the justification for the continued tax exemption for college athletic programs, the Congressional Budget Office recommended repealing the royalty exception to the extent that it applies to the licensing of a charity's name or logo:

> Some types of royalty income may reasonably be considered more commercial than others. . . . [W]hen colleges and universities license team names, mottoes, and other trademarks to for-profit businesses that supply apparel, accessories, and credit cards to the general public, they approve each product and use of their symbols and, in some cases, exchange information, such as donor lists, with the licensees to aid in their marketing. . . . The manufacture or sale of such items would clearly be commercial—and subject to the UBIT—if undertaken directly by the schools. Schools' active involvement in generating licensing income could be the basis for considering such income as

119 *See* Rev. Rul. 81-178.

120 Priv. Ltr. Rul. 200601033 (Oct. 14, 2005).

121 *See, e.g.*, Rev. Rul. 81-178, 1981-2 C.B. 135; Priv. Ltr. Rul. 200601033 (Oct. 14, 2005); Priv. Ltr. Rul. 9029047 (Apr. 27, 1990)

122 *See, e.g.*, NCAA v. Comm'r, 92 T.C. 456, 468–70 (1989), *rev'd on other grounds*, 914 F.2d 1417 (10th Cir. 1990); Fraternal Order of Police v. Comm'r, 87 T.C. 747, 758 (1986), *aff'd*, 833 F.2d 717 (7th Cir. 1987).

commercial and therefore subject to the UBTI. . . .

Bringing royalty income that accrues only to athletic departments under the UBIT would be problematic, however . . . . [I]f royalty income from licensing team names to for-profit businesses was truly considered commercial and subject to the UBIT, the same arguments would apply in full force to licensing all other university names and trademarks. A consistent policy would subject all such income to the UBIT because of its commercial nature. Such a change in policy could affect many other nonprofits in addition to colleges and universities . . . .[123]

4. Corporate Sponsorships. Under section 513(i) of the Internal Revenue Code, the receipt of qualified sponsorship payments by a charity does not constitute the receipt of income from an unrelated trade or business, and instead, the payment is treated as a charitable contribution to the charity.[124] A "qualified sponsorship payment" is "any payment[125] by any person engaged in a trade or business with respect to which there is no arrangement or expectation that the person will receive any substantial return benefit."[126] A "substantial return benefit" is any benefit other than a "use or acknowledgement"[127] of the corporate sponsor and certain disregarded benefits.[128] Substantial benefits include the charitable organization's provision of facilities, services, or other privileges to the sponsor; exclusive provider relationships;[129]

[123] CONG. BUDGET OFFICE, PUB. NO. 3005, TAX PREFERENCES FOR COLLEGIATE SPORTS 13 (2009).

[124] I.R.C. § 513(i); Treas. Reg. § 1.513-4(a). The Treasury Regulations provide the following example of a qualified sponsorship payment:

> M, a local charity, organizes a marathon and walkathon at which it serves to participants drinks and other refreshments provided free of charge by a national corporation. The corporation also gives M prizes to be awarded to the winners of the event. M recognizes the assistance of the corporation by listing the corporation's name in promotional fliers, in newspaper advertisements of the event and on T-shirts worn by participants. M changes the name of its event to include the name of the corporation. M's activities constitute acknowledgement of the sponsorship.

Id. § 1.513-4(f), example 1.

[125] "Payment" means "the payment of money, transfer of property, or performance of services." *Id.* § 1.513-4(c)(1).

[126] *Id*. For purposes of these rules, it is irrelevant whether the sponsored activity is temporary or permanent. *Id*

[127] The permitted "uses or acknowledgements" under the qualified sponsorship payment rules include (i) "logos and slogans that do not contain qualitative or comparative descriptions of the payor's products, services, facilities or company," (ii) "a list of the payor's locations, telephone numbers, or Internet address," (iii) "value-neutral descriptions, including displays or visual depictions, of the payor's product-line or services," and (iv) "the payor's brand or trade names and product or service listings." *Id.* § 1.513-4(c)(1)(iv). "Logos or slogans that are an established part of the payor's identity are not considered to contain qualitative or comparative descriptions." *Id.*

[128] *Id.* § 1.513-4(c)(2). A benefit is disregarded if "the aggregate fair market value of all the benefits provided to the payor or persons designated by the payor in connection with the payment during the organization's taxable year is not more than two percent of the amount of the payment." *Id.* § 1.513-4(c)(2)(ii). If this limit is exceeded, the entire benefit (and not just the amount exceeding the two percent threshold) provided to the payor is a substantial return benefit. *Id.*

[129] The Treasury Regulations define an "exclusive provider" relationship as any arrangement which "limits the sale, distribution, availability, or use of competing products, services or facilities in connection with an exempt organization's activity." *Id.* § 1.513-4(c)(2)(vi)(B). "For example, if in exchange for a payment, the exempt organization agrees to allow only the payor's products to be sold in

and any license to use intangible assets of the charitable organization.[130] "If there is an arrangement or expectation that the payor will receive a substantial return benefit with respect to any payment, then only the portion, if any, of the payment that exceeds the fair market value of the substantial return benefit is a qualified sponsorship payment."[131] The exempt organization has the burden of establishing the fair market value of the substantial return benefit. If the organization fails to do so, "no portion of the payment constitutes a qualified sponsorship payment."[132]

The tax treatment of any payment that does not represent income from a qualified sponsorship payment is governed by general UBIT principles.[133] The mere fact that the payments are received in connection with the corporate sponsor receiving a substantial return benefit does not necessitate the payments constituting UBTI. For example, in a memorandum released by the Internal Revenue Service in October 2001, examples of certain exclusive provider relationships were addressed.[134] Significantly, one example involved a contract between a soft drink company and a university, under which the soft drink company would be the exclusive provider of soft drinks on campus in return for an annual payment made to the university. Exclusive provider relationships are explicitly named as a substantial return benefit; therefore, the arrangement did not qualify as a qualified sponsorship payment. Because the soft drink company maintained the vending machines, there was no obligation by the university to perform any services on behalf of the soft drink company or to perform any services in connection with the contract. Accordingly, the university did not have the level of activity necessary to constitute a trade or business. Since the contract also provided that the soft drink company was given a license to market its products using the university's name and logo, the portion of the total payment attributable to the value of the license would be excluded from the university's UBTI as a royalty payment.

If the corporate sponsorship involves the charity's endorsement of the corporate sponsor's product or services, then the income from the corporate sponsorship will likely be included in the charity's UBTI as advertising income. "Advertising" is "any message or other programming material which is broadcast or otherwise transmitted, published, displayed or distributed, and which promotes or markets any trade or business, or any service, facility or product."[135] Advertising includes "messages containing qualitative or comparative language, price information or other indications of savings or value, an endorsement, or an inducement to purchase, sell, or use any company, service, facility or product."[136] For example, the Internal

connection with an activity, the payor has received a substantial return benefit." *Id.*

[130] *Id.* § 1.513-4(c)(2)(iii)(D).

[131] *Id.* § 1.513-4(d).

[132] *Id.*

[133] *Id.* § 1.513-4(f).

[134] *See IRS Issues Field Memo on Exclusive Providers and UBIT*, 2001 TAX NOTES TODAY 192-26 (Oct. 3, 2001).

[135] Treas. Reg. § 1.513-4(c)(v).

[136] *Id.* Typically, advertising is considered to be a trade or business that is unrelated to the charity's exempt purposes. Thus, the question remains whether the advertising activity is "regularly carried on." If advertising messages of a corporate sponsor's product are continuously present on the charity's website, such advertising activities would seem to be regularly carried on and the revenues therefrom would thus constitute UBTI. One counter-argument would appear to be that the limited number of advertisements makes the charity's activities dissimilar in extent to comparable commercial activities. *See* Tech. Adv. Mem. 9417003 (Dec. 31, 1993) (stating that an advertising campaign conducted by placing advertisements in programs for an organization's annual ball was not typical of commercial endeavors because solicitations for advertisements were limited in number and consisted of a single form letter). Given the variety and relative novelty of Internet advertisements, it would be unwise for a charity to rely upon such a position. *See generally* I.R.S. Announcement 2000-84, 2000-42 I.R.B. 385

Revenue Service considers the following messages to consist, at least in part, of advertising: (i) "This program has been brought to you by the Music Shop, located at 123 Main Street. For your music needs, give them a call at 555-1234. This station is proud to have the Music Shop as a sponsor,"[137] and (ii) "Visit the Music Shop today for the finest selection of music CDs and cassette tapes."[138] If a single message contains both advertising and an acknowledgement, the message is an advertisement. Where the Treasury Regulations do not allow one to clearly distinguish between advertisements and permitted uses and acknowledgements, a court may be inclined to take a common-sense approach and consider a message an advertisement if it "looks like" an ad.[139]

The United States Supreme Court considered whether advertising could be substantially related to an organization's exempt purposes in *United States v. American College of Physicians*,[140] the leading case on this topic. There, an exempt physicians' organization received income from the sale of advertising in its professional journal. The messages in question consisted of advertisements for "pharmaceuticals, medical supplies, and equipment useful in the practice of internal medicine." The organization "has a long-standing practice of accepting only advertisements containing information about the use of medical products, and screens proffered advertisements for accuracy and relevance to internal medicine." The organization argued that these advertisements were substantially related to its exempt functions because they contributed to the education of the journal's readers. At trial, experts testified that "drug advertising performs a valuable function for doctors by disseminating information on recent developments in drug manufacture and use."[141] Rejecting the organization's claim and ruling that the advertising income was UBTI, the Supreme Court analyzed this issue as follows:

> [A]ll advertisements contain some information, and if a modicum of informative content were enough to supply the important contribution necessary to achieve tax exemption for commercial advertising, it would be the rare advertisement indeed that would fail to meet the test. Yet the statutory and regulatory scheme, even if not creating a *per se* rule *against* tax exemption, is clearly antagonistic to the concept of a *per se* rule *for* exemption . . . . Thus, the Claims Court properly directed its attention to the College's conduct of its advertising business, and it found the following pertinent facts:
>
> > The evidence is clear that plaintiff did not use the advertising to provide its readers a comprehensive or systematic presentation of any aspect of the goods or services publicized. Those companies willing to pay for advertising space got it; others did not. Moreover, some of the advertising was for established drugs or devices and was repeated from one month to another, undermining the suggestion that the advertising was principally designed to alert readers of recent developments . . . . Some ads

(announcing that the Internal Revenue Service was considering whether clarification was needed as to the application of the "regularly carried on" requirement to business activities conducted on the Internet).

137 *Id.* § 1.513-4(f), example 7.

138 *Id.* at example 8. Where a document can be broken down into segments identified in the Treasury Regulations, a court or the Internal Revenue Service will likely analyze each segment with reference to the rules set out above. *See, e.g.*, Tech. Adv. Mem. 9805001 (Oct. 7, 1997) (concluding that an "ad" did not rise to the level of advertising when it consisted of a can of a sponsor's pet food made to look like a trophy and included two slogans that had long been used by the sponsor in its advertising).

139 *See, e.g.*, State Police Ass'n of Mass. v. Comm'r, 125 F.3d 1, 6 (1st Cir. 1997).

140 475 U.S. 834 (1986).

141 *Id.* at 847.

> even concerned matters that had no conceivable relationship to the College's tax-exempt purposes.
>
> . . . This is not to say that the College could not control its publication of advertisements in such a way as to reflect an intention to contribute importantly to its educational functions. By coordinating the content of the advertisements with the editorial content of the issue, or by publishing only advertisements reflecting new developments in the pharmaceutical market, for example, perhaps the College could satisfy the stringent standards erected by Congress and the Treasury.[142]

C. Payments Between Controlled Groups. When a charitable organization receives a "specified payment" from another entity which it controls, the payment is treated as unrelated business income to the extent the payment reduces the trade or business income of the controlled entity.[143] The term "specified payment" means any interest, annuity, royalty, or rent paid to the controlling organization.[144] For purposes of this rule, the term control means (1) in the case of a corporation, ownership (by vote or value) of more than 50% of the stock in a corporation,[145] or (2) in the case of a partnership, ownership of more than 50% of the profits interest or capital interest in a partnership.[146] In determining control, the constructive ownership rules of Code section 318 apply.[147] If a partnership owns stock in a corporation, ownership of the corporation will be attributed to the partners in the same proportion in which the partners hold their interests in the partnership.[148] In addition, if a shareholder owns 50% or more of the value of the stock in a corporation, stock in another entity owned by the corporation is considered as owned by its shareholder in proportion to the shareholder's ownership interest in the corporation.[149]

Code Section 318 is silent with respect to applying attribution rules among tax exempt organizations. On its face, Code Section 318 does not seem to attribute ownership in an entity from one nonstock

---

142 *Id.* at 848–50 (citation omitted). Several cases and rulings follow the reasoning of *American College of Physicians*. *See, e.g.*, Minn. Holstein-Frisian Breeders Ass'n v. Comm'r, 64 T.C.M. (CCH) 1319 (1992) (holding that advertisements that may have been of "incidental benefit to breeders in running their day-to-day operations" but that did not "contribute importantly to improving the quality of the breed of Holstein-Friesian cattle" were not substantially related to a cattle breeding organization's exempt purposes); Fla. Trucking Ass'n v. Comm'r, 87 T.C. 1039 (1986) (holding that advertisements of products of particular interest to the trucking industry did not bear a substantial relationship to the exempt functions of a trucking trade association); Rev. Rul. 82-139, 1982-2 C.B. 108 (concluding that a bar association's publication of advertisements for products and services used by the legal profession was not substantially related to the association's exempt purposes).

143 I.R.C. § 512(b)(13)(A). A modification to this rule applies to "qualifying specified payments" (i.e., specified payments made pursuant to a binding written contract in effect on Aug. 17, 2006) received or accrued after Dec. 31, 2005 and before Jan. 1, 2010. Under the modified rule, only the excess payments – the portion of the "qualifying specified payment" received or accrued by the controlling organization that exceeds the amount which would have been paid or accrued if such payment met the requirements prescribed under Code section 482 – is included in the controlling organization's UBTI, and only to the extent such excess payment reduces the trade or business income of the controlled entity. I.R.C. § 512(b)(13)(E).

144 I.R.C. § 512(b)(13)(C).

145 I.R.C. § 512(b)(13)(D)(i)(I).

146 I.R.C. § 512(b)(13)(D)(i)(II).

147 I.R.C. § 512(b)(13)(D)(ii).

148 I.R.C. § 318(a)(2)(A).

149 I.R.C. § 318(a)(2)(C).

tax exempt organization to another because the attribution rules focus on one's ownership interest in an organization. Ownership is not an appropriate criterion for tax exempt organizations because no one has an ownership interest in a nonstock tax exempt organization. For example, if two tax exempt organizations, which have identical boards of directors, each own a 50% interest in a for-profit corporation, the constructive ownership rules of Code Section 318 would not seem to attribute the ownership of the corporation's stock from one of the tax exempt organizations to the other.[150] Thus, since both tax exempt entities would own only 50% of the corporation's stock, the corporation would not be controlled by either tax exempt organization.[151] As a result, interest paid from the for-profit corporation to the tax exempt shareholders would not be considered unrelated business income.

However, by analogizing the principles of former Code Section 512(b)(13), ownership in an entity by one tax-exempt organization may be attributed to another tax-exempt organization if there is a common degree of management between the two tax-exempt organizations.[152] Former Code Section 512(b)(13) defined control by reference to Code Section 368(c) which provides that ownership of at least 80% of the corporation's stock effectuated control.[153] In applying the principles of Section 368(c), Treasury Regulation Section 1.512(b)-1(l)(4)(i)(b) states that in the context of nonstock tax-exempt organizations, control exists between two or more tax-exempt organizations in which more than 50% of the governing boards overlap.[154]

D. Unrelated Debt Financed Income. Property acquired by an exempt organization with borrowed funds may be considered debt-financed property.[155] Debt-financed property is property held by a charitable organization to produce income that is encumbered by acquisition indebtedness at any time during the taxable year.[156] The term "acquisition indebtedness" refers to acquisition or indebtedness incurred in connection with the acquisition or improvement of property, whether the debt is incurred before, after, or at the time of acquisition.[157] There are several exceptions to the term acquisition indebtedness, including exceptions for property acquired by gift, bequest, or devise, indebtedness incurred in performing the organization's exempt function, and certain real property acquired by educational organizations, qualified plans, and multiple-parent title holding organizations.[158] Exceptions under which property acquired with financing escapes classification as debt-financed property include property used by an organization in performing its exempt function, property used in an unrelated trade or business, and property acquired for prospective exempt use.[159]

A certain portion of income derived from debt-financed property must be included in unrelated business taxable income as an item of gross income derived from an unrelated trade or business.[160] Similarly, a certain portion of the deductions

[150] Robert A. Wexler & Lisa R. Appleberry, *TRA '97 Brings Charities a Little Relief . . . and Maybe a Lot of Grief*, 87 J. TAX'N 360, 363 (1997).

[151] *See* I.R.C. § 512(b)(13)(D).

[152] *See* Wexler & Appleberry, *supra* note 150 at 363; *see also* Priv. Ltr. Rul. 199941048 (Oct. 18, 1999).

[153] Former I.R.C. § 512(b)(13) (repealed by P.L. 105-34 § 1041(a)) (effective for tax years beginning before August 6, 1997).

[154] Wexler & Appleberry, *supra* note 150 at 363.
[155] I.R.C. § 514(b).
[156] I.R.C. § 514(b)(1).
[157] I.R.C. § 514(c)(1).
[158] I.R.C. § 514(c).
[159] I.R.C. § 514(b)(1), (3).
[160] I.R.C. § 514(a)(1).

Return to Table of Contents

directly connected with debt-financed property are allowed as deductions in computing unrelated business taxable income.[161] The portion of income and deduction that must be taken into account is determined by applying a debt/basis percentage, which is equal to the ratio of the average acquisition indebtedness for the taxable year with respect to the property over the average amount of the adjusted basis of the property during the period it is held by the organization during the taxable year.[162]

The treatment of income and deductions from debt-financed property described above overrides the modifications from unrelated business taxable income otherwise provided for dividends, interest, payments with respect to securities loans, annuities, loan commitment fees, royalties, rents, and gains and losses from the sale, exchange, or other disposition of property.[163] In other words, the amount ascertained under the debt-financed property rules is expressly required to be included as an item of gross income derived from an unrelated trade or business despite the fact that the source of such income is passive in nature.

E. Partnerships. Section 702(b) of the Code provides that the character in the hands of a partner of an item of partnership income is determined as if the item were realized directed from the source from which realized by the partnership. For example, if an entity's share of partnership income is derived from debt-financed property, the income from the property is generally taxable as debt-financed income.[164]

Technical Advice Memorandum 9651001 indicates that the use of multiple pass-through entities does not change this result.[165] There, an exempt organization ("X") held an interest in a limited partnership ("Z"). Z in turn owned an interest in a joint venture ("Venture"). Venture owned property that was collateral for a mortgage note. X eventually sold its interest in Z. The issue in the Technical Advice Memorandum was whether this sale was subject to unrelated business income tax under Section 511 of the Code because Z owned debt-financed property. The IRS concluded that it was, explaining, "[a]n interest in a partnership that holds debt-financed property is effectively an interest in the underlying assets and liabilities of the partnership. An anomalous result would occur if ownership of debt-financed property through a partnership would result in one tax treatment when direct ownership would result in another." Under this reasoning, the same result follows if the income in question was derived from debt-financed property other than through a sale of the exempt entity's interest in a pass-through entity. Regardless of how many layers of pass-through entities are imposed, the "lowest level" entity's property would effectively be owned by each entity up the line, and would ultimately effectively be owned by the tax exempt entity.

To avoid the realization of debt-financed income through an investment in a limited partnership or hedge fund, charitable organizations often use "blocker" entities to acquire these investments. A "blocker" entity is a corporate entity that is interposed between the investment and the charitable organization. The corporation "blocks" the attribution of any debt in the investment partnership to the charitable organization, and thus enables the charitable organization to avoid the application of the debt-financed

[161] I.R.C. § 514(a)(2).

[162] I.R.C. § 514(a)(1).

[163] I.R.C. § 512(b)(4).

[164] *See, e.g.,* Rev. Rul. 74-197, 1974-1 C.B. 143. Example 4 in Treasury Regulation Section 1.514(c)-1(a)(2) specifically demonstrates that this is so. Treas. Reg. § 1.514(c)-1(a)(2), example 4. Relying upon Section 702(b), Example 4 explains that if an entity ("X") is a limited partner in a partnership that borrows money to purchase an office building for lease to the general public, X's share of the income from the building is debt-financed income. *Id.*

[165] Tech. Adv. Mem. 9651001 (Dec. 20, 1996).

income rules with respect to the investment income generated by the investment partnership. Rather, the partnership income is taxed to the corporate blocker entity. Often, the blocker entity is a foreign corporation formed in a low tax jurisdiction. As a result, the blocker entity pays little or no tax on the income from the investment partnership or hedge fund. The blocker entity in turn distributes the income received from the investment partnership to the charitable organization in the form of dividends, which is excluded from the charitable organization's unrelated business taxable income.[166] The IRS has issued a private letter ruling determining that dividends received by a charitable organization from a foreign corporation used as a blocker entity is not subject to the unrelated business income tax.[167] Although the use of blocker entities may appear to be a "loophole," blocker entities are often used to avoid the application of the unrelated debt-financed income rules to passive investments that were never intended to be within the scope of the rules.

F. <u>S Corporations</u>. Charities are able to hold S corporation shares without breaking the S election.[168] However, all income distributable to a charitable S corporation shareholder will be treated as unrelated business taxable income from an asset deemed in its entirety to be an interest in unrelated trade or business.[169] Consequently, "(i) all items of income, loss, or deduction taken into account under Section 1366(a), and (ii) any gain or loss on the disposition of the stock in the S corporation shall be taken into account in computing the unrelated business taxable income of such organization."[170] In addition, the basis of any S corporation stock acquired by purchase is reduced by the amount of dividends received by the charitable organization with respect to the stock.[171]

G. <u>Public Disclosure of Information Relating to the Unrelated Business Income Tax</u>. Charitable organizations are required to make their annual Form 990/Form 990PF information returns and exemption materials available for public inspection.[172] Organizations that have unrelated business income also have to file a Form 990-T return. Charitable organizations described in Section 501(c)(3)[173] are required to make their Form 990-T returns[174] available for public inspection.[175] Certain information may be withheld by the charitable organization from public disclosure and inspection (e.g., information relating to a trade secret, patent, process, style of work, or apparatus of the charitable organization) *if* the Secretary determines that public disclosure of such information would adversely affect the charitable organization.[176] Under the commensurate in scope test, an exempt organization may generate a significant amount of UBTI so long as it performs charitable programs that are commensurate in scope with its financial resources.[177] However, if a substantial portion of the charity's income is from

---

[166] *See* I.R.C. § 512(b)(1).
[167] Priv. Ltr. Rul. 199952086 (Sept. 30, 1999).
[168] *See* I.R.C. § 1361(c)(6).
[169] I.R.C. § 512(e).
[170] *Id.*
[171] I.R.C. § 512(e)(2).
[172] I.R.C. § 6104(d)(1)(A).
[173] This requirement applies to all charitable organizations which file Form 990-T returns, regardless of whether such organizations are also required to file annual Form 990/Form 990PF information returns. However, state colleges and universities which are exempt from income tax solely under Section 115 of the Code are not required to make their Form 990-T returns available for public inspection. Notice 2007-45, 2007-22 I.R.B. 1320.
[174] An exact copy of the Form 990-T return, including all schedules, attachments and supporting documents must be disclosed. Notice 2007-45, 2007-22 I.R.B. 1320.
[175] I.R.C. § 6104(d)(1)(A)(ii).
[176] Staff of the Joint Comm. on Tax'n, 109th Cong., Technical Explanation of H.R. 4, The "Pension Protection Act of 2006," JCX-38-06 (Aug. 3, 2006) at 330.
[177] Rev. Rul. 64-182, 1964-1 C.B. 186.

Return to Table of Contents

unrelated activities, the organization fails to qualify for exemption.[178]

H. Effect of Unrelated Business Activities on the Charity's Tax-Exempt Status. In order to obtain and maintain tax-exempt status, a charity must be operated primarily for the purposes described in Section 501(c)(3) of the Code. Accordingly, if a charity engages in too much unrelated business activity, it risks the loss of its tax-exempt status as no longer satisfying this operational test. There is no bright line rule with respect to how much unrelated business income a charity may receive without jeopardizing its tax-exempt status.[179] Whether an organization has a substantial non-exempt purpose is a question of fact.[180]

I. Use of Taxable Subsidiaries. If a charity engages in an activity that may produce substantial unrelated business income, the charity should consider conducting the activity through a taxable corporate subsidiary wholly owned by the charity. The taxable subsidiary will be responsible for paying income tax on the net taxable income from the activity. The net income may then be distributed to the charity in the form of dividends which generally are excluded from a charity's UBTI.

One advantage of this structure is that the activities of the taxable subsidiary normally will not be attributed to the charity. This is especially important if the conduct of the activity is so substantial that it may jeopardize the charity's tax-exemption. Second, the charity will not be required to file a Form 990-T related to the activity, which is available for public inspection. Although the taxable subsidiary will file a Form 1120, such form is not required to be made publicly available. Third, use of a taxable subsidiary can protect the charity's assets from liabilities arising from the conduct of the unrelated business activity and isolate those liabilities to the taxable subsidiary. Finally, a taxable subsidiary can provide greater flexibility in structuring the unrelated business activity.

However, use of a taxable subsidiary may increase administrative burdens and costs of the charity. Additionally, the dividends from the taxable subsidiary may no longer be exempt from UBIT if the charity transfers debt-financed property to the taxable subsidiary.[181] If the charity provides administrative services to its taxable subsidiary for a fee, the IRS may reallocate income between the charity and the taxable subsidiary under Code section 482. Finally, as discussed above, if the charity receives interest, rent, annuity payments or royalties from its controlled taxable subsidiary, such payment may be treated as unrelated business income to the charity to the extent the payment reduces the trade or business income of the taxable subsidiary.[182]

V. Cause-Related Marketing.[183] Cause-related marketing involves a charity forming

178 Treas. Reg. § 1.501(c)(3)-1(c)(1).

179 In making this determination, courts may examine the amount of time or money spent on carrying out an unrelated trade or business. *See* Orange County Agricultural Society v. Comm'r, 893 F.2d 529 (2d Cir. 1990), *aff'g* 55 T.C.M. 1602 (1988) (denying exempt status where an organization received approximately one-third of its gross income from unrelated business activities).

180 *See* Better Business Bureau of Washington, D.C., Inc. v. United States, 326 U.S. 279 (1945) (holding that the presence of a single, non-exempt purpose, if substantial in nature, will destroy exemption regardless of the number of importance of truly exempt purposes); B.S.W. Group v. Commissioner, 70 T.C. 352 (1978); Nationalist Movement v. Comm'r, 102 T.C. 558, 559 (1994), *aff'd*, 37 F.3d 216 (5th Cir. 1994).

181 I.R.C. § 357(c); Rev. Rul. 77-71, 1977-1 C.B. 155.

182 I.R.C. § 512(b)(13).

183 Portions of this discussion on cause-related marketing are extracted from the author's previously published article, *The Taxation of Cause-Related Marketing*, 85 CHI-KENT L. REV. 883 (2010).

alliances with one or more for-profit corporations to allow the charity's name or logo to be used in marketing the corporation's products or services.[184] Such alliances may include selling merchandise which prominently displays the charity's name, logo, or trademark message in conjunction with a corporate partner or allowing the charity's name or logo to be displayed on promotional products of the corporate partner, with a portion of the sales proceeds of those promotional products donated to the charity. Cause-related marketing alliances provide mutual benefits to the charity and the corporate partner. Charities benefit by the amount of donations received directly from the campaign and by increasing resources and awareness of the charity and its mission.[185] The corporate partners benefit because cause-related marketing activities are generally profit motivated, with donations based upon consumer behavior in the form of purchasing the sponsoring company's products or services.[186] When a charity engages in a cause-related marketing alliance, the charity must carefully structure the alliance or the income the charity receives from the alliance may be treated as unrelated business income.

A. Sale of Merchandise Directly by Charity. A charity which directly sells merchandise bearing the charity's name, logo, or other cause-related message would analyze whether the receipts from the sale of such merchandise are UBTI under the general three-prong UBTI test. The sale of the merchandise typically is an activity carried on for the production of income from the sale of goods. Additionally, a charity would normally engage in the sales of the merchandise continuously throughout the year. Accordingly, the sale of the merchandise would be considered a regularly carried on trade or business. Whether the receipts from the sale of the merchandise are UBTI would depend on whether the sale of the merchandise is substantially related to the charity's exempt purpose.

Where a charity sells merchandise, the merchandise is examined on an item-by-item basis to determine if sales of such merchandise further the organization's exempt purposes.[187] Generally, if the primary purpose of an item is utilitarian, ornamental, or token, selling such an item is not substantially related to the organization's exempt purposes.[188] In contrast, if the utilitarian aspects of the item are incidental to the item's relationship to the organization's exempt purpose, the sale of such an item is considered to be substantially related to the organization's exempt purpose.[189] In addition, merely placing an exempt organization's name or logo on an item otherwise unrelated to its exempt purpose will not prevent sales proceeds from constituting UBTI.[190] However, in several private rulings, the Internal Revenue Service has reached the contrary conclusion regarding the sale of t-shirts and similar items bearing an

[184] *See, e.g.* Dennis R. Young, *Commercialism in Nonprofit Social Service Associations: Its Character, Significance, and Rationale*, *in* TO PROFIT OR NOT TO PROFIT 195, 198 (Burton A. Weisbrod ed., 1998) (defining cause-related marketing as involving "'a relationship which ties a company, its customers and selected products to an issue or cause with the goal of improving sales and corporate image while providing substantial income and benefits to the cause'" (citation omitted)).

[185] *See* Stacy Landreth Grau & Judith Anne Garretson Folse, *Cause-Related Marketing (CRM): The Influence of Donation Proximity and Message-Framing Cues on the Less-Involved Consumer*, J. ADVERTISING, Winter 2007, at 19, 20.

[186] *Id.*

[187] *See e.g.*, Tech. Adv. Mem. 9720002 (Nov. 26, 1996).

[188] *See, e.g.*, Priv. Ltr. Rul. 200222030 (Mar. 4, 2002); Tech. Adv. Mem. 8024111 (Jan. 3, 1980).

[189] *See* Tech. Adv. Mem. 8605002 (Sept. 4, 1985); Tech. Adv. Mem. 832-009 (Mar. 30, 1983).

[190] *See, e.g.*, Tech. Adv. Mem. 8326003 (Nov. 17, 1982).

organization's name or symbol when additional facts indicated that the sales furthered the organization's exempt purpose.[191]

Most recently, the Internal Revenue Service privately ruled in 2007 that the sale of merchandise bearing the symbol for breast cancer awareness by a charity formed to educate the general public about early detection of breast cancer was substantially related to the charity's exempt purpose.[192] Thus, the proceeds from the sale of the breast cancer awareness merchandise were excluded from the charity's UBTI. The branded merchandise described in the ruling included pins, apparel, home and office products, jewelry, and special gifts. All branded merchandise either displayed a pink ribbon, the universal symbol for breast cancer awareness, or were the color pink, the universal color for breast cancer awareness. Included with the packaging of each item was a bookmark providing the charity's recommended three-step approach to positive breast health and the charity's toll-free number and web address. The Internal Revenue Service concluded that the sale of the merchandise "reminds and encourages those who wear, display, or see the images, about breast cancer. The sale of these items further enhances [the charity's] message that early detection of breast cancer and positive breast health practice save lives and is, accordingly, related to the organization's exempt purposes."

Even though this type of merchandise sold by a charity typically has some utilitarian value, such as a t-shirt, hat, wristband, or pin, it appears that if the charity carefully links the sale of the merchandise to the spreading of the charity's message, the sale of the merchandise may be considered substantially related to the charity's exempt purpose.[193] The charity's position would be significantly weakened if the charity's primary purpose in selling the merchandise is to generate income.[194] Internal Revenue Service interest in the sales of the branded merchandise may increase as the scope and extent of sales increase. The Treasury Regulations provide that "[i]n determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function which they purport to serve."[195] Therefore,

> where income is realized by an exempt organization from activities that are in part related to the performance of its exempt functions, but which are conducted on a larger scale than is reasonably necessary for performance of such functions, [the gross income] of the activities in excess of the needs of the exempt functions constitutes gross income from the conduct of unrelated trade or business.[196]

Thus, the more popular the branded merchandise becomes, the more the sales of the branded merchandise will increase and the more likely the charity will become subject to this type of attack.

B. <u>Sale of Merchandise by Corporate Partner</u>. For sales of merchandise directly by the corporate partner containing the charity's name or logo, different considerations apply in determining whether the income received by the charity from the arrangement is excluded from the charity's UBTI. Many cause-related marketing

[191] *See, e.g.*, Priv. Ltr. Rul. 8633034 (May 20, 1986); Tech. Adv. Mem. 9436001 (Sept. 24, 1993).

[192] Priv. Ltr. Rul. 200722028 (Mar. 9, 2007).

[193] Conducting sales through a third-party vendor should not change this result. The Internal Revenue Service has accepted that appropriately conducted sales of certain items to the public through unrelated retailers do not result in UBTI. *See* Tech. Adv. Mem. 9550003 (Sept. 18, 1995).

[194] *See, e.g.*, Disabled Am. Veterans v. Comm'r, 650 F.2d 1178, 1183 (Ct. Cl. 1981)

[195] Treas. Reg. § 1.513-1(d)(3).

[196] *Id.*

alliances involve recognition of the corporate partner's participation by the charity on its website and in print materials. Thus, this section first analyzes the possible application of the corporate sponsorship rules to cause-related marketing alliances. Cause-related marketing alliances also involve payment for the use of the charity's name, logo, or trademark; accordingly, this section next analyzes the application of the royalty exception to cause-related marketing alliances. Finally, because consumer perception of product endorsement by the charity might be considered as a factor in the UBTI analysis, this section analyzes whether the income received from cause-related marketing alliances could be included in UBTI as advertising income.

1. Corporate sponsorship rules do not (fully) address the issue. The corporate sponsorship rules were enacted to address the situation where the charity uses the corporate sponsor's logo on the charity's materials. Cause-related marketing alliances typically involve the use of the charity's name or logo on the corporate partner's products. At first blush, the corporate sponsorship exception seemingly would not apply to cause-related marketing. However, cause-related marketing alliances often involve the charity's recognition of the alliance by acknowledging the corporate partner on the charity's website or print materials. Therefore, a charity may claim that at least a portion of the payment received is a "sponsorship payment" and attempt to treat that portion separately from the other revenue received from the cause-related marketing alliance. In particular, this may be the case where the alliance guarantees the charity a minimum "contribution" from the corporate partner from the sale of the promotional merchandise.

In order for a sponsorship payment received by a charity to be excluded from the charity's UBTI as a qualified sponsorship payment, the affiliation cannot provide a substantial return benefit to the corporate partner.[197] Since cause-related marketing alliances grant the corporate partner a license to use the charity's name and logo on the product, such a right would be a substantial return benefit.[198] Nonetheless, the portion, if any, of the payment that exceeds the fair market value of the license to use the charity's name or logo may still be a qualified sponsorship payment.[199]

In conjunction with the corporate partner's use of the charity's name or logo, the charity may acknowledge the affiliation on the charity's website or printed materials. Depending on how the charity describes its affiliation with the corporate partner, the "use or acknowledgement" exception may not apply. The display of the logos and/or slogans of the corporate partners are "uses or acknowledgements." The provision of hyperlinks to various sponsors' Internet sites also constitutes merely "uses or acknowledgements," provided the sponsor's Internet site does not contain additional statements indicating that the charity promotes the sponsor or its products or services.[200] However, the provision of the hyperlink to the sponsor's website by the charity may be for the purpose of encouraging consumers to purchase the merchandise from the sponsor because the proceeds from those sales benefit the charity. Since the corporate sponsorship rules were not designed with cause-related marketing activities in mind, they do not address whether the charity's motivation in providing the link to the partner's website should be taken into account in determining whether the charity is promoting the sponsor's products or services.

---

[197] *See* Treas. Reg. § 1.513-4(c)(1).

[198] A "substantial return benefit" is any benefit other than a "use or acknowledgement" of the corporate sponsor. Treas. Reg. § 1.513-4(c)(2). Importantly, substantial benefits include any license to use intangible assets of the charitable organization. Treas. Reg. § 1.513-4(c)(2)(iii).

[199] Treas. Reg. § 1.513-4(c)(2)(iv).

[200] Treas. Reg. § 1.513-4(f), examples 11 & 12; Priv. Ltr. Rul. 200303062 (Oct. 22, 2002).

2. Use of the charity's name or logo may (or may not) fit within the royalty exception. Based on the success of taxpayers in establishing royalty treatment for payments for the use of the charity's name and logo in the affinity card context,[201] it would seem that the payments received by a charity for the licensing of their name, logo, and trademarks in connection with the sale of the merchandise by the corporate partner should also be considered royalties and thus exempt from the charity's UBTI. This result presupposes that the charity is not performing more than an insubstantial amount of services in connection with the licensing of the charity's name, logo, and trademarks. If the charity performs more than insubstantial services, then the income received is considered compensation for personal services, the royalty exception would not apply, and the income would most likely be subject to tax as UBTI.[202]

However, the law is not clear that the use of the charity's name or logo on the corporate partner's products fits within the royalty exception. If the charity's name or logo is placed on the corporate partner's product, the payment could instead be viewed as received in connection with the joint advertisement of the product.[203] Especially relevant in this analysis is consumer perception of apparent endorsement of the product by the charity because the charity has allowed its name and logo to be placed on the product without qualification. Although the licensing agreement and official position of the charity may state that the charity does not endorse the product, the charity normally retains the right to approve how its name and logo are used on the product. By approving the placement of its name and logo on the product, the charity may be held to the reasonable impressions such cause-related marketing leaves in the minds of consumers. If the charity's name and logo are used in such a way as to give consumers the impression that the charity endorses the product, the charity may be deemed to have endorsed the product. If the Internal Revenue Service looks beyond the explicit terms of the agreement to the manner in which the agreement is carried out, the payment may be considered advertising income received by the charity and may no longer be excluded from the charity's UBTI.

3. Revenue from cause-related marketing may be advertising. Both the courts and the Internal Revenue Service generally consider the publication and distribution of advertising by a charity to be unrelated to the accomplishment of the charity's exempt

[201] *See, e.g.*, Or. State Univ. Alumni Ass'n v. Comm'r, 193 F.3d 1098 (9th Cir. 1999); Common Cause v. Comm'r, 112 T.C. 332 (1999); Sierra Club, Inc. v. Comm'r, 77 T.C.M. (CCH) 1569 (1999); Miss. State Univ. Alumni, Inc. v. Comm'r, 74 T.C.M. (CCH) 458 (1997). Generally, an affinity credit card arrangement provides that a credit card company may use the exempt organization's name in connection with a credit card, and the organization will receive a certain percentage, or "royalty," from the income generated by the credit card. Based on such cases, the Internal Revenue Manual now indicates that the Internal Revenue Service will consider payments under affinity credit card arrangements royalties as long as only minimal services are provided by the exempt organization's members or employees. *See* I.R.S., INTERNAL REVENUE MANUAL § 7.27.6.7.3 (CCH 1999).

[202] *See* Sierra Club Inc. v. Comm'r, 86 F.3d 1526, 1532 (9th Cir. 1996).

[203] Whether the placement of a charity's name or logo on a corporate partner's product is a joint advertisement is a fact specific determination. In some cases, the association between the charity's mission and the corporate partner's product is such that it would be clear the charity is not impliedly endorsing the corporate partner's product. In other cases, the charity's mission and the corporate partner's product are so closely aligned that it is unclear whether the charity endorses the corporate partner's product. The issue is prevalent because the most successful cause-related marketing alliances occur when the charity's mission and corporate partner's products are closely aligned.

purposes.[204] If the charity conducts advertising activities on a regular basis, then the advertising income generally is taxable as unrelated business income.

Generally, displaying the charity's name or logo on the advertisement likely would not be sufficient to cause the advertising to be substantially related to the charity's exempt purposes. Although there are no rulings or other primary authorities considering receipts from advertisements bearing an exempt organization's name or logo, the Internal Revenue Service has considered receipts from the direct sale of items bearing an exempt organization's name or logo. If the inclusion of the charity's name or logo on items directly sold by the charity would not prevent receipts from constituting UBTI, then *a fortiori*, there is little reason to suppose that receipts from advertisements of a third party's products or services which contain the charity's name or logo would not constitute UBTI. However, as discussed above, the Internal Revenue Service has on occasion reached a contrary conclusion regarding the sale of t-shirts and similar items bearing an organization's name or symbol, where additional facts demonstrated how the items furthered the organization's exempt function. If such additional facts are present—for example, if the items advertised displayed the charity's message—this would be a positive factor. Note, though, that the positive rulings would still not be directly applicable to receipts obtained from a sponsor for advertising a product. One would need to closely examine all of the facts and circumstances to determine the extent to which the advertising activity promoted the charity's message (as opposed to promoting the corporate partner more generally), with unpredictable results.

C. Private Benefit Concerns of Cause-Related Marketing. The purpose of cause-related marketing is to leverage the goodwill of the charity in a joint campaign that provides mutual benefits for the charity (increased donations) and the corporate partner (sale of the merchandise), but this raises concerns about whether cause-related marketing alliances produce impermissible private benefit for the corporate partner. Two examples addressing whether private inurement (which is similar to private benefit) has occurred are instructive in determining whether the private benefit argument would be applied to cause-related marketing activities. General Counsel Memorandum 37,289 provides the first example; there, the Internal Revenue Service concluded that a joint advertising campaign carried on between a nonprofit organization and a for-profit organization was not indicative of private inurement. Although the circumstances are somewhat unclear, it appears that the for-profit organization conducted all of the advertising while the nonprofit organization paid a sales commission. The Internal Revenue Service reasoned that (i) the for-profit entity was not capitalizing on the nonprofit's goodwill (because the nonprofit had only recently been created) and (ii) joint advertising set up a cost-efficient economy with quid pro quo benefits to both entities. The Internal Revenue Service distinguished Restland Memorial Park v. United States—the second example case—in which a joint advertising campaign between a nonprofit cemetery company and a for-profit entity did result in private inurement, because the nonprofit entity's goodwill was used to benefit the for-profit entity.

An evaluation of whether the private benefits received by the corporate partner are more than incidental is difficult at best. To be incidental, the benefit must be both quantitatively and qualitatively incidental. A benefit is quantitatively incidental if, after considering the overall public benefit conferred by the activity, the private benefit is not substantial. This requires a comparison of the value of the private benefit to the value of the public benefit of the cause related-marketing alliance. Neither

[204] *See, e.g.*, Treas. Reg. § 1.513-1(d)(iv), example 7; United States v. Am. College of Physicians , 475 U.S. 834 (1986).

valuation is easy. Some of the private benefits to the corporate partner may be quantifiable, such as increased sales or revenues, but the value of many of the benefits, such as enhanced corporate goodwill, improved employee morale, and increase in customer esteem, may be difficult to value.

The benefit is incidental in the qualitative sense if it is "a necessary concomitant of the activity that benefits the public at large." In other words, the activity only can be accomplished by benefiting the private party. Cause-related marketing alliances are viewed by the charity as a means of fundraising. The application of this test to fundraising activities is difficult as the test was designed to be applied to the carrying out of the organization's charitable activities. To be sure, fundraising is a necessary activity of most charities. A literal application of this test would appear to prohibit any private benefit from fundraising activities as long as it is possible to raise funds without conferring any benefit on the donors (i.e., by raising funds only from purely gratuitous donations). Yet, in many fundraising campaigns donors receive some benefit in return, whether it be recognition of their generosity or a trinket item that donors can use or display to show their support.

The end result of the private benefit analysis is to compare the value of the benefits flowing to the corporate partner against the value of the benefits flowing to the charity from the cause-related marketing alliance. In addition to the monetary benefits received from the cause-related marketing alliance, the charity benefits in the form of increased awareness of the charity's message and name recognition because the charity gains publicity from the corporate partner's marketing efforts to promote the alliance. The actual benefit of increased publicity of the charity resulting from a cause-related marketing alliance is hard to quantify, and necessitates a fact specific inquiry that may vary widely from one charity to the next. For example, it may be that a local unfamiliar charity can benefit greatly from the publicity achieved in a cause-related marketing alliance with a well-known corporate partner. Such an alliance could result in the charity becoming a household name, possibly resulting is additional individual donations to the charity. In contrast, a well-established charity may not gain as much additional public goodwill from a cause-related marketing alliance with a well-known corporate partner. Since the charity's name and message are already well-known, increased publicity of the charity's name or message by the corporate partner may not provide much additional benefit to the charity. In this scenario, rather, the corporate partner may benefit more by leveraging the existing public goodwill of the well-known charity to promote increased public goodwill for the corporate partner.

When a comparison of the benefits to both the charity and the corporate partner produces a substantial discrepancy in favor of the corporate partner, the cause-related marketing alliance would result in impermissible private benefit. Yet, cause-related marketing activities on the whole are generally not a significant part of the charity's activities. Therefore, revocation of the charity's tax-exempt status, the only remedy currently available for violation of the private benefit doctrine, is harsh and likely unwarranted. Rather, concerns about impermissible private benefit should be factored into a safe harbor guidance that identifies specific cause-related marketing activities which would not jeopardize a charity's tax-exempt status.

VI. Investment in Social Enterprises. Social enterprises are businesses whose primary purpose is the common good. Social enterprises "use the methods and disciplines of business and the power of the marketplace to advance their social, environmental and human justice agendas."[205] Key distinctions between a

---

205 Social Enterprise Alliance, What's a Social Enterprise, at https://www.se-alliance.org/what-is-social-enterprise; *cf.* Cassady V. ("Cass")

social enterprise and a charitable organization include: (i) a social enterprise may have individual owners who receive periodic distributions of net earnings of the social enterprise; (ii) a social enterprise generally does not qualify for tax-exemption as a charitable organization; and (iii) a social enterprise is more flexible in its ability to access capital markets and conduct its activities to accomplish its purposes because the social enterprise is not subject to the restrictions imposed on charitable organizations under the Code.

Currently, researchers believe that over 50% of nonprofits have at least one or more social enterprises,[206] which makes UBIT an important issue within many of them. In addition, in the past few years, there has been growth in social enterprise in the nonprofit sector in the United States spurred by a number of factors: reductions in government funding, increased client need, and interest in diversifying funding sources. The social needs addressed by social enterprises are widely diverse as well as the business models employed by social enterprises to accomplish their purposes.

Many states have created new organizational forms for social enterprises, including the low-profit limited liability company ("L3C").[207] The L3C starts with the traditional limited liability company form and adds features that evidence the L3C promotion of common good over profit-maximization for its members.[208] The L3C is distinguished from a traditional limited liability company by four core elements: (i) the L3C must operate to significantly further the accomplishment of charitable or educational purposes; (ii) the L3C would not have been formed but for its relationship to the accomplishment of these purposes; (iii) income production or capital appreciation may not be a significant purpose of the L3C; and (iv) the L3C may not pursue purposes that would disqualify a charity from exemption under the limitations on lobbying activities and political campaign activities imposed by the Code.[209] The L3C statutes were designed to allow private foundations to invest in properly formed L3Cs as qualifying program-related investments.[210] Accordingly, the four core elements distinguishing L3Cs from traditional limited liability companies were derived primarily with this narrow focus in mind.[211]

Another new state business form for social enterprises gaining popularity is the

---

Brewer, *A Novel Approach to Using LLCs for Quasi-Charitable Endeavors*, 38 WM. MITCHELL L. REV. 678, 679 (2012) (noting that "there is no universally accepted legal meaning of the term 'social enterprise.'").

[206] Social Enterprise Alliance, *Social Enterprises: A Snapshot* (Apr. 2009), available at https://www.se-alliance.org/resources. Most organizations operate social enterprises as a division of the parent organization. *Id.*

[207] *See* Dana Brakman Reiser, *Governing and Financing Blended Enterprise*, 85 CHI-KENT L. REV. 619, 620 (2010). Legislation authorizing the L3C form has been enacted in 9 states: Illinois, Louisiana, Maine, Michigan, North Carolina, Rhode Island, Utah, Vermont, and Wyoming. See Americans for Community Redevelopment, Legislation, Laws at http://americansforcommunitydevelopment.org/laws.php for links to the legislation in those states adopting the L3C form.

[208] *See* Reiser, *supra* note 207 at 621.

[209] *Id.*

[210] *Id.* at 622. A program-related investment ("PRI") must have as its primary purpose the accomplishment of one or more charitable purposes and no significant purpose may be the production or income or capital appreciation. I.R.C. § 4944(c). PRIs have a couple of distinct advantages for private foundations. First, a PRI is considered a qualifying distribution for purposes of meeting the private foundation's minimum payout requirement to avoid the excise tax on failure to distribute income. *See* I.R.C. § 4942. Second., a PRI is not subject to the excise tax on jeopardizing investments applicable to private foundations. *See* I.R.C. § 4944. The IRS recently issued proposed regulations on PRIs which contain new examples of permissible PRIs, including investment in social enterprise. *See* Prop. Treas. Reg. § 53.4944-3, example 11 and example 12.

