THE TEXAS TAX LAWYER

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CHAIR'S MESSAGE

While it is certainly a great honor to begin my term as Chair of the Section of Taxation, our Annual Meeting on Friday the 13th represented an inauspicious start - worthy of the connotation that day represents for those of us who are superstitious.

Rather than the election of the Nominating Committee slate of Officers and Council members by acclamation - which has occurred on a regular basis for as long as I have been involved in Section activities - there instead was a hotly contested election that began with a group of five Section members nominating each other for the positions of Chair-Elect, Secretary, and the three Council member positions that were open. Although the person nominated for Chair-Elect by this group freely admitted that he had never participated in any Section activities previously - much less occupied leadership positions - this group indicated at the Annual Meeting that the nominations were occurring because the Section had ignored the concerns of solo practitioners/small firms and their clients. For a time that Friday the 13th, it appeared that this group would prevail, since there had been no notice of their intentions, and bad weather in Dallas had prevented some of our Section members from making it to Houston.

Fortunately, because the word spread to Section members who were at meetings throughout the Houston meeting sites, the final votes were in favor - but by the slimmest of margins - in favor of the Nominating Committee's slate of R. David Wheat (Chair-Elect); William P. Bowers (Secretary); and Daniel J. Micciche and Josh O. Ungerman (two of the three Council member positions open). However, Christina Mondric, a member of a five lawyer firm in Austin who has provided years of hard work and leadership, was defeated by a single vote, resulting in one of the group's nominees - R. Rhett Buck - being elected. The other officers and Council members who will serve for 2003-2004 are Gene Wolf, Treasurer; Tina R. Green, Newsletter Editor; Kevin J. Thomason; Steven D. Moore; Jeffrey E. Sher; Allen B. Craig; Larry Jones; Tyree Collier; and G. Walter McCool, Chair Website/E-Communications.

In sum, the Section was for a time on the brink of being taken over by a small group that took well-planned actions - without prior notice - at our Annual Meeting, rather than leadership passing to a slate of people who had worked for many years in leadership roles on behalf of the Section. Frankly, our Bylaws allow that sort of thing to occur, and one of the things that I will ask the Council to consider is amending our Bylaws in order to ensure that nominations are made with ample notice to the entire Section, and with an opportunity for Section members to consider the qualifications of those who wish to serve as Officers or Council members, before a vote is taken.

Other projects which I will ask the Council to consider and implement include the following:

1. Development of prototype committee meeting formats/mechanics.

2. Liaison with Texas Community Building with Attorney Resources (known as "Texas C-BAR"), a statewide pro bono initiative for transactional attorneys.

3. Consideration of a grant program or other financial assistance for projects at law schools or other academic institutions that will be of benefit to the Section.

4. Increasing the profile of Section members with federal, state and local tax officials.

Finally, as provided for in our bylaws, I have appointed three ex-officio members of Council to serve for the 2003-2004 term (in alphabetical order): Eleanor Kim (formerly of the Comptroller's General Counsel office, but soon to be Chief Administrative Law Judge); Bernard B. Nelson, IRS Area Counsel (Natural Resources); and William P. Streng, Professor at the University of Houston Law Center. We are quite fortunate to have Eleanor, Bernie, and Bill agree to serve, and I feel sure their perspectives will be of great value to the Council over the coming year.

Please feel free to e-mail me with any suggestions you have for projects your leadership should consider over the next year.

Jasper G. Taylor, III
Chair, Section of Taxation
State Bar of Texas

CONGRATULATIONS!!

to

Vester T. Hughes, Jr

2003 recipient of the

Outstanding Tax Lawyer Award

The first presentation of the Outstanding Tax Lawyer Award was made to Vester T. Hughes, Jr. at the 2003 Advanced Tax Course held in Dallas, Texas, on September 19, 2003. The selection of Vester Hughes sets a high standard for all future recipients. His career as a tax lawyer spans six decades during which he has been an important part of the local, state and national tax practice.