[211] *See* Reiser, *supra* note 207 at 623.

benefit corporation.[212] A benefit corporation begins with the traditional state law corporate form and makes modifications to accomplish the following distinguishing characteristics of a benefit corporation: (i) a corporate purpose to create a material positive impact on society and the environment; (ii) expansion of the fiduciary duties of directors to require consideration of non-financial stakeholders as well as the financial interests of its shareholders; and (iii) an obligation to report on its overall social and environmental performance using a comprehensive, credible, independent and transparent third-party standard.[213]

In contrast to the legislatively-approved L3C and benefit corporation, the B Corporation is a business form used for social enterprises which is self-imposed and privately regulated.[214] A B Corporation (also called a "for-benefit" corporation) uses the existing state-law corporate form and incorporates into its governing documents a commitment to "uses the power of business to solve social and environmental problems."[215] B Lab, a private, nonprofit organization reviews the company's structure and operations as part of its certification process, and if the company is certified by B Lab, the company may license the "certified B Corporation" trademark from B Lab.[216] Often, benefit corporations are referred to as "B Corporations;" however, the benefit corporation is a legislatively-approved business form while the B Corporation is privately regulated.

A. <u>UBIT Treatment for a Charity Investing in a Social Enterprise</u>. When a charity invests in a social enterprise, the potential UBIT treatment of the investment to the charity will depend on the form of the investment. For example, if the investment is structured as a loan from the charity to the social enterprise, then the interest that the charity receives on the loan generally will be excluded from the charity's unrelated business income as passive interest income.[217] Similarly, if the social enterprise is formed as a corporation,[218] such as a benefit corporation or a B Corporation, and the charity's investment in the social enterprise is structured as the acquisition of shares of stock in the social enterprise, then the dividend distributions the charity receives from the corporation generally will be excluded from the charity's unrelated business income as passive dividend income.[219] These interest and dividend exclusions may not apply, however, to the extent the interest or dividend income is treated as unrelated debt-financed income.[220]

L3Cs generally are treated as a partnership for federal income tax purposes.[221] Accordingly, the L3C does not pay income tax on its net earnings. Rather, the profits and losses of the L3C are

---

[212] Legislation authorizing the benefit corporation form has been enacted in 9 states: California, Hawaii, Maryland, Louisiana, New Jersey, New York, South Carolina, Vermont, and Virginia. See Benefit Corp Information Center, State by State Legislative Status at http://www.benefitcorp.net/state-by-state-legislative-status for links to the legislation in those states adopting the benefit corporation form.

[213] William H. Clark, Jr. & Larry Vranka, *The Need and Rationale for the Benefit Corporation: Why it is the Legal Form That Best Addresses the Needs of Social Entrepreneurs, Investors, and, Ultimately, the Public* (Jan. 26, 2012), at 15, at http://www.benefitcorp.net/for-attorneys/benefit-corp-white-paper.

[214] Reiser, *supra* note 207 at 637.

[215] B Lab, What is a B Corp? at http://www.bcorporation.net/about.

[216] *See* B Lab, Why Become a B Corp? at http://www.bcorporation.net/become-a-b-Corp.

[217] *See* I.R.C. § 512(b)(1); *but see* I.R.C. § 512(b)(13)(A)for an exception for certain interest payments received from a controlled subsidiary.

[218] The result is different if the corporation is treated as an S corporation for federal income tax purposes. All income distributable to a charitable S corporation shareholder is treated as unrelated business taxable income from an asset deemed in its entirety to be an interest in unrelated trade or business. I.R.C. § 512(e).

[219] *See* I.R.C. § 512(b)(1).

[220] *See generally* I.R.C. § 514.

[221] *See* Reiser, *supra* note 207 at 623-24.

allocated to its members, each of whom report and pay tax on the allocated profits and losses in accordance with such member's own tax status.[222] For example, if a charity invests in a social enterprise that is formed as a L3C, the charity would be required to report its allocated items of profit and loss from the L3C on the charity's Form 990.

To the extent the reported items of income do not qualify for the passive exclusions from the unrelated business income tax (e.g., interest, dividends, rents, and capital gains),[223] then the charity typically must apply the general three-prong test to determine whether the income from the business operated by the L3C is unrelated business income for the charity.[224] Usually, investment in the L3C will easily meet the first two prongs: the activity conducted by the L3C typically is a trade or business and normally the activity is regularly carried on. Thus, the key determinant is whether the activity conducted by the L3C substantially furthers the charitable purposes for which the charitable investor was granted tax-exemption. This is a case by case determination. Thus, even though a L3C may operate to substantially further a charitable purpose, if the L3C's charitable purpose is unrelated to the charitable investor's tax-exempt purpose, then the income allocated to the charitable investor from the L3C may not be exempt from that charity's UBTI.[225] Accordingly, a charity desiring to invest in a social enterprise that is treated as a partnership for tax purposes must be careful to select a social enterprise that conducts activities which are closely aligned with the charity's own mission.

B. <u>Effect of Joint Venture Rules on a Charity's Investment in Social Enterprise</u>. Because a social enterprise generally includes for-profit parties as owners, a charity must be mindful of the IRS's stance on joint ventures between charities and for-profit parties when deciding to invest in a social enterprise. In particular, if the investment is a significant activity of the charity, the charity must be careful to structure its investment in the social enterprise so as to not jeopardize the charity's tax-exempt status. The case law and IRS rulings on joint ventures between charities and for-profit parties focus on the charity's ability to ensure that the joint venture is operated to further charitable purposes.[226] As applied to social enterprises, it is not clear how these rulings would impact the amount of control that a charitable investor should maintain over the operations of the social enterprise. In particular, the nature of a social enterprise dictates that the social enterprise already elevates the accomplishment of charitable purposes over the maximization of profits for its owners. This is especially true in the case of the L3C which is required to operate significantly to accomplish charitable or educational purposes and not significantly for income production or capital appreciation.[227] Accordingly, it may not be as important for a charitable investor in a joint venture formed as a L3C to ensure that the social enterprise is operated to further charitable purposes as it is when the joint venture is formed using traditional business models. However, whether the IRS and the courts will adopt this view is uncertain.

---

[222] *See id.* at 624.

[223] *See* I.R.C. § 512(b). If the L3C derives the passive income from debt-financed property, then such income may be included in the charitable investor's unrelated business income as debt-financed income. *See* Part IV.E. of this outline.

[224] *See* I.R.C. § 513; *see also* Part IV.A. of this outline.

[225] *See* Treas. Reg. § 1.513-1(d).

[226] *See e.g.*, St. David's Health Care System v. United States, 349 F.3d 232 (5th Cir. 2003); Redlands Surgical Services v. Comm'r, 113 T.C. 47 (1999), *aff'd*, 242 F.3d 904 (9th Cir. 2001); Rev. Rul. 2004-51, 2004-1 C.B. 974.; Rev. Rul. 98-15, 1998-1 C.B. 17; s*ee also* Part III. of this outline.

[227] *See* Reiser, *supra* note 207 at 622.

"PPACA" Play or Pay Mandate and "ERISA" Section 510 Claims for Interference With Protected Rights

BY HANNAH DELUCA AND HENRY TALAVERA
POLSINELLI PC:[1]

PART I: INTRODUCTION

Section 510 of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), makes it unlawful for any person to interfere with any right a participant or beneficiary has or may become entitled to receive under ERISA or under any employee benefit plan. Also, no employer may terminate or discharge an employee or otherwise discriminate against a plan participant or beneficiary for exercising an ERISA right or a right under an ERISA plan:[2] The applicable language of the statute is as follows:

> *It shall be unlawful for any person to discharge, fine, suspend, expel, discipline, or discriminate against a participant or beneficiary for exercising any right to which he is entitled under the provisions of an employee benefit plan, this title, section 3001, or the Welfare and Pension Plans Disclosure Act, or for the purpose of interfering with the attainment of any right to which such participant may become entitled under the plan, this title, or the Welfare and Pension Plans Disclosure Act. It shall be unlawful for any person to discharge, fine, suspend, expel, or discriminate against any person because he has given information or has testified or is about to testify in any inquiry or proceeding relating to this Act or the Welfare and Pension Plans Disclosure Act. In the case of a multiemployer plan, it shall be unlawful for the plan sponsor or any other person to discriminate against any contributing employer for exercising rights under this Act or for giving information or testifying in any inquiry or proceeding relating to this Act*

1 Hannah is a Texas attorney, currently working as an Associate in the Kansas City Office of Polsinelli PC. She specializes in employee benefits and executive compensation. Henry is a Shareholder in the Dallas office of Polsinelli PC, also specializing in employee benefits and executive compensation . They would both like to thank Meredith VanderWilt, an Associate in the Dallas office of Polsinelli PC, for her valuable help with this article.

2 ERISA Section 510 also makes it unlawful to discriminate against any person because the person has given information, has testified, or will testify in any inquiry or proceeding relating to ERISA.

before Congress. The provisions of section 502 shall be applicable in the enforcement of this section.

Beginning in 2015,[3] the Patient Protection and Affordable Care Act, as amended ("PPACA"), authorizes the Internal Revenue Service ("IRS") to impose financial penalties on applicable large employers (50 or more full-time employees) that do not offer health insurance coverage, as well as imposing financial penalties for offering coverage that is considered "unaffordable." The IRS refers to these penalties as the "employer responsibility" provisions under Section 4980H of the Internal Revenue Code of 1986, as amended ("Play or Pay" Rules"). Under the Play or Pay Rules, certain large employers may be subject to a penalty tax (also called an "assessable payment") for (1) failing to offer minimum essential health care coverage for all full-time employees (and their dependents); or (2) offering eligible employer-sponsored coverage that is not "affordable" (exceeds a specified percentage of the employee's household income) or does not offer "minimum value."[4]

Employers have considered manipulating or otherwise adjusting their employees' work schedules or other strategies in order to avoid being considered a "large employer" or to avoid an employee being considered full-time under the Play or Pay Rules. However, employers should tread lightly, as doing so could, depending upon the facts and circumstances, subject the employer to a claim of interference with ERISA benefits. The employer in such circumstances could be at risk of a lawsuit under section 510 of ERISA ("ERISA Section 510"). Below this article explains the basics of the Play or Pay Rules, ERISA Section 510, and how an employer could be sued under ERISA Section 510 if the employer attempts to skirt the Play or Pay Rules by keeping employees from working full-time.

PART II: PLAY OR PAY: SHARED RESPONSIBILITY FOR EMPLOYERS

Basics

As discussed above, certain employers will be subject to the employer shared responsibility provisions under the Play or Pay Rules. Under the Play or Pay Rules, if these employers do not offer affordable health coverage that provides a minimum level of coverage to their full-time

3 http://www.irs.gov/uac/Newsroom/Questions-and-Answers-on-Employer-Shared-Responsibility-Provisions-Under-the-Affordable-Care-Act.

4 Section 4980H(a)-(b) of the Internal Revenue Code of 1986, as amended ("Code").

employees and their dependents), the employer may be subject to an employer shared responsibility payment (i.e., a tax/penalty) if at least one of its full-time employees receives a premium tax credit for purchasing individual coverage on one of the new "Affordable Insurance Exchanges" (also called a Health Insurance Marketplace) ("Exchange").[5]

The penalty tax (assessable payment) on an employer subject to the Play or Pay Rules is equal to the product of the "applicable payment amount" and the number of individuals employed by the employer (disregarding the first 30-employees) as full-time employees during the month. The "applicable payment amount" for 2014 is $166.67 with respect to any month per full-time employee (that is, 1/12 of $2,000).[6] The payment amount will be adjusted for inflation after 2014.[7]

Effective Dates

The employer shared responsibility provisions are part of PPACA, as amended by the Health Care and Education Reconciliation, as amended ("HCERA"). Originally, the Play or Pay Rules were to apply to months beginning after December 31, 2013. Then, in July 2013, the U.S. Treasury Department announced a one-year delay in the application of the Play or Pay Rules and corresponding penalties.[8] In February 2014, the IRS issued final Treasury Regulations on the Play or Pay Rules ("Regulations").[9] The Regulations are applicable for periods after December 31, 2014, but employers may rely on them for periods before January 1, 2015.[10]

The Regulations also granted transition relief to applicable large employers with fewer than 100 full-time employees ("FT" or "FTs")) (including full-time equivalent employees ("FTE" or "FTEs")) during 2014. Further, employers with between 50 and 100 employees will not be

---

5 Code Section 4980H; www.irs.gov/uac/Newsroom/Questions-and-Answers-on-Employer-Shared-Responsibility-Provisions-Under-the-Affordable-Care-Act#Transition.

6 Code Section 4980H(a); Treasury Regulation Section 54.4980H-4(a).

7 Under transition relief, for 2015 (plus any calendar months of 2016 that fall within the employer's 2015 plan year), if an employer with 100 or more full-time equivalent employees on any business day during 2014 is subject to a penalty under Code § 4980H(a), the penalty with respect to the transition relief period will be calculated by reducing an employer's number of full-time employees by 80 rather than 30 referenced above.

8 Notice 2013-45, 2013-31 I.R.B. 116.

9 Shared Responsibility for Employers Regarding Health Coverage, 26 CFR Parts 1, 54, and 301, 79 Fed. Reg. 8543 (Feb. 12, 2014).

10 *Id.* Treasury Regulations Section 54.4980H-2, -3, -4.

subject to the Play or Pay Rules until 2016 if they satisfy certain conditions to qualify for the relief.[11]

The Regulations provide that in some cases, an employer will not be subject to penalties under Play or Pay Rules for the "limited non-assessment period" relating to certain employees.[12] Generally, the limited non-assessment periods are as further described in the Regulations (subject to any look-back measurement method determined under the Regulations):

- An employer's first year as an applicable large employer;
- The three (3) full calendar months beginning with the first full calendar month in which an employee is first otherwise eligible for an offer of coverage under the monthly measurement method (measurement periods are further described below);
- The initial three (3) full calendar months of employment for an employee reasonably expected to be an FT at the start date;
- The initial measurement period relating to a newly hired variable-hour employee, seasonal employee, or part-time employee, any of which is determined to be employed on average at least 30 hours of service per week;
- Following an employee's change in employment status to an FT during the initial measurement period; or
- The calendar month in which an employee's start date occurs on a day other than the first day of the calendar month.

Applicable Large Employer

An "applicable large employer" will be subject to the Play or Pay Rules.[13] Applicable large employers are those with 50 or more FTs.

---

[11] Notice 2013-45, 2013-31 I.R.B. 116.

[12] Treasury Regulations Section 54.4980H-1(a)(26).

[13] Code Section 4980H(c)(2).

Measuring Full-Time Employees[14]

Both FTs and FTEs are considered in calculating the number of employees that make up the 50 employee threshold for purposes of being subject to the Play or Pay Rules and corresponding penalties. An FTE may be categorized as part-time for other purposes under PPACA.

An FT is an employee who:

- performs more than 30 hours of service a week; or
- performs 130 hours of service in a month.

To calculate the number of FTE's for a month for the Play or Pay Rules, an employer should:

- add up the total number of hours of service for all employees who were not employed on average at least 30 hours of service per week (up to a maximum of 120 hours of service per employee per month); and
- divide that total by 120.

The resulting quotient equals the number of FTE's for that month.

If the result is not a whole number, it is rounded down to the next lowest whole number. For example, an employer with an average total of 49.9 FTs and FTEs for 2013 would not be treated as an applicable large employer for 2014. However, if such number equals 50 or more (not including fractions), the employer would be subject to compliance with the Play or Pay Rules, though not subject to penalties until 2016. An hour of service includes:

- each hour for which an employee is paid, or entitled to payment, for the performance of duties for the employer;
- each hour for which an employee is paid, or entitled to payment, by the employer on account of a period of time during which no duties are performed due to vacation, holiday, illness, incapacity (disability), layoff, jury duty, military duty, or leave of absence;

[14] The information in the following section, *Measuring Full-Time Employees,* of this article is a summary of the information found in Notice 2012-58, 2012-41 IRB 436.

- counting actual hours of service from records of hours worked and hours for which payment is made or due for vacation, holiday, illness, incapacity (disability), layoff, jury duty, military duty or leave of absence;
- using a days-worked equivalency method where the employee is credited eight (8) hours of service for each day the employee would be credited with at least one (1) hour of service; or
- using a weeks-worked equivalency of 40 hours of service per week for each week for which the employee would be credited with at least one (1) hour of service.

Coverage Calculation

The Regulations provide two (2) different measurement methods for determining FTE and FT status. One method is the monthly measurement method, under which an employer determines each employee's FT or FTE status for a calendar month by counting the employee's hours of service for that same month.[15] The other method is the "look-back" measurement method, under which an employer may count the employee's hours of service in one period (referred to as a measurement period) to determine the employee's FT or FTE status for a subsequent period (referred to as a stability period).[16]

Although the look-back measurement method for identifying full-time employees has some similarities to the method for determining an employer's applicable large employer status, it is available only for purposes of determining and computing liability for employer penalties under Play or Pay Rules and not for purposes of determining if the employer is an applicable large employer. The look-back measurement method is intended to ease the administrative burden associated with month-to-month determinations in certain special circumstances, such as determinations associated with variable hour or seasonal employees.[17]

---

[15] Notice 2011-36, 2011-21 I.R.B. 792; IRS Notice 2012-17, 2012-9 I.R.B. 430; IRS Notice 2012-58, 2012-41 I.R.B. 436.

[16] IRS Notice 2012-58, 2012-41 I.R.B. 436.

[17] IRS Notice 2011-36 I.R.B. 792,as modified in IRS Notice 2012-17 I.R.B. 436.

Measurement Periods

Employers may measure an employee's hours for determining FT, FTE or part-time employee ("PT") status over a certain measurement period no less than three (3) months and no longer than 12 months, but only if the employer does not reasonably expect that such employees will work 30 hours per week (upon hire or such other period provided by the Regulations). The measurement periods must be uniform and consistent for all classes of employees.

An employer must establish a "standard measurement period" ("SMP"), which is a certain period of time in the prior year when data will be collected on the number of FT, FTE or PT employees. There must at least one (1) SMP in a year, and there are three options:

- One 12-month period,
- Two 6-month periods, or
- Four 3-month periods.

In addition, the employer must identify a "stability period" ("SP"), which is a certain period of time, generally the year after the SMP year when the plan must consider an employee either FT, FTE or PT during the entire SMP.

Ongoing Employees

"Ongoing employees" are generally those employees who have been employed for at least one (1) SMP. If the ongoing employee works an average of 30 hours per week during the SMP, then the employee must be treated as a FT for the following SP regardless of what hours the individual actually works during the SP. The SP must be at least six (6) months and may not be shorter than the SMP. For example, if the employer uses a three (3) month SMP of January to March and April to June of 2015, the SP will be July 2015 through December 2015.

If an employee is PT during a SMP, then the PT employee will be treated as such during the SP that follows, but only for a period of time that is no longer than six (6) months. Essentially, if the SMP is three (3) months, the employee could be treated as PT for six (6) months in 2015 before calculations would have to be run again to see if they should be reclassified as FT.

New Employees

For a new employee, if it is reasonably expected upon hire that an employee will work 30 hours per week and be an FT (i.e., a full-time employee), then the employer will not be penalized for failing to offer health coverage within the FT's first 90 days of employment. For variable hour or seasonal employees or certain part-time employees, the employer may use an initial measurement period of between three (3) and 12 months to determine whether the employee works an average of 30 hours or more of service per week. The SP will then be the same length as the SP for ongoing employees.

If, to avoid the penalty under the Play or Pay Rules, an employer is considering realigning its work force with more employees working fewer than 30 hours per week, such realignment carries with it potential risk of litigation under ERISA Section 510, which generally prohibits interference with a participant's benefits or other rights under ERISA.

PART III: ERISA SECTION 510

Procedural Issues

ERISA Section 510 can be enforced under ERISA's general enforcement provisions which permit causes of actions by plan participants, beneficiaries or fiduciaries to: (i) enjoin any act or practice violating Title I of ERISA, (ii) obtain other appropriate equitable relief, or (iii) to enforce any provision of Title I (of which ERISA Section 510 is a part). [18] Alternatively, other courts have held that ERISA Section 510 may be enforced through ERISA provisions which permit actions by plan participants and beneficiaries to recover benefits due, enforce rights, or clarify rights to future benefits under the terms of the plan.[19]

An ERISA Section 510 claim may be brought against the person engaging in interference — most often the employer. However, the literal language of ERISA Section 510 refers to "any person" defined broadly to include individuals, corporations, and others.[20] Employers have had

---

[18] ERISA Section 502(a)(3).

[19] Section 502(a)(1)(B). *Babich v. Unisys Corp.*, 1994 WL 167984 (D. Kan. 1994) (finding that the damages available to an ERISA plaintiff are found in ERISA Sections 502(a)(1)(B) and (a)(3)).

[20] ERISA Section 3(9).

to defend ERISA Section 510 claims in connection with (i) plant or facility closings, (ii) general layoffs, and (iii) transfers of employees, including, but not limited to, outsourcing services.[21]

As to who can bring a claim, participants and former employees in the appropriate circumstances have been permitted to bring claims under ERISA Section 510. A "participant" under ERISA includes "any employee or former employee of an employer…who is or may become eligible to receive a benefit of any type from an employee benefit plan…."[22] So, even former employees having a reasonable expectation of returning to covered employment may be able to sue under ERISA Section 510.[23] Some courts have determined that ERISA Section 510 discrimination claims are limited to actions affecting employees, and that job applicants are not, therefore, permitted to sue under ERISA Section 510.[24] In *Williams v. Mack Trucks, Inc.*, the court found that non-employees may not sue an employer under ERISA Section 510 because a refusal to hire (or re-hire) individuals because they might create greater benefits liability under the employer's plans did not violate ERISA.[25]

However, in *Sanders v. Amerimed, Inc.*, a recent decision in the Southern District of Ohio,[26] the claimant was a part-time employee and not a participant in his employer's health care plan, because the plan's eligibility provisions provided that only full-time employees were eligible to become participants. The claimant was a pharmacist suffering from a permanent medical condition who desired full-time employment and his employer, Amerimed, denied him, so Sanders voluntarily quit.

Sanders brought suit, claiming in part that Amerimed refused to hire him for a full-time position because the Amerimed was concerned that his medical condition would add substantial medical expenses to its group health plan.[27] Sanders claimed that Amerimed violated ERISA Section 510

---

[21] *Rogers v. Int'l Marine Terminals*, 87 F.3d 755 (5th Cir. 1996); *Alexander v. Bosch Auto. Sys.*, 232 Fed. Appx. 491 (6th Cir. 2007); *Register v. Honeywell Fed. Manuf. & Tech. LLC*, 397 F.3d 1130 (8th Cir. 2005).

[22] ERISA Section 3(7).

[23] *Leszczuk v. Lucent Tech.*, 2005 WL 1400381 (E.D. Pa. 2005) (former employees terminated for cause and, therefore, ineligible for severance benefits have standing to sue).

[24] *Becker v. Mack Trucks, Inc.*, 281 F.3d 372 (3d Cir. 2002).

[25] *Williams v. Mack Trucks, Inc.*, 2000 WL 1886 575 (E.D. Pa. 2000).

[26] *Sanders v. Amerimed*, 2014 WL 1664472 (S.D. Ohio 2014).

[27] *Id* at *1.

by refusing to employ him full-time.[28] The court held that under *Firestone Tire & Rubber Co. v. Bruch*[29] and *Fleming v. Ayers & Assoc.*,[30] Sanders was a "participant" for ERISA Section 510 purposes and could bring suit.[31]

ERISA Section 510 claims are often brought by former employees who were involuntarily terminated. A terminated employee may file suit if the termination cuts off the employee's benefits or prevents the employee from getting greater or additional benefits.[32] Further, the participant will as a general rule not lack standing (even if they are a former participant) if the participant can prove "but for" the employer's interference, he or she would still be a participant.[33]

For example, in *McLendon v. Continental Can*, the Third Circuit ruled favorably for the plaintiffs in a class action ERISA Section 510 suit, even when the class included former employees. The court in *McLendon* found the defendants liable, because they laid off employees just before they became eligible for benefits under a pension plan in an effort to reduce future costs.[34] Specifically, in the *McLendon* case, the court rejected the argument that avoidance of unfunded pension liability was a permissible business reason, as well as the argument that employees would have been laid off anyway due to the declining economic industry conditions.[35]

---

[28] *Id.*

[29] *Firestone Tire & Rubber Co. v. Bruch,* 489 U.S. 101, 117 (1989).

[30] *Fleming v. Ayers & Assoc.,* 948 F.2d 993 (6th Cir.1991).

[31] *Sanders* at *3. In *Fleming*, the Sixth Circuit affirmed liability under ERISA in a case where the employer had terminated an employee because of high medical expenses of employee's child under the health plan. *Fleming*, 948 F.2d at 998.

[32] *Leszczuk v. Lucent Tech.*, 2005 WL 1400381 (holding that terminated employees had established a prima facie case for an interference with benefits claim under ERISA Section 510 when the employer involuntarily terminated employees and the employees lost their potential eligibility to ERISA-protected benefits)

[33] *Shadid v. Ford Motor Co.*, 76 F.3d 1404, 1410 (6th Cir. 1996).

[34] *McLendon v. Continental Can Co.*, 749 F. Supp. 582, (D.N.J. 1989), aff'd by 908 F.2d 1171 (3rd Cir.1990); *Gavalik v. Continental Can Co.*, 812 F.2d 834 (3rd Cir. 1987).

[35] See *McLendon v. Continental Can Co.*, 749 F. Supp. at 608-609; see also *Gavalik v. Continental Can Co.* at 860, which says "§ 510 of ERISA requires no more than proof that the desire to defeat pension eligibility is "a determinative factor" in the challenged conduct."

Discriminatory Intent

ERISA Section 510 also allows "any person" to sue for retaliation or discrimination because the person gave information, testified, or is about to testify in any inquiry or proceeding relating to ERISA. ERISA Section 510 claims impose upon the plaintiff the burden to show that the employer's decision was based on "benefits animus" meaning there was specific intent to interfere with attainment of an ERISA right.[36] While it would be ideal to have direct evidence of an employer's discriminatory intent, such as an employer's confession, the courts have recognized that direct proof may be difficult to obtain. In addition, circumstantial evidence can be sufficient.[37]

When circumstantial evidence must be evaluated, courts have borrowed from a prominent Title VII employment discrimination case establishing a three-stage burden-shifting framework.[38] First the claimant must show that he or she:

(1) was entitled to ERISA's protection,

(2) was qualified for the position, and

(3) was discharged under circumstances giving rise to an inference of discrimination.

Once these three (3) elements are established, the burden shifts to the defendant who must then state a legitimate, non-discriminatory reason for the termination (*i.e.*, a reason unrelated to the employee's ERISA benefits entitlement). If the employer can demonstrate the legitimate reason, the burden shifts back to the claimant to show it is more likely than not that the employer's stated reason is merely a pretext for discrimination.

Relief Available for ERISA Section 510 Claims

Appropriate "equitable" relief may be awarded by a court to remedy a violation, but it is not certain if this includes money damages. In 2002 in *Great-West Life & Annuity Insurance Co. v.*

---

36 *Smith v. Gencorp, Inc.*, 971 F. Supp. 1071 (N.D. Miss. Eastern Div. 1997); *Rogers v. International Marine Terminals Inc.*, 87 F. 3d 755, 761 (5th Cir. 1996); see also "ACA: Speakers Say Legal Challenges to ACA Could Greatly Impact Future ERISA Litigation," Pens. & Benefits Daily (BNA) No. 67 (April 8, 2014).

37 See *Zimmerman v. Sloss*, 835 F. Supp. 1283, 1288 (D.Kan.1993) (finding that defendant's firing plaintiff while on she was on medical leave (and while her health insurance application was pending) raised an inference of discrimination), aff'd, 72 F.3d 822 (10th Cir.1995); see also *Barbour v. Dynamics Research Corp.*, 63 F.3d 32, 37 (1st Cir. 1995), which remarks that "a plaintiff usually must rely on circumstantial evidence to prove his or her case."

38 *Dister v. Continental Group, Inc.*, 859 F. 2d 1108, 1112 (2nd Cir.1988).

Knudson, the Supreme Court held that equitable relief meant "restitution in equity, ordinarily in the form of a constructive trust or an equitable lien, where money or property identified as belonging in good conscience to the plaintiff could clearly be traced to particular funds or property in the defendant's possession."[39] Equitable claims may also seek attorney's fees and costs.[40]

PART IV: PROTECTION AGAINST RETALIATION FOR EMPLOYEES PPACA

While ERISA Section 510 claims are often connected to other employment law claims, the implementation of PPACA has created a new worry for employers to consider in avoiding a claim of "interfering with the attainment of any right to which a participant may become entitled under the plan."

Most employers are examining or have recently examined, their plans to ensure that they comply with PPACA's 30 hour definition of FT. Historically, many employers have limited health plan participation to FTs, often defined as those who work or are regularly scheduled to work more than 30 hours per week. However, many employers may now be realizing the possible financial impact of offering health coverage to employees who work fewer than 40 hours per week. It is not difficult to see how employers may make hiring and scheduling decisions by considering the issue of whether to cover the individual as an FT. Small employers will also be wary of crossing the 50 employee threshold discussed above and being considered a large employer. It is also not difficult to see how employers could be at risk of illegal "interference with benefits" in trying to skirt the full impact of Play or Pay Rules by either (i) remaining under the FT or FTE employee threshold for large employer status or (ii) by purposely keeping employees from working more than 29 hours per week.

The most basic way an employer could avoid the financial impact of the Play or Pay Rules would be to remain a small employer. As explained before, those applying for jobs should not in most cases be entitled ERISA Section 510 protection. New part-time hires do not on their face fit the definition of "participant" under the PPACA rules. Thus, based upon existing case law,

---

[39] *Great-West Life & Annuity Ins. Co. v. Knudson*, 534 US 204, 217 (2002).

[40] *Continental Group v. McClendon*, 872 F. Supp. 142, (D.N.J. 1994), in which a $33.3 million fee was awarded.

decisions on how to hire or schedule employees in the ordinary course of business do not appear to be subject to ERISA Section 510 scrutiny. However, none of the existing case law relates to PPACA, and there are likely issues to consider under ERISA Section 510 in the event FTs are scheduled for fewer hours and such employees have previously been entitled to health coverage.

Also, decisions by employers to (i) give overtime to FTs instead of increasing PT hours, (ii) add more PTs, or (iii) promote PTs to FT status, would not generally implicate ERISA Section 510, because the affected individuals are not plan participants entitled to benefits that the employer must refrain from "interfering with" under the plan.

In contrast, consider an FT who is transferred or even demoted by an employer to less than 30-hours per week status from FT status or, in the worse yet, is laid-off by an employer. In these situations, employers should consider whether their actions could give rise to a potential ERISA Section 510 claim. ERISA Section 510 may not apply because to qualify for relief under ERISA Section 510, a claimant must show interference with attainment of a right protected by ERISA to which he or she may be entitled under a plan.

The Play or Pay Rules simply impose a penalty/tax on employers that fail to provide specified healthcare benefits to FTs. PPACA does not necessarily give employees an additional ERISA right. But, if an employee is currently eligible for healthcare coverage under an employer's ERISA plan, and the employer reduces an employee's hours to avoid healthcare coverage and the Play or Pay Rules, that may give rise to an ERISA Section 510 claim. Employers should take note of the *Sanders* case discussed above, which allowed an ERISA Section 510 claim to go forward, even when the claimant never worked as a full-time employee eligible for benefits.

A complex situation might arise when an employer systematically grants overtime to certain employees, while also firing or reducing hours for others. An unhappy employee whose hours were cut or who was laid-off, may take the position that his or her employer's employment decisions were made simply to avoid granting benefits, and thus, bring ERISA Section 510 claims. In addition, an employer who in one year expands hiring and later lays-off employees, perhaps because the expansion was a poor decision or the business climate had changed, could cause employees to lose health coverage. Terminated employees or even currently employed employees could assert that hiring and firing decisions were made to avoid providing ERISA benefits as the FT or FTE threshold is crossed. Finally, an employer's decision to expand a workforce may present a more attenuated risk under ERISA Section 510, even when expansion could still result in certain employees losing health coverage and/or employment.

The look-back rules described above factor into the impact, if any, of how many employees are actually entitled to health coverage under PPACA, because the look-back rules essentially give employers the opportunity to disregard employees who are hired and terminated within a short period of time.

Another situation that may raise issues under ERISA Section 510 might arise in the context of a restructuring that allows an employer to remain under 50 (or 100) employees. In those scenarios, the question is whether hiring, firing and restructuring decisions might be construed as impermissible "interference" under ERISA Section 510. Cases like *McLendon* suggest that avoiding the payment of benefits is not a valid business decision in and of itself, and as a result, another court might extend the reasoning of *McLendon* depending upon the facts and circumstances in a situation where the employer refuses to hire an employee because such employee may be entitled to health benefits from an employer under PPACA.

ERISA Section 510 requires an employee to show prohibited employer conduct taken *for the purpose of* interfering with the attainment of any protected right to which the participant may become entitled. Employers should generally make employment and workforce decisions for valid business reasons, with a blind eye towards benefits issue, but if benefits issues to arise in the context of any such restructuring, issues under ERISA Section 510 should be carefully considered. In all such cases, employers would be well advised to consider whether any claim might be possible under ERISA Section 510.

Before PPACA, employers certainly took into account the cost of health insurance in hiring and employment decisions. But after PPACA, keeping employees at less than full time or not hiring the individual at all carries a much more clear-cut cost savings. Further, employers appear to be cutting benefits for part-time workers at least in some cases.[41] Other employer strategies to control employment costs, such as outsourcing and hiring more contract workers, may also affect existing employees.

For example, what if an applicable large employer outsources all workers in one of its divisions, and the employer then employs fewer than 50 FTs and FTEs? Does that make the outsourcing action an impermissible ERISA Section 510 interference with benefits? What if health care coverage is only one of many factors in deciding to outsource? It is uncertain how courts would rule in these types of situations, but employers should, among other things, well document non-PPACA related reasons for making outsourcing, lay-off and similar decisions.

In addition to outsourcing, employers may have ERISA Section 510 issues to considering in hiring independent contractors or converting employees to (or from) independent contractor status. While the IRS and Department of Labor ("DOL") have a joint initiative in combatting worker misclassification,[42] those misclassified employees or the DOL might also consider an ERISA Section 510 claim that the employer classified service providers as non-employees in order to avoid providing healthcare coverage. Every consultant contract, independent contractor contract or outsourcing arrangement should be carefully reviewed to determine the risk, if any, that the DOL and IRS will intervene to reclassify such relationship, in which case, there could be the risk of an ERISA Section 510 suit.

Under any of the employment situations discussed above, employers would do well to be careful in their communications with employees. While some employers may be tempted to publicly blame PPACA for their unpopular decisions, it might be best to limit any communication in this regard to the employees. For example, a human resources manager should avoid saying the following:

> "We wish we could keep you on a full-time schedule, but we can't afford the healthcare cost;" or

---

[41] Target Joins Home Depot, Walmart, Others In Cutting Health Care For Part-Timers, Citing Obamacare, Jan. 22, 2014, Forbes.com, available at http://www.forbes.com/sites/clareoconnor/2014/01/22/target-joins-home-depot-walmart-others-in-dropping-health-care-for-part-timers-citing-obamacare/.

[42] http://www.dol.gov/whd/workers/misclassification/

> "We didn't want to have to outsource those jobs, but if we had that many employees, we'd have to provide Obamacare and it is too expensive."

While an employer may believe it is avoiding liability for employment-related claims by pointing the finger at PPACA in hiring and firing decisions, it may be in fact creating an ERISA Section 510 case by admitting to interfering with a participant's right to benefits.

PART V: CONCLUSION

Since PPACA, employers have had four (4) years to work on designs for flexible workforce. Whether those practices are subject to ERISA Section 510 claims after PPACA presents an open question, which the courts undoubtedly will decide. While it is impossible to predict how courts will treat ERISA Section 510 claims for interference with benefits related to PPACA requirements, employers should keep in mind any potential ERISA Section 510 claim in making any employment, hiring, firing, or reorganization decisions that affect FT or FTE count or the FT status of individual employees. If the single motive for cutting employees' hours or reorganizing is to avoid PPACA mandates or the Play or Pay Rules, an ERISA Section 510 claim may be filed by participants or former employees.

Financial institutions
Energy
Infrastructure, mining and commodities
Transport
Technology and innovation
Life sciences and healthcare

NORTON ROSE FULBRIGHT

Texas Tax Issues – Current Developments for Business in Texas

Jay M. Chadha
Senior Counsel
Fulbright & Jaworski LLP
April 16, 2014

Texas Franchise Tax

Franchise Tax appears as a simple computation:

1.		Total Revenue
2.		Less a Deduction:
		Cost of Goods Sold
		Compensation
		30% of Total Revenue
	=	Margin
3.	x	Apportionment factor
	=	Taxable Margin
4.	x	Tax Rate
	=	Franchise Tax

NORTON ROSE FULBRIGHT

Texas Franchise Tax

Legislative Changes for Total Revenue

– Small Business Deduction – *Tex. Tax Code § 171.101(a)(1)(A)(ii)*

Old Law – a taxable entity did not owe franchise tax if its total revenue was less than or equal to $1 million dollars on an annualized basis.

New Law – creates a permanent $1 million deduction from total revenue.

Texas Franchise Tax

Legislative Changes for Total Revenue

– Exclusion from Total Revenue for certain flow-through funds – *Tex. Tax Code § 171.1011(g)(3)*

Old Law – Comptroller interpreted Section 171.1011(g)(3) to exclude subcontracting payments only when a taxable entity had a contract in place.

New Law - allows an exclusion from total revenue for certain flow-through funds made under *a contract or subcontract* entered into by the taxable entity mandated by contract or subcontract to be distributed to other entities in connection with services, labor or material for real property construction that includes remediation, even in the absence of prime contract.

NORTON ROSE FULBRIGHT

Texas Franchise Tax

Legislative changes - Exclusions from Total Revenue

- Pharmacy networks – *Tex. Tax Code § 171.1011(g-4)*
- Aggregate transporters – *Tex. Tax Code § 171.1011(g-8)*
- Barite transporters – *Tex. Tax Code § 171.1011(g-10)*
- Landman Services – *Tex. Tax Code § 171.1011(g-11)*
- Vaccines – *Tex. Tax Code § 171.1011(u)*
- Waterway Transportation – *Tex. Tax Code § 171.1011(v)*
- Registered Motor Carrier – *Tex. Tax Code § 171.1011(x)*

Texas Franchise Tax

Legislative Changes - Cost of Goods Sold Deduction

– Pipeline entity may subtract as COGS its depreciation, operations and maintenance costs. This applies only to a pipeline entity that owns or leases and operates a pipeline by which the product is transported for others and only to that portion of the product to which the entity does not own title. *Tex. Tax Code §§ 171.1012(k-2) and (k-3)*.

– Movie theaters may deduct as COGS the costs related to the acquisition, production, exhibition or use of a film or motion picture, including expenses for the right to use the film or motion picture. *Tex. Tax Code § 171.1012(t).*

Texas Franchise Tax

Cost of Goods Sold – Revisions to Rule § 3.588
Comptroller Letter Ruling 201307727L (Jul. 16, 2013)

- Old policy: Comptroller only allowed direct labor costs, meaning compensation paid to individuals who physically produced or acquired goods. Did not allow indirect labor costs, such as supervisory costs.

- New Policy: labor costs include: (A) direct labor costs, or labor costs for individuals who actually touch the goods, and (B) indirect labor costs, or labor costs, other than service costs, that can be directly attributed to production or resale activities. Based on IRC § 263A labor capitalization rules, but without regard to whether the taxable entity is required to or actually capitalizes such costs for federal income tax purposes.

- "Service costs" as indirect costs and administrative overhead costs that can be identified specifically with a service department or function or that directly benefit or are incurred by reason of a service department or function.

Texas Franchise Tax

Cost of Goods Sold – Bonus Depreciation
Comptroller Letter Ruling 201401856L (Jan. 30, 2014)

- Franchise tax is based on Internal Revenue Code as of January 1, 2007. Tex. Tax Code § 171.0001(9). Accordingly, no bonus depreciation is allowed.
- When calculating its franchise tax deduction, a taxable entity must recompute its franchise tax depreciation using an appropriate federal depreciation method in effect for the federal tax year beginning January 1, 2007.
- When an eligible asset's federal and franchise tax depreciation are different, its adjusted basis for federal and franchise tax are different. This difference might affect the amount of gain/loss reportable on the sale of that asset.

Texas Franchise Tax

Compensation

- Compensation deduction equals W-2 wages and other compensation, up to an indexed amount, plus *benefits*.
- The wage limitation for report years 2014 and 2015 is $350,000.
- Benefits – *Winstead PC v. Combs*, Travis County District Court No. D-1-GN-12-000141 (Mar. 18, 2013)
  - Tex. Tax Code § 171.1013(b)(2) allows deduction for the cost of all benefits, to the extent deductible for federal income tax purposes. Comptroller Rule § 3.589(e)(2)(D) stated that benefits do not include "working condition amounts".
  - Court held that Comptroller's rule was invalid to the extent it disallowed a deduction for benefits that are deductible for federal income tax purposes.

Texas Franchise Tax

Tax Rate

– **General rule** - *Tex. Tax Code § 171.002.*
  - 1% tax rate, or
  - 0.5% for entities primarily engaged in wholesale or retail trade.

– **Rate Reduction**
  - Reduced rate for 2014 - 0.975 percent of taxable margin or, for a taxable entity primarily engaged in retail or wholesale trade, a rate of 0.4875 percent of taxable margin. *Tex. Tax Code § 171.0022*
  - Potential rate reduction for 2015 – if the Comptroller certifies on or after September 1, 2014 that the probable revenue exceeds the estimate for the 2014-2015 fiscal biennium, then rate will be .95 percent of taxable margin, or 0.475 percent for a taxable entity primarily engaged in retail or wholesale trade. *Tex. Tax Code § 171.0023*
  - *With no further changes, rates would rise back to 1 percent and 0.5 percent starting in 2016.*

NORTON ROSE FULBRIGHT

Texas Franchise Tax

Tax Rate

Amendments to *Tex. Tax Code § 171.0001(12)* classify certain activities as being "retail trade":

- SIC Industry Group 753 (Automotive Repair Shops);
- SIC Code 7359 activities involving the:
  - rental or leasing of tools;
  - rental or leasing of party and event supplies;
  - rental or leasing of furniture;
- heavy construction equipment rental or leasing activities under SIC Code 7353; and
- rental-purchase agreement activities regulated by Chapter 92, Business & Commerce Code.

Texas Franchise Tax

Relocation Expenses - *Tax Code Section 171.109*

- Taxable entity can deduct “relocation costs” from its apportioned taxable margin. To qualify for this deduction:
  - Taxable entity must relocate its main office or other principal place of business.
  - The entity did not do business in Texas before relocating its main office or other principal place of business.
  - The entity cannot be a member of a combined group that had nexus in Texas, prior to relocation.
- "relocation costs" means the costs incurred by a taxable entity to relocate the taxable entity's main office or other principal place of business from one location to another, and includes
  - costs of relocating computers and peripherals, other business supplies, furniture, and inventory; and
  - any other costs related to the relocation that are allowable deductions for federal income tax purposes.

Texas Franchise Tax

Franchise Tax Credits

Certified Historic Structures - *Tax Code Chapter 171, Subchapter S*

- Credit available for "certified rehabilitation of certified historic structures."
- Entity must first request a certificate of eligibility from the Texas Historical Commission.
- Credit amount can be up to 25 percent of eligible costs and expenses incurred in the certified rehabilitation of a certified historic structure placed in service on or after September 1, 2013.
- Not operative until the 2015 tax year and credit cannot be applied prior to 2015, but entity can include costs and expenses associated with the certified historic structure after September 1, 2013 into account.
- All or part of the credit may be sold or assigned without limit, and the credit can be carried forward for up to five consecutive reports.
- Exempt entities may claim the credit and transfer it.
- More information available in Tex. Atty Gen. Op. GA-1045 (Mar. 3, 2014).

Texas Franchise Tax

Franchise Tax Credits

Research and Development Credit - Tax Code Chapter 171, Subchapter M

- Option for either a franchise tax credit for certain research and development activities or a sales tax exemption.
- Credit is allowed for “Qualified research” and “qualified research expense” as defined in I.R.C. § 41, but limited to research conducted in Texas.
- Credit is equal to five percent of the difference between a company’s qualified research expenses during the tax year for which the credit is claimed and 50 percent of the average qualified research expenses for the three preceding tax years (base period).
- An increased amount of credit is allowed for taxable entities that contract with public or private institutions of higher education for the performance of qualified research and have qualified research expenses incurred in Texas under the contract during the period on which the report is based.

Texas Franchise Tax

Franchise Tax Credits

Tax Credit for Clean Energy Project

– Provision moved from Government Code, Chapter 490, Subchapter H to Tax Code Chapter 171, Subchapter L.

– Credits cannot be issued before the later of September 1, 2018, or the expiration of an agreement under Chapter 313, Texas Economic Development Act, regarding the clean energy project for which the credit is issued.

– The definition of “clean energy project” is amended to include the construction of a natural gas-fueled electric generating facility and allows only one of the three clean energy projects certified to be a natural gas project.

Texas Franchise Tax

Franchise Tax Cases

Newpark Resources, Inc. v. Combs, Tex. Ct. App., 3d Dist., Dkt No. 03-12-00515-CV (12/31/2013*)*

- Newpark is an integrated oilfield services company, whose primary activity involved the manufacture, sale, injection and removal of drilling mud. Newpark accomplished each of these tasks through a separate subsidiary.
- Newpark filed a combined report using the COGS for all of its subsidiaries. Comptroller argued that subsidiary involved in the removal of drilling mud was not entitled to cost of goods sold deduction. Newpark prevailed at trial.
- Court of Appeals held that each member's COGS deduction must be determined by considering the member's expenses in the context of the combined group's overall business.
- Motion for rehearing was denied on Feb. 4, 2014, so case is final.

Texas Franchise Tax

Franchise Tax Cases

Titan Transportation LP v. Combs, Tex. Ct. App., 3d Dist., Dkt No. 03-13-00034-CV (03/14/2014)

– Titan in the business of hauling, delivering and depositing "aggregate" at real-property construction sites. Titan sought to exclude from its total revenue payments to its subcontractors under Section 171.1011(g)(3). Comptroller argued that Titan was in the transportation business and did not qualify for the revenue exclusion.

– Section 171.1011(g)(3) (before amendment) provided an exclusion for *flow-through funds that are mandated by contract* to:

subcontracting payments handled by the taxable entity to provide services, labor, or materials *in connection with* the actual or proposed design, construction, remodeling, or repair of improvements on real property or the location of the boundaries of real property.

NORTON ROSE FULBRIGHT

Texas Franchise Tax

Titan Transportation LP v. Combs

– "In connection with" - a phrase of intentional breadth. Court construed phrase to require there must be a reasonable—i.e., more than tangential or incidental—relationship between the activities delineated in the statute and the services, labor, or materials for which the subcontractors receive payment.

– "flow-through" - Comptroller argued that there has to be a three party contract and customer had to make payments to taxpayer who then would pay subcontractor. Court ruled that nothing in the statute's plain language required such an overly formalistic reading of the statute's requirements.

– Changes made to Section 171.1011(g)(3) in the 2013 Legislative session clarified that the revenue exclusion applies without the contract specifying the use of subcontractors.

NORTON ROSE FULBRIGHT

Texas Franchise Tax

Franchise Tax Cases – Pending case

Hallmark Marketing Company, LLC v. Combs, Tex. Ct. App., 13th Dist., Dkt No. 03-13-00842-CV (filed 12/19/2013)

- Tex. Tax Code § 171.105(b) provides that for determining gross receipts for apportionment purposes, if a taxable entity sells an investment or capital asset, the taxable entity's gross receipts from its entire business for taxable margin includes only the *net gain from the sale*.
- For the 2008 tax year, Taxpayer had a net loss from the sale of capital assets, and argued that the net gain should be zero. Comptroller is arguing that if the transactions result in a net loss, that amount should reduce the denominator in the apportionment fraction.
- Appeal filed in the 3rd Court of Appeals, but then transferred to the 13th Court of Appeals.

Texas Franchise Tax

Franchise Tax Cases – Pending case

Graphic Packaging Corporation v. Combs, Tex. Ct. App., 3d Dist., Dkt No. 03-14-00197-CV (filed 04/02/2014)

- Taxpayer argues that it should be permitted to use three factor apportionment formula under the Multistate Tax Compact, which Texas has adopted and located in Chapter 141 of the Texas Tax Code.
- MTC applies to an “income tax“, which includes “any tax imposed on or measured by an amount arrived at by deducting expenses from gross income, one or more forms of which expenses are not specifically and directly related to particular transactions.”
- Taxpayer’s argument is that franchise tax is deducting indirect expenses from gross income, thereby meeting the definition.
- First case claiming the MTC apportionment to reach Court of Appeals.

NORTON ROSE FULBRIGHT

Texas Sales Tax

Research and Development Exemption - *Tex. Tax Code § 151.3182*

- Sales and use tax exemption for the purchase, lease or rental of depreciable tangible personal property purchased by a person for direct use in qualified research, as defined in Internal Revenue Code (IRC) Section 41.

- The depreciable property must have a useful life exceeding one year and must be subject to depreciation either under generally accepted accounting principles (GAAP), or under IRC Section 167 or Section 168.

- Eligibility to claim the sales tax exemption requires an application and an annual information report must be filed with the Comptroller.

- Comptroller Rule § 3.335 – final rule effective February 26, 2014.

Texas Sales Tax

Legislative updates

- Certain Data Centers – *Tex. Tax Code § 151.359, 151.317 and 151.1551*
  - Must apply and be certified for exemption.
  - Must make capital investment of $200 million over a five year period and create at least 20 permanent jobs.
  - Exemption for qualified purchases for 10-15 years after certification.
  - May be revoked if capital or employment requirements are not met.

- Health Care Supplies Exemption – *Tex. Tax Code § § 151.313(e) and (f)*
  - For the sales tax exemption applicable to “health care supplies” in Tex. Tax Code 151.313, definitions for “intravenous systems” and “hospital beds” are added.

- Snack foods are now exempt. *Tex. Tax Code § § 151.314(b) and (b-1)*

NORTON ROSE FULBRIGHT

Texas Sales Tax

Sales Tax Cases – Pending Case

Southwest Royalties v. Combs, Tex. Ct. App., 3d Dist., Dkt No. 03-12-00511-CV

– Taxpayer seeks sales tax refunds based on the manufacturing exemption for certain equipment used for oil and gas production.

– Manufacturing exemption allowed for items that “directly makes or causes a chemical or physical change.” Issue is whether down-hole equipment and well bore casing, that brings the oil and gas to the surface causes a physical change as separation occurs on way to surface.

– In an oral hearing, trial court ruled in favor of taxpayer, but then reversed himself on a motion for reconsideration. Taxpayer appealed to Third Court of Appeals.

– Oral arguments held on September 25, 2013. Case is awaiting decision.

NORTON ROSE FULBRIGHT

Texas Sales Tax

Sales Tax Cases

Richmont Aviation v. Combs, Tex. Ct. App., 3d Dist., Dkt No. 03-11-00486-CV (09/12/2013).

- Substantive tax issue is whether airplane purchase qualified for exemption, but case ruled on important jurisdictional/procedural issue.
- Taxpayer sought an injunction prohibiting the Comptroller from collecting the taxes and seizing assets.
  - Injunctive relief was warranted to avoid irreparable injury, and
  - Filing a bond to pursue injunctive relief was an unconstitutional bar to access to the courts.
- Court of Appeals held that Tex. Tax Code § 112.108 is unconstitutional, and remanded proceeding back to trial court.
- Comptroller has filed a petition for review with the Texas Supreme Court (Case No. 13-0857).

Texas Sales Tax

Sales Tax Cases

Cirrus Exploration Company v. Combs, Tex. Ct. App., 3d Dist., Dkt No. 03-13-00036-CV (02/12/2014)

- Taxpayer owns and operates a helicopter which it hired out with a pilot, for aerial tours, photography, surveys, and inspections.
- Taxpayer held a “Letter of Authorization” from the FAA that expressly authorized Taxpayer to conduct commercial air tours under Part 91 of the FAA’s regulations.
- Taxpayer purchased two helicopters and claimed the sales tax exemption under Section 151.328(a).
- Comptroller denied the exemption based on its “longstanding policy” that holding an FAA carrier authorization under Part 91 does not, in itself, qualify a person as a “licensed and certificated carrier” for purposes of Tax Code section 151.328(a).

Texas Sales Tax

Cirrus Exploration Company v. Combs, No. 03-13-00036-CV

– Court of Appeals held that the Comptroller's policy improperly narrowed the types of carrier authorizations that qualified for a sales tax exemption.

– Court will not automatically defer to the Comptroller's "longstanding policy" regarding a Tax Code provision, or regarding the agency's own rule if the rule is unambiguous. Agency deference is appropriate only where the statute or rule in question is ambiguous.

Texas Tax Issues

Looking Forward:

– Budget Surplus

– School Finance Lawsuit

– SOAH Administrative Hearings Sunset Review

– New Comptroller Election in November

NORTON ROSE FULBRIGHT

NORTON ROSE FULBRIGHT

Disclaimer

Norton Rose Fulbright LLP, Norton Rose Fulbright Australia, Norton Rose Fulbright Canada LLP, Norton Rose Fulbright South Africa (incorporated as Deneys Reitz Inc) and Fulbright & Jaworski LLP, each of which is a separate legal entity, are members ("the Norton Rose Fulbright members") of Norton Rose Fulbright Verein, a Swiss Verein. Norton Rose Fulbright Verein helps coordinate the activities of the Norton Rose Fulbright members but does not itself provide legal services to clients.

References to "Norton Rose Fulbright", "the law firm", and "legal practice" are to one or more of the Norton Rose Fulbright members or to one of their respective affiliates (together "Norton Rose Fulbright entity/entities"). No individual who is a member, partner, shareholder, director, employee or consultant of, in or to any Norton Rose Fulbright entity (whether or not such individual is described as a "partner") accepts or assumes responsibility, or has any liability, to any person in respect of this communication. Any reference to a partner or director is to a member, employee or consultant with equivalent standing and qualifications of the relevant Norton Rose Fulbright entity.

The purpose of this communication is to provide information as to developments in the law. It does not contain a full analysis of the law nor does it constitute an opinion of any Norton Rose Fulbright entity on the points of law discussed. You must take specific legal advice on any particular matter which concerns you. If you require any advice or further information, please speak to your usual contact at Norton Rose Fulbright.

NORTON ROSE FULBRIGHT

MAYER • BROWN

Tax Privilege – New Developments

General Principles and Other Recent Cases

Andrew W. Steigleder
Michelle A. Spiegel

Tax Executives Institute – Houston Chapter
26th Annual Tax School

February 3, 2014

Overview

I. What Privileges Are Most Relevant to Tax?

a) Attorney-Client Privilege (“ACP”)

b) I.R.C. § 7525/Tax Practitioner Privilege (“7525 Privilege”)

c) Work Product Doctrine (“WPD”)

II. How Are Privileges Waived?

III. Impact of Claiming Privilege

IV. Case Studies and Best Practices

a) Tax Accrual Workpapers

b) Tax Opinions

c) Employment Evaluations and Other Sensitive Documents

I. What Privileges Are Most Relevant to Tax?

a) Attorney-Client Privilege ("ACP")

b) I.R.C. § 7525/Tax Practitioner Privilege ("7525 Privilege")

c) Work Product Doctrine ("WPD")

Attorney-Client Privilege

- ACP protects both:
  - Communications by the client for purposes of obtaining legal advice
  - Communications by the lawyer to client if resting on confidential information obtained from client, or where communications reveal substance of a confidential communication by the client

Attorney-Client Privilege (cont.)

- What if the "client" is a corporation?
  - Supreme Court has rejected notion that only communications with the management "control group" are protected. *Upjohn*, 449 U.S. 383 (1981).
  - ACP will attach as long as information is relayed for purpose of obtaining legal advice
  - In the US, communications with in-house counsel are protected to the same extent as outside counsel
  - Outside the US, communications with in-house counsel may not be protected; rules vary by jurisdiction
    - *See, e.g.,* Case C-550/07, *Akzo Nobel Chems. Ltd. v. Comm'n*, 2010 E.C.R. I-08301 (in the EU, "legal professional privilege" does not apply to communications with in-house counsel).
  - Communications with non-US lawyers and non-lawyers regarding US law may not be protected; protection depends on rules in jurisdiction with predominant interest in the communications
    - *See, e.g., Gucci Am., Inc.*, 2010 WL 2720015 (S.D.N.Y.); *Louis Vuitton Malletier*, 2006 WL 3476735 (S.D.N.Y.).

Attorney-Client Privilege (cont.)

- Is all communication with a lawyer protected? No.
  - Business advice
    - If the communication is primarily business advice rather than legal advice, even if coming from a licensed attorney, the privilege will not attach. *Boca Investerings*, 31 F. Supp. 2d 9, 12 (D.D.C. 1998).
  - Tax compliance
    - ACP does not extend to a lawyer doing accountant's work, *e.g.*, preparing a tax return. *Canaday*, 354 F.2d 849 (8th Cir. 1966).
  - Routine, non-confidential communications, or information that is otherwise publicly available
- In today's environment, lawyers and other decision makers often wear two hats

I. What Privileges Are Most Relevant to Tax?

a) Attorney-Client Privilege (“ACP”)

b) I.R.C. § 7525/Tax Practitioner Privilege (“7525 Privilege”)

c) Work Product Doctrine (“WPD”)

7525 Privilege

- In 1998, Congress enacted I.R.C. § 7525, effective for communications made after July 22, 1998:
  - "With respect to tax advice, the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney shall also apply to a communication between a taxpayer and a federally authorized tax practitioner..."
- "Federally authorized tax practitioner" includes CPAs, enrolled agents and actuaries
  - What about in-house tax department employees?
    - Employees may qualify to "represent" their employers before the IRS
    - Any individual qualifying under Circular 230 Section 10.7 is eligible to practice before the IRS. Circ. 230 Section 10.3(g). Circular 230 Section 10.7(c)(i)(iv) provides that a bona fide officer or regular full-time employee of an entity may represent the entity before the IRS. Circ. 230 Section 10.7(c)(i)(iv).
- 7525 Privilege is the direct statutory analog of ACP, subject to the same limitations

7525 Privilege (cont.)

- 7525 Privilege does not apply to:
  - Criminal tax matters before the IRS or in federal court
  - Communications based on foreign tax advice
  - Business advice or accounting services
  - Communications in connection with the "promotion of" the direct or indirect participation in any "tax shelter"
    - "Tax shelter" is defined as "any plan or arrangement"…"if a significant purpose is the avoidance or evasion of Federal income tax." I.R.C. §6662(d)(2)(C)(ii).
    - "Promotion" is defined very broadly as any written communication between a tax practitioner and a client that encourages participation in a tax shelter, even if the plan is not mass-marketed or cookie-cutter in nature. *Valero*, 569 F.3d 626 (7th Cir. 2009).

I. What Privileges Are Most Relevant to Tax?

a) Attorney-Client Privilege ("ACP")

b) I.R.C. § 7525/Tax Practitioner Privilege ("7525 Privilege")

c) Work Product Doctrine ("WPD")

Work Product Doctrine

- WPD protects documents prepared "in anticipation of litigation." *What does that mean?*
  - Fifth Circuit's "primary motivation" test (federal courts in TX, LA, MS)
    - "[L]itigation need not be imminent … as long as the primary motivating purpose behind the creation of the document was to aid in possible future litigation." *United States v. Davis*, 636 F.2d 1028, 1040 (5th Cir. 1981) (emphasis added)
  - First Circuit's *Textron* test (federal courts in MA, ME, NH, RI, PR)
    - Only protects documents created to assist in the conduct of litigation
  - Other Circuits' "because of" test (most other federal courts in US)
    - Protects documents created because of anticipated litigation that would not have been prepared in substantially similar form but for the prospect of litigation
    - A document does not lose work product protection merely because it is intended to assist in the making of a business decision influenced by the likely outcome of the anticipated litigation

Work Product Doctrine

- Fifth Circuit's "primary motivation" test (federal courts in TX, LA, MS)
  - *U.S. v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982)
    - At issue was the enforcement of a summons the IRS issued to El Paso with regard to a tax audit seeking El Paso's "tax-pool analysis"—a summary of El Paso's contingent liability for additional taxes should it ultimately be determined that El Paso owed more taxes than indicated on its return
    - The Court found the work product doctrine "unavailable" based on the test outlined in *Davis*
    - "The primary motivating force behind the tax pool analysis … is not to ready El Paso for litigation over its tax returns. Rather, the primary motivation is to anticipate, for financial reporting purposes, what the impact of litigation might be on the company's tax liability. El Paso thus creates the tax pool analysis with an eye on its business needs, not its legal ones."
  - *See also Chemtech Royalty Associates, L.P. v. U.S.*, 103 AFTR 2d 2009-1498 (M.D.La.) (a reasonable anticipation of litigation requires the existence of an identifiable specific claim or impending litigation at the time the materials were prepared)

II. How Are Privileges Waived?

Waiver

- Privileges are fragile and can be waived by disclosing the communication, or even the gist of the communication, to third parties
- ACP and 7525 Privilege
  - Waived upon disclosure to <u>any</u> third party
- WPD
  - Waived upon disclosure to an <u>adversary</u>, or if disclosure increases the likelihood that an adversary will subsequently be able to obtain the document
  - Is your independent auditor your "adversary"?
    - A small minority of courts say "yes"
    - But most courts say "no," so there is no waiver

Waiver: Scope of Waiver

- ACP and WPD (Fed. R. Evid. 502(a) and (b))
  - Intentional waivers extend to undisclosed communications and information, if the disclosed and undisclosed materials:
    - Concern the same subject matter *and*
    - Ought in fairness be considered together
  - Inadvertent waivers extend to undisclosed communications and information, unless the holder of the privilege:
    - Took reasonable steps to prevent disclosure *and*
    - Promptly took reasonable steps to rectify the error
- 7525 Privilege
  - Waivers typically extend to all communications on the same subject matter

III. Impact of Claiming Privilege

The Obligation to Preserve Records in Litigation

The duty to preserve "arises when the party has notice that the evidence is relevant to the litigation or when a party should have known that the evidence may be relevant to future litigation."

- *Zubulake v. UBS Warburg LLC,* 220 F.R.D. 212 (S.D.N.Y. 2003) (Zubulake IV) (*citing Fujitsu Ltd. v. Fed. Exp. Corp*., 247 F.3d 423, 436 (2d Cir. 2001))

The Obligation to Preserve Records in Litigation

- For LITIGATION purposes: The duty to preserve evidence arises when litigation is reasonably foreseeable
  - Litigation need not be "imminent" to be reasonably foreseeable
  - Contingencies whose resolutions are reasonably foreseeable do not foreclose a conclusion that litigation is reasonably foreseeable
  - The mere existence of a dispute does not indicate that litigation is reasonably foreseeable
- Failure to preserve evidence may result in sanctions if relevant evidence is destroyed

Are Administrative Proceedings Litigation?

- Administrative proceedings can constitute "litigation"
  - *Deseret Management Corp. v. U.S.*, 76 Fed. Cl. 88 (2007)
    - Relying on the guidance of the Second, Fourth, and Fifth Circuits…the court determined that document production during the IRS's appeals process may be conducted "in anticipation of litigation" considering the size of the company and the business significance of the transaction.
  - *Southern Union Co. v. Southwest Gas Corp.*, 205 F.R.D. 542 (D. Ariz. 2002):
    - Adversarial administrative hearings can constitute "litigation" for purposes of determining whether work product protection applies
    - Proceedings before the Arizona Corporation Commission were anticipated to be adversarial proceedings
  - *Evergreen Trading, LLC. v. United States*, 80 Fed. Cl. 122 (Fed. Cl. 2007):
    - For purposes of work product protection, "litigation has been understood to include proceedings before administrative tribunals"

Are Administrative Proceedings Litigation?

- Not all administrative proceedings constitute "litigation"
  - *Consolidated Edison Co*. (Fed. Cl. 2009):
    - The taxpayer did not anticipate litigation until it became clear that the dispute could not be resolved through administrative proceedings
    - "[N]ot … all audits by the IRS, or even extensive, IRS administrative proceedings to challenge results of those audits … will necessarily lead to litigation…. Although there is a point in time during interaction with the IRS that it is reasonable to conclude that litigation is likely or should be anticipated, that determination will differ in every case"
    - "the courts are split among several circuits regarding when a party involved in the IRS administrative process should be deemed to anticipate litigation"

Anticipation of Litigation: Impact of Work Product Claims

- By asserting work product protection, a party is affirmatively identifying a point at which it "reasonably anticipated litigation"
  - Assertion of work product likely creates an obligation to preserve documents related to the same subject matter
- *Siani v. State University of NY at Farmingdale* (E.D.N.Y. 2010):
  - Court agreed with party that "If [litigation] was reasonably foreseeable for work product purposes, … it was reasonably foreseeable for duty to preserve purposes"

IV. Case Studies and Best Practices

a) Tax Accrual Workpapers

b) Tax Opinions

c) Employment Evaluations and Other Sensitive Documents

Definition of Tax Accrual Workpapers

- IRS's definition of Tax Accrual Workpapers ("TAWs") is broad:
  - "those audit workpapers, whether prepared by the taxpayer, the taxpayer's accountant, or the independent auditor, that relate to the tax reserve for current, deferred and potential or contingent tax liabilities, however classified or reported on audited financial statements, and…footnotes disclosing those tax reserves on audited financial statements. These workpapers reflect an estimate of a company's contingency analysis, tax cushion analysis, or tax contingency reserve analysis." I.R.M. 4.10.20.2(2).

IRS's Summons Authority

- IRC § 7602(a)
  - IRS may summon "the person liable for tax…or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax...to produce such books, papers, records, or other data…as may be relevant or material" to determining a person's proper tax liability
- IRC § 7604(b)
  - IRS may bring summons enforcement actions in district court "for the district in which [the summonsed person] resides or may be found"

IRS's Policy of Restraint

- IRM 4.10
  - IRS follows a self-imposed "policy of restraint" under which it will not automatically ask for TAWs during an examination, except in certain circumstances
- Announcement 2010-76
  - If a document was privileged under ACP, 7525 Privilege, or WPD, and the document was shared with independent auditor, IRS "will not assert during an examination that privilege has been waived"
- LB&I FAQ (March 23, 2011)
  - "Examination" includes any request during the administrative process for determining the correct tax, <u>even Appeals</u>
  - "In general," it also includes discovery requests by <u>IRS Counsel</u> in proceedings in the US Tax Court
- Policy of restraint does not apply to DOJ, which handles summons enforcement actions

Tax Accrual Workpapers:
The *Textron* Case Study

- *United States v. Textron Inc. and Subsidiaries*, 577 F.3d 21 (1st Cir. 2009)
  - At issue was whether WPD protected a master reserve schedule and supporting documentation which contained hazards of litigation assessments of in-house tax counsel
  - Court looked at the <u>purpose</u> for preparing the schedules, not the content, and found that Textron's immediate motive in preparing TAWs was to satisfy its independent auditor
  - Court found no evidence that the TAWs had been prepared "for use in" litigation as "case preparation materials"

Tax Accrual Workpapers: The *Deloitte* Case Study

- *United States v. Deloitte LLP*, 610 F.3d 129 (D.C. Cir. 2010)
  - At issue was whether WPD protected a memo prepared by independent auditor memorializing oral opinions expressed by tax counsel
  - Court looked to content, not purpose, of the memo, saying "the question is not who created the document or how they are related to the party asserting work product protection, but whether the document contains work product"
  - Court held that material developed in anticipation of litigation can safely be incorporated into documents produced during a financial statement audit "without ceasing to be work product"

Tax Accrual Workpapers:
The *Wells Fargo* Case Study

- *Wells Fargo & Co. v. United States*, 2013 WL 2444639 (D. Minn.)
  – Consolidation of summons enforcement actions addressing whether:
    - IRS had a proper purpose in summoning TAWs identifying and analyzing uncertain tax positions ("UTPs") for Wells Fargo's 2007 and 2008 tax years
    - WPD protected these TAWs
  – Summonsed TAWs included:
    - Approximately 130 documents prepared by Wells Fargo
    - Approximately 170 documents prepared by KPMG
  – Court held four-day evidentiary hearing during which it reviewed all TAWs that Wells Fargo sought to protect from disclosure

Tax Accrual Workpapers: The *Wells Fargo* Case Study (cont.)

- In order to be valid, a summons must satisfy requirements outlined by the Supreme Court
  - *Powell*, 379 U.S. 48 (1964)
- IRS's burden in making a *prima facie* showing that the *Powell* requirements are met is slight; taxpayer's burden to rebut that showing is great
- Court found that IRS satisfied the *Powell* requirements
  - IRS had a legitimate purpose in seeking Wells Fargo's TAWs: to "verify[] the accuracy of Wells Fargo's tax returns"
  - There were "no equally effective means of verifying this information and, even if there were other means, the existence of other methods would not overcome the legitimacy of the summonses"

Tax Accrual Workpapers: The *Wells Fargo* Case Study (cont.)

- In assessing applicability of WPD, court looked at the content, not purpose, of the TAWs
  - Information "closely related to an attorney's legal thinking about an individual case—including attorneys' estimates of anticipated settlement values—is protected by the work product privilege even if disclosed within business documents"
  - Material "developed in anticipation of litigation can be incorporated into a document produced during an audit without ceasing to be work product"
    - This approach is consistent with the D.C. Circuit's approach in *Deloitte*, but contrary to First Circuit's approach in *Textron*

Tax Accrual Workpapers: The *Wells Fargo* Case Study (cont.)

- Court held that Wells Fargo's <u>identification</u> of UTPs and <u>factual information</u> related to those UTPs are not protected by WPD
  - Identification of UTPs "around the time [Wells Fargo] entered into business transactions was not a task prepared in anticipation of litigation but rather an event that occurred in the ordinary course of business"

Tax Accrual Workpapers:
The *Wells Fargo* Case Study (cont.)

- Court held that Wells Fargo's recognition and measurement analysis is protected by WPD, even though Wells Fargo's TAWs were created "to assist with its financial statements"
  - Analysis reflected "legal analysis conducted by Wells Fargo's attorneys in preparation of litigation"
  - Analysis included strengths and weaknesses of Wells Fargo's case and assessments of its chances of prevailing in litigation
  - At the time analysis was prepared, Wells Fargo was "actively participating in litigation or IRS Appeals on many of the UTPs and, for others, such litigation appeared likely"

Tax Accrual Workpapers: The *Wells Fargo* Case Study (cont.)

- Court held that Wells Fargo did not waive WPD by disclosing TAWs to KPMG
  - In the Eighth Circuit, "a party must intend for an adversary to see its work product in order to waive the privilege through disclosure"
- Court found that Wells Fargo did not intend for an adversary to see its work product when disclosing it to KPMG
  - KPMG is not an actual or potential adversary of Wells Fargo
  - KPMG is not a conduit to an adversary of Wells Fargo

Tax Accrual Workpapers: The *Wells Fargo* Case Study (cont.)

- Court held that KPMG's analysis of the recognition and measurement steps is also protected by WPD
  - KPMG's analysis was "closely tied to the analysis of Wells Fargo's attorneys"

Best Practices for Tax Accrual Workpapers

- Do:
  - Ensure that the role of counsel in analyzing tax positions is clear
  - Implement written policies for preparing TAWs
  - Be mindful of <u>where</u> your documents are located
    - This might inform which circuit's law applies; as noted above, the tests for WPD are quite different
  - Be thoughtful about the documents for which you claim WPD
    - If you claim WPD on each and every document related to each and every issue, you might lose credibility
    - Consider focusing on the documents and issues that matter most

III. Case Studies and Best Practices

a) Tax Accrual Workpapers

b) Tax Opinions

c) Employment Evaluations and Other Sensitive Documents

Tax Opinions:
The *Roxworthy* Case Study

- *United States v. Roxworthy*, 457 F.3d 590 (6th Cir. 2000)
  - At issue were two KPMG opinions
    - One long form, one short form
    - Analyzed tax consequences of transactions and discussed potential IRS arguments
    - Concluded at “more likely than not” level of comfort
    - Labeled as attorney-client communication, but not WPD
    - Issued after transactions were undertaken, but before return was filed
    - IRS initiated summons enforcement proceedings
  - District Court (W.D. Ky.) had enforced summons, saying that opinions were not prepared in anticipation of litigation, but rather to help prepare the tax return

Tax Opinions:
The *Roxworthy* Case Study (cont.)

- On appeal, after *in camera* review, the Sixth Circuit held both opinions were protected as work product
  - Court applied “because of” test; the fact that there were other purposes was not dispositive
  - Labels and headers were not dispositive
  - Self-serving declarations that the taxpayer anticipated litigation were not dispositive
- Court looked to the objective and subjective evidence of “anticipation” when the opinions were drafted
  - $112 million book/tax difference existed
  - Issue would be conspicuous on the taxpayer’s return
  - Company’s size made audit inevitable
  - Law was unsettled; IRS had been litigating the issue with other taxpayers
  - Opinions included language like “we believe that it is likely that a court will agree…”; “it appears reasonable to rely on…”; “although not free from doubt, we believe [X argument] would be rejected by a court…”

Best Practices for Tax Opinions

- Document factors that may demonstrate “anticipation”:
  - Unsettled nature of law in the area
  - Indicia that IRS would litigate issue (*e.g.*, designation for litigation, “Tier 1,” industry coordination, evidence of litigation against other taxpayers, etc.)
  - Recognition of large tax benefit (*e.g.*, large loss)
  - Conspicuous nature of reporting on return
  - Taxpayer under frequent or continuous audit
  - Consulting with litigation counsel or involvement of attorneys
  - Language in tax opinion supporting anticipation of litigation
- Remember, <u>any</u> disclosure to a third party will waive ACP and 7525 Privilege

III. Case Studies and Best Practices

a) Tax Accrual Workpapers

b) Tax Opinions

c) Employment Evaluations and Other Sensitive Documents

Employment Evaluations

- IRS sometimes seeks performance evaluations prepared by and/or regarding employees
- While not strictly privileged, performance evaluations may implicate privacy concerns that are protected under federal law
  - "The use of the administrative summons, including the third-party summons, is a necessary tool for the IRS in conducting many legitimate investigations concerning the proper determination of tax....[However,] the use of this important investigative tool should not unreasonably infringe on the civil rights of taxpayers, including the right to privacy." S. Rep. No. 94-938 at 368, 176-3 C.B. 49, 406.

Employment Evaluations: The *Eaton* Case Study

- *Eaton Corp.*, 2012 WL 3486910 (N.D. Ohio)
  - At issue was whether taxpayer could be required to disclose performance evaluations related to a former employee in its tax department
  - Court held that the evaluations were properly withheld from disclosure
    - IRS failed to establish that the evaluations contained any "relevant substantive information" related to the issues under investigation
    - IRS had sufficient opportunity to interview and collect non-privileged materials from the former employee

Other Sensitive Documents: The *Eaton* Case Study (cont.)

- *Eaton* also addressed whether taxpayer could be required to disclose:
  – Notes of interviews that tax practitioners had conducted with employees
  – Binders of documents related to APAs
  – Specific documents withheld under claims of ACP, 7525 Privilege, and WPD in response to an IDR

Other Sensitive Documents: The *Eaton* Case Study (cont.)

- Interview Notes
  - IRS summons sought original notes from Eaton's "functional analysis" employee interviews, which were conducted to determine arm's-length prices for Eaton's intercompany transactions in connection with each of the company's two APA applications
  - Eaton did not provide a privilege identifying these documents and instead argued that:
    - A privilege log is not required when the privileged nature of the documents is readily apparent
    - A privilege log would have provided no useful information when summons itself specifically identified the documents as interview notes and included the dates, locations and purposes of the interviews
  - Under FRCP 26(b)(5), the court said a party claiming a privilege must provide a privilege log to enable other parties to assess the claim
  - Without a privilege log, it is not clear *how many* documents are responsive

Other Sensitive Documents: The *Eaton* Case Study (cont.)

- APA Binders
  - IRS summonses sought “APA Binders” and documents withheld from a prior IDR
  - Eaton claimed privilege for 68 documents and produced detailed privilege logs and declarations substantiating the elements of the privileges claimed
  - Court rejected the government’s arguments and ruled that:
    - Eaton’s privilege logs and declarations were sufficient
    - Eaton did not impliedly waived privileges by claiming that its functional analysis supported the transfer-pricing methodology or by filing a petition in U.S. Tax Court
    - 7525 Privilege applies to in-house practitioners
    - While not every audit is potentially subject to litigation, Eaton’s factual history demonstrated that its particular audit was entitled to such characterization

Best Practices for Employment Evaluations and Other Sensitive Documents

- Don't:
  - Avoid preparing privilege logs because the privileged nature of documents appears obvious
  - Discuss substantive tax issues in evaluations of employees
- Do:
  - Prepare detailed privilege logs
  - Consider providing affidavits to support privilege logs
  - Alert employees to the possibility that the IRS may request their evaluations
  - Encourage employees to limit discussion of substantive tax issues in self-evaluations
  - When responding to IDRs seeking evaluations
    - Explain absence of relevant information in evaluations
    - Identify and provide alternate sources for relevant information sought by IRS

Questions?

IRS Circular 230 Notice

- Any advice expressed in this document as to tax matters was neither written nor intended to be used and cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed under U.S. tax law. If any person uses or refers to any such tax advice in promoting, marketing, or recommending a partnership or other entity, investment plan, or arrangement to any taxpayer, then (i) the advice was written to support the promotion or marketing (by a person other than Mayer Brown LLP) of that transaction or matter, and (ii) such taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

Tax Considerations in Choice of Entity

Sam Merrill
Thompson & Knight LLP
One Arts Plaza
1722 Routh St. Ste. 1500
Dallas, Texas 75201
214.969.1389
sam.merrill@tklaw.com

The State Bar of Texas
Section of Taxation - Tax Law Survey in a Day
February 28, 2014
Cityplace, Dallas

Return to Table of Contents

Sam L. Merrill

Associate

Thompson & Knight LLP
One Arts Plaza
1722 Routh Street, Suite 1500
Dallas, TX 75201 USA
214.969.1389
214.999.9244 (fax)
Sam.Merrill@tklaw.com

Sam Merrill represents clients in domestic and international tax matters, including business formation; mergers, acquisitions and dispositions; and general tax planning. Sam's practice focuses on oil and gas financing and joint venture transactions, partnership taxation, and private equity fund formation and operations.

Distinctions/Honors

- *Texas Rising Stars*® by Thomson Reuters (Tax); 2010–2012

Publications

"Weblinks"	May 2013
Client Alert: American Taxpayer Relief Act of 2012	January 03, 2013
"Making Employees Partners: Compensating Employees with Partnership Equity"	August 23, 2012
Client Alert: Mexican Congress Approves Tax Reforms for 2010	November 18, 2009
Client Alert: Mexico's Chamber of Deputies Approves Tax Reforms for 2010	October 26, 2009
Client Alert: IRS Extends Relief for Late Entity Classification Elections	October 20, 2009
Client Alert: Proposed International Tax Reforms Reduce Foreign Tax Incentives	May 07, 2009

News

T&K Attorneys Appointed to Leadership Positions for the State Bar of Texas Section of Taxation Press Release	August 6, 2013
Jeff Zlotky, David Wheat, Shelly Youree, Steven Bartz, Sam Merrill, Lee Meyercord, and Emily Tubb Mentioned in *Law360* on Carlyle/NGP Deal	December 20, 2012

Related Practices

Tax
Corporate Tax
Global Tax
Oil and Gas Tax
Partnership Tax

Education

J.D., 2006, The University of Texas School of Law; *Texas Law Review*, Chancellors

B.A., Economics, 2003, *cum laude*, Southwestern University

Admissions

Texas

Return to Table of Contents

Sam L. Merrill

In the News

T&K Advises Meritage in Eagle Ford Shale Deal Press Release	March 22, 2012
Twenty-Nine T&K Attorneys Listed in *Texas Rising Stars®* 2012 Press Release	March 09, 2012
T&K Assists EIG in $1.25 Billion Acquisition Press Release	January 04, 2012
Thirty-One T&K Attorneys Listed in *Texas Rising Stars®* 2011 Press Release	March 18, 2011
Joe Rudberg, David Wheat, James McKellar, Sam Merrill, and Lucas LaVoy Mentioned in *Texas Lawyer* on Newpek/Reliance Joint Venture In the News	August 02, 2010
Joe Rudberg, David Wheat, James McKellar, Sam Merrill, and Lucas LaVoy Mentioned in *Latin Lawyer* on Newpek/Reliance Joint Venture In the News	July 09, 2010
T&K Assists Alfa in $1.3 Billion Eagle Ford Shale Joint Venture Press Release	July 09, 2010
Arthur Wright, Ron Fry, Ned Price, Lucas LaVoy, Emily Parker, David Wheat, Sam Merrill, Bill McDonald, and John Rain Mentioned on dBusinessNews.com on Mitsui/Anadarko Deal In the News	March 17, 2010
Forty T&K Attorneys Listed in *Texas Rising Stars®* 2010 Press Release	March 17, 2010
T&K Assists Mitsui in $1.4 Billion Marcellus Shale Joint Venture with Anadarko Press Release	March 17, 2010
T&K's 2006 New Associates Press Release	October 16, 2006

Return to Table of Contents

TAX CONSIDERATIONS IN CHOICE OF ENTITY DECISION

SAM MERRILL
THOMPSON & KNIGHT LLP
DALLAS, TX

A. An Overview of Entity Types

When organizing a business, one of the first decisions prospective business owners must make is a choice of entity decision. At the outset, the organizers must decide what type of entity structure they will use to operate their business. This decision is critical because it will have many tax and business implications throughout the life of the business. There is no one business entity that is right for every business venture. Rather, the answer will depend on a multitude of factors, many of which vary significantly from state to state. In general, prospective business owners should select a business entity that offers limited liability, flexibility of management, and attractive exit options, all at the lowest tax cost to the owners. Given the variety of business entity choices and the different tax and business consequences inherent in each, the decision is not always an easy one to make.

In general, there are five primary business entity options. Those options include: (1) a regular (or "C") corporation, (2) an "S" corporation, (3) a general partnership, (4) a limited partnership, and (5) a limited liability company.

A C corporation is an entity created under state law that has a legal existence separate and distinct from its owners. Each state has different laws regulating the creation and operation of C corporations. C corporations can range in size from very small (one shareholder) to very large (millions of shareholders). They can be privately held or publicly traded. C corporations are managed by a board of directors elected by the shareholders and by various officers chosen by the board of directors. C corporations are considered separate taxpayers and thus, are subject to federal income tax at the entity level.

An S corporation is a C corporation in which the shareholders have elected to be taxable at the shareholder level, rather than the entity level. Like C corporations, S corporations are created under a state's "normal" corporation statute and have a legal existence separate and distinct from their owners. They too are managed by a board of directors elected by the shareholders and by various officers chosen by the board of directors. Unlike C corporations, however, S corporations generally are not subject to federal income taxation (and perhaps, state taxation) at the entity level, as all of the corporation's income flows through and is taxable to the shareholders at the shareholder level. To elect S corporation status, a corporation generally must: (1) be a domestic, corporation, (2) have 100 or fewer shareholders, (3) have as shareholders only persons who are U.S. individuals, estates, certain trusts and certain tax-exempt organizations, and (4) not have more than one class of stock. These requirements are strict, and a failure to comply with such requirements will terminate the corporation's "S election" and cause the corporation to be taxed as a C corporation.

A general partnership is an association of two or more persons who join together to carry on a trade or business for profit. General partnerships do not have to file under state law to have a legal existence. Under state law, general partnerships are treated as separate and distinct entities capable of owning property. There are no restrictions on who may be a partner in a general partnership. Assuming a general partnership does not elect under the "check the box" rules to be taxed like a corporation, a general partnership is not subject to tax at the partnership level; instead, partnership income passes through to the general partners who include their shares of partnership income on their own income tax returns. Unlike other forms of business entities described in this article, general partnerships do not provide their owners with limited liability for the obligations of the partnership.

A limited partnership is a partnership formed by two or more persons under the limited partnership laws of a state that must by definition have one or more general partners and one or more limited partners. A limited partnership operates in much the same fashion as a general partnership. However, a limited partnership differs because the limited partners have limited liability whereas the general partner or partners do not. A limited partnership is taxed in the same manner as a general partnership.

Finally, a limited liability company is a hybrid entity that possesses certain characteristics of both corporations and partnerships. Limited liability companies are formed pursuant to a state's limited liability company statute and are treated as entities separate and distinct from their owners. They may be managed by the owners or by managers appointed by the owners and may range in size from one owner (in which case the entity could be "disregarded" and treated for tax purposes as a branch of the sole member) to thousands of owners. Like corporations, limited liability companies shield their members from liability. Like partnerships, limited liability companies are not subject to federal income tax at the entity level unless the LLC elects under the "check the box rules" to be taxed like a corporation; instead, income passes through to the members who include their shares of income on their own income tax returns.

When choosing a type of business entity, various factors must be taken into consideration, including: (1) limited liability for the owners; (2) management of the business; (3) means of return on capital; (4) federal and state taxation; and (5) exit strategies. The remainder of this article will focus on the primary tax distinctions between the various types of entities.

B. Number and Types of Owners

Except for S corporations, each of the above business entities generally presents few restrictions regarding the number of owners or the types of owners that may own an interest in the business.

a. C Corporations

There are no limitations on the number of owners that a C corporation may have or on the types of persons that may be shareholders.

b. S Corporations

S corporations are subject to the greatest limitations regarding ownership. To qualify as an S corporation, a corporation generally must: (1) have 100 or fewer shareholders, and (2) have as shareholders only persons who are U.S. individuals, estates, certain trusts and certain tax-exempt organizations.[1] Thus, an S corporation cannot have as a shareholder a C corporation, a partnership or an LLC. These requirements are strict, and a failure to comply with such requirements will cause the corporation to be classified as a C corporation.

c. General Partnerships, Limited Partnerships and LLCs[2]

In general, there are no restrictions on the number or type of persons that may own interests in a partnership or LLC. However, it should be noted that a partnership or LLC generally will be classified as a corporation for federal tax purposes if interests in the partnership or LLC are publicly traded or readily tradable on a secondary market (or the substantial equivalent thereof).[3] Treasury Regulations provide that interests in a partnership or LLC will not be considered "readily tradable" if (1) the interests were issued in a transaction that was not required to be registered under the Securities Act of 1933 and (2) the partnership or LLC does not have more than 100 partners or members.[4] Thus, partnerships or LLCs with more than 100 owners must be careful to avoid being classified as a "publicly traded partnership," which would cause the entity to be taxable as a C corporation.

C. General Federal Income Tax Treatment

Generally speaking, business entities are subject to one of two federal tax regimes: the corporate tax regime or the pass-through (partnership) tax regime. In the corporate tax regime, the profits of a corporation are taxed twice—once when the corporation earns the profits (at the entity level) and once when the shareholders receive dividend distributions from the corporation (at the shareholder level). In the partnership

[1] I.R.C. § 1361(b)(1).

[2] In general, partnerships and LLCs are treated similarly for federal tax purposes. Accordingly, the remainder of this article discusses these types of entities together. Note, however, that there are certain areas where federal tax law treats limited partnerships differently than LLCs and general partners, including with respect to self employment taxes and with respect to allocations of liabilities among the owners of a partnership or LLC. Thus, in certain circumstances, the owners of an entity may prefer a limited partnership over an LLC (or vice versa).

[3] I.R.C. § 7704(b).

[4] Treas. Reg. § 1.7704-1(h).

tax regime, the profits of a partnership are taxed only once at the partner level. The following example illustrates these principles:

> A and B own a corporation (AB Corporation) and a partnership (AB Partnership). In year one, AB Corporation and AB Partnership each have $100 of net income. AB Corporation pays corporate income tax (at 35%) on its net income in the amount of $35. This leaves $65 for distribution between A and B, who each receive a $32.50 dividend. A and B each then pay individual tax (at 20%) on their dividends in the amount of $6.50 each. After taxes, A and B each end up with $26 from the AB Corporation. Thus, the effective tax rate is 48%.
>
> On the other hand, AB Partnership is not subject to an entity-level tax. Instead, A and B are each taxed on $50 of AB Partnership's income. A and B each then pay individual tax (at 39.6%) on their distributive shares in the amount of $19.80. After taxes, A and B each end up with $30.20 from the AB Partnership.

Clearly, A and B are better off, for tax purposes, operating their business as a partnership rather than as a corporation. As corporate shareholders, each receives after-tax profits of $26. As partners, each receives after-tax profits of $30.20.[5] Of course, methods exist to reduce the tax disparity between a corporation and a partnership, but at the end of the day, corporate profits are still subject to double taxation, whereas partnership profits are not. The following discussion analyzes in more detail the tax attributes of the various entities.

a. C Corporations

C corporations are subject to corporate double taxation as described above. While, for federal tax purposes, many business entities may choose under federal tax regulations whether to be taxed as a corporation or as a partnership, a corporation has no such option. C corporations are always subject to the double taxation dilemma. In addition, many states also impose income and franchise taxes on a C corporation's income. As a result of these tax attributes, a C corporation is often an unattractive entity choice for prospective business venturers.

b. S Corporations

S corporations are substantially the same as C corporations in every respect except for taxation. Unlike C corporations, S corporation profits are not subject to corporate double taxation. Instead, S corporations benefit from partnership style taxation because profits pass through the S corporation to the owners and are taxed only once at the shareholder level. The drawback is that S corporation profits are taxable to the shareholders whether the profits are distributed to the shareholders or not. In addition,

---

[5] Notably, the example assumes that all income of the corporation and the partnership are taxable as ordinary income. If some or all of the income were capital gains, then the distinction between corporate and partnership treatment is even more dramatic because corporations are taxed on capital gains at the same rate as ordinary income, while individuals are taxed at capital gains at lower rates.

many states follow the federal S corporation rules and impose state taxes only at the shareholder level. However, some states ignore a corporation's S election and impose income tax on the S corporation at the entity level.

c. General Partnerships, Limited Partnerships and LLCs

Partnerships and LLCs are by default subject to partnership style taxation. All items of income, gain, loss, deduction and credit are passed through to the individual partners and reported by them on their own income tax returns. Like shareholders of S corporations, the partners must pay tax on their share of partnership income whether that income is actually distributed to them or not. A distinct advantage of partnerships is their ability to choose their style of taxation for federal income tax purposes. Federal law allows a partnership to choose whether to be taxed as a partnership or as a corporation. In addition, a partnership may receive state income and franchise tax benefits that are unavailable to corporate taxpayers.

D. Capitalization of the Entity

Once an entity has been formed, one of the first actions will be to capitalize the entity. In general, this will involve the owners making some combination of equity contributions and loans to the entity. Cash generally can be contributed to any business entity without the recognition of income or gain. If an owner contributes property to a business entity in exchange for an equity interest, general tax principles would require the owner to recognize gain equal to the difference between the fair market value of the equity interest received and the adjusted basis of the property contributed. Fortunately, various Code provisions provide for nonrecognition of gain or loss upon a contribution of property to an entity in exchange for an ownership interest. Thus, capital contributions can generally be made to business entities without tax. However, there are several exceptions that can cause the contributors to recognize gain or loss upon a contribution to an entity. An overview of the general rule and the exceptions for each type of business entity are discussed below.

a. C Corporations

Capital contributions to a C corporation in exchange for stock of the C corporation generally can be made without recognition of gain if the contributors are in control of the corporation immediately after the exchange.[6] For this purpose, control means ownership of 80% of the voting power and 80% of the shares of all non-voting classes of stock the corporation.[7] If a contribution qualifies for nonrecognition under this rule, a contributor generally takes a carryover basis in his stock (*i.e.*, an adjusted basis equal to the adjusted basis of the property contributed).[8] Moreover, the corporation's

[6] I.R.C. § 351(a).
[7] I.R.C. § 368(c).
[8] I.R.C. § 358.

adjusted basis in the contributed property generally equals the adjusted basis of the property immediately before the contribution.[9]

Notwithstanding the general rule of nonrecognition rule, there are four key situations where a contributor may be subject to tax upon a capital contribution to a C corporation.

First, to the extent a contributor receives, in addition to stock of the C corporation, cash or other non-stock property in connection with the exchange (referred to as "boot"), the contributor will recognize gain up to the amount of such "boot".[10]

Second, a contributor may recognize gain on a contribution of property to a C corporation if the corporation assumes a liability of the contributor. In general, liabilities assumed by a C corporation in connection with a capital contribution are not treated as "boot" that causes the contributor to recognize gain. However, an assumed liability will be treated as boot if either (1) the assumed liability exceeds the adjusted basis of the contributed property, or (2) the principal purpose of the liability assumption was to avoid tax on the exchange, or there otherwise was not a bona fide business purpose for the liability assumption. In the case of (1), the excess of the assumed liability over the adjusted basis of the contributed property is treated as boot. In the case of (2), the entire assumed liability is treated as boot.[11]

Third, a contributor will recognize gain where a transfer is made to a C corporation that is classified as an "investment company."[12] A transfer is deemed to be made to an investment company where (1) it results, directly or indirectly, in diversification of the transferors' interests and (2) immediately after the transfer, more than 80% of the corporation's assets consist of certain investment assets (e.g., cash, stock, debt, options, other securities, etc.). The purpose of this rule is to prevent multiple contributors from diversifying their investments without current taxation.

Fourth, a contribution of services to a corporation in exchange for stock generally will cause the contributor to recognize compensation income equal to the fair market value of the stock received.

b. S Corporations

Contributions to S corporations generally are subject to the same rules as are applicable to C corporations.

c. General Partnerships, Limited Partnerships and LLCs

[9] I.R.C. § 362(a).
[10] I.R.C. § 356.
[11] I.R.C. § 357.
[12] I.R.C. § 351(e).

A different set of rules applies to capital contributions made to partnerships and LLCs. The general rule is that capital contributions to a partnership or LLC in exchange for an equity interest do not cause the partners (or members) or the entity to recognize gain.[13] Unlike corporations, there is no requirement that the contributors be in control of the partnership following the exchange. The contributing partner or member generally takes a carryover basis in his interest in the partnership or LLC (*i.e.*, an adjusted basis equal to the adjusted basis of the property contributed).[14] Furthermore, the partnership's adjusted basis in the contributed property generally equals the adjusted basis of the property immediately before the contribution.[15]

As with corporations, there are several exceptions that can cause a contributor to recognize gain or loss. These exceptions run somewhat parallel to the exceptions described above for corporations.

First, if a partner contributes property to a partnership and there is a related transfer of cash or other property by the partnership to the partner, the contributing partner may be treated as selling all or a portion of the contributed property to the partnership, such that the contributing partner is required to recognize gain or loss on the transaction.[16]

Second, if the partnership assumes debt of the partner in excess of the contributing partner's adjusted basis in the property, the contributing partner could be required to recognize gain.[17]

Third, a contributing partner will recognize gain or loss on the contribution of property to an investment company.[18] An investment company is defined in the same manner as it is for purposes of the rules described above for corporations.

Finally, the transfer of a partnership interest in exchange for services generally will be taxed as compensation income to the service provider. However, there is an important exception for "profits interests," which are interests in the partnership that provide the owner only with an interest in future profits of the partnership and no right to the existing capital of the partnership. In general, the grant of a profits interest is not treated as a taxable event for either the partnership or service provider.[19]

E. Flexibility of the Business Arrangement

[13] I.R.C. § 721(a).
[14] I.R.C. § 722.
[15] I.R.C. § 723.
[16] I.R.C. § 707(a)(2)(B).
[17] The partnership's assumption of the partner's liability is treated as a distribution of cash to the partner, and a partner must recognize gain to the extent a cash distribution exceeds its adjusted basis. I.R.C. §§ 731, 752.
[18] I.R.C. § 721(b).
[19] Rev. Proc. 93-27.

Return to Table of Contents

Another key distinction between various types of entities is the amount of business flexibility afforded to the owners of the entity in setting forth their business arrangement. As described below, partnerships and LLCs provide the most business flexibility due in part to their ability to make special distribution and allocations of income among the partners and members. Corporations, and in particular S corporations, do not provide as much business flexibility to their owners.

a. C Corporations

C corporations provide some flexibility to their owners in defining their business arrangement because C corporations can have multiple classes of stock. For instance, a C corporation could have one or more classes of (1) preferred stock, which generally is entitled to a priority with respect to operating distributions and distributions upon liquidation of the corporation, and (2) common stock, which generally can receive distributions only after preferred shares have been paid and is entitled to the residual assets of the corporation upon a liquidation.

b. S Corporations

One of the primary disadvantages of S corporations is that they are the most rigid with respect to the business arrangement of their owners. S corporations must have only one class of stock.[20] As a result, all distributions by an S corporation must be made pro rata among its shareholders in accordance with their ownership of shares.[21] If an S corporation has more than one class of stock, it will be classified as a C corporation for federal tax purposes.

c. General Partnerships, Limited Partnerships and LLCs

Partnerships and LLCs provide their owners with considerable flexibility in crafting their business arrangement. A partnership or LLC can provide that operating and liquidating distributions can be made in essentially any order of priority. Moreover, partnerships and LLCs can provide for different sharing of distributions attributable to separate assets or lines of business. Likewise, partnerships and LLCs may make special allocations of income, gain, loss and deduction to their members, provided that the special allocations are reasonably consistent with the business arrangement of the partners or members. Partnerships and LLCs thus can accommodate almost any bona fide business arrangement among their owners, and this flexibility is one of the key attractions of these entities.

F. Deduction of Losses

Often a business entity is expected to incur losses during the initial period of its operations. Thus, another important consideration in choosing an entity is whether, and

---

[20] I.R.C. § 1361(b)(1)(D).
[21] I.R.C. § 1366(a)(1).

to what extent, the owners of the entity will be able to deduct operating losses on their own tax returns.

a. C Corporations

The shareholders of a C corporation cannot deduct the corporation's losses on their own tax returns. A C corporation deducts its losses only when computing its entity-level tax. If a C corporation incurs initial losses, such losses can be carried forward and deducted only when the C corporation has future profits.

b. S Corporations

The income and deductions of an S corporation flow through to its shareholders. Accordingly, the shareholders of an S corporation generally can deduct its losses on their individual tax returns. However, such losses can be deducted only to the extent of a shareholder's adjusted basis in the S corporation's stock.

Importantly, debt incurred at the S corporation level generally does not increase the adjusted basis of the S corporation shareholders. Therefore, debt incurred by the S corporation does not increase the potential amount of losses that can be deducted by the shareholders of an S corporation.

In addition to the basis limitation, shareholders of an S corporation may also be subject to various limitations on their ability to deduct their shares of losses from an S corporation, including the at risk limitations and the passive activity loss limitations.

c. General Partnerships, Limited Partnerships and LLCs

The income and deductions of a partnership or LLC flow through to its partners or members. Accordingly, the partners or members generally can deduct their shares of the entity's losses on their individual tax returns. However, such losses can be deducted only to the extent of a partner's or member's adjusted basis in the partnership or LLC.

In contrast to S corporations, debt incurred by a partnership or LLC is allocated among the partners or members and results in an increase in their adjusted bases in their interests in the partnership or LLC. Therefore, debt incurred by a partnership or LLC potentially increases the amount of losses that can be deducted by its owners.

In addition to the basis limitation, owners of a partnership or LLC may also be subject to various limitations on their ability to deduct their shares of losses from the entity, including the at risk limitations and the passive activity loss limitations.