Contrary to popular opinion, Mr. Hughes did not start life as the Tax Czar. He grew up in a small ranching community close to San Angelo. In 1949, he graduated from Rice with degrees in physics and math, and in 1952, graduated from Harvard Law School. Following graduation, Mr. Hughes served as the law clerk to U.S. Supreme Court Justice, Tom Clark, and then after his judicial clerkship, he served in the U.S. Army during the Korean War.

Mr. Hughes returned to Dallas after the war and started law practice as an associate with the law firm that would become Jackson Walker. He continued with that firm for 16 years until 1976 when he joined the law firm that would become the firm that bears his name, Hughes & Luce.

Mr. Hughes is one of the world's top tax experts and his accomplishments are many. He has served as the Chairman of the Tax Section of the Texas State Bar; as member of the Council of the Taxation Section of the ABA; member of the Council of the American Law Institute; visiting professor of law at Southern Methodist University Law School; Institute Chairman of the Taxation Division of the Southwestern Legal Foundation. He is also the author of many tax publications and a frequent lecturer at tax institutes.

Mr. Hughes is an active participant in a number of charities. He has served as a trustee of the Texas Scottish Rite Hospital for Children since 1967 and has served as a member of the Board of Directors of the Juvenile Diabetes foundation since 1982.

Mr. Hughes has argued a number of cases before the U.S. Supreme Court and U.S. Court of Appeals, advised congressional committees and administrative agencies regarding tax laws, and represented public companies such as American Airlines and Electronic Data Systems.

With all that said, when thinking of words to describe Vester T. Hughes, Jr. and the values he has taught those that have followed him in practice, people choose such words as: ethical, and principled, a lawyer of integrity and character, and a friend and mentor to many.

SECTION OF TAXATION OF THE STATE BAR OF TEXAS

2003-2004 CALENDAR

July	
11	New Chair/Treasurer Orientation, Texas Law Center - Austin
15	Quarterly dues check mailed to section treasurers
August	
1-2	Local Bar Leaders Conference, Omni Mandalay, Las Colinas
10	Texas Bar Foundation grant application deadline
September	
1	Inform State Bar of section's Annual Meeting program chair
12	Council of Chairs meeting, Austin
21	State Bar of Texas CLE 21st Advanced Tax Law Course (co-sponsored by the Section of Taxation) in Dallas, Texas. For more information, visit www.TexasBarCLE.Com click on "Courses" and search Practice Areas for "Tax"
26	10:00 a.m. - 12:00 p.m. Council/Committee Chairs Meeting **MANDATORY IN PERSON ATTENDANCE BY ALL COUNCIL MEMBERS AND EITHER CHAIR OR VICE CHAIR** Fulbright & Jaworski L.L.P. 1301 McKinney, Suite 5100 Houston, Texas 77010-3095 713-651-5100
October	
3	SBOT section program chair: Select program and proposed speakers for SBOT Annual Meeting 2004
15	Quarterly dues check mailed to section treasurer

November	
14	10:00 a.m. - 12:00 p.m. Council/Committee Chairs Meeting Fulbright & Jaworski L.L.P. 1301 McKinney, Suite 5100 Houston, Texas 77010-3095 713-651-5100
December	
12	Prepare section mid-year report (due Jan. 1)
January	
15	Quarterly dues check mailed to section treasurer
16	Council of Chairs meeting, Austin
16	10:00 a.m. - 12:00 p.m. Council/Committee Chairs Meeting **MANDATORY IN PERSON ATTENDANCE BY ALL COUNCIL MEMBERS AND EITHER CHAIR OR VICE CHAIR** Fulbright & Jaworski L.L.P. 1301 McKinney, Suite 5100 Houston, Texas 77010-3095 713-651-5100
February	
6	Send information to State Bar for promotional section flyers and annual meeting registration form
March	
12	10:00 a.m. - 12:00 p.m. Council/Committee Chairs Meeting Fulbright & Jaworski L.L.P. 1301 McKinney, Suite 5100 Houston, Texas 77010-3095 713-651-5100