G. Means of Return on Capital

Of utmost importance to any business owner is the ability to make a return on his capital investment. Each of the business entities has different rules pertaining to distributions of profits that must be taken into consideration when making a choice of entity decision.

a. C Corporations

C corporations return profits to their shareholders in the form of distributions generally referred to as dividends. When dividends are paid, they must be paid in proportion to ownership interests according to state law. While it is possible to prioritize dividends among different classes of stock, corporations cannot selectively pay dividends to certain shareholders and not to others if they all own the same class of stock.

Shareholders are taxed on distributions by a C corporation in the year they are paid. In general, corporate distributions are taxable as ordinary income to the extent of the C corporation's earnings and profits. However, "qualified dividends," which include dividends paid by most U.S. corporations and certain foreign corporations, are subject to tax at capital gain rates.[22] To the extent distributions by a C corporation exceed its earnings and profits, such distributions are treated as non-taxable return of capital distributions to the extent of a shareholder's adjusted basis in its stock. Distributions in excess of such adjusted basis are taxable as capital gain.[23]

Distributions generally do not give rise to tax at the C corporation level. However, a C corporation must recognize gain upon the distribution of appreciated property (even if the distribution is also taxable as a dividend to the recipient shareholder).[24]

b. S Corporations

Like C corporations, S corporations also return profits to shareholders in the form of dividends. When dividends are paid, they must be paid in proportion to ownership interests. Unlike C corporations, however, S corporation shareholders are taxed on their allocable share of S corporation income whether dividends are actually paid or not. Thus, when dividends are paid, because the shareholders have already been taxed on those distributions, the distribution of the dividends is a non-taxable event.[25] If an S corporation distributes appreciated property, the built-in gain in the property is recognized and allocated to the S corporation shareholders.[26]

c. General Partnerships, Limited Partnerships and LLCs

Partnerships and LLCs return profits to their owners via distributions. The partners or members typically agree in the partnership or LLC agreement how partnership

[22] I.R.C. § 1(h)(11).
[23] I.R.C. § 301.
[24] I.R.C. § 311(b).
[25] I.R.C. § 1368.
[26] I.R.C. § 311(b).

Return to Table of Contents

profits are to be allocated and distributed. Allocations and distributions need not be proportionate to partnership ownership; as described above, special allocations and distributions of profits are allowed.

Partners are taxed on their allocable portions of partnership profits whether they receive a distribution or not. When distributions are made, in most circumstances, because the recipients have already been taxed, the distribution is a non-taxable event. However, there are several scenarios in which a partner can recognize gain upon the receipt of a distribution, including (1) distributions of money or marketable securities in excess of the partner's or member's adjusted basis in the partnership or LLC,[27] (2) distributions where the partner makes a related contribution of property to the partnership or LLC,[28] (3) distributions where the partner has contributed appreciated property to the partnership or LLC within the last seven years,[29] and (4) distributions where the partner or member receives a disproportionate share of certain types of assets of the partnership (*i.e.*, certain types of distributions of property that are not made pro rata).[30]

H. Exit Strategies

When choosing among business entity alternatives, prospective business owners must consider the different methods by which they can cash out their investments in the business. Multiple methods exist for cashing out, including in part: a sale of an individual owner's ownership interest to a third party, a sale of an individual owner's ownership interest back to the business, a sale of the entire business to a buyer, and a reorganization. Prospective business owners should consider the tax and business consequences of each of these methods before making any choice of entity decision.

a. C Corporations

A C corporation shareholder who wishes to cash out his investment in the corporation is generally at liberty to sell all or part of his shares of the corporation to a third party, unless the shareholders have agreed otherwise in the corporation's governing documents. In most cases, a sale of stock will result in capital gain (or capital loss) to the seller, which is taxable at lower capital gain rates if the stock was held for more than twelve months. A shareholder may also sell part or all of his shares back to the corporation in a stock redemption, if the corporation is willing. Gain from a complete redemption may be taxable at preferential capital gain rates.

In addition, the shareholders of a corporation may decide to sell the entire business to a buyer. This can be done either by selling all shareholders' corporate stock or by selling the corporation's underlying assets. If the shareholders sell stock to the buyer, then they recognize gain or loss on the sale only at the shareholder level as

[27] I.R.C. §§ 731(a), (c).
[28] I.R.C. § 707(a)(2)(B).
[29] I.R.C. §§ 704(c)(1)(B), 737.
[30] I.R.C. § 751(b).

Return to Table of Contents

described above. If they sell the corporation's assets and then distribute the sale proceeds to themselves in liquidation of their stock, unless the sale is pursuant to a tax-free reorganization, there are two levels of tax—one on the corporation's sale of its assets, and the other on the shareholders' liquidating distribution. This is problematic in the corporate context because buyers generally prefer to buy assets in order to obtain a cost basis in the purchased assets equal to the assets' fair market value that can be written off over the respective assets' useful lives, but corporate sellers prefer to sell stock to avoid double taxation.

In the alternative, the shareholders may instead choose to exit the business through a tax-free reorganization. Provided certain statutory, regulatory, and case law requirements are satisfied, shareholders of a corporation may dispose of the stock or assets of their corporation in exchange for stock of the acquiring corporation under federal tax law in a wholly or partially tax-free manner.

b. S Corporations

Because state corporate statutes govern the business aspects of both C and S corporations, S corporation shareholders are also generally at liberty to sell all or part of their shares in the corporation, subject to any restrictions in the S corporation's governing documents. Again, such a sale will result in capital gain (or capital loss) to the seller. A limiting factor, however, is that the prospective purchaser must be eligible to be an S corporation shareholder under the strict S corporation eligibility rules described above if the corporation is to remain an S corporation following the sale. Thus, the field of prospective S corporation stock purchasers may be limited. S corporation shareholders may also sell part or all of their shares back to the corporation in a redemption transaction.

Like C corporation shareholders, the owners of an S corporation may also decide to sell the entire business to a buyer. This may be accomplished either by a stock or asset sale. Unlike a C corporation's sale of assets, a sale of either stock or assets by an S corporation results in only one level of tax at the shareholder level. Finally, S corporations, like C corporations, are eligible to participate in tax-free reorganizations of the business.

c. General Partnerships, Limited Partnerships and LLCs

Unless otherwise stated in the governing agreement, partners and members are permitted to sell all or part of their interests in a partnership or LLC to third parties, other partners or members, or the partnership or LLC itself in accordance with the terms of the governing agreement. Generally, the selling partner or member will realize capital gain or loss to the extent his amount realized exceeds his basis in his partnership interest. However, to the extent the proceeds are attributable to certain types of assets of the partnership (including inventory and accounts receivable), the sale will cause the partners or members to recognize ordinary income.

In addition, all partners or members may together transfer the entire business to a buyer. A sale of the entire business may be accomplished either by a sale of interests or by a sale of the underlying assets to the buyer. Because partnerships and LLCs are pass-through entities, whether the partners or members sell their interests or the company sells its assets directly, the sale will result in only one level of tax at the owner level. If interests are sold, the owners generally recognize capital gain or loss to the extent their amounts realized exceeds their bases in their interests, subject to the look-through rule described above.

If the partnership sells assets, and the proceeds are distributed to the partners in liquidation, the liquidating distributions will be received tax-free by the partners to the extent of their adjusted basis in the partnership. Any excess will be capital gain. Unlike corporations, partnerships cannot take advantage of the tax-free reorganization provisions.

Return to Table of Contents

Estate and Gift Tax – Where are We Now?

Wesley L. Bowers
Fizer, Beck, Webster, Bentley & Scroggins, P.C.
1330 Post Oak Boulevard, Suite 2900
Houston, Texas 77056
713.840.7710
wbowers@fizerbeck.com

The State Bar of Texas
Section of Taxation - Tax Law Survey in a Day
February 28, 2014
Cityplace, Dallas

Special thanks to Amanda M. Gyeszly from FizerBeck, who provided the basis for which this paper was updated.

Wesley L. Bowers
Fizer, Beck, Webster, Bentley & Scroggins, P.C.
1330 Post Oak Boulevard, Suite 2900
Houston, Texas 77056
713.840.7710
wbowers@fizerbeck.com

EDUCATION:

Baylor Law School, Waco, Texas
J.D., *with Honors*, 2007; Baylor Law Review (Managing Executive Editor and Articles Editor); Student Bar Association (Vice President and Executive Treasurer); Joe Cannon Professionalism Award

Baylor University, Waco, Texas
B.A. in Political Science, *summa cum laude*, 2002; Phi Beta Kappa

PROFESSIONAL EXPERIENCE:

Fizer, Beck, Webster, Bentley & Scroggins, P.C., Houston, Texas
Shareholder, 2014 – present; Associate Attorney, 2011-2013

Fulbright & Jaworski L.L.P., Houston, Texas
Associate Attorney, 2007-2011

PROFESSIONAL ACTIVITIES AND HONORS:

Board Certified in Estate Planning and Probate Law, Texas Board of Legal Specialization, 2012
Vice-Chair, Estate and Gift Tax Committee, Tax Section of the State Bar of Texas, 2013-2014
Member: State Bar of Texas (Real Estate, Probate and Trust Law Section and Tax Section), Houston Bar Association (Real Estate, Probate and Trust Law Section), Houston Estate and Financial Forum, and American Bar Association (Real Property, Trust and Estate Law Section)

SELECTED PRESENTATIONS AND PUBLICATIONS:

Presenter and Co-Author, *Estate and Gift Tax – Where Are We Now?*, State Bar of Texas Tax Law Survey in a Day, Dallas, Texas February 2014
Planning Committee, State Bar of Texas Intermediate Estate Planning and Probate Course, San Antonio, Texas, June 2014
Presenter and Author, *Pulling It All Together: Strategies for Intermediate Planning*, State Bar of Texas Intermediate Estate Planning and Probate Course, Houston, Texas, June 2013
Planning Committee, State Bar of Texas Intermediate Estate Planning and Probate Course, Houston, Texas, June 2013
Presenter and Co-Author, *Irrevocable Life Insurance Trusts*, State Bar of Texas Intermediate Estate Planning and Probate Course, San Antonio, Texas, June 2012
Presenter and Co-Author, *ILITs: Failed Assumptions, Underperformance, and Fiduciary Liability*, State Bar of Texas Advanced Drafting: Estate Planning and Probate Course, Dallas, Texas, October 2011
Presenter, *What Now? Estate Planning In Light of the 2010 Tax Relief Act*, Northwestern Mutual Wealth Management Co., Houston, Texas, February 2011
Author, *Revocable Trusts: A Flexible Alternative to the Traditional Will*, Fulbright & Jaworski L.L.P. Client Briefing, Winter 2010
Author, *Dealing with the Rogue Executor: A Page From the Fiduciary Litigation Playbook*, The Advocate, The State Bar Litigation Section Report, Fall 2009
Author, *Estate Planning Opportunities in an Uncertain Economic Market*, Fulbright & Jaworski L.L.P. Client Briefing, Winter 2008

TABLE OF CONTENTS

Gift and Estate Tax: Where Are We Now?[1]

The 2012 American Taxpayer Relief Act imposed a number of significant changes to the United States transfer tax structure, most notably providing for a permanent and significant increase of the estate tax exemption and making permanent the portability of estate tax exemptions between spouses. The 2012 Act also increased the maximum ordinary income and capital gains rates for individuals, trusts and estates. In addition to these changes, the Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act of 2010, imposed an additional Medicare tax effective January 1, 2013, for individuals, trust and estates. The combined tax rate increases set forth in these acts, paired with the favorable and permanent estate tax exemption, results in a decreased emphasis on transfer tax planning, and increased emphasis on income tax planning for many clients. In addition to the permanent law changes under these acts, the administration's "Green Book" was recently released and includes a glimpse at proposed tax changes that may be enacted in the future.

The purpose of this article is to provide a summary of the current federal transfer tax and income tax laws for the attorney to consider in the estate planning and probate context, along with a summary of proposed tax law changes that could be enacted in the near future. As with all such presentations, this Article is for educational purposes only and cannot be taken as legal advice. Furthermore, any tax discussion in this Article and the appendices is not intended or written to be used, and cannot be used, for the purpose of: (i) avoiding penalties under the Internal Revenue Code, as amended or (ii) promoting, marketing or recommending to another party any transaction or tax-related matter[s].

I. OVERVIEW AND RECENT HISTORY OF U.S. GIFT AND ESTATE TAX

A. <u>The Transfer Tax System</u>.

Our tax system imposes a tax on the transfer of assets, whether made during life (gift tax) or at death (estate tax).[2] Estate and gift taxes are unified under one rate schedule. All transfers of a taxpayer are added together to determine the ultimate tax liability.

1. <u>The Estate and Gift Tax Exemption</u>.

Central to planning under the law is the utilization of transfers that escape taxation, either completely or for a period of time. Each U.S. citizen and resident has an applicable exemption amount that is the sum of assets that the taxpayer can give away during lifetime and/or at death.[3] This exemption is sometimes called the "basic exclusion amount", "credit amount", "exemption amount" or "tax-free amount". In past years, the tax-free amount was not the same for gifts made during lifetime versus transfers at death.

In addition to the tax-free amount, certain transfers to a U.S. citizen spouse qualify for the unlimited marital deduction, which does not allow assets to completely avoid taxation, but rather defers taxation to a later date.[4] The marital deduction excludes from taxation transfers to a spouse during the taxpayer's life or at his death, as long as the recipient spouse is a U.S. citizen and the property passes to the spouse in a qualifying manner (generally outright or to a specific type of trust). Because there is no limit to the amount, just the manner in which assets may be transferred, this transfer is often referred to as the "unlimited marital deduction". There are limited deferral options available to transfers to a non-citizen spouse, but those techniques are not discussed in this outline.[5]

2. <u>Assets Included in Taxable Estate</u>.

The assets subject to the estate tax include everything a person owns or has certain property interests in at his date of death, not just the assets that pass according to a Will. The fair market value of these items is used, not necessarily what the owner paid for

[1] The author wishes to acknowledge and thank two people who contributed to this Article. Lora Davis graciously allowed portions of her article on portability to be included herein, and Sarah Snook of FizerBeck assisted with the preparation and organization of this Article.

[2] I.R.C. §§ 2001(a); 2501(a)(1). Unless otherwise indicated, all Section ("§") references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all Regulation Section ("Reg. §") references are to the Treasury regulations promulgated thereunder.

[3] §§ 2010, 2505.

[4] See §2056.

[5] For a discussion of how transfers to a non-citizen spouse can qualify for the marital deduction under certain circumstances, see R. Glenn Davis, "International Issues in Estate Administration," which was presented at the State Bar of Texas 34th Annual Advanced Estate Planning and Probate Course, June 23-25, 2010.

them or what their values were when they were acquired. The total of all of these items is called the "gross estate." The gross estate may include probate as well as non-probate property, and the following are a few examples:

1. **Real estate**, including surface and mineral interests.
2. **Tangible personal property** such as artwork, collectibles jewelry, firearms, and boats or motor vehicles.
3. **Financial assets**, including stocks, bonds, mutual funds, annuities, promissory notes, and bank accounts.
4. **Retirement accounts**, including IRAs and 401k plans.
5. **Marital Trusts**. The assets in a Marital Trust are not taxed at the first spouse's death, but whatever remains in the trust at the surviving spouse's death will be taxed as part of the surviving spouse's estate.
6. **Life insurance** is generally included if the insured owns or controls the policy, or if the policy ownership was transferred within 3 years of death.

3. Basis Adjustment for Assets Acquired from a Decedent.

Generally, assets acquired from a decedent will receive an automatic new cost basis at death (often referred to as a "step up" in basis, but sometimes the result is a step down in basis).[6] The new basis is the value of the asset as of the Decedent's date of death, unless the alternate valuation election is made, in which case the alternate valuation date value will become the new basis. [7] However, not all assets includable in a Decedent's gross estate qualify for a basis adjustment. For example, items which constitute "income in respect of a decedent" do not receive a basis adjustment at death.[8]

B. Recent Exemption History.

From 1976 through 2003, the estate and gift tax exemptions and rates were "unified," which includes two concepts. First, a single **rate** schedule applied for both gift and estate taxes.[9] Second, each individual had a single **exemption amount** available for both gift and estate tax, meaning that use of the exemption during life results in a corresponding reduction in the tax-free amount available at death.[10]

The Economic Growth and Taxpayer Relief Act of 2001 ("EGTRRA") enacted drastic changes to the transfer tax regime starting January 1, 2002.[11] Since EGTRRA, the transfer tax landscape has been ever-changing, as EGTRRA gradually phased out the estate tax, and was extended and amended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010[12]("TRA 2010") for years 2010 through 2012. During the time period in which EGTRRA and TRA 2010 have applied, the estate tax exemption has gradually increased, while the estate and gift tax rates have generally decreased until 2013, yielding a decreasing transfer tax burden.

EGTRRA provided that there would be no estate or GST tax for deaths in 2010. EGTRRA was scheduled to sunset at the end of 2010, returning us to the $1,000,000 exemption and a 55% top rate on January 1, 2011. At the end of 2010, Congress passed the TRA 2010 that addressed only 2010, 2011 and 2012. TRA 2010 set the exemption amount at $5,000,000, indexed for inflation in 2012. The transfer tax rate for 2010 through 2012 was 35%. We faced another cliff of uncertainty at the end of 2012, when TRA 2010 expired.

From 2004 through 2010, the estate and gift tax exemptions were not unified. Beginning in 2011 and now under current "permanent" law, the estate and gift tax (as well as the generation-skipping transfer tax) exemptions are again unified. These changes are illustrated by the following chart, shown with the gift and estate tax exemption "de-unified" years shaded:

Year	Estate Tax Exemption	Top Marginal Rate	Gift Tax Exemption
2001	$675,000	55%	$675,000
2002	$1,000,000	50%	$1,000,000
2003	$1,000,000	49%	$1,000,000
2004	$1,500,000	48%	$1,000,000
2005	$1,500,000	47%	$1,000,000
2006	$2,000,000	46%	$1,000,000
2007	$2,000,000	45%	$1,000,000

[6] §1014
[7] §1014
[8] §1014(c)

[9] *See* I.R.C. § 2502(a)(1).
[10] §2001(b).
[11] Pub. L. 107-16
[12] Pub. L. 111-312

Year	Estate Tax Exemption	Top Marginal Rate	Gift Tax Exemption
2008	$2,000,000	45%	$1,000,000
2009	$3,500,000	45%	$1,000,000
2010	$5,000,000 (or unlimited*)	35% (or 0% for estates*)	$1,000,000
2011	$5,000,000	35%	$5,000,000
2012	$5,000,000 adjusted for inflation ($5,120,000 in 2012)	35%	$5,120,000
2013	$5,000,000 adjusted for inflation ($5,250,000 in 2013)	40%	$5,250,000
2014+	$5,000,000 adjusted for inflation ($5,340,000 in 2014)	40%	$5,340,000

***** Estates for persons dying in 2010 could opt out of the estate tax, but were required to apply "carry-over" basis rules and lose the advantage of a step-up in basis at death.

C. <u>Generation-Skipping Transfer Tax</u>.

In addition to the gift and estate taxes, there is another type of transfer tax called the generation-skipping transfer (GST) tax. This tax applies to inter vivos and testamentary transfers to beneficiaries more than one generation below the donor (i.e., grandchildren), either outright or in trust.[13] The GST tax developed as a response to taxpayers' attempts to "skip" taxation in the children's estates by transferring assets directly to grandchildren.

EGTRRA phased out the GST tax along with the estate tax, and provided for no GST tax in 2010. However, TRA 2010 reinstated the GST tax, but at a 0% rate for 2010. In 2011 and 2012, the GST tax was reunified with the estate and gift taxes, with a 35% rate and a $5,000,000 exemption indexed for inflation beginning in 2012 (see above estate/gift tax chart).

Like the gift and estate tax, the GST tax can be reduced by application of the $5,000,000 GST exemption to transfers during life and at death.[14] However, while the GST exemption is "unified" in the sense that the amount of the exemption is the same as the amount of the gift/estate tax exemption, the GST exemption is calculated separately. Use of GST exemption does not reduce the amount of gift/estate tax exemption available.

[13] §§2601, 2611-2613.
[14] §2631.

II. AMERICAN TAXPAYER RELIEF ACT OF 2012

A. <u>Permanent (and Unified) Transfer Tax Exemptions and Rates</u>.

Finally, the American Taxpayer Relief Act of 2012[15]("ATRA 2012") was passed by Congress on January 2, 2013, and was signed into law on January 4, 2013. Because it contains no sunset provisions, ATRA 2012 is considered to be permanent law, as an act of Congress would (literally) be required to change the law. ATRA 2012 essentially revived and made permanent the transfer tax laws that were in effect in 2012, but increased the top transfer tax rate from 35% to 40%. It was structured to extend the laws in effect under TRA 2010, which extended provisions of EGTRRA, so many of the user-friendly provisions of EGTRRA continue to apply (such as the automatic allocation of GST exemption).

The Gift, Estate and Generation-Skipping Transfer Tax exemption amount is $5,000,000 per taxpayer (or decedent in the estate tax context), indexed annually for inflation, which will have a significant effect over time. The inflation adjusted exemption amount for 2013 is $5,250,000 and for 2014 is $5,340,000.

B. <u>Permanent Portability of Estate Tax Exemptions</u>.

ATRA 2012 also made permanent the concept of "portability" of estate tax exemptions between spouses. Portability generally allows a married couple to use the estate tax exemption of the first spouse to die at any of three times: (1) at the death of the first spouse for any transfers to taxable recipients, (2) during the surviving spouse's lifetime on gifts to taxable recipients by the surviving spouse, and/or (3) at the surviving spouse's death. It is not necessary for the entire exemption to be used at only one of the foregoing times – for example, a portion of the exemption of the first spouse to die could be used on taxable transfers under his Will, with the remaining exemption available to be used during the surviving spouse's lifetime, and if not used during her life, then at her death. However, regardless of how the exemption is "broken up" and used over time, it is still limited to the estate tax exemption available to the first spouse to die at the time of his death. This new tax concept has resulted in a significant change to standard husband-and wife estate planning. Portability is discussed in more detail in section III, below.

[15] Pub. L. 112-240.

C. Increases to the Maximum Income and Capital Gains Rates.

ATRA 2012 increased the maximum ordinary income and capital gains rates for individuals, trusts and estates starting on January 1, 2013. The income tax changes under ATRA 2012 are discussed in more detail in section V, below.

III. PORTABILITY OF ESTATE TAX EXEMPTION

A. Background.

"Portability" allows a surviving spouse to "port" or use his or her deceased spouse's unused estate and gift tax exemption amount. The portability concept has been discussed as sound tax policy for many years. It was recommended in 2004 by a task force comprised of representatives from the American Bar Association ("ABA") Section of Taxation, the ABA Section of Real Property, Probate and Trust Law, the American College of Tax Counsel, the American College of Trust and Estate Counsel ("ACTEC"), the American Bankers Association and the American Institute of Certified Public Accountants.[16] Although it appeared in several congressional bills subsequent to that time, portability was not available by law until 2011 with the enactment of TRA 2010. The provisions allowing portability were set to expire on December 31, 2012 under TRA 2010, so very few clients and practitioners actively relied on portability after its initial introduction. However, portability was permanently extended under ATRA 2012, and has created a fundamental shift in basic husband-and-wife estate planning for many clients.

B. Portability Is Allowed for Spouses Only.

Portability applies to the surviving spouse of a married couple.[17] A few definitions are important in determining the players involved.

"Last Deceased Spouse." The last deceased spouse means "the most recently deceased individual who, at that individual's death after December 31, 2010, was married to the surviving spouse."[18] Even if the surviving spouse (W) remarries after the death of her deceased spouse (H1), as long as W predeceases her new spouse (H2), H1 is considered to be W's last deceased spouse.[19] The identification of the last deceased spouse is not affected by the amount of any unused exemption amount or portability elections.[20] It is simply based on the facts existing at the time with respect to the relationships of the parties.

"Other Deceased Spouse." Although the "other deceased spouse" is not a defined term in the temporary regulations, that term is used to refer to a spouse who is not the last deceased spouse, but whose deceased spousal unused exclusion ("DSUE") amount was previously used by his or her surviving spouse for gifting purposes. A special rule applies in the case of multiple deceased spouses and such previously-applied DSUE amounts.[21] See the discussion of DSUE amount below.

"Non-US Citizens." Portability has limited availability to non-US citizens, depending on residency and citizenship. For a detailed explanation of the availability of the portability election to non-US citizens and non-US residents (both decedents and their surviving spouses), see Lora G. Davis, "Portability – Boom or Bust for Your Bailiwick?" which was presented at the State Bar of Texas Intermediate Estate Planning and Probate Course, June 25, 2013.

C. Calculating the DSUE Amount.

Several defined terms are used to describe the amount of the deceased spouse's exemption amount that is eligible for portability.

1. Related Defined Terms:

a. "*Basic Exclusion Amount*."

The basic exclusion amount is $5 million beginning in 2011, and is subject to inflation adjustment

---

[16] 58 Tax Law. 93, 200 (Fall 2004).

[17] Under the Defense of Marriage Act (Pub. L. 104-199, 110 Stat. 2419, enacted September 21, 1996, 1 U.S.C. § 7 and 28 U.S.C. § 1738C) ("DOMA"), marriage is defined as the legal union of one man and one woman for federal and interstate purposes. Thus portability, prior to the Supreme Court's ruling in Windsor v. United States, 570 U.S. ____ (2013), which was issued on June 26, 2013, only applied to married spouses of the opposite sex. However, with the Windsor ruling holding that the portion of DOMA containing the above-described definition of "marriage" is unconstitutional, the IRS has stated that portability may be allowed for same sex spouses (if they were married in a state whose laws authorize the marriage of same sex individuals). The IRS issued guidance to this effect in Revenue Ruling 2013-17.

[18] Reg. § 20.2010-1T(d)(5).

[19] Reg. §§ 20.2010-3T(a)(3); 20.2505-2T(a)(3).

[20] Reg. §§ 20.2010-3T(a)(2); 20.2505-2T(a)(2).

[21] Reg. §§ 20.2010-3T(b)(1)(ii); 20.2505-2T(c)(1)(ii).

thereafter.[22] The basic exclusion amount for 2012 was $5.12 million, for 2013 was $5.25 million, and for 2014 is $5.34 million.

b. "*Applicable Exclusion Amount*."

The applicable exclusion amount is the sum of the basic exclusion amount and the deceased spousal unused exclusion amount (the DSUE amount).[23]

c. "*Applicable Credit Amount*."

The applicable credit amount is the amount of tax that would be determined under section 2001(c) for estate or gift tax purposes on the applicable exclusion amount.[24] This amount is subject to reduction for certain pre-1977 gifts. The applicable exclusion amount is reduced by twenty percent of the total specific exemption amount that was allowed under section 2521 for gifts made after September 8, 1976 and before January 1, 1977.[25]

2. DSUE Amount.

"Deceased Spousal Unused Exclusion (DSUE) Amount."

a. *The Code*.

Section 2010(c)(4) of the code defines the DSUE amount as:

> "DECEASED SPOUSAL UNUSED EXCLUSION AMOUNT.—For purposes of this subsection, with respect to a surviving spouse of a deceased spouse dying after December 31, 2010, the term 'deceased spousal unused exclusion amount' means the lesser of—
>
> (A) the basic exclusion amount, or
>
> (B) the excess of—
>
> (i) the applicable exclusion amount of the last such deceased spouse of such surviving spouse, over
>
> (ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse."[26]

b. *The Regulations*.

The temporary regulations also clarify that the basic exclusion amount referred to in Section 2010(c)(4)(A) means the amount in effect in the year of the decedent's death (as opposed to the year in which it is used).[27] The regulations provide that the DSUE Amount is to be calculated as follows:

> *"(c) Computation of the DSUE amount.*
>
> *(1) General rule.* Subject to paragraphs (c)(2) through (c)(4) of this section *{relating to special rules for gift taxes paid by decedent and special rules for Qualified Domestic Trusts}*, the DSUE amount of a decedent with a surviving spouse is the lesser of the following amounts—
>
> (i) The basic exclusion amount in effect in the year of the death of the decedent; or
>
> (ii) The excess of—
>
> (A) The decedent's applicable exclusion amount; over
>
> (B) The sum of the amount of the taxable estate and the amount of the adjusted taxable gifts of the decedent, which together is the amount on which the tentative tax on the decedent's estate is determined under section 2001(b)(1)."

The Regulations on portability are quite taxpayer friendly and describe the computation of the DSUE amount more clearly than the Code.

Prior to the publication of the temporary regulations and the legislative fix under ATRA 2012, there was a lot of controversy over how the DSUE amount was calculated.[28] The confusion arose from the reference

[22] § 2010(c)(3); Reg. § 20.2010-1T(d)(3).
[23] § 2010(c)(2); Reg. § 20.2010-1T(d)(2).
[24] § 2010(c)(1); Reg. § 20.2010-1T(d)(1).
[25] Reg. § 20.2010-1T(b).

[26] § 2010(c)(4).
[27] Reg. § 20.2010-2T(c)(1)(i).
[28] For a brief summary of the issues, see T.D. 9593 at p. 20. For a more detailed discussion, see the American Bar Association's paper "Portability – Part One," prepared by the Estate and Gift Tax Committee of the ABA Tax Section (in coordination with other committees from the Real Property Trust and Estate Law Section), found at http://www.americanbar.org/content/dam/aba/events/real_p

in the statute to the "basic exclusion amount" in section 2010(c)(4)(B)(i) instead of to the "applicable exclusion amount." There is quite a bit of discussion about this in the temporary regulations. Example 1 in temporary Regulation Section 20.2010-2T(c)(5) shows how to calculate the DSUE amount based on the Treasury's interpretation of the statute prior to the correction made under ATRA 2012.[29]

3. Prior Taxable Gifts.

For purposes of computing the DSUE amount, the regulations provide that a special rule applies if the decedent made taxable gifts on which he or she paid gift tax. The amount of the adjusted taxable gifts of the deceased spouse is reduced by the amount of gifts on which tax was paid when calculating the DSUE amount. This is an appropriate adjustment from a fairness standpoint. However, the statute does not provide for this adjustment. It appears that the Treasury and the Secretary are making this interpretation based on authority under Sections 2010(c)(6) and 7805. See Example 2 in temporary Regulation Section 20.2010-2T(c)(5) for an example of how to calculate the DSUE amount where gift tax was previously paid by the deceased spouse.

4. Effect of Tax Credits.

The temporary regulations do not address the order in which available credits are applied in computing the DSUE amount. At this point, it is unclear if the DSUE amount is calculated before or after the application of credits arising for taxes on prior transfers under Section 2013, foreign death taxes under Section 2014 and death taxes on remainders under Section 2015. ACTEC's comments in response to Notice 2011-82 briefly address this issue, requesting that the DSUE amount be calculated after taking into account any credits, so that the surviving spouse will receive the full benefit of the deceased spouse's unused exclusion amount.[30] This issue is still under consideration by the Treasury and the IRS and they have requested comments on this topic to assist in their analysis.[31] It is likely that guidance will eventually be published to address this issue. The temporary regulations reserve a section for this guidance.[32]

5. Example of the DSUE Amount Calculation.

The regulation provides the following basic example of how the DSUE amount is to be calculated.

"*(5) Examples.* The following examples illustrate the application of this paragraph (c):

Example (1). Computation of DSUE amount. (i) Facts. In 2002, having made no prior taxable gift, Husband (H) makes a taxable gift valued at $1,000,000 and reports the gift on a timely-filed gift tax return. Because the amount of the gift is equal to the applicable exclusion amount for that year ($1,000,000), $345,800 is allowed as a credit against the tax, reducing the gift tax liability to zero. H dies on September 29, 2011, survived by Wife (W). H and W are US citizens and neither has any prior marriage. H's taxable estate is $1,000,000. The executor of H's estate timely files H's estate tax return and elects portability, thereby allowing W to benefit from H's DSUE amount.

(ii) Application. The executor of H's estate computes H's DSUE amount to be $3,000,000 (the lesser of the $5,000,000 basic exclusion amount in 2011, or the excess of H's $5,000,000 applicable exclusion amount over the sum of the $1,000,000 taxable estate and the $1,000,000 amount of adjusted taxable gifts). "[33]

D. Making the Portability Election.

1. In General.

In order to take advantage of portability, an election must be made on behalf of the decedent's estate. That election must be made on a decedent's timely-filed United States Estate (and Generation-Skipping Transfer) Tax Return (Form 706).[34] The temporary regulations make it clear that even though an estate tax return would not otherwise be required, if a portability election is desired, then the estate will be considered to be required to file a return under Section 6018(a).[35] The return will be considered timely filed if it is filed within nine months after the decedent's

roperty_trust_estate/heckerling/2012/heckerling_report_2012_portability_part_one.authcheckdam.pdf.

[29] Reg. § 20.2010-2T(c)

[30] *See* ACTEC letter to the IRS (Oct. 28, 2011), p. 17, which may be found at http://www.actec.org/Documents/misc/Radford_Comments_Notice_2011-82.pdf.

[31] T.D. 9593 at p. 21.

[32] Reg. § 20.2010-2T(c)(3).

[33] Reg. § 20.2010-2T(c)(5) Example (1).

[34] § 2010(c)(5)(A); Reg. § 20.2010-2T(a)(1).

[35] Reg. § 20.2010-2T(a)(1).

death or within the amount of time provided in any extensions obtained from the IRS.[36]

To date, there are limited provisions available for making a late filed election. However, where an estate is filing an estate tax return only to make a portability election (i.e., the estate falls below the dollar threshold for having to file an estate tax return), Treasury Regulation § 301.9100-3 provides the rules for granting an extension of time to elect portability.[37] In general, under Reg. § 301.9100-3, relief will be granted if the taxpayer establishes to IRS's satisfaction that the taxpayer acted reasonably and in good faith and that the grant of relief will not prejudice the interests of the government.[38] To date, IRS has issued several letter rulings under Reg. § 301.9100-3 granting an extension of time to elect portability in situations in which the decedent's estate was not required to file an estate tax return.[39]

In Revenue Procedure 2014-18, the IRS has provided a procedure under which estates of decedents that died before January 1, 2014, that fall below the dollar threshold for having to file an estate tax return, and that want to elect to make the estate tax portability exclusion, can get an automatic extension of time to make that election. A taxpayer who meets the requirements listed below will be deemed to meet the requirements for relief under Regulation § 301.9100-3, and relief is granted to extend the time to elect portability such that for purposes of electing portability, the taxpayer's Form 706 will be considered to have been timely filed. In order to qualify for the automatic extension under Revenue Procedure 2014-18, the following requirements must be met:

(1) The taxpayer is the executor of the estate of a decedent who: (a) has a surviving spouse; (b) died after December 31, 2010, and on or before December 31, 2013; and (c) was a citizen or resident of the United States on the date of death.

(2) The taxpayer is not required to file an estate tax return under Code Sec. 6018(a) (as determined based on the value of the gross estate and adjusted taxable gifts, without regard to Reg. § 20.2010-2T(a)(1));

(3) The taxpayer did not file an estate tax return within the time prescribed by Reg. § 20.2010-2T(a)(1) for filing an estate tax return required to elect portability;

(4) A person permitted to make the election on behalf of a decedent, pursuant to Reg. § 20.2010-2T(a)(6), must file a complete and properly-prepared Form 706 (i.e., meeting the requirements of Reg. §20.2010-2T(a)(7)) on or before December 31, 2014; and

(5) The person filing the Form 706 on behalf of the decedent's estate must state at the top of the Form 706 that the return is "FILED PURSUANT TO REV. PROC. 2014-18 TO ELECT PORTABILITY UNDER § 2010(c)(5)(A)."

These new procedures do not apply to taxpayers that timely filed an estate tax return for the purpose of electing portability. Such a taxpayer either will have elected portability of the DSUE amount by timely filing that estate tax return or will have affirmatively opted out of portability in accordance with Regulation § 20.2010-2T(a)(3)(i). Taxpayers that are not eligible for relief under Revenue Procedure 2014-18 may request an extension of time to make the portability election by requesting a letter ruling under the provisions of Regulation § 301.9100-3. If, subsequent to the grant of relief pursuant to Revenue Procedure 2014-18, it is determined that, based on the value of the gross estate and taking into account any taxable gifts, the taxpayer was required to file an estate tax return, the grant of an extension under such revenue procedure becomes void.

Until January 1, 2015, for estates meeting requirements (1)-(3) of Revenue Procedure 2014-18 above, the procedure described at (4) and (5) above must be used to obtain an extension of time to make a portability election in lieu of requesting a letter ruling under the provisions of Regulation § 301.9100-3. However, if an executor has filed a request for a letter ruling seeking an extension of time under Regulation § 301.9100-3 to make a portability election, that letter ruling is pending in the national office on January 27, 2014, and the decedent's estate meets requirements (1)-(3) above, the executor may rely on Revenue Procedure 2014-18, withdraw the letter ruling request, and receive a refund of its user fee. However, the IRS will process letter ruling requests pending on January 27, 2014, unless, before the earlier of March 10, 2014

[36] *Id*.
[37] Rev. Proc. 2014-18.
[38] *Id*.
[39] *Id*.

or the issuance of the letter ruling, the executor notifies IRS that it will rely on Revenue Procedure 2014-18 and withdraw its letter ruling request.

2. Who Makes the Election.

Only the executor is able to make an election to take advantage of or opt out of portability.[40] Under the new regulations, an executor is defined as an administrator or executor "that is appointed, qualified, and acting within the United States, within the meaning of section 2203…."[41] In addition, if there is no such appointed executor or administrator, the regulations provide that "any person in actual or constructive possession of any property of the decedent (a non-appointed executor) may file the estate tax return on behalf of the estate of the decedent"[42] to elect portability or to elect not to have portability apply. These regulations mirror the provisions of Section 2203.

3. Election is Irrevocable.

Once made, the election is irrevocable.[43] If the executor makes an election on a return filed before the due date, and then files a subsequent return that indicates no election is made, as long as the subsequently filed return is timely it will supersede the previously filed return.[44] However, as discussed above, there may be several people who are eligible to make the election in the case of an estate with no appointed executor. In the case of multiple "non-appointed" executors, whose election takes effect? It appears that it is the election that is made first. The temporary regulations provide that "[a] portability election made by a non-appointed executor cannot be superseded by a contrary election made by another non-appointed executor of that same decedent's estate (unless such other non-appointed executor is the successor of the non-appointed executor who made the election)."[45] Challenges may arise for a non-appointed executor who wishes to make this election. If a non-appointed executor desires to make a portability election, he or she will need to gather sufficient information about the entire estate in order to file a complete return. However, if a non-appointed executor desires to opt out of making a portability election, it is not entirely clear that the return must be a complete and properly prepared return. The temporary regulations provide that an election will not be made if the executor either "…states affirmatively on a timely-filed estate tax return…that the estate is not electing portability…"[46] or fails to timely file an estate tax return.[47] Note that the words "complete and properly-prepared" are omitted from this section of the regulations. It could be argued that any return filed by a non-appointed executor to opt out of portability is sufficient for that purpose, even though it would not be considered sufficient to make the election.

4. Election Made on a Complete Return.

The "complete and properly-prepared" requirement for the estate tax return is described in the temporary regulations.[48] As a general rule, the return will be deemed complete and properly-prepared if it is prepared in accordance with Form 706 instructions and the regulations under Section 6018.[49] However, some relaxed reporting requirements are provided under the temporary regulations if the return is not otherwise required to be filed, but is being filed to elect portability.[50] In these cases, there are special rules for valuing property that qualifies for the estate tax marital or charitable deduction. In most cases, the executor will only need to report the following information with respect to marital and charitable bequests, devises and transfers:

- Description, ownership and/or beneficiary of the qualifying property;
- Information necessary to establish that the property qualifies for the marital or charitable deduction; and
- An estimate of the total estate, including the qualifying property.[51]

The executor must include a best estimate of this property, rounded to the nearest $250,000.[52] The

[40] § 2010(c)(5).
[41] Reg. § 20.2010-2T(a)(6)(i).
[42] Reg. § 20.2010-2T(a)(6)(ii).
[43] § 2010(c)(5)(A); Reg. § 20.2010-2T(a)(4).
[44] Reg. § 20.2010-2T(a)(4).
[45] *Id*.
[46] Reg. § 20.2010-2T(a)(3)(i).
[47] Reg. § 20.2010-2T(a)(3)(ii).
[48] Reg. § 20.2010-2T(a)(7).
[49] *Id*.; Reg. §§ 20.6018-2 (relating to persons required to file a return), 20.6018-3 (relating to required contents of the return), 20.6018-4 (relating to documents to accompany a filed return).
[50] Reg. § 20.2010-2T(a)(7)(ii).
[51] *Id*.
[52] Reg. § 20.2010-2T(a)(7)(ii)(B).

regulations remind the executor that this estimation is a part of the return that is signed under penalties of perjury.[53] The Form 706 provides that where this provision applies, the values for these estimated items are reported on a new line that is included in the recapitulation instead of being included on schedules A through I of the return, although a description of the property (without values) is still reported on the schedules. The examples in the temporary regulations are helpful in understanding the application of this special rule.[54]

It appears that for many traditional estate plans including a bypass trust, this relief may not apply since the relaxed reporting rules do not apply to marital or charitable deduction property if one of the following applies:

- The value of the property relates to the value of property passing to another beneficiary of the estate;
- The value of the property is needed to determine the estate's eligibility for special treatment such as alternate valuation, special use valuation or estate tax deferral;[55]
- <u>Only a portion of the property includable in the estate qualifies for the marital or charitable deduction;</u> or
- A partial qualifying terminable interest property election or a partial disclaimer is made with respect to the property. [56]

In fact, the Regulations include an example of a division of property between a marital trust and a bypass trust on a *percentage* basis, and conclude that since "the amount passing to the non-marital trust cannot be verified without knowledge of the full value of the property passing under the Will…therefore the value of the property of the marital trust relates to or affects the value passing to the trust for W and descendants of H and W…accordingly, the general return requirements apply to all of the property includable in the gross estate and the provisions of paragraph (a)(7)(ii) of this section [*the relaxed reporting requirements*] do not apply".[57]

5. <u>Computation of DSUE Amount Required on Return</u>.

The temporary regulations require a computation of the DSUE amount to be made by the executor on the filed estate tax return.[58] Prior to the issuance of the new Form 706 in 2012, a complete and properly prepared estate tax return was deemed to be sufficient for this purpose.[59] The temporary regulations confirmed that this method of election was acceptable prior to the issuance of the new Form 706.[60] The regulations also clarify that executors who filed returns before the new form was available are not required to file a supplemental estate tax return using the revised form.[61] The new Form 706 simplifies this calculation by providing the new Part 6, Portability of Deceased Spousal Unused Exclusion (DSUE).

6. <u>Opting Out</u>.

Most of the emphasis in the temporary regulations has to do with an affirmative election to take advantage of portability. However, the regulations also clarify how to avoid or proactively avoid the election. The simplest way to avoid a portability election is not to file an estate tax return, provided that a return is not otherwise required to be filed.[62] If a return must be filed for other reasons, the executor must state affirmatively on the return or on a statement attached to the return that the estate is not electing portability under Section 2010(c)(5).[63] Form 706 for 2012 and 2013 both provide a check box for the executor to elect out of portability.

7. <u>The Statute of Limitations and the DSUE Amount</u>.

As provided in Section 2010(c)(5)(B), the IRS can examine the deceased spouse's estate tax return at any time – *even after the expiration of the statute of limitations with respect to the return itself* – in order to determine the proper DSUE amount to which the surviving spouse is entitled for his or her own use. Any materials that may be relevant to the calculation

[53] *Id*.
[54] *See* Reg. § 20.2010-2T(a)(7)(ii)(C).
[55] It's not clear how estate tax deferral would ever be a factor in an estate electing portability.
[56] Reg. § 20.2010-2T(a)(7)(ii)(C).
[57] Reg. §20.2010-2T(a)(7)(ii)(C), Example 3.
[58] Reg. § 20.2010-2T(b)(1).
[59] I.R.S. Notice 2011-82, 2011-42 I.R.B. 516, 517.
[60] Reg. § 20.2010-2T(b)(2).
[61] *Id*.
[62] Reg. § 20.2010-2T(a)(3)(ii).
[63] Reg. § 20.2010-2T(a)(3)(i).

of the DSUE amount, including the estate tax returns of each deceased spouse, can be examined by the IRS for these purposes.[64] However, any adjustments from such examination can only result in additional estate tax in cases in which the statute of limitations for such assessment has not yet expired.[65] The IRS has indicated that an examination of an estate tax return will not be suspended merely because of a possible future review in connection with a portability election.[66] The IRS is currently issuing closing letters in estates in which a portability election has been made. These closing letters do not include any reference to the extended period of time allowed to review the return with respect to the portability election. These letters are also being issued fairly quickly—sometimes within three to four months after the estate tax return is filed. The IRS is selecting estate tax returns that elect portability for audit as well, which may come as a surprise to some practitioners.

When the surviving spouse later dies, if he or she has a gross estate (increased by adjusted taxable gifts and the specific exemption amount) that is more than the basic exclusion amount, then the surviving spouse will have to file an estate tax return. This is true even if no tax will be due because of the use of the deceased spouse's DSUE amount. This will give the IRS the opportunity to review the valuations on the deceased spouse's estate tax return for purposes of challenging the DSUE amount calculated.

Attention should be given to this issue, particularly if there are previous spouses or blended families with respect to the estate. Those in control of the information with respect to the estate may not always be aligned or in communication with the surviving spouse. The surviving spouse will want to ensure that he or she has all of the relevant returns and documentation to support the DSUE amount from each predeceased spouse. Note that the temporary regulations provide that it is the surviving spouse's responsibility to substantiate the DSUE amount claimed on his or her return.[67]

[64] T.D. 9593 at p. 22; Reg. § 20.2010-2T(d).
[65] T.D. 9593 at p. 23; § 6501.
[66] T.D. 9593 at p. 23.
[67] Reg. § 20.2010-3T(c)(1)(iii).

E. Navigating the Regulations.

Temporary regulations,[68] which are also serving as proposed regulations, have been issued. These regulations address both the estate tax and the gift tax issues relating to portability. The regulations under Section 2010 are arranged so that Regulation Section 20.2010-1T provides definitions and applicable dates. Regulation Section 20.2010-2T addresses the portability issues as they apply to decedent's estates. Regulation Section 20.2010-3T discusses portability provisions that are applicable to the surviving spouse's estate. Regulation Section 25.2505-1T describes the general rule, special rules and applicable dates. Regulation Section 25.2505-2T explains the use of the DSUE amount by the surviving spouse for gift tax purposes.

F. Mechanics of How the DSUE Amount is Utilized if Portability is Elected.

The temporary regulations provide a very generous approach to the use of the DSUE amount by the surviving spouse. Although the surviving spouse is entitled only to the DSUE amount of the last deceased spouse, special rules apply in cases of multiple deceased spouses and previously used DSUE amounts.

The first piece of good news is that generally the deceased spouse's DSUE amount is considered "available for use" by the surviving spouse as of the date of the deceased spouse's death, presuming a valid portability election is made on the decedent's estate tax return.[69] This clarification makes planning much simpler for the most part, as the surviving spouse can rely on the availability of the DSUE amount of a deceased spouse to offset any taxable gifts before having to use his or her own exemption amount without having to wait until an estate tax return is filed for the deceased spouse. Special rules apply when property passes to the surviving spouse in a QDOT.

The second bit of good news is that the deceased spouse's DSUE amount is applied to gifts of the

[68] T.D. 9593, 2012-28 I.R.B. 54. Note that these temporary regulations are effective on June 15, 2012 and are set to expire on or before June 1, 2015. The temporary regulations also serve as the text for the proposed regulations. Prop. Treas. Reg. §§ 20.2001-2; 20.2010-0 to -3; 25.2505-0 to -2, 77 Fed. Reg. 36229 (June 18, 2012).
[69] T.D. 9593 at p. 21; Reg. § 20.2010-3T(c)(1); Reg. § 25.2505-2T(d)(1).

surviving spouse before his or her own remaining exemption is used.[70]

The remaining good news is that a surviving spouse can take advantage of the DSUE amounts of multiple predeceased spouses during the surviving spouse's lifetime.[71] Thus, to the extent a surviving spouse can use the full amount of each predeceased spouse's DSUE amount before the next spouse's death, he or she can make gifts far in excess of the exemption amount. The surviving spouse must use these exemptions through lifetime gifting.

Upon the surviving spouse's death, he or she is limited only to the last deceased spouse's DSUE amount.[72] The Regulations provide the following comprehensive example of the application of these rules.

"(b) Special rule in case of multiple deceased spouses and previously-applied DSUE amount.

(1) *In general*. A special rule applies to compute the DSUE amount included in the applicable exclusion amount of a surviving spouse who previously has applied the DSUE amount of one or more deceased spouses to taxable gifts in accordance with § 25.2505-2T(b) and (c) of this chapter. If a surviving spouse has applied the DSUE amount of one or more last deceased spouses to the surviving spouse's transfers during life, and if any of those last deceased spouses is different from the surviving spouse's last deceased spouse as defined in §20.2010-1T(d)(5) at the time of the surviving spouse's death, then the DSUE amount to be included in determining the applicable exclusion amount of the surviving spouse at the time of the surviving spouse's death is the sum of—

(i) The DSUE amount of the surviving spouse's last deceased spouse as described in paragraph (a)(1) of this section; and

(ii) The DSUE amount of each other deceased spouse of the surviving spouse, to the extent that such amount was applied to one or more taxable gifts of the surviving spouse.

(2) *Example*. The following example, in which all described individuals are US citizens, illustrates the application of this paragraph (b):

Example. (i) Facts. Husband 1 (H1) dies on January 15, 2011, survived by Wife (W). Neither has made any taxable gifts during H1's lifetime. H1's executor elects portability of H1's DSUE amount. The DSUE amount of H1 as computed on the estate tax return filed on behalf of H1's estate is $5,000,000. On December 31, 2011, W makes taxable gifts to her children valued at $2,000,000. W reports the gifts on a timely-filed gift tax return. W is considered to have applied $2,000,000 of H1's DSUE amount to the amount of taxable gifts, in accordance with §25.2505-2T(c), and, therefore, W owes no gift tax. W has an applicable exclusion amount remaining in the amount of $8,000,000 ($3,000,000 of H1's remaining DSUE amount plus W's own $5,000,000 basic exclusion amount). After the death of H1, W marries Husband 2 (H2). H2 dies in June 2012. H2's executor elects portability of H2's DSUE amount, which is properly computed on H2's estate tax return to be $2,000,000. W dies in October 2012.

(ii) Application. The DSUE amount to be included in determining the applicable exclusion amount available to W's estate is $4,000,000, determined by adding the $2,000,000 DSUE amount of H2 and the $2,000,000 DSUE amount of H1 that was applied by W to W's 2011 taxable gifts. Thus, W's applicable exclusion amount is $9,000,000."[73]

G. Pros and Cons of Relying on Portability in Estate Planning for Married Couples.

Many practitioners believe that portability is a good safety net for those who have not done any estate planning, but relying on portability is not something they would recommend to their clients. However, portability has really opened up the landscape of estate planning options for couples at all wealth levels. Below are some of the pros and cons of relying on portability versus the use of traditional bypass or credit shelter trust planning.[74]

1. Pros:

The main benefit of portability is its relative simplicity.

[70] Reg. § 25.2505-2T(b).
[71] Reg. § 25.2505-2T(c).
[72] Reg. § 20.2010-3T(c).
[73] Reg. § 20.2010-3T(b).
[74] For a thorough comparison of various forms of spousal estate planning, including Portability, Clayton QTIPs and the implications of Revenue Procedure 2001-38 on "unnecessary" marital deductions, see Blattmachr, Bramwell and Zeydel, *Portability or No: The Death of the Credit-Shelter Trust?*, The Journal of Taxation Volume 118, Number 05, May 2013.

a. Married couples who are not interested in spending money on comprehensive estate plans that include bypass trust planning may opt to rely on portability to shelter their combined estate from estate tax. In many cases, the average couple can title their probate assets as joint tenants with rights of survivorship. This may avoid the need for probate on the first spouse's death. Although the estate tax return filing requirement may create some additional complexity, the relaxed reporting requirements of the temporary regulations mitigate this burden to a certain degree.

b. For married couples with one or more large qualified retirement accounts, relying on portability may be particularly desirable. Although a bypass trust that is drafted as a see-through trust can be named as the beneficiary of a retirement account without accelerating the income tax on the account, including the required provisions necessary to meet this requirement is not consistent with the traditional purposes of the bypass trust.[75]

c. Married couples with disparate wealth may prefer to rely on portability rather than on lifetime equalization planning between the spouses. If one spouse's estate is nontaxable and the other spouse's estate exceeds the taxable limits, bypass trust planning is not effective for the "poorer" spouse. If the non-wealthy spouse dies first, his or her estate tax exemption will be lost without portability, even with bypass trust planning because he or she simply does not have enough money to fund the bypass trust.

d. If the marital assets consist of low basis assets, portability may be a better option than traditional bypass planning in order to take advantage of the step-up in basis in non-IRD assets at both deaths. With the increase in income tax rates on capital gains and the relatively low estate tax rate, this is a good alternative in the right circumstances. As an alternative to relying on portability in these circumstances, some practitioners favor the use of the "all to QTIP trust" or the "one lung trust", which is described in more detail in the article cited in footnote 77 and which involves the current uncertainty about the application of Revenue Procedure 2001-38 (describing situations in which a QTIP election will be treated as a nullity in certain circumstances).[76]

2. Cons:

The most commonly discussed drawbacks of portability include the following.

a. Assets of the deceased spouse that pass outright to the surviving spouse are subject to creditors of surviving spouse, whereas if those same assets are transferred to a bypass trust they are more likely to be protected from creditors.

b. Appreciation received from the deceased spouse's estate will be included in the surviving spouse's estate. If proper bypass trust planning is implemented on the death of the first spouse, all of the appreciation from the assets transferred to the bypass trust that are not distributed to the surviving spouse during his or her lifetime should not be subject to estate tax at the subsequent death of the surviving spouse.

c. There is a possibility that the deceased spouse's exemption amount could be lost entirely if the surviving spouse later remarries a new spouse and the new spouse predeceases the surviving spouse after using his or her entire exemption amount.

d. Portability does not extend to the generation-skipping transfer ("GST") tax. Any amount of the GST tax exemption amount that was not used during the deceased spouse's life or through other planning at his or her death will be lost.

e. Portability has not been adopted at the state level. Use of bypass planning may help mitigate state estate taxes that would be imposed on the presumably larger estate of the second spouse to die.

f. Traditional bypass trust planning can allow some income shifting to descendants by making distributions of trust income to descendants in lower tax brackets, resulting in the trust income being paid at the beneficiary's rate.

[75] For an excellent summary and discussion of the issues relating to naming trusts as beneficiaries of qualified retirement plans, see Karen S. Gerstner, "Current Issues Related to Estate Planning with Qualified Retirement Plans and IRAs," which was presented at the State Bar Advanced Estate Planning And Probate Course, June 28, 2012. It can be found at http://www.texasbarcle.com/Materials/Events/9220/144091.pdf.

[76] For a detailed discussion of this planning technique and the potential issues, see Jason Roy Flaherty, "Marital Deduction Planning for 2013", which was presented at the Texas State Bar Estate Planning and Probate Drafting Course in 2013.

g. A Form 706 must be filed to make the election, which creates some risk of the plan not working as intended if the return is not filed. If the return is filed, there will likely be costs and delays associated with the return preparation.

IV. BASIC ESTATE PLANNING OPTIONS FOR MARRIED COUPLES UNDER CURRENT LAW.

Though portability is generally a simple concept for clients to understand, there may be reasons for certain clients to choose a traditional bypass trust or disclaimer to bypass trust plan over portability. Some commentators have noted that "although touted as a simplification, portability will make planning more complex for many clients because it is yet another option that requires analysis to determine whether relying on it, or at least preparing an estate plan that makes relying on it possible, is beneficial."[77]

For couples with significant estates, the limitations on the portability of the GST Exemption will often result in a continuance of the standard bypass and marital trust plan at the first death. This would probably apply to couples with combined estates in excess of $5 million. However, for couples with assets in the 0-$5 million range, there are three common planning structures that may be well suited at the first death and which are described in more detail below. Also included with this article as Exhibit A is a table summarizing the pros and cons of these three techniques into a one-page grid, which the author has found most helpful in providing to clients who are struggling to decide which plan is the best fit for their family. Please note that this article does not address the “all to QTIP” or “One Lung” marital deduction planning as we have yet to receive guidance on the impact of Revenue Procedure 2001-38. See footnotes 77 and 79 for a more detailed discussion of these issues.

A. <u>Outright to Spouse Planning</u>.

This is the most straight forward from a drafting and administration standpoint, and the pros and cons of this plan are described above in the "Pros and Cons of Relying on Portability" section.

B. <u>Traditional Bypass Trust Planning</u>.

1. <u>Primary Purposes of Testamentary Trusts</u>.

Before the introduction of portability, a central purpose of testamentary trusts was maximizing a spouse's use of his available tax-free amount for his or her respective estate, since the unused tax-free amount available to a spouse was lost, if not used, upon his death. Under those circumstances, the unlimited marital deduction prevented taxation at the first death, but the combined estates of a married couple were exempt only up to the survivor's available tax-free amount.

With the advent of portability, there is no longer the same "use it or lose it" circumstance in the case of a spouse's tax-free amount. The availability of portability, however, does not address all of the other purposes for which testamentary trusts may be useful. Some of the important goals that testamentary trusts serve include the following:

- protect trust assets from creditors, divorce/remarriage, and lawsuits;
- ensure assets are directed to descendants or desired beneficiaries;
- protect growth on assets held in trust from estate tax; and
- use generation-skipping transfer (GST) tax exemption.

2. <u>Description of Plan</u>.

Rather than give all assets outright to W, H can give up to his tax-free amount ($5.34 million (in 2014)) of his estate to a Bypass Trust and the balance to W outright. The gift to the Bypass Trust uses H's tax-free amount, so these assets are not taxed at H's death. The outright gift to W eliminates the tax in H's estate due to the unlimited marital deduction.

Upon W's death the Family Trust assets pass to the children or other selected beneficiaries without being taxed as part of W's estate since they are not owned by W. W's tax-free amount is $5.34 million (using 2014 rates - not taking into account future inflation adjustments), and the excess over her tax-free amount will be taxed at 40%.

Typically this plan would include GST Trust planning for a child, so that upon a child's death, the child's

[77] Blattmachr, Bramwell and Zeydel, *Portability or No: The Death of the Credit-Shelter Trust?*

trust passes to trusts for that child's descendants. The continued transfer of assets to descendants in trust can have significant benefits in conjunction with the use of GST exemption. When GST exemption is allocated to all or part of the transfers to a trust, the portion of the trust that is GST exempt may continue to grow and avoid estate tax in future generations. When a parent's GST exemption is insufficient for all assets passing to a child's trust, the child's trust is typically severed into separate trusts which are designated as "Exempt" (which may continue to grow fully exempt from estate and GST tax) and "Non-Exempt" (which is subject to tax in the child's and future descendants' estates).

3. Typical Bypass Trust Provisions.

The provisions of the typical Bypass Trust are often simple and straightforward.

a. *Distributions*.

Distributions are permitted for the health, support and maintenance of the surviving spouse.

(1) This meets the "ascertainable standard" test, which prevents the trust assets from being included in the surviving spouse's estate.

(2) Words such as "comfort" and "welfare" must be avoided if the surviving spouse is to be a trustee.

(3) Unlike a marital deduction trust that must pay all income to the surviving spouse, it is generally preferable to not to require automatic distribution of income to the spouse. Instead, distributions should be discretionary in order to maintain flexibility for income tax planning.

(4) Usually, distributions to descendants are permitted.

(5) Income tax savings can perhaps be achieved by distributions to descendants who are in lower tax brackets than the surviving spouse.

(6) The surviving spouse can be given a veto power over distributions to descendants, giving the surviving spouse control over the distribution of the trust assets at the first spouse's death.

b. *Powers of Appointment*.

The surviving spouse is sometimes given a "special" power of appointment to direct disposition of trust assets by Will or during lifetime.

(1) This device permits the spouse to take a "second look" at family needs in deciding how assets should be distributed.

(2) In order to avoid giving the surviving spouse a "general" power of appointment (which would cause inclusion in the spouse's estate), language should be included expressly prohibiting appointment to the "surviving spouse, his or her estate, his or her creditors or the creditors of his or her estate".

(3) However, some clients choose not to give powers of appointment because they do not want the original distribution scheme altered.

c. *Trustees*.

There are no special restrictions affecting trustee appointments.

(1) Many clients avoid trust planning because of a mistaken belief that non-family trustees are required and that the related fees will be costly.

(2) The surviving spouse may be (and often is) the sole trustee.

(3) Management assistance may be built into the Will, either through other individuals and/or a corporate trustee. Where outside trustees are included, the spouse can be given broad powers to remove and appoint trustees.

d. *Inflation Savings*.

The impact of inflation could make the estate tax savings much more dramatic.

4. Pros and Cons of Traditional Bypass Trust Planning:

a. *Pros*:

- Creditor and divorce protection applies to all trust assets during survivor's lifetime
- Assets in trust can be earmarked for descendants
- All growth is excluded from survivor's taxable estate (no cap)

- Maximizes GST Exemption usage (GST Exemptions are not "portable")

- Trustee selection can provide management and distribution assistance to surviving spouse

b. *Cons*:

- Survivor's estate receives a basis adjustment at second death, but trust assets do not receive a basis adjustment at second death

- Trusts reach the highest income tax bracket at approximately $12,000 of income (though the tax rates can be managed with distributions to the surviving spouse and/or descendants)

- Trust structure creates some accountability to remainder beneficiaries (descendants – can be managed by giving the surviving spouse a power of appointment over trust assets and a veto power over distributions to descendants)

- Annual 1041s would be required for the trust

C. <u>Disclaimer Trust Planning</u>.

Prior to the enactment of ATRA 2012, many married couples preferred to leave their estates to the surviving spouse, outright and free of trust at the first death, but there was some uncertainty about the tax effects of such a plan with the future of portability and the Estate Tax Exemptions unclear. In this situation, a disclaimer plan was very popular as it allowed the surviving spouse to take a "second look" at the death of the first spouse by incorporating a "disclaimer" trust in the couple's Wills. In disclaimer planning, a deceased spouse's Will generally gives all his estate outright to the surviving spouse; however, the surviving spouse may elect to refuse to accept the assets ("disclaim"), which will then pass to a trust as provided in the deceased spouse's Will. While this plan was desirable when the future of the transfer tax structure was unclear, it continues to be desirable for clients who want to build in flexibility for other changes that may occur in their assets or family situation between the execution of their Wills and the time of the first spouse's death.

1. <u>Description of Plan</u>.

As noted above, the traditional disclaimer plan would provide for all assets to pass outright to the surviving spouse at the first death; however, the surviving spouse may elect to disclaim some or all of those assets, which will then pass to a Bypass Trust created by the deceased spouse's Will. To effectively disclaim, the surviving spouse must do so within 9 months of the date of the deceased spouse's death by a written memorandum of disclaimer. The memorandum of disclaimer must be received by the representative of the transferor (i.e, the executor) and be filed with the probate court in which the deceased spouse's Will has been probated. The disclaimed property must pass without any direction by the surviving spouse, and the surviving spouse must not have accepted the property or any of its benefits prior to disclaiming.

When a person makes a qualified disclaimer of an interest in property, the interest is treated for transfer tax purposes as if it had never been transferred to the disclaimant. *Absent a contrary provision in the Will*, a disclaimer will cause the property to pass as though the disclaimant (the surviving spouse) had predeceased the deceased spouse, and the assets will pass to the contingent beneficiaries (generally, the children). In order to have assets pass to a trust, the Will must specifically provide that disclaimed property will pass to a Disclaimer Trust. Typically the disclaimer plan is structured so that the disclaimed assets in the trust are not subject to estate tax in the surviving spouse's estate.

2. <u>Partial Disclaimer</u>.

The surviving spouse may disclaim an undivided portion or a specific amount or asset. There is no dollar limit on the value of disclaimed property; however, a spouse will normally limit the disclaimer to an amount equal to or less than the deceased spouse's tax-free amount. If the deceased spouse's estate is greater than the tax-free amount, the excess that is not disclaimed (and that passes to the surviving spouse outright) will generally qualify for the unlimited marital deduction.

a. Property that is not disclaimed and that passes to the surviving spouse outright will obtain a step-up in basis upon the surviving spouse's death. The option to disclaim assets (and what amount or which assets) allows the surviving spouse the opportunity to consider whether a step-up in basis at his death is more advantageous than the use of the deceased spouse's tax-free amount and the deceased spouse's GST exemption.

3. Disclaimer Trust Provisions.

The provisions of the typical Disclaimer Trust are similar to the Bypass Trust described above, but the terms may not grant the surviving spouse a power of appointment over the disclaimed assets.

a. *Spouse May Serve as Trustee*.

The surviving spouse may serve as trustee of the Disclaimer Trust if there is an ascertainable distribution standard, so the disclaimer does not cause the surviving spouse to lose the ability to manage the disclaimed assets.

b. *Power of Appointment Not Permitted.*

Unlike a Family Trust, a Disclaimer Trust may not grant the surviving spouse a power of appointment over the disclaimed assets. A power of appointment allows a spouse the power to direct how the property passes.

c. *Disclaiming Spouse Permitted as Beneficiary.*

The surviving spouse is permitted to be a beneficiary of the Disclaimer Trust, thereby preserving the disclaimed assets for the surviving spouse's support and protecting such assets from creditors or remarriage. Similar to the Bypass Trust described above, a Disclaimer Trust is typically structured so that distributions are required for the surviving spouse's support, and are permitted to descendants. However, if the surviving spouse is the trustee, the distributions to the spouse must be limited to the "ascertainable standard".

d. *Termination.*

Upon the surviving spouse's death, the Disclaimer Trust terminates and passes in the manner set forth in the deceased spouse's Will.

4. Pros and Cons of Disclaimer Planning.

a. *Pros*:

- Flexibility – get second look before deciding whether to disclaim
- Not stuck with bypass trust you may not need
- Option to not disclaim, and take basis step-up for all property at second death

b. *Cons*:

- No powers of appointment over disclaimed assets
- More complicated to administer, especially if disclaiming an IRA
- Limited time (nine months) to disclaim
- Reliance on survivor to disclaim

V. INCOME TAX CHANGES AFFECTING TRUSTS AND ESTATES

A. New Rates.

ATRA 2012 added a new top income tax rate of 39.6% beginning at $450,000 for married couples filing jointly, or $400,000 for singles. I.R.C. § 1. In addition, the brackets widened slightly. The brackets for married couples filing jointly are shown here to illustrate the changes:

Married Filing Jointly

2012 Rates

10%	$0 - $17,400
15%	$17,401 - $70,700
25%	$70,701 - $142,700
28%	$142,701 - $217,450
33%	$217,451 - $388,350
35%	Over $388,350

2013 Rates

10%	$0 - $17,850
15%	$17,851 - $72,500
25%	$72,501 - $146,400
28%	$146,401 - $223,050
33%	$223,051 - $398,350
35%	$398,351 - $450,000
39.6%	Over $450,000

2014 Rates

10%	$0 - $18,150
15%	$18,151 - $73,800
25%	$73,801 - $148,850

28%	$148,851 - $226,850
33%	$226,851 - $405,100
35%	$405,101 - $457,600
39.6%	Over $457,600

The personal exemptions and deductions also increased slightly. In 2012, the amounts were $3,800 personal and dependent exemption, $11,900 deduction for married filing jointly, and $5,950 deduction for singles. In 2013, the amounts increased to $3,900 personal and dependent exemption, $12,200 deduction for married filing jointly, and $6,100 deduction for singles. In 2014, the amounts increased to $3,950 personal and dependent exemption, $12,400 deduction for married filing jointly, and $6,200 deduction for singles.

The same income tax rates apply to trusts, though the brackets are very compressed, so that the top income tax rate applies beginning at income of $11,950 in 2013 and $12,150 in 2014.

In addition, the maximum capital gains tax rate increased from 15% to 20%, with the 20% rate generally being applicable to taxpayers in the 39.6% ordinary income bracket.

B. <u>3.8% Medicare Surtax</u>.

In addition to the new 39.6% top income tax bracket, the Health Care and Education Reconciliation Act of 2010 introduced a Medicare tax of 3.8% on individuals, trusts and estates for taxable years beginning after December 31, 2012.[78] Regarding estates and trusts, the tax is imposed on the lesser of 1) "undistributed net investment income" (abbreviated below "UNII"), or 2) adjusted gross income of the estate or trust less the amount at which the highest income tax bracket begins ($11,950 in 2013 and $12,150 in 2014). In shorthand, for 2013, you would calculate the tax as 3.8% times the <u>lesser</u> of:

UNII v. (AGI - $11,950)

This results in a tax rate of 43.4% on trust or estate income exceeding $11,950. The Medicare tax takes effect for taxable years beginning after December 31, 2012. One planning strategy for 2012 decedents is to use a fiscal year that begins in late 2012, in order to defer the initial application of the Medicare tax to the fiscal year beginning late in 2013, for which income tax returns are not due until April 2014.[79]

Net investment income is income from a trade or business that is a "passive activity," or from trading in financial instruments or commodities. I.R.C. §§ 469(c)(1), 475(e)(2). In order to avoid having income from a passive activity, the taxpayer would need to "materially participate" in the business by being involved in the operations on a "regular, continuous and substantial" basis. I.R.C. § 469(h)(1). While it is not yet clear how the material participation requirement will play out in the Trustee context, in recent letter rulings, the IRS has required that the trustee itself, acting as a fiduciary, must materially participate in the business, rather than the trustee's agents or employees. IRS Letter Rulings (TAMs) 201317010 (April 26, 2013); 201029014 (July 23, 2010); and 200733023 (Aug. 17, 2007).

What is "undistributed net investment income" for purposes of calculating the Medicare surtax? First, "net investment income" comprises three categories of income: 1) gross income from interest, dividends, annuities, royalties, and rents (excluding income derived in the ordinary course of a trade/business); 2) other gross income from a passive activity or business of trading in financial instruments or commodities; and 3) net gain from the disposition of property held by a trade or business. IRC § 1411(c)(1).

The statute does not define "undistributed" net investment income, but the proposed regulations contain rules similar to those regarding the carry-out of distributable net income ("DNI").[80] The proposed regulations provide that, if a trust has both net investment income and other income, distributions will carry out both types of income pro rata to the beneficiaries.[81]

78 Pub. L. 111-152; §1411.

79 For additional planning ideas, see Theodore (Ted) B. Atlass, Mickey R. Davis, *Planning and Administering Estates and Trusts: Income Tax Consequences You Need to Consider*, THE AMERICAN LAW INSTITUTE, Telephone Seminar, May 9, 2013.

80 Prop. Treas. Reg. § 1.1411-3(e). For additional discussion, see Melissa J. Willms, *Living with the "New" Estate Tax*, Houston Bar Association, Probate, Trusts and Estates Section, January 29, 2013, p. 12.

81 Prop. Treas. Reg. § 1.1411-3(e).

VI. ADDITIONAL PROPOSALS FOR TRANSFER TAX LEGISLATION

Although the TRA 2010/ATRA 2012 transfer tax scheme is viewed as "permanent," President Obama's 2014 revenue proposals (released April 10, 2013[82]) contain some potential changes, which are generally consistent with the administration's previous budget proposals. The budget proposals are referred to as the "Greenbook."

A. Restore the Estate, Gift, and Generation-Skipping Transfer Tax Parameters in Effect in 2009

The administration proposes returning to the 2009 transfer tax "parameters," which were a 45% tax rate, a $3,500,000 estate tax exemption and a $1,000,000 gift tax exemption, not indexed for inflation. The Greenbook states these changes would take effect in 2018. It also proposes that portability be retained, which would be difficult with the different estate and gift tax exemption amounts from 2009. It seems unlikely that Congress would want to make any of these changes since it recently reached a deal on these issues as codified in TRA 2012.

B. Require Consistency in Value for Transfer and Income Tax Purposes

Currently, there is no requirement that the tax basis for an asset as reported by an executor on the Estate Tax Return (IRS Form 706) be the same as the basis reported by the recipient of the asset for income tax purposes. It is possible for the beneficiary to report a higher tax basis (with appropriate appraisals, etc.) in order to minimize capital gains. This proposal would require the same basis to be reported in both instances. The proposal provides that regulations may create a reporting requirement in instances where a gift or estate tax return is not required, and may extend it to personal representatives, donors, and even surviving joint tenants.

C. Require a Minimum Term for Grantor Retained Annuity Trusts

A grantor retained annuity trust ("GRAT") is a vehicle that is used to make gifts to beneficiaries while reducing gift tax. GRATs are governed by I.R.C. § 2702. The GRAT lasts for a term of years, during which the grantor receives an annuity payment from the trust. The gift is valued at the beginning of the term and the value is reduced by the value of the annuity interest retained by the grantor, thereby reducing or sometimes eliminating gift tax on the gift. At the end of the term, the trust assets are distributed to the beneficiaries, including appreciation in the assets. Any appreciation in excess of the IRS-assumed rate of return (the Section 7520 rate) is transferred to the beneficiaries free of gift tax. If the GRAT assets do not outperform the 7520 rate (which is unlikely in the current low interest rate environment), the assets are simply returned to the grantor at the end of the GRAT term. The catch is that if the donor dies before the end of the GRAT term, the assets are included in his or her estate, and the tax benefit is lost. *See* I.R.C. § 2036. Of course, the shorted the GRAT term, the less likely the grantor is to die during the term. Currently, GRATs with a term as short as two years have been upheld by the tax court. *Walton v. Commissioner*, 115 T.C. 589 (2000). The Administration seeks to reign in the use of GRATs by exposing the donors to more downside risk. GRATs are required to last only two years. The Administration proposes to require a minimum GRAT term of at least ten years, and a maximum term of the life expectancy of the annuitant plus ten years. In addition, decreases in the annuity during the GRAT term may be prohibited, and GRATS may be required to have a remainder interest that is greater than zero at the time the interest is created.

D. Limit Duration of Generation-Skipping Transfer (GST) Tax Exemption

Currently, the duration of GST trusts is limited by the rule against perpetuities in the situs state. Recently, some states have extended or eliminated the rule against perpetuities. In response, the Administration has proposed a 90-year rule across the board, by which the GST exemption of a trust would terminate on the 90th anniversary of the first contribution made to the trust after the law takes effect (whether its a new or pre-existing trust). After the law takes effect, it would operate by changing the GST inclusion ratio of a new trust to one on the 90th anniversary of the trust's initial funding.

E. Coordinate Certain Income and Transfer Tax Rules Applicable to Grantor Trusts

Under current law, a taxpayer may transfer assets to a "grantor trust." The assets and any later appreciation are removed from the grantor's estate. The grantor

[82] U.S. Treasury Department, *General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals*, released April 10, 2013.

remains responsible for paying the income taxes on the trust property, which reduces his gross estate. No gift tax applies to this payment of income tax on behalf of the trust.

The Administration proposes to coordinate the income tax rules and the transfer tax rules for grantor trusts, meaning that either the trust belongs to the grantor and must be included in his gross estate, or it does not belong to the grantor and all contributions to it will be treated and taxed as gifts. Also, if an owner of the trust engages in a sale or exchange transaction with the trust, the portion of trust property involved in the transaction would be subject to transfer tax. In other words, the trust assets would be subject to estate tax in the grantor's estate upon his or her death, would be subject to gift tax if the ownership interest is terminated during the owner's life, and any distributions during the owner's life would be subject to gift tax. The proposal provides that regulations may create exceptions to the new provision.

F. Extend the Lien on Estate Tax Deferrals Provided Under Section 6166 of the Internal Revenue Code

In instances where a closely held business comprises a large portion of an estate, the beneficiaries may have difficulty paying the estate tax all at once. Therefore, when a closely held business engaged in manufacturing, mercantile or service functions makes up more than 35% of the adjusted gross estate, Section 6166 permits the beneficiaries to pay the estate tax in up to fourteen annual installments, with interest-only payments for the first four years. This schedule means it could be about fifteen years before the estate tax is paid in full. However, under current law, the tax lien only lasts ten years from the date of death. The Administration proposes to extend the duration of the tax lien to match the period during which payments may be made under 6166.

G. Clarify Generation-Skipping Transfer (GST) Tax Treatment of Health and Education Exclusion Trusts (HEETs)

Section 2611(b)(1) excepts trust distributions directly for a beneficiary's school tuition or medical care or insurance from qualifying as generation-skipping transfers. If a gift to a trust is not a direct skip at the time of funding, no GST Exemption is required to be allocated, and as long as all skip person distributions qualify as direct payments of qualified medical and educations expenses, no GST tax would be applicable to such distributions in the future. Such trusts are called "health and education exclusion trusts," or HEETs. The Administration proposes to remove the exception for trusts, so that only payments made by individuals can escape GST tax. This proposal may be a reaction to the technique of including a charity as a permissible beneficiary of a HEET, which is an attempt to stretch the HEET over multiple generations, escaping the GST tax that would otherwise come due upon the taxable termination of the trust once all beneficiaries who are non-skip persons have died.

VII. PRIORITY GUIDANCE PLAN

The Treasury and the IRS released their annual Priority Guidance Plan for 2013-2014 on November 20, 2013, listing eleven items slated to be addressed regarding gifts, estates and trusts. Most noticeably, Treasury plans to issue guidance on the Revenue Procedure 2001-38 issue discussed herein (the impact of QTIP elections made on a 706 which are unnecessary to reduce estate taxes). The complete list of gift and estate tax items from the Plan is attached as Exhibit B.

VIII. ETHICAL CONSIDERATIONS

[The following material is an excerpt from "Joint Representation is a Revolving Door – Avoid the Crush" by Michael V. Bourland, David P. Dunning and Jeffrey N. Meyers, 21st Annual Entertainment Law Institute, October 20-21, 2011, Austin, TX, Chapter 6.3, pages 6-11, and16-18, which has been reproduced with the permission of the authors. *The numbering from the original article has been preserved so the references will remain intact.*]

I. Introduction/Texas Disciplinary Rules of Professional Conduct

A lawyer practicing in the areas of estate planning and family business planning must be knowledgeable in the laws of taxation, property, and trusts. However, the prudent estate and family business planning lawyer cannot stop there; in addition, he must have a thorough understanding of the rules regulating lawyer conduct.

Rules regulating lawyer conduct arise from several different sources including i) common law (i.e. tort law, fiduciary law, agency law), ii) criminal law, and iii) the rules of evidence. This presentation, however, focuses on the regulation of lawyer conduct under the Texas Disciplinary Rules of Professional Conduct

("TDRPC"). In particular, this presentation discusses certain rules ("Rules") of the TDRPC that will likely affect the estate and family business planning lawyer. This presentation neither discusses all of the Rules contained in the TDRPC, nor does it address every provision of a particular Rule. Accordingly, a lawyer should refer to the actual text of the TDRPC, including the Comments, for more comprehensive guidance. The TDRPC are found at Title 2, Subtitle G, Appendix A, Article X, Section 9 of the Government Code and became effective as of January 1, 1990.

[**Note**: Occasional references are made to counterpart rules contained in the American Bar Association Model Rules of Professional Conduct (the "ABA Model Rules"). The ABA Model Rules are the blueprint for the TDRPC; however there are some important differences between them.]

The violation of a Rule may subject a lawyer to disciplinary action. In addition, although the Preamble to the TDRPC expressly states that the violation of a Rule does not give rise to a private cause of action against a lawyer or create a presumption that a lawyer has breached a legal duty to a client, a court may look to the TDRPC for guidance in determining whether a lawyer has committed malpractice or otherwise breached a legal duty to a client.

II. Duty of Communication/Rule 1.03

Rule 1.03 imposes a duty of communication on a lawyer. The purpose of the Rule is to ensure that a client has sufficient information to make intelligent decisions regarding the representation. A lawyer's duty of communication under Rule 1.03 has three basic elements: i) to keep the client reasonably informed about the status of the representation; ii) to promptly comply with reasonable client requests for information regarding the representation; and iii) to reasonably explain the legal matter so that the client can make informed decisions regarding the representation.

1. The standard of compliance with all three duties is reasonableness; the lawyer must make a reasonable effort to communicate with the client so that the client may be able to actively participate in the representation and make informed decisions. The question of whether a lawyer has acted reasonably is ordinarily a question of fact. ROBERT P. SCHUWERK & JOHN F. SUTTON, JR., A GUIDE TO THE TEXAS DISCIPLINARY RULES OF PROFESSIONAL CONDUCT 54 (1990).

2. A lawyer should keep in mind four basic principles underlying the communication requirements of Rule 1.03. SCHUWERK at 57-59.

    a. The communication must be truthful.

    b. Explanations given by the lawyer should be in terms that the client can understand. Further, Comment 5 encourages lawyers to make a reasonable attempt to communicate directly with clients who are minors or mentally disabled, in addition to consulting with the client's representative.

    c. The lawyer must give comprehensive advice concerning all possible options - including the potential risks associated with each option.

    d. In the litigation context, the lawyer's duty to communicate does not end with a judgment, but also includes informing a client about appeal matters, including the client's right to appeal and the relative advantages and disadvantages of an appeal.

3. ABA Model Rule 1.4 is the ABA counterpart to Rule 1.03 of the TDRPC.

III. Duty of Confidentiality/Rule 1.05

Rule 1.05 imposes a duty of confidentiality on a lawyer. Subject to certain exceptions and limitations, this Rule generally prohibits a lawyer from knowingly disclosing or using "confidential information" of a client or former client. The purposes of the Rule are: (a) to encourage people to seek professional legal counsel for their legal problems and questions by providing assurance that communications with their legal counsel will be kept in strict confidence, and (b) to promote the free exchange of information between the client and the lawyer so that the lawyer is equipped with all of the information necessary to provide effective representation.

1. <u>Confidential information</u> is broadly defined to include: i) "<u>privileged information</u>" - client information protected by the lawyer-client privilege under Rule 503 of the Texas Rules of Evidence, Rule 503 of the Texas Rules of Criminal Evidence, and Rule 501 of the Federal Rules of Evidence and ii) "unprivileged

information" - all other client information (other than privileged information) acquired by the lawyer during the course of, or by reason of, the representation.

2. Rule 1.05 contains several exceptions whereby a lawyer may (discretionary disclosures) or even must (mandatory disclosures) disclose confidential client information. In particular, a lawyer may disclose confidential information: i) if the client (or former client) consents after consultation; ii) if the lawyer reasonably believes that disclosure is necessary to comply with the law or a court order; iii) to enforce a claim by the lawyer against the client (i.e. claim for attorney's fees for legal services rendered); iv) to establish a defense to a malpractice claim asserted by the client; and v) to prevent the client from committing a crime or fraud. Furthermore, a lawyer must disclose confidential information if such confidential information clearly establishes that a client is likely to engage in criminal/fraudulent conduct that will likely kill or inflict substantial bodily harm on another. [**NOTE:** See Rule 1.05 and the accompanying Comment for additional discretionary and mandatory disclosures]. In the event a lawyer decides to disclose confidential information adverse to the client, the lawyer should only disclose such information as is necessary to accomplish the authorized purpose of the disclosure.

3. ABA Model Rule 1.6 is the ABA counterpart to the TDRPC Rule 1.05.

IV. Duty of Loyalty

The TDRPC impose a duty of loyalty on a lawyer in that it generally prohibits a lawyer from representing conflicting interests. Rules 1.06-1.13 of the TDRPC address various situations involving conflicting interests.

A. Rule 1.06 Conflict of Interest: General Rule

Rule 1.06 is the general conflict of interest rule. It establishes three (3) basic types of conflict situations. First, a conflict exists if the lawyer undertakes to represent opposing parties to the same litigation. Second, a conflict exists if the representation of a client (or prospective client) involves a substantially related matter in which that client's (or prospective client's) interests are materially and directly adverse to the interests of another client of the lawyer. Third, a conflict exists if the representation of a client (or prospective client) reasonably appears to be or become adversely limited by the lawyer's responsibilities to another client or to a third party, or by the lawyer's own interests. A representation involving the first type of conflict described above is never permissible. However a representation involving either the second or third type of conflict described above is permissible but only if: 1) the lawyer reasonably believes that the representation of each client (or prospective client) will not be materially affected AND 2) each affected or potentially affected client (or prospective client) consents to such representation after full disclosure of the existence, nature, implications, and possible adverse consequences of the common representation and the advantages involved.

1. Comment 15 to Rule 1.06 contemplates conflicts occurring in estate planning and estate administration:

   > "Conflict questions may also arise in estate planning and estate administration. A lawyer may be called upon to prepare wills for several family members, such as husband and wife, and, depending upon the circumstances, a conflict of interest may arise. In estate administration it may be unclear whether the client is the fiduciary or is the estate or trust, including its beneficiaries. The lawyer should make clear the relationship to the parties involved."

2. Comment 13 recognizes that conflicts of interest in the non-litigation context (i.e. estate planning and family business planning) may be difficult to assess. Relevant factors to consider include: a) the length and intimacy of the lawyer-client relationships involved, b) the functions being performed by the lawyer, c) the likelihood that a conflict will actually arise, and d) the probable harm to the client or clients involved if the conflict actually arises. The question is often one of proximity and degree.

3. Comment 6 states that the representation of one client is "directly adverse" to the representation of another client if the lawyer's independent judgment on behalf of a client or the lawyer's ability or willingness to consider, recommend or carry out a course of action will be or is reasonably likely to be adversely affected by the

lawyer's representation of, or responsibilities to, the other client. The dual representation also is directly adverse if the lawyer reasonably appears to be called upon to espouse adverse positions in the same matter or a related matter. On the other hand, simultaneous representation in unrelated matters of clients whose interests are only generally adverse, such as competing economic enterprises, does not constitute the representation of directly adverse interests. However, common sense may deem such dual representation inadvisable depending upon the extent of competition between the clients.

4. Although not required by Rule 1.06, a prudent lawyer will make sure that a conflict disclosure and a client's consent to the representation are set forth in writing and signed by each of the clients (or prospective clients). *See Rule 1.06/Comment 8.*

5. A conflict that prevents a lawyer from representing a person also prevents every other lawyer at the firm from doing so.

6. ABA Model Rule 1.7 is the ABA counterpart to Rule 1.06 of the TDRPC. Also, ABA Model Rule 1.8 sets forth certain specific rules relating to current client conflicts, and ABA Model Rule 1.18 addresses a lawyer's duties to prospective clients, including avoiding conflicts with prospective clients.

B. Rule 1.07 Conflict of Interest: Intermediary

1. Generally

Rule 1.07 governs a situation in which the lawyer acts as an intermediary by jointly representing multiple clients in the same matter. The intermediary form of representation (or joint representation) is possible where the joint clients have common goals and interests that outweigh potential conflicting interests. The role of the lawyer is to develop these common goals and interests on a mutually advantageous basis—with the end result being that everybody "wins". Examples of this type of joint representation include: assisting multiple persons in the formation of a jointly owned business enterprise, or performing estate planning for a husband and wife.

2. Role of the Lawyer-Intermediary

In acting as an intermediary, the lawyer assumes a special role. Rather than acting in partisan manner, advocating for the interests of one person only, the role of the lawyer-intermediary is to promote the interests of all of the joint clients—with the goal of achieving a resolution that benefits everyone. At the beginning of the intermediation (joint representation), each client should be advised of the lawyer's special role in the intermediation.

3. Intermediation (Joint Representation) Requirements

A lawyer may not undertake an intermediary representation/joint representation unless all of the following conditions are satisfied:

(1) the lawyer consults with each client concerning the implications of the joint representation, including the advantages and risks involved, and the effect on the attorney-client privileges;

(2) the lawyer obtains each client's written consent to the joint representation; and

(3) the lawyer reasonably believes that:

(a) the matter can be resolved without the necessity of contested litigation on terms compatible with the clients' best interests,

(b) each client will be able to make adequately informed decisions in the matter,

(c) there is little risk of material prejudice to the interests of any of the clients if the contemplated resolution is unsuccessful, and

(d) the joint representation can be undertaken impartially and without improper effect on other responsibilities the lawyer has to any of the clients. *Rule 1.07(a).*

4. Evaluating the Propriety of Intermediation (Joint Representation)

In evaluating whether a particular legal matter is appropriate for a joint representation, a lawyer should remember the following: A lawyer may never represent opposing parties to the same litigation. *Rule 1.06(a).* In addition, a lawyer cannot undertake a joint representation if contested litigation between the parties is reasonably expected or if contentious negotiations are contemplated. *See Rule 1.07/Comment 4.* If definite antagonism already exists between parties, the lawyer should strongly consider declining joint representation because the possibility that the parties' interests can be adjusted by the joint representation is not very good. *See Rule 1.07/Comment 4*. Finally, as discussed below in more detail, the lawyer needs to consider the impact the joint representation will have on confidentiality of information and the attorney client privilege. *See Rule 1.07/Comment 5*. If the lawyer concludes that Rule 1.07 prohibits him from acting as an intermediary in a legal matter, then all of the lawyers in the same firm would also be disqualified. *Rule 1.07(e)*.

5. Confidentiality/Attorney-Client Privilege

In a joint representation, there are no secrets. All information obtained by the lawyer from whatever source (third parties, one of the clients, the lawyer's own investigations, etc.) that would help the clients make informed decisions regarding the common legal matter should be disclosed to each of the clients. Moreover, in the event litigation subsequently arises between the clients concerning the common legal matter, the attorney-client privilege will likely not protect any of the communications between the lawyer and any of the clients concerning such legal matter. Before undertaking the joint representation, each of the clients should be advised of the effect that the joint representation will have concerning confidentiality and the attorney-privilege.

6. Ongoing Consultation

In carrying-out the joint representation, the lawyer must regularly consult with each of the clients regarding the decisions to be made and the considerations relevant in making them so that each client can make adequately informed decisions. *Rule 1.07(b).* However, because the lawyer is not advocating for a particular client, each of the clients will have to assume a more active role in the decision making process.

7. Termination of Intermediation (Joint Representation)

A lawyer must withdraw as an intermediary if any of the clients requests or if any of the requirements for serving as an intermediary cease to exist. The withdrawal must be a complete withdrawal, meaning that the lawyer cannot represent any of the clients in the legal matter subject to the joint representation. *Rule 1.07(c).* Furthermore, arguably the lawyer's continued representation of some of the clients would be improper even with the consent of all of the clients involved in the joint representation. The break-down of the joint representation can be disastrous for everyone (i.e. the lawyer and the clients) because the situation has probably deteriorated to the point where each of the clients will need to obtain separate legal counsel and the lawyer who served as the intermediary may face complaints from one or more of the joint clients.

***

9. ABA Model Rule 1.7 is the ABA counterpart to Rule 1.07 of the TDRPC.

***

V. Family Representation Matters and Attorney-Client Privilege

The TDRPC apply to all types of representations (i.e. litigation work, transactional work, etc.). However, the Rules are more easily applied in some types of representations than others. Estate and family business planning is one area where a practitioner is likely to struggle with the TDRPC. The notion of a "family lawyer" permeates the fields of estate and family business planning. Often, the "family lawyer" is called upon to represent multiple family members with varying plans, goals and interests. The multiplicity of individuals and goals inherent in family representation gives rise to ethical problems and legal problems in two main areas—confidentiality and conflicting interests.

For many practitioners, the most common type of family representation is the representation of a husband and wife for estate planning. In the context of estate planning for a husband and wife, three basic models of representation have been proposed by commentators and practitioners for addressing confidentiality and conflicting interests concerns -- 1) joint representation (i.e. the open relationship), 2) separate representation (i.e. the closed relationship), and 3) independent representation.

In a joint representation or open relationship, the same lawyer represents the husband and wife jointly. The husband, wife, and lawyer work together as a team to implement a coordinated estate plan. There are no secrets in a joint representation, and any information and communications relevant to the joint representation disclosed to the lawyer by one spouse should be disclosed by the lawyer to the other spouse. Furthermore, in the event litigation subsequently arises between the husband and wife involving such estate planning matters, the attorney-client evidentiary privilege would not apply. See Rule 503(d) of the Texas Rules of Evidence for exceptions to the attorney-client privilege including fraud, claimants through the same deceased client, documents attested to by the lawyer, and joint clients. (**NOTE:** The attorney-client evidentiary privilege would continue to apply, however, to litigation between the husband/wife, on the one hand, and outside third parties on the other hand). A joint representation may discourage both the husband and wife from fully confiding in the lawyer because they know that anything disclosed that is relevant to the joint representation may be disclosed to the other spouse. Nevertheless, the joint representation model is probably the most common form of representation of husband and wife for estate planning purposes.

Like the joint representation model, in a separate representation or closed relationship, the same lawyer represents both the husband and the wife in the estate planning process. However, in a separate representation, the husband and wife are each regarded as separate and distinct clients of the lawyer. Because the lawyer regards the husband and wife as separate clients, the lawyer must not disclose the confidences of one spouse to the other spouse. This puts the lawyer at risk of being caught in the unenviable position of learning information from one spouse that would be important to the other spouse in formulating his or her estate plan. However, the lawyer would not be permitted to disclose such information to the other spouse because of the duty of confidentiality owing to the disclosing spouse and consequently the attorney-client privilege should apply to such information. It is important to note that there is disagreement among commentators about the propriety of the separate representation model. The practitioner should carefully review applicable rules and regulations before undertaking such representation.

In an independent representation, the husband and wife are each represented by different legal counsel. This form of representation ensures that each spouse has his or her own counsel "looking-out" solely for the interests of that spouse. It further protects the confidentiality and attorney-client privilege of communications between a spouse and his or her lawyer. From the lawyer's perspective, independent representation is the safest form of representation in terms of avoiding conflict and confidentiality issues. A major drawback of this form of representation, however, is that it is more costly and less efficient than the other forms of representation in which only one lawyer is retained.

It is very important that the lawyer discuss each of the forms of representation described above with the husband and wife at the very beginning, along with the advantages and disadvantages of each form, and let the husband and wife select the form of representation that will best suit their needs. In the event the husband and wife select either the joint representation (i.e. open relationship) or separate representation (i.e. closed relationship), the lawyer should obtain their agreement to such representation in writing.

[End of excerpt from "Joint Representation is a Revolving Door – Avoid the Crush."]

Exhibit A

	Outright to Spouse at First Death	Bypass Trust for Spouse at First Death	Disclaimer Option at First Death
Pros:	• Simple • All assets receive a basis adjustment at second death • Income on all assets will be taxed at surviving spouse's personal income tax rates (vs. potentially higher trust rates)	• Creditor and divorce protection applies to all trust assets during survivor's lifetime • Assets in trust can be earmarked for descendants • All growth is excluded from survivor's taxable estate (no cap) • Maximizes GST Exemption usage (GST Exemptions are not "portable") • Trustee selection can provide management and distribution assistance to surviving spouse	• Flexibility – get second look before deciding whether to disclaim • Not stuck with bypass trust you may not need • Option to not disclaim, and take basis step-up for all property at second death
Cons:	• Exemption amount of first spouse is fixed/capped at first death and does not adjust for inflation • All assets (including appreciation thereon) of first spouse will be includable in survivor's estate for estate tax purposes • Generation-Skipping Transfer Tax exemption ("GST Exemption") is not portable, so the GST Exemption of the first spouse to die is lost • No creditor or remarriage protection for the surviving spouse applicable to deceased spouse's assets • No earmarking of assets for descendants (survivor could leave all assets to any person/charity of his or her choosing) • Portability has some limitations (remarriage after first death *can* cause a reduction in exemptions available at second death) • Required estate tax return (Form 706) to take advantage of Portability	• Survivor's estate receives a basis adjustment at second death, but trust assets do not receive a basis adjustment at second death • Trusts reach the highest income tax bracket at approximately $12,000 of income (though the tax rates can be managed with distributions to the surviving spouse and/or descendants) • Trust structure creates some accountability to remainder beneficiaries (descendants – can be managed by giving the surviving spouse a power of appointment over trust assets and a veto power over distributions to descendants) • Annual 1041s would be required for the trust	• No powers of appointment over disclaimed assets • More complicated to administer, especially if disclaiming an IRA • Limited time (nine months) to disclaim • Reliance on survivor to disclaim

Exhibit B

Gifts and Estates and Trusts: Items from Priority Guidance Plan

GIFTS AND ESTATES AND TRUSTS

1. Final regulations under §67 regarding miscellaneous itemized deductions of a trust or estate. Proposed regulations were published on September 7, 2011.
2. Guidance concerning adjustments to sample charitable remainder trust forms under §664.
3. Guidance concerning private trust companies under §§671, 2036, 2038, 2041, 2042, 2511, and 2601.
4. Regulations under §1014 regarding uniform basis of charitable remainder trusts.
5. Revenue Procedure under §2010(c) regarding the validity of a QTIP election on an estate tax return filed only to elect portability.
6. Final regulations under §2032(a) regarding imposition of restrictions on estate assets during the six month alternate valuation period. Proposed regulations were published on November 18, 2011.
7. Guidance under §2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate.
8. Regulations under §2642 regarding the allocation of GST exemption to a pour-over trust at the end of an ETIP.
9. Final regulations under §2642(g) regarding extensions of time to make allocations of the generation-skipping transfer tax exemption. Proposed regulations were published on April 17, 2008.
10. Regulations under §2704 regarding restrictions on the liquidation of an interest in certain corporations and partnerships.
11. Guidance under §2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates.

For the complete text of the priority guidance plan, see http://www.irs.gov/pub/irs-utl/2013-2014_pgp_1st_quarter_update.pdf.

Gift and Estate Tax: Where Are We Now?

The State Bar of Texas Tax Section

February 28, 2014

Wesley L. Bowers
Fizer, Beck, Webster, Bentley & Scroggins, P.C.
Houston, Texas

Transfer Tax System

- Gift Tax
  - Annual Exclusion - $14,000 for 2014
  - Lifetime Exemption - $5.34M for 2014
  - 40% Rate
- Estate Tax
  - Exemption - $5.34M (less lifetime gifts) for 2014
  - 40% Rate
- Generation-Skipping Transfer (GST) Tax
  - Exemption - $5.34M for 2014
  - 40% Rate

Recent Tax Exemptions and Rates

Year	Estate Tax Exemption	Gift Tax Exemption	GST Exemption	Top Marginal Tax Rate
2009	$3,500,000	$1,000,000	$3,500,000	45%
2010	$5,000,000 OR CAN ELECT No estate tax and carry-over basis	$5,000,000	$5,000,000	35%
2011	$5,000,000	$5,000,000	$5,000,000	35%
2012	$5,120,000*	$5,120,000*	$5,120,000*	35%
2013	$5,250,000*	$5,250,000*	$5,250,000*	40%
2014	$5,340,000*	$5,340,000*	$5,340,000*	40%

* Adjusted for Inflation.

American Taxpayer Relief Act

- "Permanent" Estate, Gift, and GST Exemptions and Rates
  - $5M Indexed for Inflation at a 40% Rate
- Unified Gift and Estate Tax Regimes
- Increased Income Tax Rates
  - Continued "Step-Up In Basis"
- "Portability" is Now Permanent

Portability

- Allows Surviving Spouse to “Port”/Transfer Unused Exemption from Predeceased Spouse
- DSUE Amount (Deceased Spousal Unused Exclusion Amount)
  - Unused Exemption from Predeceased Spouse

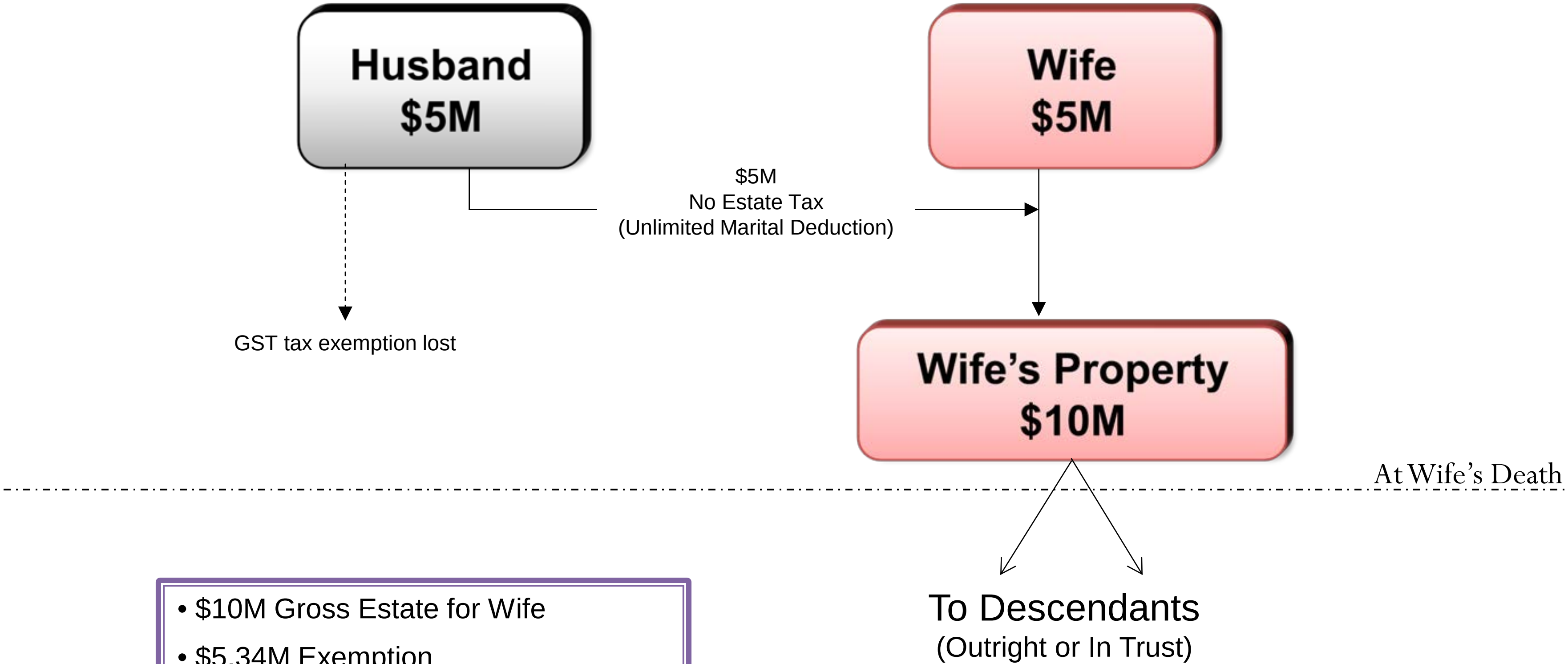
Portability Rules

- Available for Estates Beginning in 2011
- Available for "Spouses"
  - (Special Rules for Non-U.S. Citizen Spouses)
  - Last Deceased Spouse Controls at Time of Transfer
- Election Made on Timely Filed 706
  - Revenue Procedure 2014-18
- Irrevocable Election Made by Executor (or person possessing property if no Executor)

Discussions & Possible Strategies

- Community Property
- Possible Planning Options
  - Outright to Surviving Spouse
  - Portability Planning
  - Bypass/Marital Trust Planning
  - Disclaimer Planning

Outright to Surviving Spouse

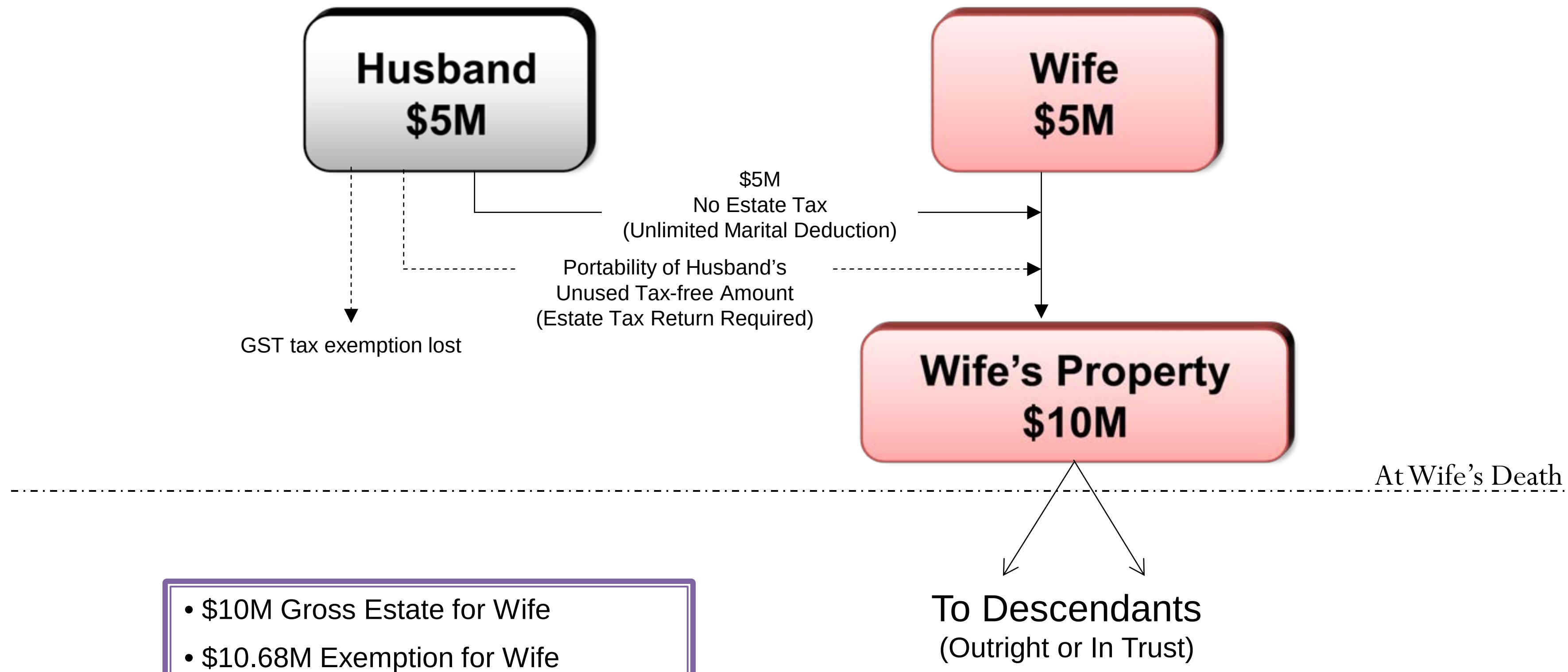


- $10M Gross Estate for Wife
- $5.34M Exemption
- Tax on $4.66M @ 40% = $1,864,000

Outright to Surviving Spouse

Advantages	Disadvantages
Simplicity	Lose Unused Estate Tax Exemption
Basis Adjustment	All Assets & Appreciation in Survivor's Estate
Income Tax at Surviving Spouse's Rate	GST Exemption is Lost
	No Creditor Protection
	No Divorce Protection
	No Management Assistance
	No Direction of Assets at Second Death

Portability Planning

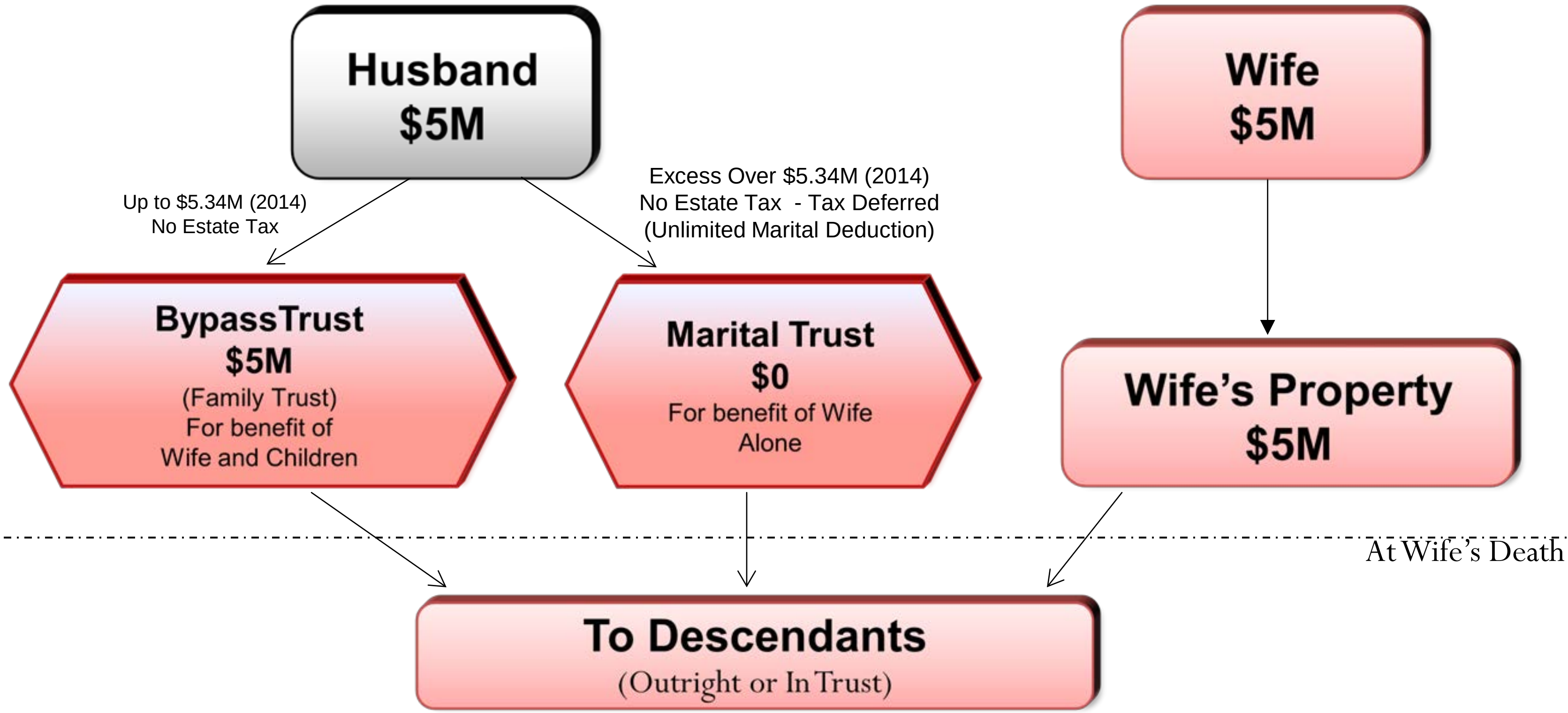


- $10M Gross Estate for Wife
- $10.68M Exemption for Wife
- No Estate Tax Owed

Portability Planning

Advantages	Disadvantages
Moderate Simplicity	Estate Tax Return Required
Capture Unused Estate Tax Exemption	Exemption Amount Capped at First Death
Basis Adjustment	All Assets & Appreciation in Survivor's Estate
Income Tax at Surviving Spouse's Rate	GST Exemption Lost
	No Creditor/Divorce Protection
	No Management Assistance
	No Direction of Assets at Second Death
	Remarriage Forfeiture of Exemption

Bypass/Marital Trust Planning

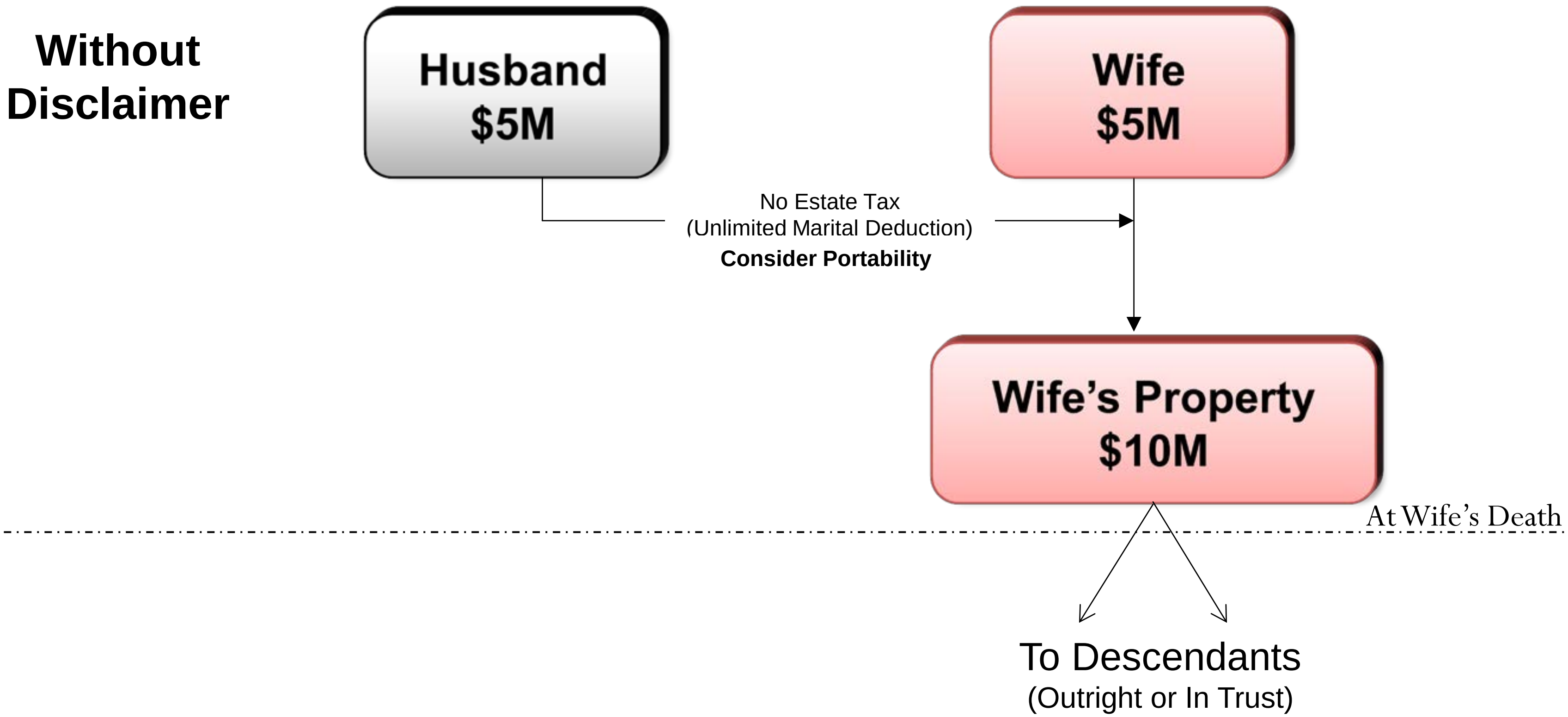


- Bypass Trust Not in Wife's Estate
- $5M Gross Estate for Wife
- $5.34M Exemption
- No Estate Tax Owed

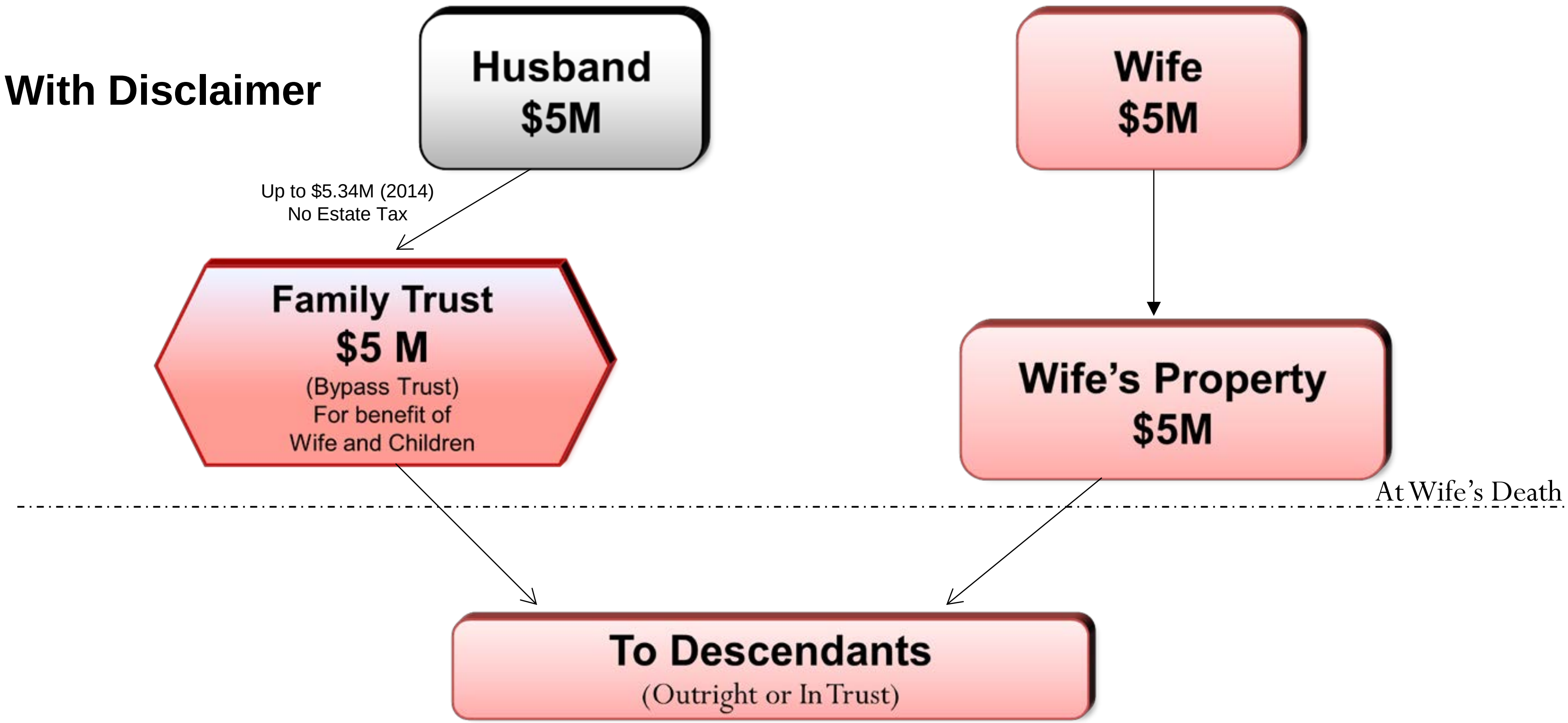
Bypass/Marital Trust Planning

Advantages	Disadvantages
Maximizes GST Exemption Usage	No Basis Adjustment at Second Death
All Growth Excluded from Survivor's Estate	Trust Income Tax Rates
Creditor Protection	Accountability to Remainder Beneficiaries
Divorce Protection	Annual Income Tax Returns for Trust
Management Assistance Available	Adds More Complexity to Plan
Can Direct Assets Upon Second Death	
Give Surviving Spouse Power of Appointment	

Disclaimer Planning



Disclaimer Planning



Disclaimer Planning

Advantages	Disadvantages
Flexibility	Limited Time to Decide
Avoid Mandatory Bypass Trust	Rely on Second Spouse to Make Election
Basis Adjustment if No Disclaimer	No Powers of Appointment Over Trust
	More Complicated to Administer

Ethical Considerations

- Joint Representation (the "Open Relationship")
- Separate Representation (the "Closed Relationship")
- Independent Representation

Income Tax in 2014

- ATRA Raised Individual Income Tax Brackets
  - MFJ: Over $457,600 – 39.6%
  - Capital Gains: 15% (20% for MFJ Over $457,600)
- Income Tax On Trusts and Estates
  - Maximum Income Tax Brackets at $12,150
- 3.8% Medicare Tax

Gift and Estate Tax: Where Are We Now?

The State Bar of Texas Tax Section
February 28, 2014

Wesley L. Bowers
Fizer, Beck, Webster, Bentley & Scroggins, P.C.
Houston, Texas

Like – Kind Exchanges with Special Focus on the Energy Industry

Todd D. Keator
Thompson & Knight LLP
1722 Routh St Ste 1500
Dallas, Texas 75201
214.969.1797
todd.keator@tklaw.com

The State Bar of Texas
Section of Taxation - Tax Law Survey in a Day
February 28, 2014
Cityplace, Dallas

Return to Table of Contents

Todd D. Keator

Partner

Thompson & Knight LLP
One Arts Plaza
1722 Routh Street, Suite 1500
Dallas, TX 75201 USA
214.969.1797
214.999.1513 (fax)
Todd.Keator@tklaw.com

Todd Keator represents clients in general tax matters including corporation, partnership, and LLC formation and operation; tax-deferred 1031 exchanges; federal and state tax planning and advice; real estate syndications (TICs, REITs, LPs and LLCs); corporate tax issues including mergers, acquisitions, divisions and financing; private equity transactions; MLP formation and acquisitions; private toll road development; oil and gas tax; and FIRPTA tax. Todd provides clients with transactional planning and advice, document preparation, and preparation of tax opinions on federal and state tax implications of business transactions.

Experience

- Represented individuals, partnerships and corporations in various transactions involving insurance products, including syndication of fractional interests in life insurance policies and transactions involving protected cell company insurers
- Represented corporations in tracking stock transactions
- Represented multiple corporate clients in private and public debt offerings
- Represented multiple corporate clients in private and public stock offerings
- Represented real estate holding partnership in refinancing and recapitalization of real estate assets and disguised sale issues
- Represented multiple clients in oil and gas acquisitions and divestitures, including preparation and negotiation of tax partnership agreements
- Represented multiple real estate sponsors in the syndication of tenancy-in-common interests in commercial and residential properties
- Represented an investment firm in the syndication of low income housing tax credits
- Drafted partnership and LLC agreements for clients in all types of industries
- Represented state department of transportation in private toll road development project
- Represented various MLPs in formation, secondary offering, and asset acquisition transactions

Related Practices

Tax
Corporate Tax
Partnership Tax
Real Estate Tax
Tenancy-in-Common (TIC) and 1031 Exchanges
Master Limited Partnerships

Education

LL.M, 2004, New York University School of Law

J.D., 2002, Louisiana State University, Paul M. Hebert Law Center; Order of the Coif; Junior Associate, *Louisiana Law Review*

B.A., Economics, 1999, *summa cum laude*, Louisiana State University

Admissions

Texas

Return to Table of Contents

Todd D. Keator

- Represented individuals and partnerships with various forward, reverse and drop & swap 1031 exchanges
- Represented sponsor in formation of private REIT
- Drafted tax opinions for various clients on a wide range of federal income tax issues

Distinctions/Honors

- Chair of Real Estate Leasing Subcommittee, Real Estate Committee, ABA Section of Taxation (2010)
- Vice Chair of the Partnerships and Real Estate Committee, Texas Tax Section (2010)
- *Texas Rising Stars*® by Thomson Reuters (Tax); 2007-2013
- Best Lawyers in Dallas (Tax: General), *D Magazine*; 2013
- Nolan Fellow, American Bar Association Section of Taxation, 2009
- Chair of Subcommittee on Important Developments, Real Estate Committee, ABA Section of Taxation (2008)

Publications

"'Hydraulically Fracturing' Section 7704(d)(1)(E) - Stimulating Novel Sources of 'Qualifying Income' for MLPs"	August 7, 2013
"Rental Real Estate and the Net Investment Income Tax"	August 2013
"Net Investment Income Tax and Its Specific Impact on Real Estate"	May 10, 2013
"Current Trends in Master Limited Partnerships (MLPs)"	March 14, 2013
REITs and the Expanding Universe of "Rents from Real Property"	Winter 2012
Client Alert: American Taxpayer Relief Act of 2012	January 03, 2013
"International Investing - Inbound and Outbound Considerations and Techniques"	November 2012
"Like-Kind Exchanges in the Energy Industry"	May 17, 2012
"Like-Kind Exchanges Involving Oil, Gas and Mineral Interests - Tax Gold"	May 12, 2012
"Tax Issues Pertaining to Real Estate"	March 13, 2012
"Private REITs"	January 19, 2012

Todd D. Keator

"'Bad Boy' Carve-Outs and Their Effect on Nonrecourse Debt"	4th Quarter 2011
"Newly-Enacted REIT Legislation Paves the Way for REIT-Friendly Guidance"	Winter 2011
"Like-Kind Exchanges in the Energy Sector"	October 27, 2011
"Hot Topics with Government Panelists"	October 21, 2011
"Partnership Workouts"	June 2-3, 2011
"Like Kind Exchanges in a Recovering Economy: Update, Planning & Possibilities"	May 26, 2011
"Workout-Driven Exchanges"	March 2, 2011
"Like-Kind Exchange Issues in a Struggling Economy"	January 2011
"Like-Kind Replacement Property in a Depressed Market"	January 2011
"The IRS Offers Lenience for Beleaguered Tenancy-in-Common Investors"	4th Quarter 2010
"Workout Drive 1031 Exchanges"	October 2010
"Section 1033 - Back to the Basics"	September 2010
"Tax Issues in Debt Workouts"	August 2010
"Like Kind Exchange Current Developments"	May 2010
"Basis in a Life Insurance Contract: The Janus Face of Revenue Ruling 2009-13"	Spring 2010
"Sale or Surrender of Life Insurance Contracts"	September 2009
"Sale or Surrender of Life Insurance Contracts"	September 26, 2009
"Meltdowns in the Section 1031 Neighborhood"	June 2009
"Like Kind Exchanges - Forward, Reverse and Current Developments"	May 2009
"1031 Exchanges - General Principles"	March 2009
"Workout-Driven Exchanges"	February 4, 2009
"Involuntary Dispositions"	January 2009
"Meltdowns in the Section 1031 Neighborhood"	2009
"Select Section 1031 Issues"	September 2008
"Tax Aspects of Tenancy-in-Common Offerings"	March 2008
"Alternative Energy TIC Investments"	September 2007

Return to Table of Contents

"Tax Opinions in TIC Offerings and Reverse TIC Exchanges"	March 2007
"1031 Transactions with Related Parties"	January 2007
Client Alert: Circular 230-Investor Explanation	October 26, 2006
"So You Want To Invest In A TIC Deal?"	October 2006
"Tax Strategies Using Like-Kind Exchanges"	December 2004
Comment, *Louisiana Law Review*	Winter 2002

News

T&K's 1401 Elm Street Deal Featured in *The Wall Street Journal* on Deal of the Week In the News	February 18, 2014
T&K Advises Olympic Property Partners and BDRC in Acquisition of 1.5 Million Square Foot Building Press Release	February 14, 2014
T&K Attorneys Mentioned in *Law360* on 1401 Elm Street Deal In the News	February 14, 2014
Sixteen T&K Attorneys Named "Best Lawyers in Dallas" by *D Magazine* Press Release	April 25, 2013
Thirty-Three T&K Attorneys Listed in *Texas Rising Stars®* 2013 Press Release	March 11, 2013
Todd Keator Quoted by *Tax Analysts* on REIT Growth In the News	November 12, 2012
Twenty-Nine T&K Attorneys Listed in *Texas Rising Stars®* 2012 Press Release	March 09, 2012
Thirty-One T&K Attorneys Listed in *Texas Rising Stars®* 2011 Press Release	March 18, 2011
T&K Names New Partners Press Release	February 21, 2011
T&K Assists Falcon in Acquisition of Permian Basin Properties Press Release	January 10, 2011
T&K Assists Sumitomo in Marcellus Shale Joint Venture	September 07, 2010

with Rex Energy
Press Release

T&K Assists Petrohawk in $825 Million Debt Offering Press Release	August 23, 2010
Arthur Wright, David Wheat, Shelly Youree, Ron Fry, Ned Price, Brandon Bloom, and Todd Keator Mentioned in *Texas Lawyer* on Eagle Rock/Black Stone Deal In the News	July 05, 2010
T&K Assists Eagle Rock in $174.5 Million Sale of Minerals Business Press Release	June 03, 2010
T&K Secures Important IRS Guidance for TIC Investors Press Release	May 18, 2010
Todd Keator Mentioned on WCAX.com on IRS Guidance for TIC Investors In the News	May 18, 2010
Forty T&K Attorneys Listed in *Texas Rising Stars*® 2010 Press Release	March 17, 2010
T&K Assists Petrohawk in $571.5 Million Public Offering Press Release	September 09, 2009
Thirty-Seven T&K Attorneys Listed in *Texas Rising Stars*® 2009 Press Release	March 19, 2009
Todd Keator Mentioned in *Texas Lawyer* on ABA Nolan Fellowship In the News	January 26, 2009
ABA Tax Section Recognizes Outstanding Young Tax Lawyers, Names Six 2009 Nolan Fellows Press Release	January 07, 2009
"Eagle Rock Energy Partners acquires Millennium Midstream Partners," *Texas Lawyer* In the News	November 03, 2008
T&K Featured on dBusinessNews.com on Eagle Rock Acquisition of Millennium Midstream In the News	October 07, 2008
T&K Assists Eagle Rock in $235.5 Million Acquisition Press Release	October 07, 2008
Twenty-eight T&K Attorneys Named "Texas Rising Stars"	March 17, 2008

Todd D. Keator

Press Release

Todd Keator Interviewed on 103.3 FM ESPN on Tax Law In the News	August 22, 2007
29 T&K Attorneys Named 2007 "Rising Stars" Press Release	March 19, 2007

Return to Table of Contents

Section 1031 Exchanges in the Oil & Gas Sector

Todd D. Keator
Todd Lowther
Nancy Allred[1]

Domestic oil and gas exploration and production is on the rise. For example, Texas is producing about 1.6 million barrels of oil per day now, which is nearly a 50% increase over production levels from 2011.[2] This past October 2013, for the first time in nearly 20 years, the U.S. extracted more oil from the ground than it imported from abroad, with crude oil production topping 7.7 million barrels per day.[3] And a recent study from Harvard forecasts that shale-oil production in the U.S. could more than triple from 1.5 million barrels per day in 2012 to 5 million barrels per day by 2017, raising total U.S. oil production to approximately 10.4 million barrels per day.[4] Add to this the prolific shale gas boom that has occurred over the last ten years, such as the Barnett, Haynesville, Marcellus, and Eagle Ford shale plays, and it becomes obvious that domestic "E&P" activity is very hot right now.

Naturally, the increase in E&P activity has been accompanied by a corresponding increase in oil and gas acquisitions and divestitures. In many cases, these transactions are structured (or intended to be structured) as tax deferred exchanges under Code Section 1031 (a "1031 Exchange").[5] Investors considering using a 1031 Exchange as a means to dispose of or acquire oil & gas properties should consider several key issues that can impact the transaction, including:

- The types of oil & gas interests that qualify for use in a 1031 Exchange, including special issues regarding pipelines;

- Whether the transaction will be respected as an "exchange" or recast as a leasing transaction (and ineligible for 1031 Exchange treatment);

- The impact of intangible drilling costs ("IDC") and depletion recapture in the exchange;

- The presence of a "tax partnership" and the need to elect out of subchapter K in order to utilize a 1031 Exchange; and

---

[1] Todd Keator is a Partner, and Todd Lowther and Nancy Allred are Associates, at the law office of Thompson & Knight LLP.

[2] *See* Leslie Haines, *Construction Cranes Per Rig*, Oil and Gas Investor at 7 (August 2013).

[3] *See* Josh Lederman, *In Key Shift, US Oil Production Tops Net Imports*, MSN Money (November 13, 2013).

[4] Leonardo Maugeri, *The Shale Oil Boom: A U.S. Phenomenon*, Harvard Kennedy School, Discussion Paper # 2013-05 (June 2013).

[5] All "Section" references are to the Internal Revenue Code of 1986, as amended (the "Code").

- The effect of oil and gas unitizations under Section 1031.

Oil and Gas Interests under in a 1031 Exchange

Introduction

As a general rule, gain from the sale or exchange of property must be recognized for federal income tax purposes.[6] The gain that must be recognized is the excess of the amount realized from the sale or exchange over the taxpayer's adjusted basis in the property sold or exchanged.[7] Section 1031(a)(1) provides an exception to the general rule for exchanges of "like-kind" properties held for productive use in a trade or business or for investment. Specifically, Section 1031(a)states, "no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment."[8]

Thus, assuming that properties to be exchanged are held for productive use in trade or business or for investment, the critical inquiry under Section 1031(a)(1), particularly in the oil and gas context, is whether the properties are of "like-kind" within the meaning of the Treasury Regulations and published guidance.

Real Property Exchanges

Treasury Regulation Section 1.1031(a)-1(b) provides that, as used in Section 1031(a)(1), the term *like-kind* refers to the nature or character of the property, not to its grade or quality.[9] One kind or class of property may not be exchanged for property of a different kind or class. For example, a taxpayer cannot exchange real property for personal property because the nature or character of the property is not of like-kind. However, real property is considered to be like-kind to all other real property, regardless of how different the property interests may seem.[10]

Example 1. Larry the Landman has worked diligently to assemble a 75% working interest in approximately 10,000 acres (comprised of hundreds of individual leases). Larry has decided that he wants out of the oil business and has negotiated to exchange the entire working interest for a ranch that he will hold for investment purposes. Can Section 1031 apply to the transaction?

The answer is yes. A working interest in oil and gas is considered an interest in real property and may be exchanged for other real estate in a 1031 Exchange. On numerous

[6] I.R.C. § 1001(a).

[7] *Id*.

[8] I.R.C. § 1031(a)(1).

[9] Treas. Reg. § 1.1031(a)-1(b).

[10] *Comm'r v. Crichton*, 122 F.2d 181 (5th Cir. 1941).

Return to Table of Contents

occasions, the IRS has found that an unlimited economic interest to the minerals in place is a real property interest, so long as the interest is for an unlimited duration.[11] Generally, state law defines whether an interest in property is real or personal.[12] However, due to the dramatic disparities in state law treatment of mineral interests, multiple revenue rulings have decided that state law is not determinative of whether an oil and gas interest qualifies as real property for purposes of Section 1031.[13] Under these rulings, federal law, independent of state law considerations, determines the nature of an oil and gas interest. In so ruling, the IRS determined that "economic interests" in oil, gas, and other minerals – including leasehold interests, working interests, royalty interests, and overriding royalty interests – are all considered real property for purposes of Section 1031,[14] regardless of the state law characterization.[15]

As real property interests, oil and gas interests may be exchanged for other oil and gas interests or other types of real property (e.g., land and buildings) pursuant to a 1031 Exchange. The interest may be exchanged for other kinds of real property without recognition of gain.[16] Some examples from published guidance include:

- An exchange of an undivided interest in a hotel for mineral properties;[17]
- An exchange of an undivided interest in unimproved real estate for an interest in overriding oil and gas royalties;[18]
- An exchange of one working interest in a lease for another;[19]

---

[11] *See Palmer v. Bender*, 287 U.S. 551 (1933); Rev. Rul. 68-226, 1968-1 CB 362.

[12] *Aquilino v. U.S.,* 363 U.S. 509 (1960).

[13] Rev. Rul. 68-226, 1968-1 CB 362; Rev. Rul. 88-78, 1988-2 CB 330.

[14] *See* G.C.M. 39,572 (December, 01, 1986) ("[b]ecause this standard has been liberally construed, the replacement of one real property interest held for productive use in trade or business or for investment by another that is similarly held generally would be deemed to fall within the definition of a like-kind exchange."); s*ee also* Rev. Rul. 68-226, 1968-1 CB 362 ("the interest of a lessee in oil and gas in place . . . is an interest in 'real property' for Federal income tax purposes . . ."); Rev. Rul. 88-7, 1988-2 CB 330 ("the disposition of oil rights is the disposition of an interest in real property."); Rev. Rul. 73-428, 1973-2 CB 303 ("A royalty interest in oil and gas in place is a fee interest in mineral rights and real property for Federal income tax purposes."); G.C.M. 34,033 (February 03, 1969) (An "overriding royalty and . . . working interest are both considered interests in real property for purposes of the Federal income tax."); Rev. Rul. 72-117, 1972-1 CB 226 ("[O]verriding oil and gas royalties are interests in real property.").

[15] I.R.M., Oil and Gas Handbook, 4.41.1.4.1 (last revised July 31, 2002). Moreover, the Internal Revenue Manual provides that "[a]n interest in an oil and gas lease is an interest in 'real property' for Federal income tax purposes (Rev. Rul. 68-226). This ruling applies in all cases, regardless of how the oil and gas lessee's interest is treated under state law."

[16] However, if relinquished property constitutes a developed interest in mineral reserves and the replacement property is not a similar interest, the recapture of prior intangible drilling costs and depletion deductions cannot be deferred. *See* discussion of Section 1254 recapture, below.

[17] *See Comm'r v. Crichton*, 122 F.2d 181 (5th Cir. 1941).

[18] G.C.M. 34,651 (October 20, 1971)..

- An exchange of an interest in a producing lease of an oil deposit in place for a fee interest in an improved ranch;[20] and

- An exchange of overriding royalties for unimproved real estate.[21]

Example 2. DrillCo finds itself in a liquidity crisis and does not have sufficient capital to develop the 75% working interest in approximately 10,000 acres that it acquired from Larry the Landman. Therefore, to provide Drillco with a steady stream of income, DrillCo has negotiated with Harold to exchange the entire working interest for "production payments" burdening Harold's other oil and gas wells. The terms of the production payments provide that Drillco will receive a fixed percentage of all revenues from Harold's other wells until Drillco has received a total payment of $X, at which point the payments will cease. Can Section 1031 apply to DrillCo's transaction?

No, a production payment is generally considered to be personal property because it is simply an assignment of income. Therefore, a production payment is not of like-kind to real property interests.[22] The main distinction between a production payment and a royalty is the duration of the interest. A royalty or overriding royalty continues until the mineral deposit is exhausted whereas a carved-out oil production payment right usually terminates when a specified quantity of minerals has been produced or a stated amount of proceeds from the sale of minerals has been received.

In other instances where the oil and gas interest to be exchanged is of limited duration, the IRS also has found that the interests *do not* qualify for 1031 Exchange treatment. Specific examples include:

- An exchange of a limited oil payment right for an overriding oil and gas royalty reserved from the same lease;[23]

- An exchange of a leasehold measured in terms of a fixed percentage of all oil that might be produced from certain lands for a leasehold measured in terms of a fixed number of barrels of oil;[24] and

- An exchange of carved-out oil payment rights *of limited duration* for a fee interest in a ranch.[25]

---

[19] Rev. Rul. 68-186, 1968-1 CB 354.

[20] Rev. Rul. 68-331, 1968-1 CB 352.

[21] Rev. Rul. 72-117, 1972-1 CB 226.

[22] *See* I.R.C. § 636; *See also Comm'r. v. P. G. Lake, Inc.,* 356 U.S. 260 (1958).

[23] *Midfield Oil. Co. v. Comm'r.,* 39 BTA 1154 (1939).

[24] *Bandini Petroleum Co. v. Comm'r.*, PH T.C.M. ¶ 51,310 (1951).

Oil and Gas Equipment and Multiple Property Exchanges

Example 3. At the Wildcatters' Society annual poker tournament, Harold, Big Al, and Salty begin boasting about the wells they are producing. The next day, Harold visits your office with several tax questions. Harold thinks that he can parlay his operating interest in Mediocre Well, a producing well, and all the associated well equipment in exchange for either (i) Big Al's operating interest in Spindletop, another producing well, and all the well equipment, or (ii) Salty's operating interest in Waterworks, a producing well located offshore, and the drilling platform. Harold thinks that it's all a wash, and, therefore, neither exchange should have any tax consequences. Although Harold's response seems logical and you have some experience with 1031 Exchanges, you are hesitant to agree because of the personal property involved.[26] As delineated above, the exchange of the operating interests should qualify as a 1031 Exchange of real property, assuming the working interests are not limited as to duration. However, you are concerned with whether the well equipment also qualifies for 1031 Exchange treatment or whether it will it be treated as taxable "boot" in the exchange.

Section 1031(a)(1) allows property (whether personal property or real property) held for productive use in a trade or business or for investment to be exchanged without recognition of gain or loss for like kind property. Treasury Regulation Section 1.1031(a)-2) provides additional rules for determining whether personal property has been exchanged for property of a like kind. According to that section, "[p]ersonal properties of a *like class* are considered to be of a 'like kind' for purposes of section 1031."[27] Thus, as long as two properties are of "like class," they qualify as "like kind" properties in a 1031 Exchange. It is important to note that the "like class" standard is simply a safe harbor, and that two types of properties may still meet the more general "like kind" test, even though they may not be of like class under the safe harbor.[28]

The Treasury Regulations give further guidance on the meaning of "like class." Treasury Regulation Section 1.1031(a)-2(b)(1) states that "[d]epreciable tangible personal property is of a like class to other depreciable tangible personal property if the exchanged properties are either within the same *General Asset Class* or within the same *Product Class*."[29] Thus, all personal properties within the same General Asset Class or within the same Product Class are considered to be of like class, and thus of like kind. The General Asset Class categories are listed in

---

[25] *Fleming v. Comm'r.*, 24 T.C. 818 (1955) (stating a "horizontal" carve-out would be an anticipatory assignment of income from a contractual arrangement, not an exchange of an economic interest in the property).

[26] Although it is explicitly stated in this example, it should be noted that most transfers of an operating interest in a producing well will (implicitly or explicitly) involve the transfer of the equipment utilized to operate the well. In a transfer of a producing working interest for non-producing property, practitioners should be careful to consider the tax implications of equipment, which may be treated as "boot" in the exchange.

[27] Treas. Reg. § 1.1031(a)-2(a) (emphasis added).

[28] Treas. Reg. § 1.1031(a)-2(a).

[29] Treas. Reg. § 1.1031(a)-2(b)(1) (emphasis added).

Treasury Regulation Section 1.1031(a)-(b)(2), while the Product Class categories are contained within the NAICS Manual (defined below).

In the oil and gas context, the General Asset Class categories are not useful because they generally do not apply to any oil and gas equipment or personal property used in oil and gas exploration or production, except for items such as trucks, furniture, and fixtures.[30] Therefore, one must look to the Product Class rules for useful guidance. Under the Product Class rules, to be like class (and thus like kind), depreciable tangible personal property must be described within the same 6-digit product class within Sectors 31, 32, or 33 (pertaining to manufacturing industries) of the North American Industry Classification System set forth in Executive Office of the President, Office of Management and Budget, *North American Industry Classification System*, United States, 2002 (the "NAICS Manual"), which may be accessed on the internet. As an exception, any 6-digit code with a last digit of 9 (a miscellaneous category) is not a product class for purposes of the Product Class rules. Examples of Product Class codes that are relevant to oil and gas personal property and equipment include:

- NAICS 333132, which covers oil and gas derricks, drilling rigs, oil and gas field-type machinery and equipment, water well drilling machinery, well logging equipment, rock drill bits and Christmas tree assemblies;

- NAICS 333120, which covers all heavy construction equipment;

- NAICS 333911, which covers oil well and oil field pumps; and

- NAICS 336611, which covers floating oil and gas drilling platforms, barges, cargo ships, container ships, towboats, and other marine vessels.

In Harold's proposed exchange with Big Al, assuming that each site has similar well equipment of equivalent fair market values, and such equipment falls into the same Product Class (as listed above, most likely code 333132), then the equipment will be of "like class" and thus of "like kind." However, this analysis can become more complex if the package of equipment exchanged falls into multiple product classes. For example, Big Al's equipment may include some oil pumps, while Harold's equipment may have no equivalent pumps, in which case the pumps received would not be of "like class" to Harold's relinquished equipment. If the

---

[30] The general asset classes include: (i) Office furniture, fixtures, and equipment (asset class 00.11), (ii) Information systems (computers and peripheral equipment) (asset class 00.12), (iii) Data handling equipment, except computers (asset class 00.13), (iv) Airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines) (asset class 00.21), (v) automobiles, taxis (asset class 00.22), (vi) Buses (asset class 00.23), (vii) Light general purpose trucks (asset class 00.241), (viii) Heavy general purpose trucks (asset class 00.242), (ix) Railroad cars and locomotives, except those owned by railroad transportation companies (asset class 00.25), (x) Tractor units for use over-the-road (asset class 00.26), (xi) Trailers and trailer-mounted containers (asset class 00.27), (xii) Vessels, barges, tugs, and similar water-transportation equipment, except those used in marine construction (asset class 00.28), and (xiii) Industrial steam and electric generation and/or distribution systems (asset class 00.4).

pumps also were not of "like kind," then the value of the pumps would be taxable "boot" in the exchange.[31]

Notably, Harold's proposed exchange of onshore drilling equipment for Salty's offshore drilling platform would not qualify for 1031 Exchange treatment. Although the equipment and the offshore drilling platform are both classified as personal property, such properties are in different Product Class codes and therefore are not of like class. Moreover, it is doubtful that such assets could be considered like kind under the general standard. Therefore, the drilling platform received from Salty should be treated as taxable "boot" in the exchange.

Pipelines and Distribution Systems

Pipelines and distribution systems pose a particularly difficult issue with regard to 1031 Exchanges because state law classification rules for pipelines vary dramatically. For example, in Texas, pipelines that are buried are considered real property, while in Oklahoma, pipelines are considered personal property. Historically, this state law disparity had potential to cause identical property to be treated differently based on its location, thus thwarting the intent of Section 1031. Moreover, federal personal property classifications do not assist in alleviating this tension because pipelines are not listed in any of the General Asset Class or Product Class categories discussed above.

Example 4. A natural gas pipeline in State A (constructed along a right-of-way on real property) that is classified as personal property in State A is exchanged for a State B natural gas pipeline that is constructed along a right-of-way on real property and that is classified as real property in State B. (The rights of way associated with the exchanged pipelines in State A and State B are also exchanged). Is this a valid 1031 Exchange?

The answer is yes. According to a recent Internal Legal Memorandum released by the IRS, the pipelines are considered like kind property, regardless of their state law classification as real or personal property, because they have the same basic nature and character.[32] This is an example of how the IRS has tried to alleviate some of the tension between state law classifications for 1031 Exchanges. According to the memorandum, "state law property classifications, while relevant for determining if property is real or personal property, are not determinative of whether properties are of the same nature and character," which is the essential determination under Section 1031. Rather, all facts and circumstances should be considered in determining whether properties are of the same nature and character and thus are of like-kind. While this Internal Legal Memorandum cannot be cited as precedent, its applicability will likely be much more far reaching that just pipelines and provides a flexible and favorable position for taxpayers looking to utilize 1031 Exchanges of energy-related infrastructure. For example, it would be logical to extend the ruling to cover gathering lines, which is a similar asset.

The "Sale vs. Lease" Issue

---

[31] For further explanation, see the multiple property exchange examples provided in Treas. Reg. § 1.1031(j)-1.

[32] I.L.M. 2012238027 (April 17, 2012).

Of all the "gotchas" in 1031 Exchanges involving oil and gas, the sale vs. lease question is probably the most important. In many situations, a transaction that for all purposes looks to be structured as a sale or 1031 Exchange will instead be recast as a leasing transaction for federal tax purposes. If recast as a lease, any upfront consideration is ordinary income, and ineligible to be used in a 1031 Exchange. It is paramount to understand the circumstances in which an exchange may be recast as a lease, and the steps that can be taken to prevent this result.

Example 5. Drillco owns a 75% working interest in approximately 10,000 acres (comprised of hundreds of individual leases). Drillco has negotiated a deal to sell the entire working interest to "Buyer" for $100,000,000, plus Drillco will retain an overriding royalty ("ORRI") equal to 25% less all landowner royalties burdening the leases. Thus, for example, on leases burdened by a 20% landowner royalty, the retained ORRI will equal 5%, but on leases burdened by a 25% landowner royalty, Drillco will retain no ORRI. Drillco intends to reinvest the entire $100,000,000 in "like kind" property pursuant to a 1031 Exchange. Is this a valid 1031 Exchange?

The answer is yes and no, because the answer is determined on a lease-by-lease basis.[33] The answer is yes for any lease for which Drillco retains no ORRI. However, the answer is no for any lease upon which Drillco retains the ORRI.[34] The reason is that, for any leases upon which Drillco retains an ORRI, the transaction with respect to those leases will be treated as a leasing transaction, and not as a sale or exchange, for federal tax purposes.[35] Because the transaction is treated as a lease, the portion of the $100,000,000 payment allocable to the leasing transaction will be treated as lease bonus, which is ordinary income.

Many clients in this situation are surprised to learn that, by retaining an ORRI on a purported sale of working interests, the transaction becomes ineligible for 1031 Exchange treatment, and the gain on sale is no longer long-term capital gain, but instead is ordinary income in its entirety. The rationale for this treatment is simple. Drillco, by reserving the ORRI in one or more of the leases, merely grants to the Buyer exclusive exploitation privileges, and retains as its share of the oil and gas in place that portion which, freed of the burdens of development and operation costs, has a value equivalent to the value of the entire interest subject to such burdens.[36] Therefore, Drillco is not regarded as having disposed of a capital asset, and the up front consideration is viewed as ordinary bonus income.

Upon learning this information, Drillco comes to you to ask what can be done to fix the situation and allow Drillco to structure the disposition as a 1031 Exchange? At this stage, the likely choices are to restructure the business deal such that Drillco either (a) retains no ORRI and

---

[33] *See Cullen v. Comm'r*, 118 F.2d 651 (5th Cir. 1941) (whether a sale or lease occurs must be determined on a property-by-property basis).

[34] *See* Crooks v. Comm'r, 92 T.C. 816 (1989).

[35] *Id*.; *See also* Rev. Rul. 69-352, 1961 C.B. 34.

[36] For a detailed discussion of this theory, *see* G.C.M 22730, 1941-1 C.B. 214.

Return to Table of Contents

the parties increase the cash consideration commensurately, (b) retains no ORRI and sells a smaller working interest for the same cash consideration, or (c) redefines the terms of the retained ORRI such that it is no longer treated as a "royalty" for federal tax purposes (e.g., use a term shorter than the expected life of the burdened properties such that the ORRI will be treated as a production payment instead of a royalty).[37]

Example 6. Same as example 5, but now assume that Drillco has pre-negotiated a deal to sell the retained ORRI at closing to a separate buyer for a separate $25,000,000 payment. Can Drillco use the entire $125,000,000 in a 1031 Exchange?

The answer should be yes. Because Drillco will dispose of its entire interest in the leases pursuant to a single, integrated transaction, the transaction should be respected as a sale or exchange, instead of being treated as a lease.[38]

Example 7. Same as example 5, but assume that Drillco instead negotiates a deal to sell 50% of its 75% working interest (i.e., a 37.5% working interest) to Buyer for $50,000,000, thereby retaining a 37.5% working interest. Drillco intends to reinvest the $50,000,000 proceeds in a 1031 Exchange. Can this work?

Yes. Although Drillco has retained 50% of the working interest, it has disposed of the entire 37.5% working interest sold to Buyer, and has not retained any economic interest in the portion that was transferred.[39] Thus, the situation is distinguishable from *Crooks* and other cases involving a retained royalty. The difference is that Drillco has sold a "vertical slice" of the entire working interests, and has retained no economic interest in the vertical slice that was sold, whereas in Example 5, Drillco retains an economic interest burdening the interest conveyed to Buyer. As a result, in Example 7, Drillco may initiate a 1031 Exchange with the sale proceeds.[40]

Recapture

---

[37] *See, e.g., Cullen v. Comm'r*, 118 F.2d 651 (5th Cir. 1941) (sales of leases coupled with retained production payments respected as sales for federal tax purposes); P.L.R. 9437006 (retained production payments). However, caution should be exercised if retaining a production payment on "wildcat" acreage, because the production payment in this instance will likely be treated as a royalty for federal tax purposes. *See Watnick v. Comm'r*, 90 T.C. 326 (1988).

[38] *See* FSA 1999-819, Vaughn # 223 (sales of working interests to third parties, coupled with reservation of ORRIs and contemporaneous assignment of the ORRIs to a trust for the benefit of the seller's children, respected as sales of the working interests for federal tax purposes).

[39] *See Berry Oil Co. v. U.S.*, 25 F. Supp. 96 (Ct. Cl. 1938); *see also Ratliff v. Comm'r*, 36 BTA 762 (1937).

[40] It should be noted that the same would be true if Drillco instead were to sell 50% of a royalty, instead of a working interest. *See Ratliff v. Comm'r*, 36 BTA 762 (1937) (sale of ½ of a royalty respected as a sale and not treated as a leasing transaction). Again, the fundamental point is that the interest being sold is a fractional interest identical with the fractional interest being retained (except as to the quantity being sold), such that no "economic interest" is retained with respect to the interest being sold.

Oil and gas interests raise special recapture issues in the Section 1031 context. While oil and gas properties generally are of like kind to any other type of real property, including land and buildings, oil and gas properties typically carry special recapture attributes that may only be deferred where the replacement property consists of other oil and gas properties. Thus, where oil and gas properties are exchanged for real estate in a 1031 Exchange, recapture becomes a significant issue.

Example 8. Mr. Y. K. Doodle owns a working interest upon which he previously drilled three operating wells. Doodle previously took IDC deductions of $500,000 and depletion deductions of $600,000 with respect to the working interest. At a time when Doodle's adjusted basis in the working interest is $0, Buyer offers to purchase the working interest from Doodle for $2,000,000. Doodle finds the price particularly attractive, but would prefer to reinvest the sales proceeds in another producing oil and gas property on a tax-free basis. On the other hand, his wife, Mrs. Y. K. Doodle, has her eye on a Montana ranch. Furthermore, their son, Junior Doodle, proposes that the family invest in a recently discovered (and yet undeveloped) shale gas play (he is very bullish on natural gas prices). Mr. Doodle calls you to discuss his options under Section 1031.

Recall that Doodle previously took IDC deductions of $500,000 and depletion deductions of $600,000 with respect to the working interest. If Doodle sells the working interest for cash, Doodle will recognize gain of $2,000,000 under Section 1001. Furthermore, $1,100,000 of such gain will be recaptured as ordinary income under Section 1254, which requires recapture in an amount equal to the lesser of prior deductions ($1,100,000) or gain from the sale ($2,000,000).[41] The remaining $900,000 of gain will be taxed as long-term capital gain, assuming Doodle has held the property for investment for more than one year.[42] (Note, that if Doodle receives cash at any point, even if it is later reinvested in other property, Doodle cannot utilize Section 1031 to defer recognition of the gain and, thus, recapture of the previously deducted amounts.)

Alternatively, assume that Doodle sells the working interest and deposits the $2,000,000 with a "qualified intermediary" for use in a 1031 Exchange. Doodle intends to invest all $2,000,000 in another producing working interest. Here, Doodle would recognize no gain pursuant to the 1031 Exchange. With respect to recapture, there is an exception if both the relinquished and replacement properties qualify as "Section 1254 property." Section 1254 includes property that has been subject to IDC or depletion deductions. Under the exception, because the relinquished property and the replacement property are both producing working interests that qualify as "Section 1254 property," Doodle will recognize no recapture at the time of the sale under Treasury Regulation § 1.1254-2(d). Instead, the recapture will be deferred and carry over to the replacement property, under Treasury Regulation § 1.1254-3(d). Note that if only $1,900,000 were reinvested in the replacement working interest, the remaining $100,000 of cash boot received would be ordinary income under the Section 1254 recapture rules, and deferred recapture of $1,000,000 would carry over to the replacement working interest under Treasury Regulation § 1.1254-3(d).

---

[41] I.R.C. § 1254(a)(1).

[42] I.R.C. § 1222(3).

Mr. Doodle shows you pictures of the Montana ranch, and his wife says you should come visit. The Doodles are on the fence about the ranch. Updating the facts, assume that Doodle sells the working interest and utilizes a 1031 Exchange to reinvest all $2,000,000 of proceeds in the Montana ranch, which Doodle intends to hold for investment purposes. As before, Doodle would recognize no gain pursuant to the 1031 Exchange, because the relinquished working interest and the Montana ranch are like kind real property. Nevertheless, Doodle would be required to recapture as ordinary income all $1,100,000 of prior IDC and depletion deductions because the ranch is not Section 1254 property.[43] Mrs. Doodle is crushed.

Given this result, Mr. Doodle asks whether he can roll $500,000 into the Montana ranch using a Section 1031 exchange, with a mortgage for the balance of the $2,000,000 purchase price. This would leave $1,500,000 of sales proceeds to exchange into another producing working interest. Doodle asks how the recapture rules apply in this scenario. Now, Doodle would recognize no gain in connection with the 1031 Exchange, because the relinquished working interest and replacement property (consisting of the Montana ranch and the working interest) are of like kind. As before, Doodle would be required to recapture as ordinary income $500,000 of prior IDC and depletion deductions related to the Montana ranch because the ranch is not Section 1254 property.[44] On the other hand, because $1,500,000 of the replacement property is a producing working interest (and Section 1254 property), the remainder of the recapture ($600,000) will be deferred and will remain preserved in the replacement working interest under Treasury Regulation § 1.1254-3(d).

Finally, Doodle asks you about Junior's idea. Junior Doodle has been attending seminars on emerging shale gas plays, and thinks there are tremendous opportunities acquiring undeveloped "wildcat" leases rather than producing working interests. Based on your conversation so far, Doodle assumes that the exchange would qualify under Section 1031, and that he could avoid any recapture. You though, are less confident. The answer depends on whether *undeveloped* leases constitute "section 1254 property." The primary authority is Treasury Regulation § 1.1254-2(b)(2)(iv)(A), which defines "section 1254 property" in part as property "if any expenditures described in paragraph (b)(1)(i)(A) of this section (relating to costs under section 263, 616, or 617) are *properly chargeable to such property*."[45] The costs referred to include IDCs. Furthermore, the regulations instruct that an expenditure (such as IDC) "is properly chargeable to property if—(1) The property is an operating mineral interest with respect to which the expenditure *has been deducted*."[46] The use of past-tense language may mean that undeveloped working interests that have never had any IDCs associated with them may not

[43] Treas. Reg. §§ 1.1254-2(d), 1.1254-1(b)(2).

[44] Treas. Reg. §§ 1.1254-2(d), 1.1254-1(b)(2). Note that under taxpayer-favorable ordering rules, the replacement working interest ($1,500,000) is first matched against the relinquished working interest ($2,000,000) in the 1031 Exchange in order to minimize the potential for recapture. *See* Treas. Reg. § 1.1254-2(d)(2). Here, the ordering rules leave only $500,000 subject to recapture.

[45] Treas. Reg. § 1.1254-1(b)(2)(ii) (emphasis added).

[46] Treas. Reg. § 1.1254-1(b)(2)(iv)(A)(1) (emphasis added).

qualify as section 1254 property. Thus, if such property serves as replacement property in Doodle's 1031 Exchange, recapture may be required.

Tax Partnerships

Section 1031(a)(2)(D) specifically excludes partnership interests from the realm of a 1031 Exchange. Many oil and gas working interests are owned via tax partnership arrangements. Thus, caution is warranted in determining the status of working interests when contemplating their use in a 1031 Exchange.

Example 9. Drillco owns a 75% working interest in Texas leases. Drillco sells half of the leases to Buyer for $1,000,000. Drillco and Buyer execute a joint operating agreement appointing Drillco as the operator of the leases. The first well is a gusher, and Investor approaches Drillco to purchase Drillco's 37.5% working interest for $10,000,000. Drillco is interested in selling, but only if Drillco can defer gain via a 1031 Exchange. Is this possible?

On the face of the transaction, the disposition of a 37.5% working interest appears to be eligible for 1031 Exchange treatment, assuming the other requirements of Section 1031 are satisfied.[47] However, by default, the working interest jointly owned and operated by Drillco and Buyer creates a partnership for federal tax purposes.[48] Thus, by selling the 37.5% working interest, Drillco in fact will be viewed as selling a partnership interest for federal tax purposes, which prevents Drillco from structuring the disposition as a 1031 Exchange.

However, notwithstanding the tax partnership, under Section 761(a), Drillco and Buyer may jointly elect out of subchapter K, in which case Drillco may proceed with a 1031 Exchange.[49] The election out will be effective on the first day of the taxable year for which the election is made. Under Treasury Regulation § 1.761-2(b)(1), the election must be made on the partnership return for the "first taxable year for which exclusion from subchapter K is desired."[50] Here, if Drillco and Buyer make the election for the 2014 return, the election will be effective on January 1, 2014. Thus, provided the disposition occurs after such date, the disposition should be eligible for 1031 Exchange treatment.

Example 10. Assume the facts are the same as example 9, but now assume that the consideration paid by Buyer for the initial assignment of half of Drillco's working interests consisted of $1,000,000 plus Buyer's obligation to pay 100% of the cost to drill the first 5 wells on the leasehold. Buyer and Drillco will divide all revenues produced from such wells 50/50.

---

[47] *See*, *e.g.*, Rev. Rul. 68-331, 1968-1 C.B. 352.

[48] *See Bentex Oil Corp. v. Comm'r*, 20 T.C. 565 (1953); I.T. 2749, XIII-1 C.B. 99 (1934).

[49] *See* I.R.C. § 1031(a)(2)(flush language) ("an interest in a partnership which has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K shall be treated as an interest in each of the assets of such partnership and not as an interest in a partnership.").

[50] Treas. Reg. § 1.761-2(b)(1); Rev. Rul. 83-129, 1983-2 C.B. 105.

As a practical matter, will Buyer consent to Drillco's request to elect out of subchapter K in order to facilitate Drillco's 1031 Exchange?

The answer is probably not. Under these facts, the arrangement does not satisfy the "complete payout" rule, and so Buyer would be unable to deduct 100% of the costs it funds to drill the first 5 wells (and instead would be limited to deducting only 50% of those costs).[51] By keeping the tax partnership in place, however, the tax partnership is able to specially allocate 100% of the costs of the first 5 wells to Buyer. Thus, Buyer needs the tax partnership to remain in place in order to deduct 100% of the IDCs it funds for the initial wells. Therefore, as a practical matter, Drillco probably will be unable to obtain Buyer's consent to the election out of subchapter K, meaning Drillco cannot presently dispose of the 37.5% working interest in a 1031 Exchange.

Unitization

A natural gas reservoir may extend over several hundred acres. The related mineral interests may be held by multiple owners, who together may have leased such interests to several lessees. To reduce waste and maximize production, many state conservation laws compel lessees within a specified spacing unit to pool their interests in a unitization. Furthermore, lessees holding rights on adjoining tracts commonly form unitizations voluntarily under pooling agreements to maximize production within a given area. Whether under state statute or by voluntary agreement, a unitization raises special issues in the context of a 1031 Exchange.

Example 11. Dorothy Oil recently leased the 300 acre West tract in Wicked for a one-eighth royalty. Toto Oil is negotiating a lease for the contiguous 900 acre East tract in Wicked for a one-sixth royalty. Toto Oil approached Dorothy Oil about forming a unitization to voluntarily pool the Wicked West tract with the Wicked East tract to maximize production from a single underlying mineral deposit. Auntie Em, president of Dorothy Oil, calls you at 5 o'clock on a Friday to ask if she will encounter adverse tax consequences by signing the pooling agreement. You ask her to email you a copy of the agreement, and promise to try and respond by email over the weekend.

Under the agreement, the Wicked East tract and the Wicked West tract would be unitized under a participation formula that allocates 25 percent of unit production to the Wicked West tract (300 West acres divided by 1,200 total acres) and 75 percent of unit production to the Wicked East tract (900 East acres divided by 1,200 total acres), in each case burdened by the applicable one-eighth or one-sixth royalty. Dorothy Oil would be asked to cover its share of the operating costs under the same formula (25 percent). In essence, the agreement calls for Dorothy Oil to hedge its risk by exchanging its lease for a share of production from the entire 1,200 acre tract.

Does the unitization qualify as a 1031 Exchange? Generally, yes.[52] A unitization generally results in an exchange of a taxpayer's interest in a smaller property for an undivided

---

[51] *See* Rev. Rul. 70-336; *see also* Rev. Rul. 71-207.

[52] Rev. Rul. 68-186, 1968-1 C.B. 354; G.C.M. 33,536 (June 19, 1967).

interest in the overall unit. Unitization usually includes not only the mineral interest but also depreciable equipment. Generally, a party to a unitization agreement will have a leasehold cost, which will become the basis for the participating interest in the new unit. If the working interest owner has depreciable equipment, the adjusted basis of the depreciable equipment becomes the basis to his/her interest in the unitized equipment. Boot received upon the unitization exchange is considered to be for a sale of property. Gain must be allocated between the equipment and the leasehold.[53]

Example 12. Same facts as Example 11, but now assume Dorothy Oil is a disregarded entity owned entirely by Auntie Em, and Toto Oil is a disregarded entity owned entirely by Auntie Em's brother, Uncle Ozzie. Thus, Auntie Em and Uncle Ozzie are treated as owning the Wicked West tract and the Wicked East Tract directly. One year after the unitization is formed, Toto Oil sells the Wicked East tract to a third party in a fully taxable sale.

Because Auntie Em and Uncle Ozzie are siblings, the subsequent disposition within two years of the exchange implicates Section 1031(f), which a special accelerated recognition rule that applies to related parties. Generally, under Section 1031(f), where related parties (such as Em and Ozzie) engage in a 1031 Exchange, if either party disposes of the property received in the exchange within two years following the exchange, nonrecognition of gain under Section 1031 shall no longer apply to the taxpayer with respect to such exchange.[54]

Notwithstanding the general rule, Section 1031(f)(2) contains exceptions to the accelerated recognition rule in Code Section 1031(f)(1). For example, under Section 1031(f)(2)(C), the accelerated recognition rule does not apply if the taxpayer can establish that neither the exchange nor the subsequent disposition had as one of its principal purposes the avoidance of federal income tax. Legislative history clarifies that the non-tax avoidance exception under Section 1031(f)(2)(C) generally will apply when a transaction involves an exchange of undivided interests in different properties that results in each taxpayer holding either the entire interest in a single property or a larger undivided interest in any of such properties.[55] Although a unitization is basically the inverse situation, *i.e.*, an exchange of single contiguous properties that results in each taxpayer holding an undivided interest in the combined unit, the underlying nontax avoidance purpose is analogous. Thus, a strong argument can be made that the accelerated recognition rule in Section 1031(f)(1) should not apply. Given the uncertainty, Auntie Em should consider obtaining a private letter ruling, if certainty is required.

Conclusion

1031 Exchanges in the oil and gas sector have been hot in recent years, and all indications are that the trend will continue into the foreseeable future. Taxpayers considering

---

[53] *See* Internal Revenue Manual, Oil and Gas Handbook at § 4.41.1.4.5 (July 31, 2002).

[54] *See* I.R.C. § 1031(f)(1).

[55] *See* H.R. Rep. No. 247, 101st Cong. 1st Sess. 1340 (1989); S. Print. No. 56, at 152; PLR 200820017 (May 16, 2008).

Return to Table of Contents

entering into 1031 Exchanges involving oil and gas interests should carefully consider the unique problems that may be encountered in this area. Taxpayers are advised to consult with reputable tax counsel to help navigate and avoid the various traps they may encounter when exchanging oil and gas assets.

999999 001000 9073923.1

Return to Table of Contents

Like-Kind Exchanges In The Energy Industry

Todd D. Keator
Thompson & Knight LLP
todd.keator@tklaw.com

February 28, 2014

Background

- **General Rule** – Gain or loss recognized upon a sale or exchange of property. § 1001.
  - Current LTCG tax rate either 20.0% or 23.8%.
- **Exception** – Since 1924, no gain or loss recognized if disposition structured as a “1031 exchange” for “like kind” property.
- **Purpose** – Congress did not want to impose a tax on theoretical gain where taxpayer continued his investment in like kind property.

Exceptions

- **Key exclusions:** no stock, partnership interests, certificates of trust, or "dealer" property.
  - Oil and gas tax partnerships must elect out of subchapter K prior to a 1031 exchange.
  - No buying and "flipping" inventory.
- Special rules for related parties (1031(f)).

“Boot”

- **Boot:** taxpayer allowed to receive cash “boot” in the exchange, but boot is taxable to the extent of gain realized.
- Liability relief also considered boot, but may be offset by liabilities assumed in the exchange or cash paid in the exchange.
- Boot always recognized first without any basis offset.

Basis

- **Basis:** generally, basis in relinquished property rolls over into replacement property, with certain adjustments.
- **MACRS** – the default MACRS Treatment for replacement property is to “step into the shoes” of the relinquished property. Treas. Reg. 1.168(i)-6.

Key Elements of § 1031

- § 1031(a) provides: "No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment."
- 3 prongs of the general rule:
  - There must be an "exchange."
  - The exchanged properties must be "held for" productive use in trade or business or investment ("held for" test).
  - The exchanged properties must be of "like kind."

Meaning of “Exchange”

- Reciprocal transfer of property.
- Sale and immediate reinvestment of cash does not qualify – can’t touch the cash.
- No requirement that exchange be simultaneous; forward and reverse exchanges are allowed (and normal).
- Special rules govern “exchanges of multiple properties.” Treas. Reg. 1.1031(j)-1.
- Cannot start a 1031 exchange with a lease (but oil & gas leases are different). *Pembroke v. Helvering,* 23 B.T.A. 1176 (1931) (99-year lease).

The “Held For” Requirement

- Both “relinquished property” and “replacement property” must be held for productive use in a trade or business or for investment.
- Intent determined at time of the exchange.
- Oil and gas properties generally qualify, unless held as dealer property. *See, e.g.,* H.E. Gerke v. Comm’r, TC Memo 1954-30; FSA 1999-819.

Satisfying the "Held For" Requirement

- Test is intent at the time of the exchange; prior bad intent may be converted to good.
- No bright line tests for holding period of relinquished or replacement property.
- Same taxpayer must start and complete the 1031 exchange; disregarded entities are disregarded.
  - Ex.) TP owns royalties and exchanges them for working interests. For liability reasons, TP causes a new, 100%-owned LLC to take title to the working interests. 1031 exchange still valid because the LLC is a DRE.

Meaning of "Like Kind"

- Broadly defined:
  - "The words 'like kind' have reference to the nature or character of the property and not to its grade or quality. . . . The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class."
- Any real property usually qualifies.
- By statute, foreign and domestic properties are never of "like kind."

Oil & Gas Interests = Real Property Examples of "Like Kind"

- Mineral properties for undivided interest in hotel (Comm'r v. Crichton, 122 F.2d 181 (5th Cir. 1941));
- Undivided interest in unimproved real estate for interest in overriding oil and gas royalties (General Counsel Memorandum 34651);
- Working interests in two leases (Revenue Ruling 68-186);

Examples, cont'd

- Interest in a producing lease of an oil deposit in place for a fee interest in an improved ranch (Revenue Ruling 68-331);
- Overriding oil and gas royalties for unimproved real estate (Revenue Ruling 72-117).
- Note that the above examples are unlimited "economic interests" in oil and gas in place. *See* Palmer v. Bender, 287 U.S. 551 (1933); Rev. Rul. 68-226.

Potential Exceptions

- Production payments are treated as <u>loans</u> and are not “like kind” to other real property.
- Recapture items may not be deferred (*e.g.*, depletion recapture cannot roll over into a fee interest in real property).

Potential Exceptions, cont'd

- Personal property and equipment not like kind to real property, but might be like kind to other personal property and equipment acquired in the exchange.
- Personal property generally must be within same 6-digit NAICS code to qualify. Examples:
  - 333132 (derricks, drilling equipment, drilling rigs);
  - 333911 (oil-field pumps);
  - 3336611 (floating oil and gas drilling platforms);
  - Pipelines not listed in any of these categories.

Pipelines and Distribution Systems

- State law determines whether property is real or personal.
- Fixtures generally regarded as real property under most state law.
- Installed pipeline generally (but not always a fixture).

Pipelines, cont’d

- TX v. OK-
  - In Texas, pipelines are real property if they are buried.
  - In Oklahoma, pipelines are personal property.
- Can a pipeline in TX be “like kind” to a pipeline in OK?
- IRS has tried to alleviate some of the tension for 1031 exchanges in ILM 20123807

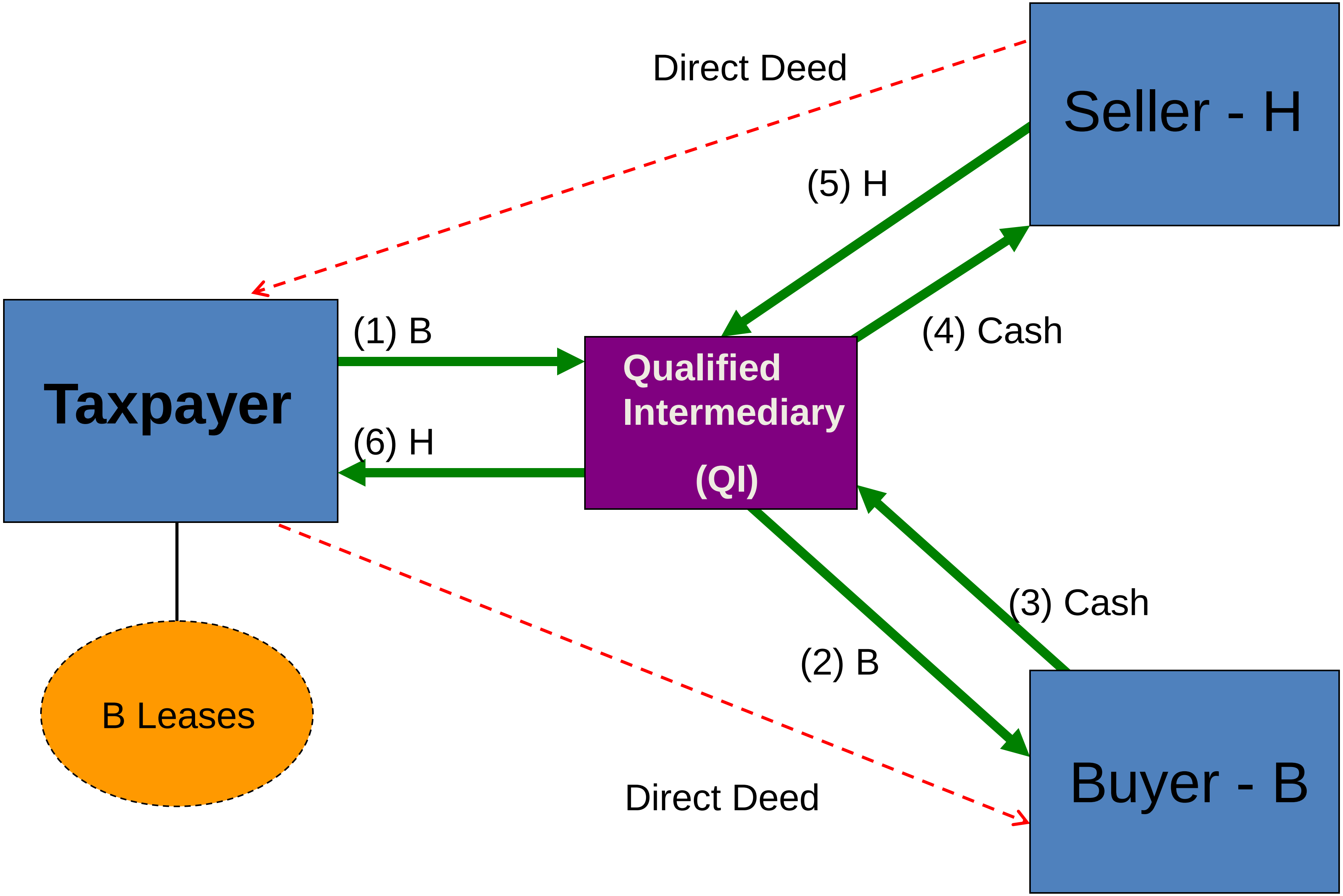
Typical Exchange Structures

- <u>"Forward" Exchanges</u> are products of IRC 1031(a)(3) and generally use a "Qualified Intermediary" (and sometimes a "qualified trust" or "qualified escrow").
- <u>"Reverse" Exchanges</u> have no Code authority and rely on safe harbor Rev Proc 2000-37, generally using an "Exchange Accommodation Titleholder."
- 45-day "identification" and 180-day closing required.

Forward Exchange

- Taxpayer owns Barnett ("B") Leases and desires to acquire Haynesville ("H") Leases from Seller. However, Seller wants to sell H Leases for cash. A different Buyer, however, desires to purchase B Leases for cash. Taxpayer engages QI to facilitate the transaction.
- At closing, Taxpayer "transfers" B Leases to QI, and QI sells B Leases to Buyer for cash. Next, QI uses the cash to purchase H Leases from Seller, and then QI "transfers" the H Leases to taxpayer to complete taxpayer's 1031 exchange.
- QI normally doesn't take title to anything. Transfers typically occur via "direct deeding" per Reg authority.
- QI respected as the "exchange" counterparty (not agent).

Typical Forward Exchange



“Identification” of Replacement Property

- Identification for each “single exchange” is limited to
  - 3 properties (without regard to the FMV) OR
  - Any number of properties so long as aggregate FMV does not exceed 200% of FMV of the relinquished property.
  - There is also safety valve 95% rule

Identification of Oil & Gas

- Identification of Oil and Gas properties in 1031 exchanges raises several questions:
  - Do non-contiguous properties under a single lease represent multiple properties for 3 prop/200% Rule?
  - How specific do you need to be in identifying oil and gas properties?
- For oil & gas, each individual lease or royalty must be identified; thus, 200% rule usually applies.

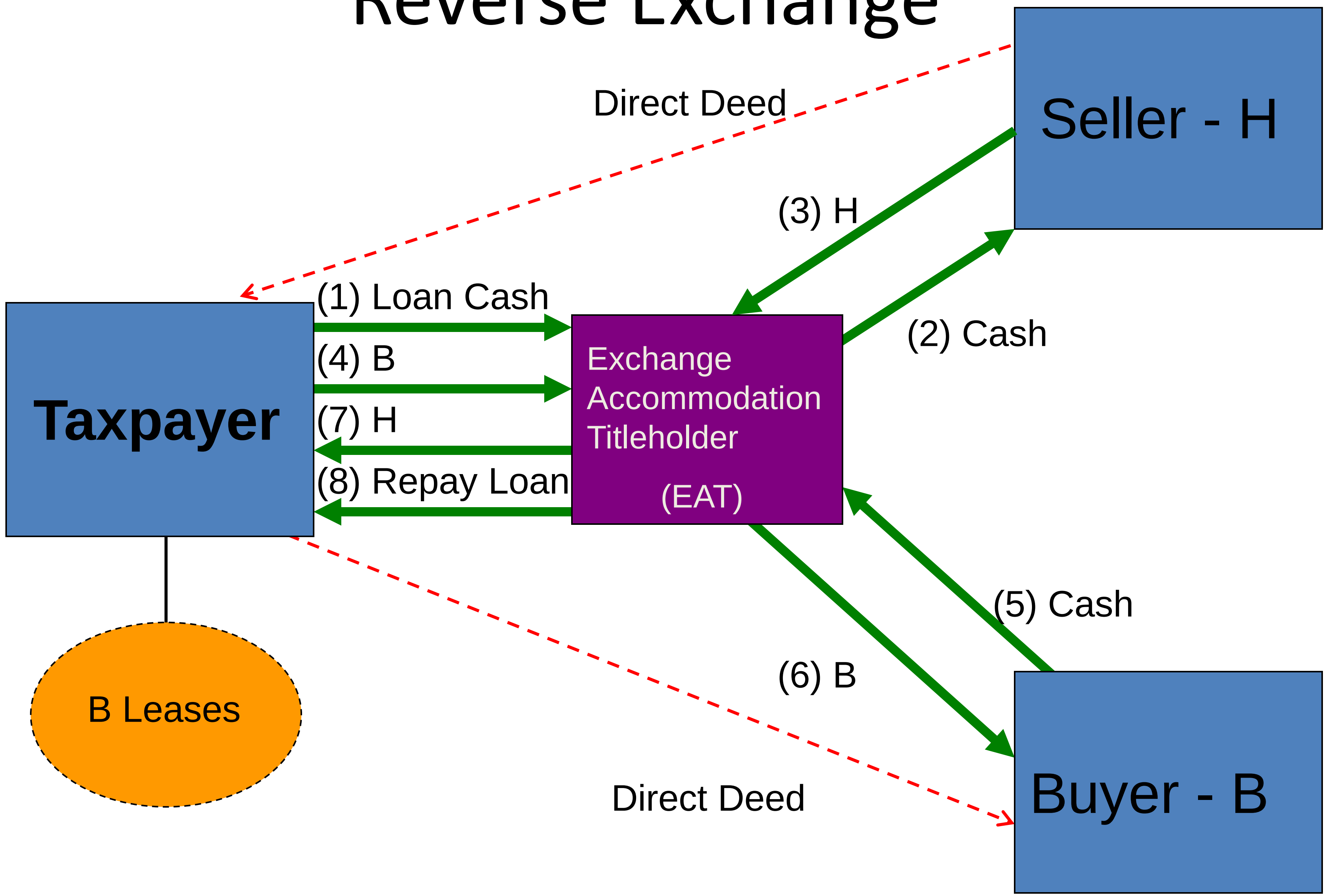
Reverse Exchange Safe Harbor

- The IRS issued a safe harbor Rev Proc 2000-37 pursuant to which taxpayers may safely engage in reverse 1031 exchanges.
- To summarize, the taxpayer engages an “Exchange Accommodation Titleholder” (EAT, similar to a QI) to “park” either the replacement property or the relinquished property in a “Qualified Exchange Accommodation Arrangement” (“QEAA”).
- Basic requirements: taxpayer and the EAT must enter into a written QEAA Agreement; if the replacement property is parked, taxpayer must properly identify the relinquished property in the same manner as described for forward exchanges; taxpayer must complete the entire transaction within 180 days; EAT must report itself as tax owner of the property it holds during the QEAA period.

Reverse Exchange Safe Harbor

- Where EAT parks replacement property, known as Exchange Last QEAA, since exchange occurs at end when relinquished property is sold. This is most common structure.
- Where EAT parks relinquished property, known as Exchange First QEAA, since exchange occurs at beginning when replacement property acquired, EAT acquires and immediately trades for taxpayer relinquished property, holding it until sale.
- Benefits: taxpayer can safely loan money to the EAT to acquire the replacement property (whether or not it is to be parked), or taxpayer can guaranty loans to the EAT for such purpose. Taxpayer can lease the parked property from the EAT pending completion of the exchange for no rent. Taxpayer can also manage the parked property during such period.

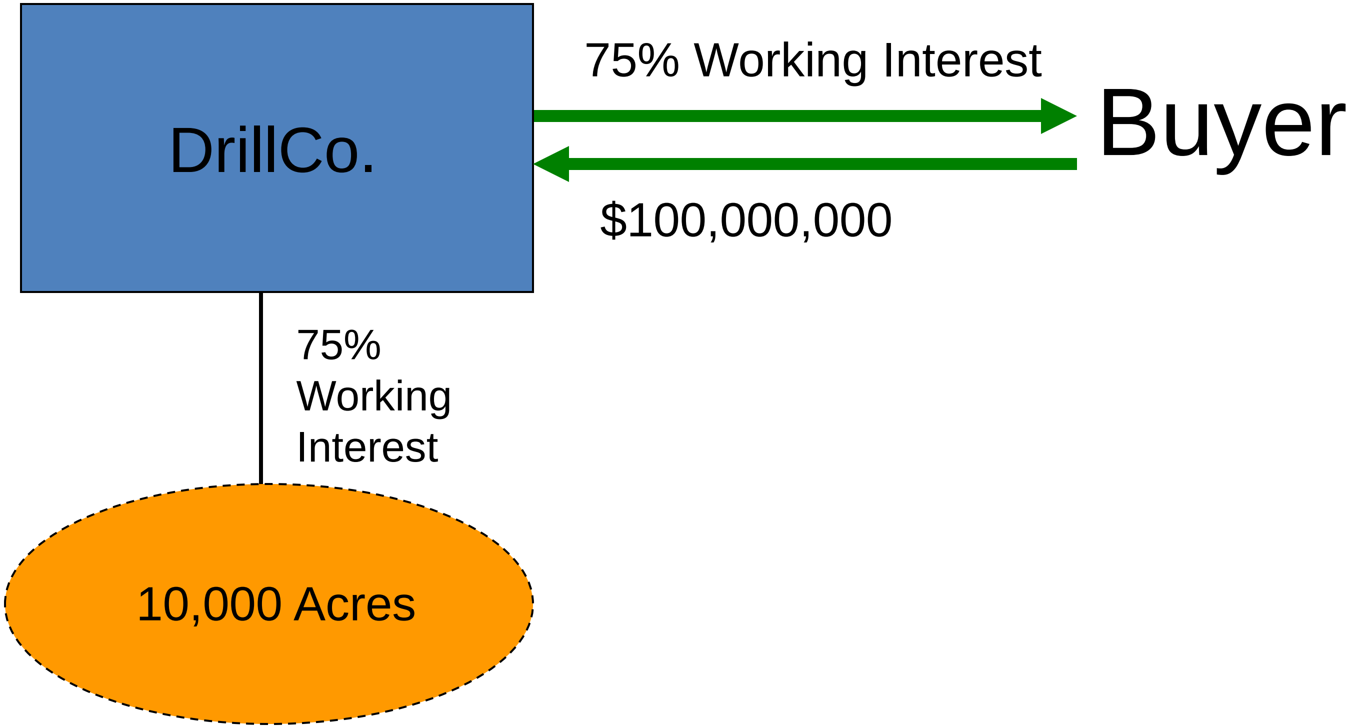
Typical Exchange Last Reverse Exchange



Key Issues in Oil & Gas Exchanges

1. Sale vs. Lease
2. Recapture
3. Tax Partnerships
4. Royalty Trusts
5. Unitizations and 1031(f)
6. Exchange Bifurcation

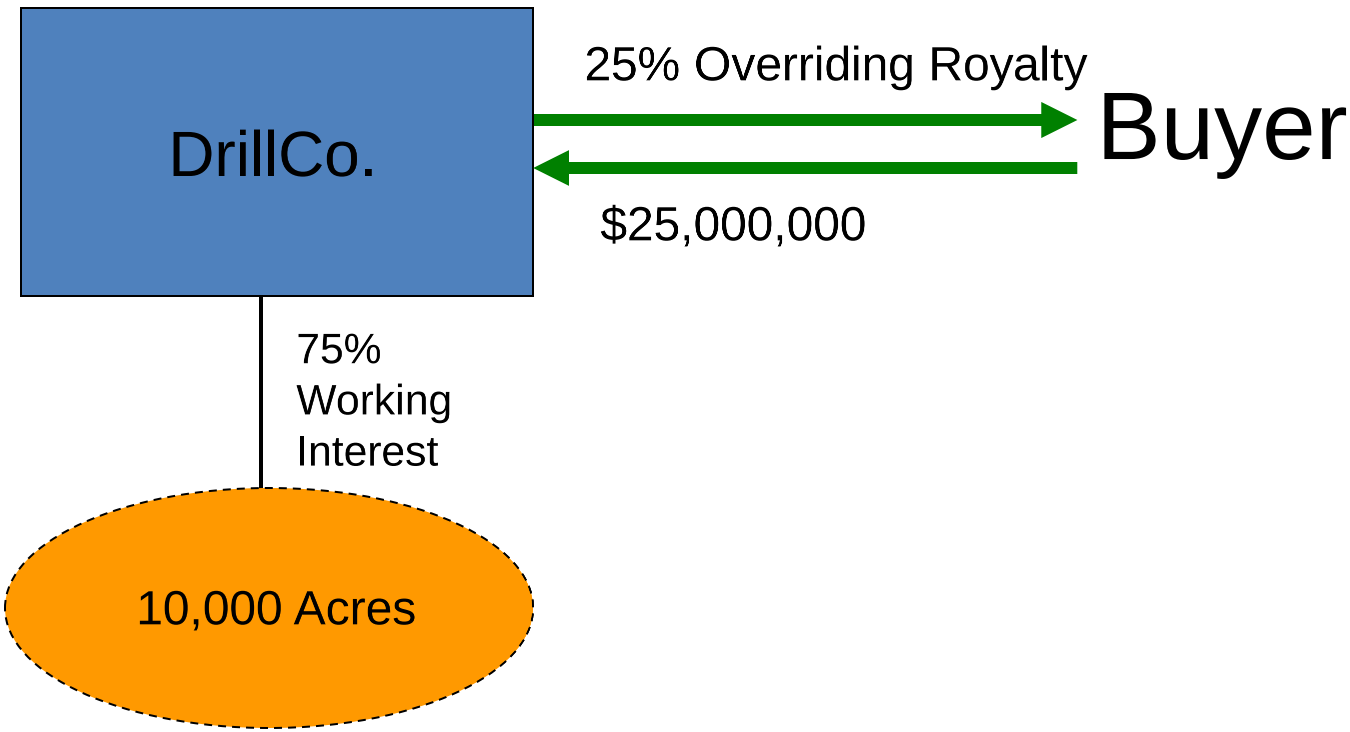
1a. “DrillCo” owns a 75% working interest in approximately 10,000 acres (comprised of hundreds of individual leases). DrillCo has negotiated to sell the entire working interest to a purchaser (“Buyer”) for $100,000,000. Can Section 1031 apply to DrillCo’s transaction?



Example 1a – Authorities

- The answer is yes.
  - *See* GCM 39572; Rev. Rul. 88-78; GCM 34033; Rev. Rul. 72-117; Comm'r v. Crichton, 122 F.2d 181 (5th Cir. 1941); GCM 34651; Rev. Rul. 68-186; Rev. Rul. 68-331; Rev. Rul. 72-117.
  - The answer would be the same upon an exchange of a lesser fraction of the working interest (e.g., 65% of the 75%). *See* Berry Oil Co. v. U.S., 25 F. Supp. 96 (Ct. Cl. 1938); Ratliff v. Comm'r, 36 B.T.A. 762 (1937).

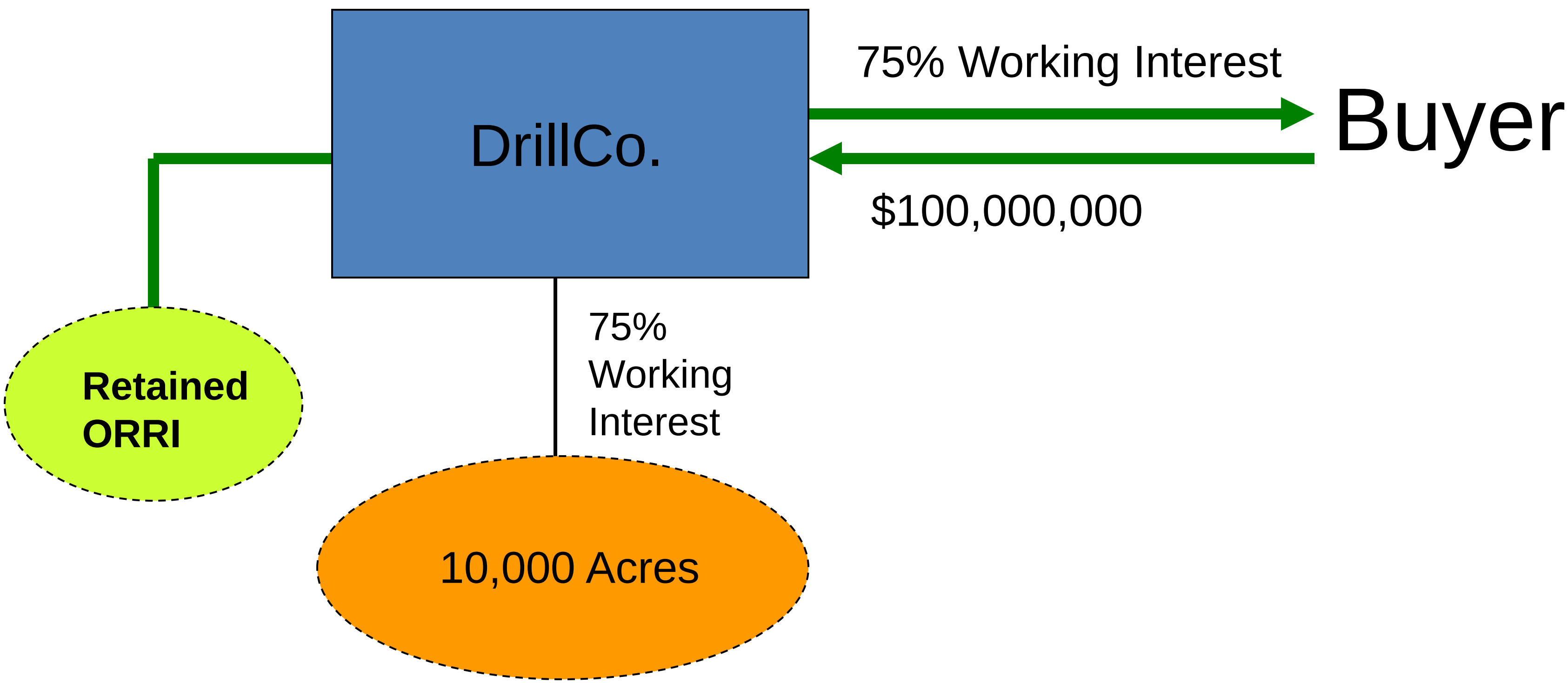
1b. Continue assuming that DrillCo owns the 75% working interest, but now DrillCo instead agrees to sell only a 25% overriding royalty in the leases to the Buyer for $25,000,000. Can Section 1031 apply?



Example 1b – Authorities

- Probably so.
  - *See* PLR 8237017 (exchange of working interests for overriding royalty interests in the same properties qualified as a Section 1031 exchange); G.C.M. 38907 (carved out net profits interest is not an assignment of income); G.C.M. 39181 (sale of carved out royalties).
- Any issue with the "held for" test?
  - Probably not. *See Fleming v. Comm'r*, 241 F.2d 78 (5th Cir. 1957), *rev'd sub nom. Comm'r v. P.G. Lake*, 356 U.S. 260 (1958).

1c. Assume DrillCo negotiates a better deal to sell the 75% working interest to Buyer for (A) $100,000,000 and (B) retention of an overriding royalty (an "ORRI") equal to 25% less all landowner royalties on the leases. Thus, on leases burdened by a 20% landowner royalty, the ORRI will be 5%, but on leases burdened by a 25% landowner royalty, there will be no ORRI. Is the transaction eligible for a 1031 exchange?



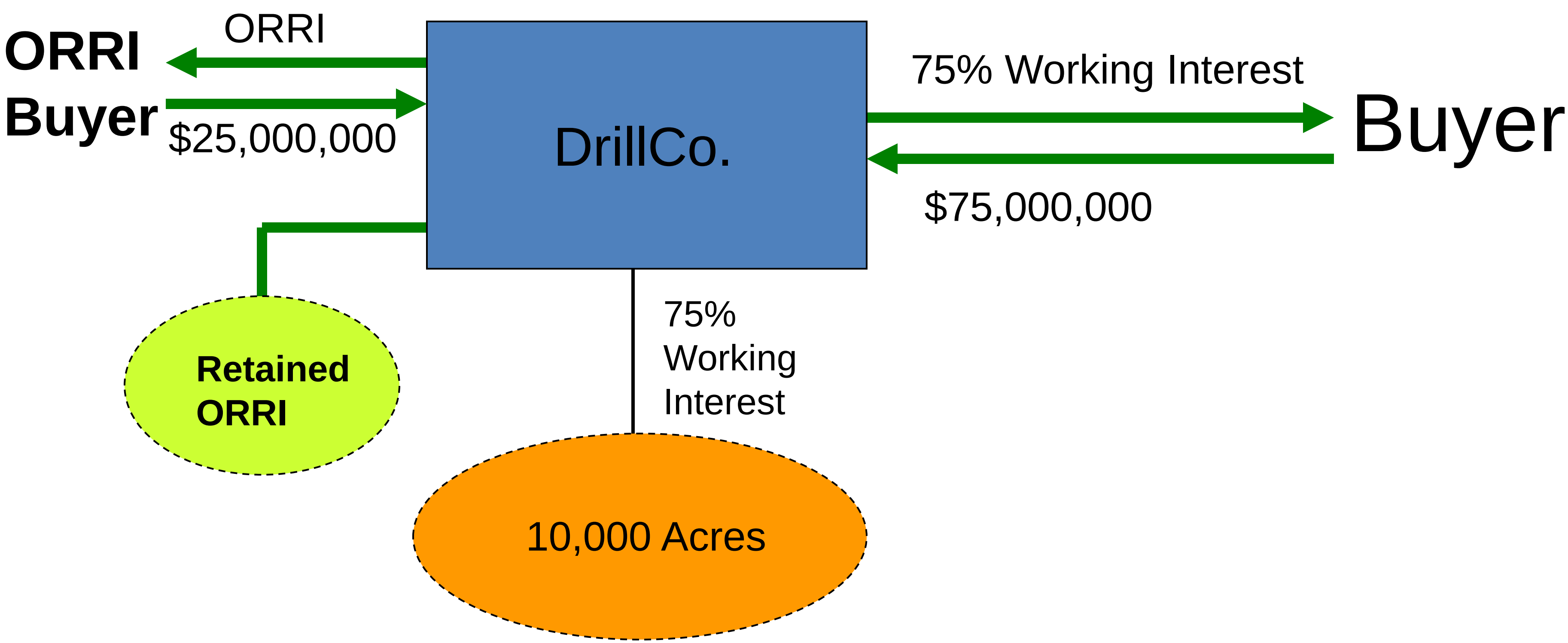
Example 1c – Authorities

- The answer is determined on a lease-by-lease basis. *See* Cullen v. Comm'r, 118 F.2d 651 (5th Cir. 1941) (whether a sale or lease occurs must be determined on a property-by-property basis).
- The answer is no for any leases upon which DrillCo retains an ORRI.
  - *See* Crooks v. Comm'r, 92 T.C. 816 (1989) (retention of a royalty in the "sale" of mineral interests converts the transaction into a lease for federal income tax purposes; Section 1031 is not available); Rev. Rul. 69-352.
- The answer is yes for leases upon which DrillCo does not retain an ORRI.

Example 1c, Continued

- Can DrillCo change the business deal and fix the problem?
- Probably so. Some possibilities are:
  – Don’t retain an ORRI and instead ask for more cash or other consideration.
  – Sell a smaller working interest for the same cash payment.
  – Re-define the retained “ORRI” so that it is not a “royalty” for federal income tax purposes (e.g., use a term shorter than the expected life of the burdened properties). What impact does this have on the Buyer? See *Cullen* and PLR 9437006 (re. retained production payments).
    – Beware retained production payment on “wildcat” acreage! *See* Watnick v. Comm’r, 90 T.C. 326 (1988).

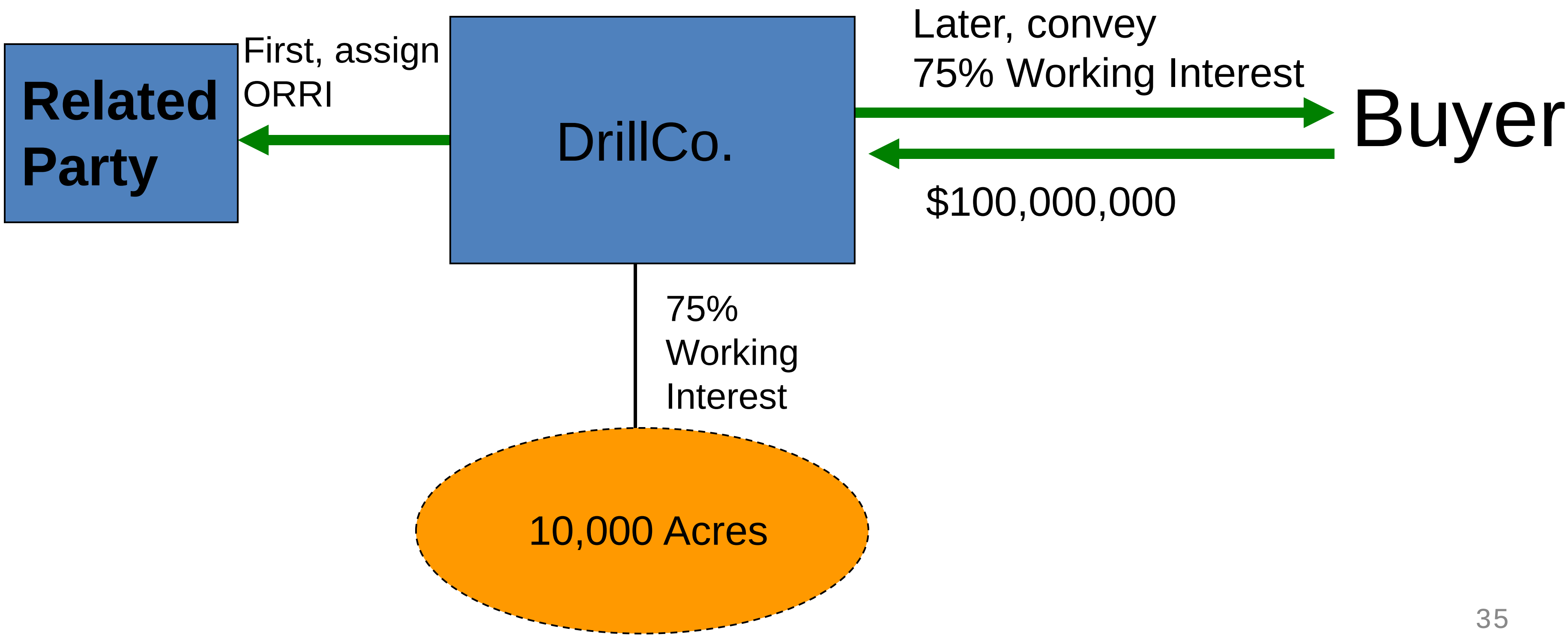
1d. Now assume instead that Drillco sells the 75% working interest to Buyer for $75,000,000 plus reservation of the ORRI, and at closing, Drillco also sells the ORRI to a third party for $25,000,000 as part of an integrated plan. Can Drillco use the $100,000,000 total consideration in a Section 1031 exchange?



Example 1d – Authority

- Because DrillCo has disposed of its entire interest in the leases in one transaction, the answer should be yes, but is not clear.
  - *See* FSA 1999-819 (sales of working interests to third parties, coupled with reservation of ORRIs and contemporaneous conveyance of ORRIs to trust for benefit of seller's children, respected as sales of the working interests for federal income tax purposes).

1e. Assume that DrillCo wants to preserve the ORRI as part of the deal with a potential buyer. Thus, prior to entering into discussions with Buyer, DrillCo carves off the ORRI and assigns it to a separate, related entity ("Related Party") for a business reason. Later, DrillCo negotiates the same deal with Buyer, except that DrillCo's sale to Buyer now is "subject to" the pre-existing ORRI held by Related Party (instead of DrillCo reserving the ORRI at closing). Can DrillCo use a Section 1031 exchange?



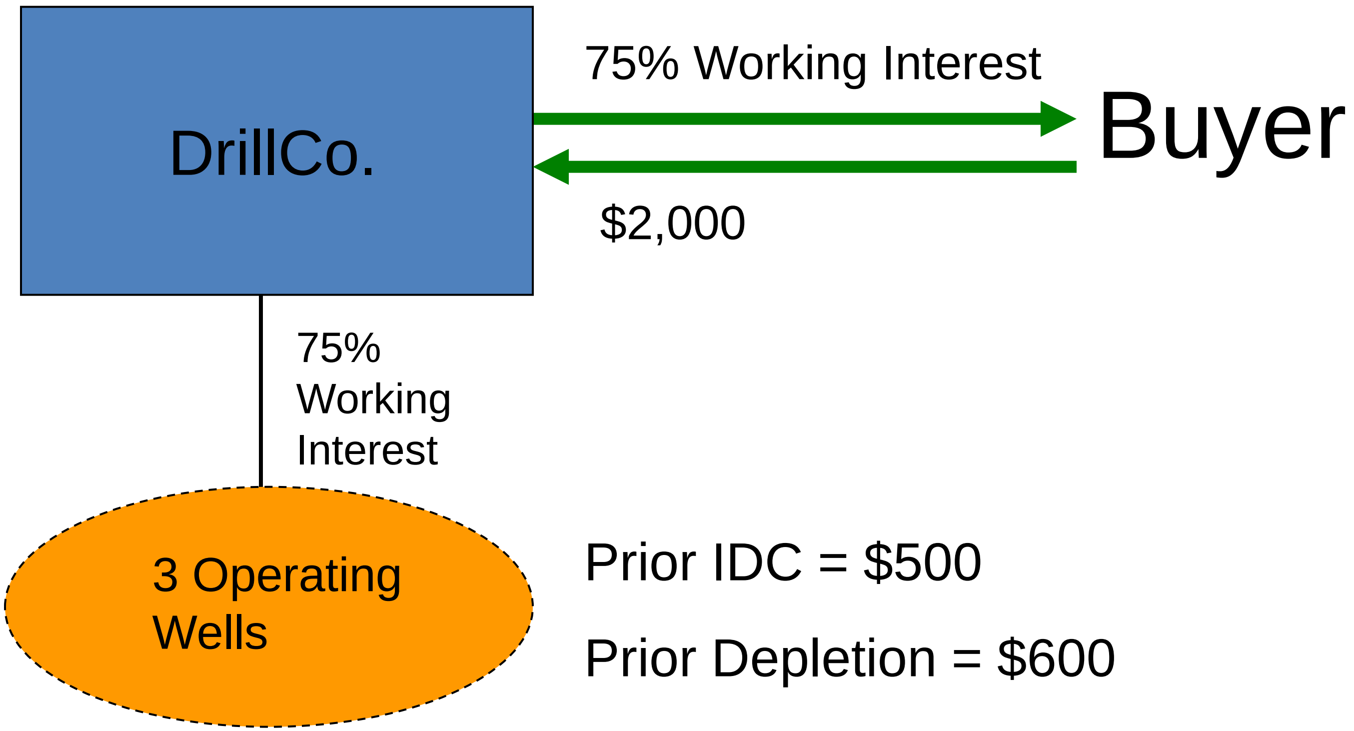
Example 1e – Authorities

- The answer clearly is yes under the *form* of the transaction because DrillCo has sold a working interest and has not "retained" an ORRI as part of the transaction with Buyer.
  - Instead, the ORRI is a pre-existing interest owned by a separate taxpayer (Related Party).
  - *Cf.* Badger Oil Co. v. Comm'r, 118 F.2d 791 (5th Cir. 1941).
- Can IRS attack the transaction on *substance over form or step transaction* grounds.
  - Provided DrillCo has a bona fide business purpose and the assignment has economic substance, DrillCo's Section 1031 exchange should be valid. *See* FSA 1999-819.
- What business purposes might suffice?

Example 1e - Continued

- What if Drillco is a partnership, and Drillco carves off and distributes the ORRI to its partners the day before closing, to be held by the partners in proportion to their % interests?
- In form, the answer looks the same at 1(d).
- In substance, this transaction seems more vulnerable on economic substance or step transaction grounds.

2a. Assume DrillCo owns a working interest upon which DrillCo has 3 operating wells. Drillco previously has taken IDC deductions of $500 and depletion deductions of $600. At a time when Drillco's adjusted basis in the working interest is $0, Drillco sells the working interest to Buyer for $2,000. What result?



Example 2a – Authorities

- Drillco recognizes gain of $2,000. IRC § 1001. $1,100 of such gain is recaptured as ordinary income. IRC § 1254.
  - i.e., must recognize recapture in an amount equal to the lesser of prior deductions ($1100) or gain from the sale ($2000).

2b. Recall that DrillCo contemplates selling working interests subject to $500 of IDC recapture and $600 of depletion recapture. Now assume that Drillco is investigating a possible Section 1031 exchange of the working interest for the following property interests (each valued at $2,000) and asks you what recapture it might face in the exchange:

- **Other producing working interests?**
  - Drillco recognizes no gain pursuant to the Section 1031 exchange and is not required to recognize any recapture. Treas. Reg. § 1.1254-2(d). Instead, the recapture of $1,100 rolls over and remains preserved in the replacement properties. Treas. Reg. § 1.1254-3(d).
  - <u>Reason</u>: No recapture required if "Sec. 1254 property" is exchanged solely for other "Sec. 1254 property."
  - <u>Exception</u>: Must still recapture to the extent of boot and like kind property that is not Sec. 1254 property received in the exchange.

Example 2b, Continued

- **Royalties worth $1,800 and $200 cash boot?**
  - Drillco must recapture $200, to the extent of the cash boot.

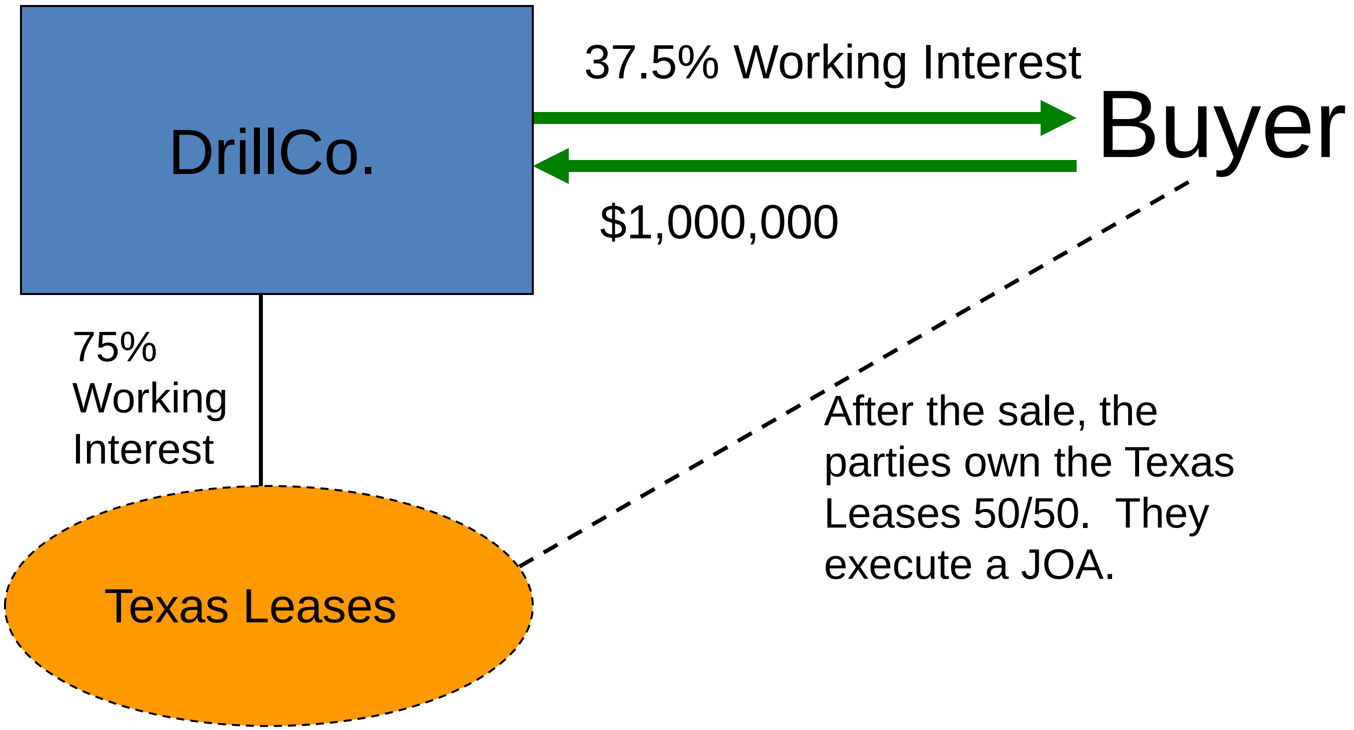
- **A ranch in Montana?**
  - Because the ranch is "like kind," Drillco recognizes no gain from the exchange but must recapture all $1,100 of prior deductions because the ranch is not "section 1254 property." Treas. Reg. §§ 1.1254-2(d), 1.1254-1(b)(2).

- **Other working interests with producing wells ($1,500) and a ranch in Montana ($500)?**
  - Again, Drillco recognizes no gain pursuant to the Section 1031 exchange but must recapture $500 of prior deductions because the ranch is not "section 1254 property." Treas. Reg. §§ 1.1254-2(d), 1.1254-1(b)(2).

Example 2b, Continued

- **Undeveloped leases in a recently-discovered shale play?**
  - The answer depends on whether *undeveloped* leases constitute "section 1254 property." *See* Treas. Reg. § 1.1254-2(b)(2)(iv)(A) (defining property as Sec. 1254 property in part if the property "is an operating mineral interest with respect to which the expenditure [IDC] *has been deducted*."
  - Note the past-tense language – may mean recapture is required on exchange of producing for nonproducing.
  - Contrast § 1245 and § 1250 recapture which define "section 1245 property" and "section 1250 property" as property "which is or has been property of a character subject to the allowance for depreciation."

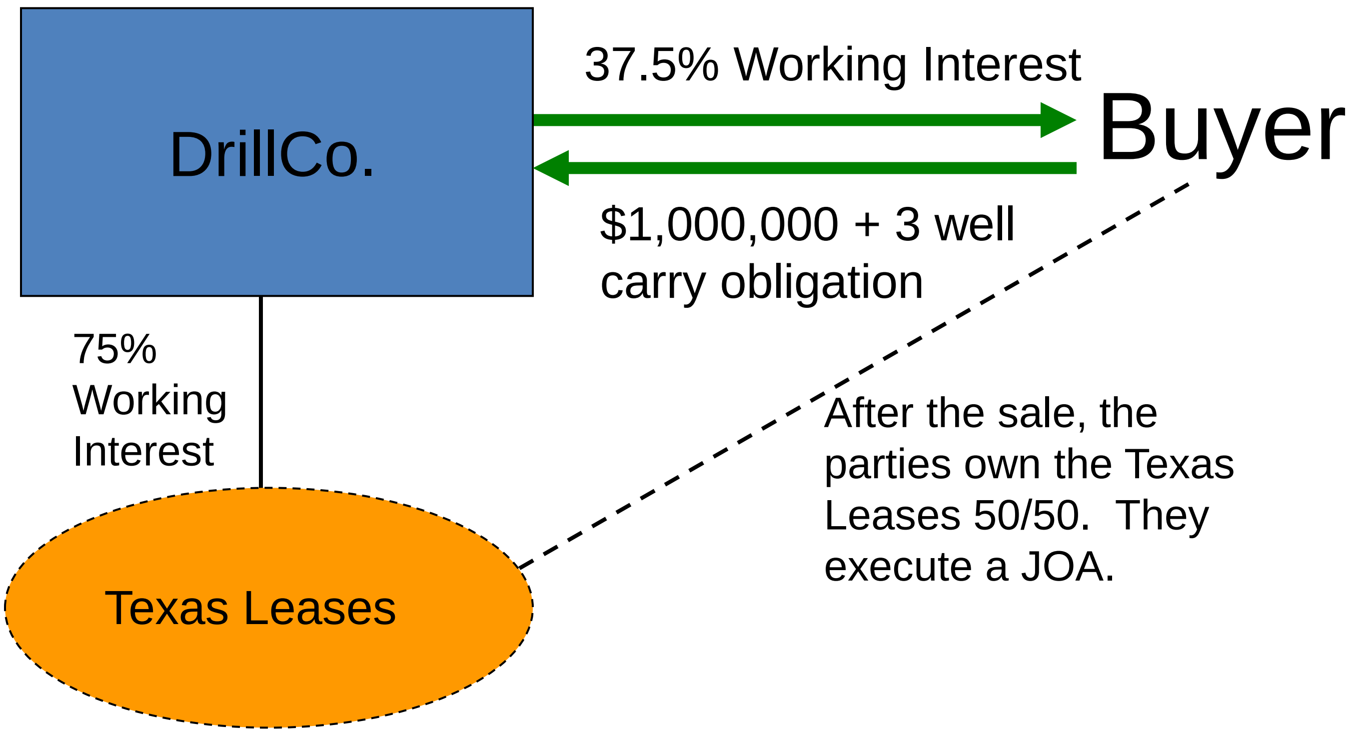
3a. DrillCo owns a 75% working interest in Texas leases. DrillCo sells half of the leases to Buyer for $1,000,000. DrillCo and Buyer execute a joint operating agreement appointing DrillCo operator. The first well is a gusher. Investor then seeks to purchase DrillCo's 37.5% working interest for $10,000,000. Can DrillCo structure the deal as a 1031 exchange?



Example 3a – Authorities

- Yes, unless the WI is subject to a tax partnership.
  - By default, the working interest jointly owned and operated by Drillco and Buyer creates a tax partnership. *See Bentex Oil Corp. v. Comm'r*, 20 T.C. 565 (1953); I.T. 2749, XIII-1 C.B. 99 (1934).
- Notwithstanding the tax partnership, Drillco and Buyer may jointly elect out of subch. K, and then Drillco may proceed with a 1031 exchange. §761(a).
  - Election out effective as of first day of taxable year for which the election is filed.

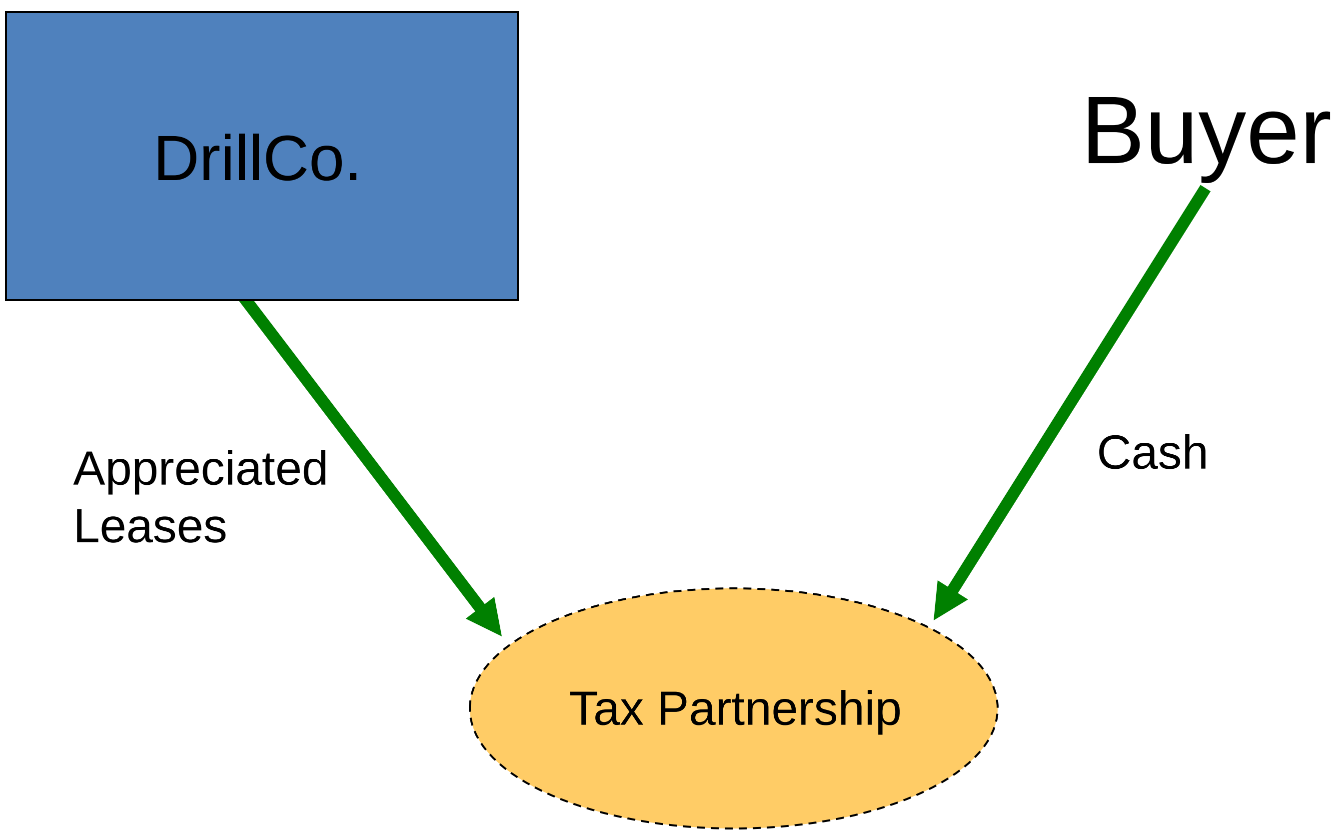
3b. Now assume that the consideration paid by Buyer for half of Drillco's working interest is (A) $1,000,000 plus (B) Buyer's obligation to pay 100% of the cost of the first 3 wells to be drilled on the property. Buyer and Drillco will divide all revenues 50/50. As a practical matter, will Buyer consent to Drillco's request to elect out of Subchapter K?



Example 3b – Authorities

- Not likely.
  - The arrangement does not satisfy the "complete payout" rule. *See* Rev. Rul. 70-336; Rev. Rul. 71-207. Thus, Buyer needs the tax partnership in place in order to deduct 100% of the IDCs funded by Buyer on the first 3 wells.
  - As a practical matter, Drillco probably cannot obtain Buyer's consent to elect out, meaning Drillco cannot dispose of the 37.5% working interest in a Section 1031 exchange.

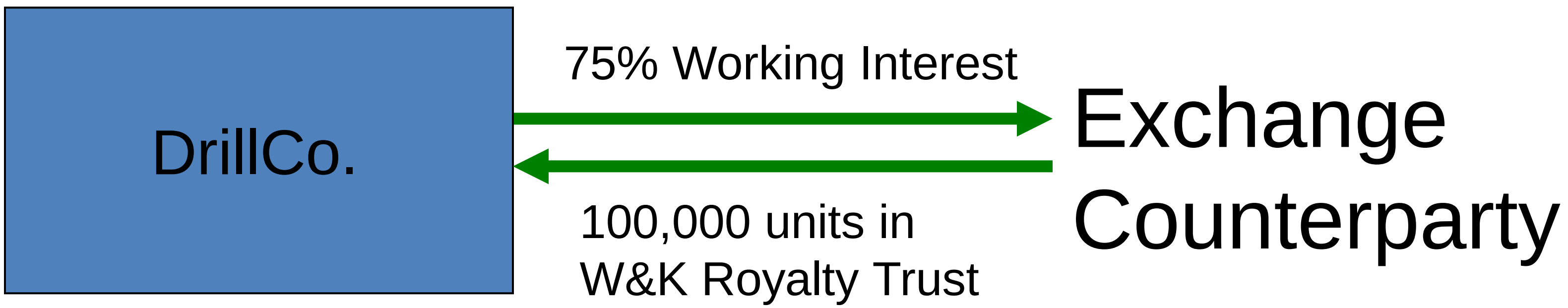
3c. Now assume that DrillCo contributes appreciated leases to a tax partnership and Buyer contributes cash to develop the properties. Later, the tax partnership acquires additional leases within an AMI. Three years later, after Buyer has deducted all of its IDCs, DrillCo locates a purchaser for its share of the leases and requests and election out of subchapter K. Issues?



Example 3c – Authorities

- DrillCo may recognize gain due to the distribution of the AMI properties. *See* IRC Sec. 737.
- *See also* IRC Sec. 704(c)(1)(B).

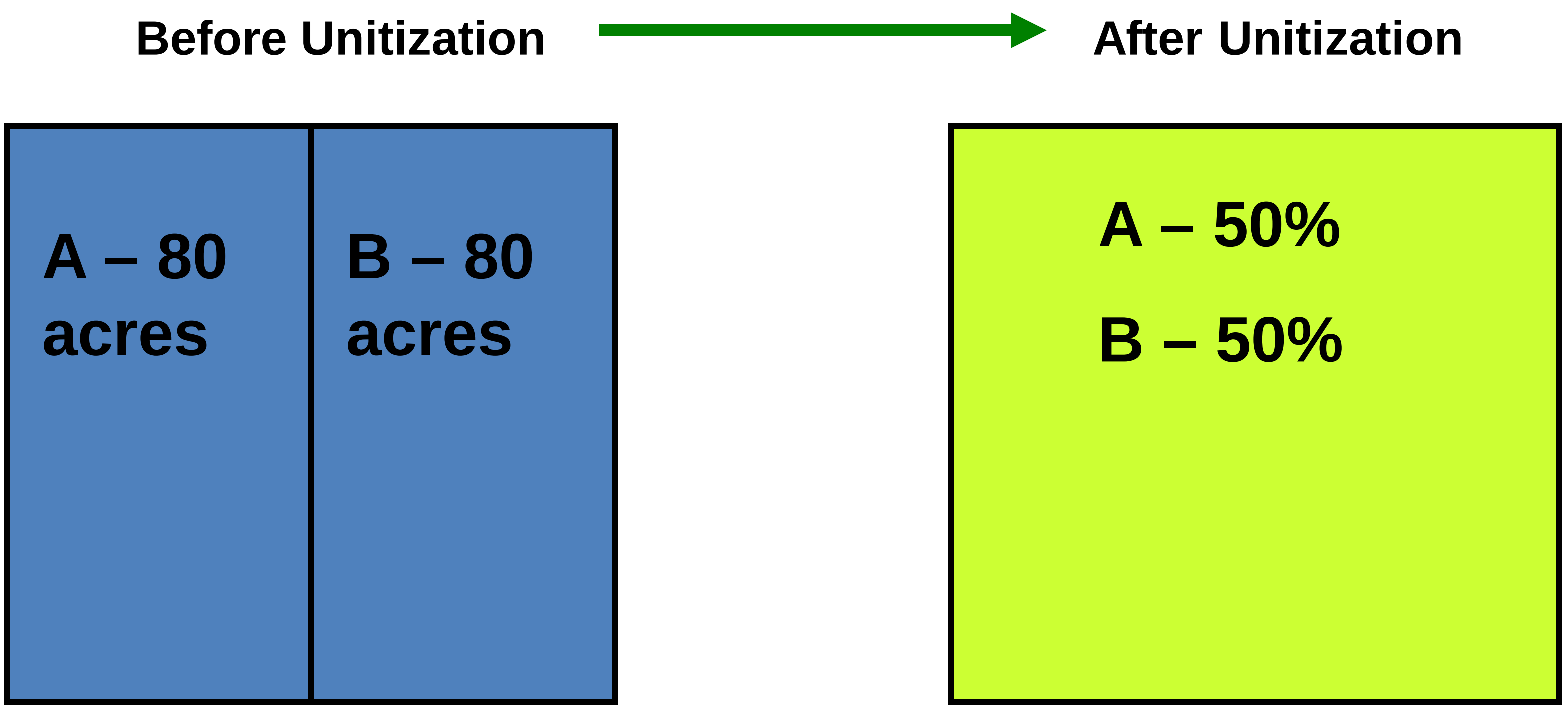
4. DrillCo desires to exchange a 75% working interest (valued at $5,000,000) for 100,000 units in the W&K Royalty Trust (valued at $5,000,000). The W&K Royalty Trust (a) is publicly traded on the NYSE, (b) is a "grantor trust" for federal tax purposes, and (c) owns thousands of interests classified as oil and gas royalties for federal tax purposes. Are the properties "like kind"?



Example 4 – Authorities

- Prohibited trust interest?
  - *See* Rev. Rul. 2004-86 addressing a non-public Delaware Statutory Trust.
  - *See also* CCA 201343021 (grantor trusts are "DREs").
- Prohibited security?
  - *See* G.C.M. 35242 (whisky warehouse receipts were not "securities" for purposes of Section 1031); Plow Realty Co. of Texas v. Comm'r, 4 T.C. 600 (1945) (mineral deeds were not securities under [former] Section 543 even though they were securities under the securities laws).
- Eligible real property?
- Identification?
- IRS opinion?

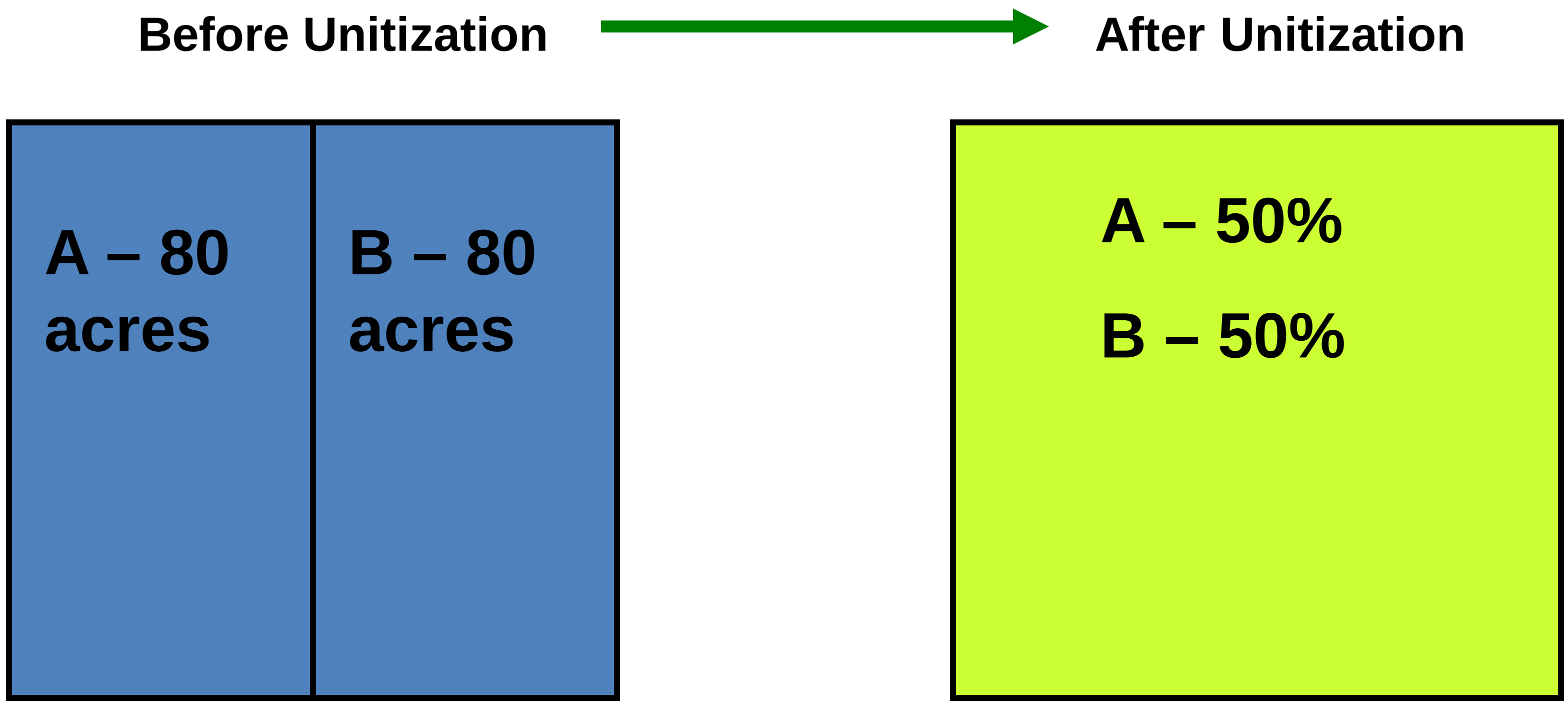
5a. A and B each own 80 acres of contiguous mineral property, each with a FMV of $100 and basis of $0. State implements a unitization program and forces A and B to combine their 80 acre tracts into one 160-acre unit. A and B each receive a 50% interest in the 160-acre unit. Is this a 1031 exchange?



Example 5a – Authorities

- Unitization qualifies as a 1031 exchange.
  - *See* Rev. Rul. 68-186 (unitization of oil and gas interests was a 1031 exchange); GCM 33536 (same).

5b. Same question as 5a, but now assume that A and B are father and son, and that one year later A sells his 50% interest in the unit for $200.



Example 5b – Authorities

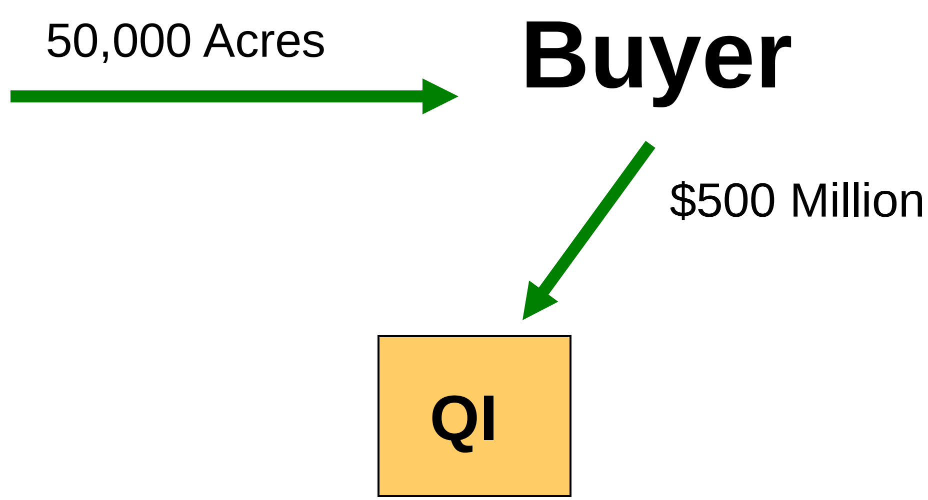
- The original 1031 exchange may no longer be valid. *See* IRC 1031(f)(1).
- Does the “no tax avoidance purpose” exception apply? *See* IRC 1031(f)(2)(C).

6. DrillCo owns 50,000 acres in the H Shale. Half of the acreage is located in De Soto Parish, and the other half in Red River Parish. DrillCo accepts an offer to sell everything to Buyer for $500 million. DrillCo desires to acquire new leases in the Eagle Ford Shale for at least $250 million, and possibly up to $500 million. Therefore, DrillCo structures the sale of the H acreage as a 1031 exchange. DrillCo asks if it can split the transaction into 2 separate exchanges ($250M each). Why? Is this possible?

DrillCo's H Acreage

De Soto	**Red River**
FMV $250 Million	FMV $250 Million
Basis $20 Million	Basis $200 Million
BIG $230 Million	BIG $50 Million

*Total BIG = $280 Million



Example 6 – Authorities

- Can the transaction be bifurcated into two exchanges? Maybe.
  - *See* Sayre v. U.S., 163 F. Supp. 495 (D. W.Va. 1958); Serdar v. U.S., TC Memo 1986-504.
- Factors: Separate PSAs? Separate negotiation? PSAs cross-conditioned? Division of assets along natural lines? Different closing dates? Different buyers?
- Do separate QIs solve the problem? Is a business purpose required?

QUESTIONS???

411 on Fundraising for Charitable Organizations

Terri Helge
Texas A&M University School of Law
1515 Commerce St.
Fort Worth, Texas 76102
thelge@law.tamu.edu

The State Bar of Texas
Section of Taxation - Tax Law Survey in a Day
February 28, 2014
Cityplace, Dallas

Return to Table of Contents

Terri Helge

Professor of Law
Email Professor Helge

Courses: Wills & Estates, Estate & Gift Tax, Estate Planning Practicum, Trusts & Fiduciary Responsibilities, Nonprofit Organizations, Legislation & Regulation, and Marital Property

Professor Terri Helge joined the faculty in 2006, bringing her interests in nonprofit law, estates and trusts, and estate and gift taxation. Prior to teaching, Professor Helge was an associate with the law firm of Thompson & Knight, LLP, where she helped nonprofit organizations with the organization, operation, and termination of nonprofit corporation and charitable trusts, and where she also represented individuals seeking to plan and implement wealth transfers to family members and charitable organizations. Before coming to law, Professor Helge worked as a tax manager at the accounting firm of Arthur Andersen, LLP, dealing with nonprofit organizations, individuals, and closely-held businesses.

Professor Helge's scholarship focuses on the law of nonprofit organizations and the standards for tax exemption. Professor Helge earned her J.D. degree *summa cum laude* from South Texas College of Law, where she served as a note and comment editor and assistant managing editor for the *South Texas Law Review*. She earned her B.S. in accountancy with highest honors from the University of Illinois at Urbana-Champaign.

Selected Publications and Presentations

The Taxation of Cause-Related Marketing, 85 CHI.-KENT L. REV. 883 (2010). [LexisNexis] [Westlaw]

Policing the Good Guys: Regulation of the Charitable Sector Through a Federal Charity Oversight Board, 19 CORNELL J. L. & PUB. POL'Y 1 (2009) (lead article). [Hein] [LexisNexis] [Westlaw]

Teaching Specialized Legal Research: Business Entities, 29 LEGAL REFERENCE SERVICES Q. 51 (2010) (with Kristyn S. Helge).

Other People's Money: Implications of the Bernard Madoff Scandal on a Charitable Director's Fiduciary Duties Regarding Investments, TEX. WESLEYAN LAW., Spring/Summer 2009, at 26.

Selected Presentations and Interviews

The Limitless Private Benefit Doctrine – The Law and Society Association 2010 Annual Meeting, Chicago, Illinois (May 28, 2010)

Cause Related Marketing: Legal Issues and Business Challenges – 2010 Texas Society of Certified Public Accountants Nonprofit Organizations Conference, Dallas, Texas (May 24, 2010)

Led discussion on federal regulation of the nonprofit sector at the Emerging Issues in Philanthropy Seminar: A Federal Office on the Nonprofit Sector: What Do We Have? What Do We Need?, hosted by the Urban Institute's Center on Nonprofits and Philanthropy and Harvard University's Hauser Center,

Return to Table of Contents

Washington, D.C. (April 23, 2010)

The Limitless Private Benefit Doctrine – Southwest Junior Scholars Conference (Arizona State University), Tempe, Arizona (March 15, 2010)

Cause-Related Marketing: Legal Issues and Business Challenges – 27th Annual Nonprofit Organizations Institute, Austin, Texas (January 14, 2010)

Interviewed on The Paul Edwards Program, a radio talk program airing on WLQV Salem, Detroit (December 14, 2009) (discussed a proposal for the creation of a federal charity oversight board)

Probate Basics – Dallas Association of Young Lawyers, Dallas, Texas (November 5, 2009)

The Taxation of Cause-Related Marketing – American College of Trust and Estate Counsel (ACTEC) Symposium on Philanthropy in the 21st Century, Chicago-Kent College of Law, Chicago, Illinois (October 23, 2009)

Policing the Good Guys: Regulation of the Charitable Sector Through a Federal Charity Oversight Board – The Law and Society Association 2009 Annual Meeting, Denver, Colorado (May 2009)

Interviewed for With the Economy Down, Bartering Explodes, FORT WORTH STAR-TELEGRAM (March 14, 2009), reprinted in ATLANTA JOURNAL-CONSTITUTION (March 23, 2009)(quoted on the tax implications of bartering transactions for an article describing the substantial increase in bartering transactions in light of the economic crisis)

Tax Aspects of Transactions with Charitable Organizations – Tarrant County Probate Bar Association, Fort Worth, Texas (March 2009)

Interviewed for Mission in Peril, HOOD COUNTY NEWS (February 7, 2009) (quoted on the fiduciary duties of charity managers for an article exposing alleged misuse of charitable assets at a local charity)

When Two Worlds Collide: Issues to Consider when Taxable Parties Enter into Transactions with Charitable Organizations – State Bar of Texas Tax Section, Webcast (February 2008)

Incorporating Asset Protection into Your Estate Plan – Tarrant County Bar Association Tax and Estate Planning Section, Fort Worth, Texas (February 2008)

Tax Aspects of Transactions with Charitable Organizations – Dallas Bar Association Tax Section, Dallas, Texas (October 2007)

Legislative Update from Washington on Charitable Reforms: The Pension Protection Act of 2006 – 2007 Texas Society of Certified Public Accountants Nonprofit Organizations Conference, Dallas, Texas (May 2007)

Return to Table of Contents

The 411 on Fundraising for Charitable Organizations

Terri Lynn Helge
Professor of Law
Texas A&M University School of Law

February 28, 2014

Introduction

- I.R.C. Section 501(c) lists organizations that are exempt from federal income tax
- I.R.C. Section 501(c)(3) describes charitable organizations that are exempt from federal income tax, contributions to which are generally deductible to the donor on the donor's federal income tax return

Charitable Organizations

- Section 501(c)(3) Requirements
  - Organized and operated exclusively for religious, charitable, educational or other exempt purposes
  - No part of the net earnings of which inures to the benefit of any private individual
  - No substantial lobbying activities
  - No participation in, or intervention any political campaign on behalf of (or in opposition to) any candidate for public office
  -

Charitable Contributions

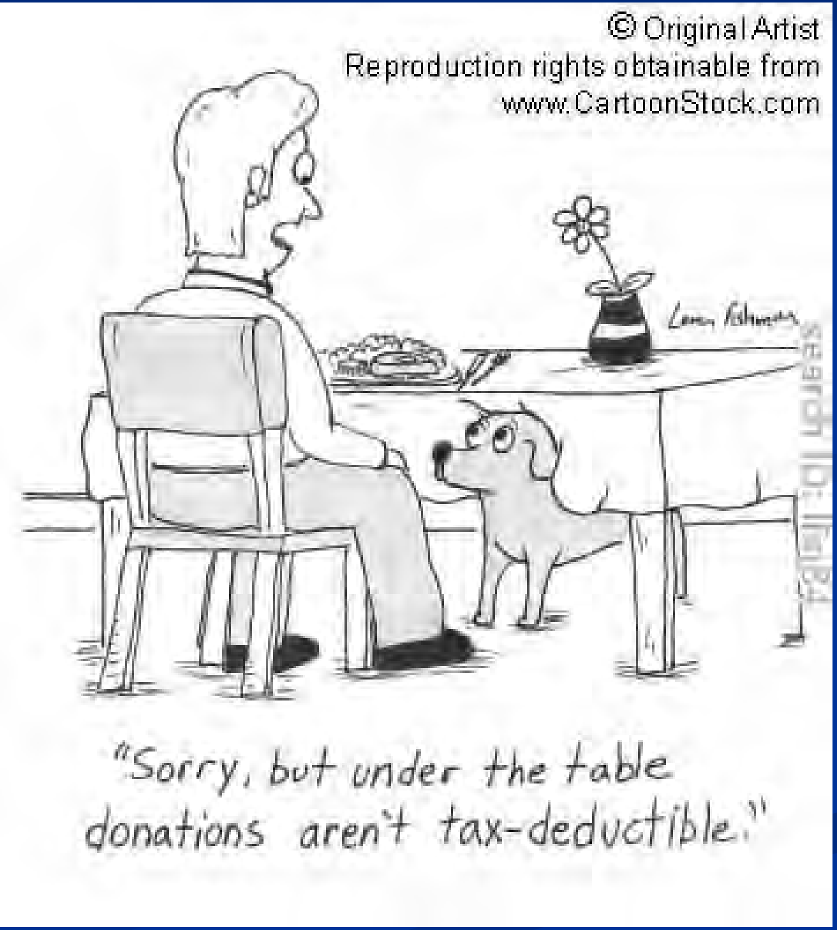
- Charitable deductions of cash and property to qualifying organizations generally are allowed as itemized deductions.
- Amount and availability of deduction depends on:
  - Type of donee organization
  - Type of property donated
  - Benefits received by donor
- No deduction for contribution of services

Charitable Contributions

- Quid Pro Quo Limitation
  - Amount of Deduction is reduced by the FMV of any benefit received by the donor
  - Exception: Token items
  - Exception: mere donor acknowledgement, such as naming rights, placement of donor plaque, etc.

Charitable Contributions

- Contents of Receipt
  - Name of charity
  - Date and location of contribution
  - Amount of cash or reasonably detailed description of property contributed
    - Charity is NOT required to state a value of the contributed property
  - Whether quid pro quo benefits were received, and if so, a good faith estimate of their value



Unrelated Business Income Tax

- Section 511 imposes income tax on a charitable organization's UBTI
- Unrelated Business Defined
  - Trade or business activity
  - Regularly carried on
  - Unrelated to charity's exempt purposes

Unrelated Business Income Tax

- Exceptions:
  - Bingo, but not other games of chance
  - Activities carried out substantially by volunteers
  - Sales of donated merchandise
  - Qualified corporate sponsorship payments

Corporate Sponsorships

- Qualified Sponsorship Payment - § 513(i)
  - Payment from corporate sponsor to charity with no expectation of "substantial return benefit"
  - "Use or acknowledgement" of corporate sponsor is permitted.

Charitable Gaming Activity

- Texas Gambling Law
  - Chapter 47 of the Texas Penal Code provides that a person commits a criminal offense if the person engages in gambling or participates in the earnings of a place that is used for gambling
  - Exceptions:
    - Texas Charitable Raffle Enabling Act
    - Bingo Enabling Act
    - Charitable poker tournaments (no explicit exception)

Texas Charitable Raffle Enabling Act

- What is a raffle?
  - "the awarding of one or more prizes by chance at a single occasion among a single pool or group of persons who have paid or promised a thing of value for a ticket that represents a chance to win a prize."
- Qualified nonprofit organizations can hold up to two raffles per year
  - Exempt as a I.R.C. Section 501(c)(3) organization
  - Has existed for at least 3 years
  - No political campaign intervention
  - No substantial lobbying

Texas Charitable Raffle Enabling Act

- Raffle requirements
  - Organization may not promote the raffle through the use of paid advertising in mass media
  - Raffle may not be promoted or advertised statewide
  - Money may not be offered or awarded at the raffle
  - If the organization pays for or provides consideration for the prize to be awarded, the fair market value of the prize may not exceed $50,000 (except for a residence of up to $250,000)
  - Organization may not compensate any person for organizing or conducting the raffle

Texas Charitable Raffle Enabling Act

- Raffle requirements (con't)
  - Certain information must be printed on the raffle ticket:
    - Name and address of the organization
    - Price of the ticket
    - General description of each raffle prize having a value of more than $10
    - The date on which the prize or prizes will be awarded
  - Organization must own or possess the prize or post bond equal to the fair market value of the prize
  - All proceeds from the sale of the raffle tickets must be spent for the organization's charitable purposes

Charitable Raffles – Federal Tax Implications

- No charitable contribution deduction allowed for the purchase of a raffle ticket
- Possibly subject to unrelated business income tax unless the raffle is not "regularly carried on" or an exception applies
- Reporting and withholding rules
  - Charity must report winnings on Form W-2G if the charity awards prizes valued at $600 or more to a single winner
  - If the prize is worth more than $5,000 and at least 300 times the cost of the raffle ticket, the charity must also comply with the requirements for withholding gambling winnings (28% withholding rate)

Charitable Poker Tournaments

- No specific exemption under Texas law
- Texas law defines "gambling" as:
  - "making a bet on the partial or final result of a game or contest or on the performance of a participant of a game or contest" or
  - "play[ing] and bets for money or other thing of value at any game played with cards, dice, balls or any other gambling device."

Charitable Poker Tournaments

- Op. Tex. Att'y Gen. No. DM-112 (1992)
  - Purpose of raising funds for charity or only giving out donated items as prizes does not exempt a charitable gaming activity from being an illegal gambling activity
- Exemption from illegal gambling activity can be obtained if:
  - Eliminate the prize
  - Eliminate the consideration
    - No "pay to play" requirement

Charitable Poker Tournaments

- Op. Tex. Att'y Gen. No. DM-112 (1992)
  - Purpose of raising funds for charity or only giving out donated items as prizes does not exempt a charitable gaming activity from being an illegal gambling activity
- Exemption from illegal gambling activity can be obtained if:
  - Eliminate the prize
  - Eliminate the consideration
    - No "pay to play" requirement

Bingo Enabling Act

- Certain organizations may obtain a bingo license from the Charitable Bingo Operations Division of the Texas Lottery Commission
  - Religious society that has existed in Texas for at least 8 years
  - Nonprofit organizations in existence for at least 3 years whose predominant activities are for the support of medical research and treatment programs
- The Bingo Enabling Act provide detained regulations that describe the application for a bingo permit and govern bingo operations in Texas.

Â§ 212. Expenses for production of income.

Archive

United States Statutes

Title 26. INTERNAL REVENUE CODE

Subtitle A. Income Taxes

Chapter 1. NORMAL TAXES AND SURTAXES

Subchapter B. Computation of Taxable Income

Part VII. ADDITIONAL ITEMIZED DEDUCTIONS FOR INDIVIDUALS

Current through P.L. 113-103

§ 212. Expenses for production of income

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year-

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income; or

(3) in connection with the determination, collection, or refund of any tax.

Cite as 26 U.S.C. § 212

Source: Aug. 16, 1954, ch. 736, 68A Stat. 69.

Notes from the Office of Law Revision Counsel

current through 4/25/2014

DENIAL OF DEDUCTION FOR AMOUNTS PAID OR INCURRED ON JUDGMENTS IN SUITS BROUGHT TO RECOVER PRICE INCREASES IN PURCHASE OF NEW PRINCIPAL RESIDENCE

No deductions to be allowed in computing taxable income for two-thirds of any amount paid or incurred on a judgment entered against any person in a suit brought under section 208(b) of Pub. L. 94-12, see section 208(c) of Pub. L. 94-12, set out as a note under section **44** of this title.