April	
1	Deadline for SBOT Annual Meeting resolutions
9	Council of Chairs Meets - TLC, Austin
15	Quarterly dues check mailed to section treasurer
May	
7	Prepare section end-of-the year report for publication in July Bar Journal
14	10:00 a.m. - 12:00 p.m. Council/Committee Chairs Meeting Fulbright & Jaworski L.L.P. 1301 McKinney, Suite 5100 Houston, Texas 77010-3095 713-651-5100
June	
24-25	SBOT Annual Meeting, San Antonio

"NO NEW TAXES" BUT STILL WORTH A LOOK: STATE TAX DEVELOPMENTS IN THE REGULAR SESSION OF THE 78TH LEGISLATURE

Geoffrey R. Polma[1]
Daniel L. Timmons[2]

Notwithstanding the political promise of "no new taxes" by the Governor, Lieutenant Governor, and most legislators, the regular session of the 78th Texas Legislature saw the passage of several bills notably affecting tax laws in the State of Texas. This Article summarizes and comments on selected new legislation affecting state-administered taxes,[3] including changes to the laws governing tax refund procedures, sales and use taxes, franchise taxes, motor fuels taxes, oil and gas production taxes, cigarette taxes, hotel occupancy taxes, and other miscellaneous tax and related provisions.

General Tax Refunds

Comptroller's Fiscal Bill

H.B. 2425[4] was introduced as the Comptroller's "fiscal bill," a legislative vehicle traditionally proposed by the Comptroller each session to make various statutory adjustments to facilitate the administration of the state's financial resources and to maximize the effectiveness of the agency's resource control. As the regular session progressed, H.B. 2425 was amended to include a number of tax provisions originally introduced in other bills, including many affecting a taxpayer's ability to claim a tax refund.[5]

The most significant provisions of H.B. 2425 try to restrict who can file a refund, the specificity with which a refund must be claimed, and the limitations period applicable to the refund. These new procedural rules apply only to refunds filed after H.B. 2425's June 20, 2003 effective date[6]; refunds on file as of the effective date will continue to be subject to prior law.[7]

An initial provision of uncertain significance narrows the ability to file a refund "only" to a person who "directly" paid the tax "to this state."[8] This provision seemingly responds to a Texas Supreme Court decision that allowed a customer who paid sales tax to a retailer to seek a refund directly from the Comptroller, overruling the Comptroller's long-standing policy of restricting refunds to vendors who collected and remitted the tax or purchasers holding assignments of refund rights from such vendors.[9] However, at approximately the same time as the supreme court case, the Legislature incorporated into the Texas Tax Code the right of a taxpayer with a sales tax permit to claim directly a refund for taxes overpaid on purchases from vendors.[10] Thus, the main effect of the new provision might be to eliminate the ability of non-permitted purchasers to claim refunds directly from the state of taxes paid in error to vendors.

Historically, taxpayers have been able to file very skeletal refund claims that broadly tolled statute of limitations and initiated the refund process. These "placeholder" refund claims were common. The law has been amended to prevent a taxpayer from relying on a general statement of the reasons or grounds for making a refund claim; instead, the taxpayer must fully state in detail each reason or ground on which the claim relies.[11]

H.B. 2425 also creates new procedural bars to limit refund claims. If a taxpayer does not request an administrative hearing on the denial of a refund claim, the period during which the Comptroller informally reviewed the refund claim does not toll the statute of limitations applicable to any subsequent refund on the same period and type of tax.[12] Also, in a potentially significant development, the Comptroller can now set a binding deadline of at least 180 days after the filing of a refund claim for submission of any supporting evidence. This deadline acts as a procedural bar to the consideration of any additional evidence during an administrative hearing; however, the evidence exclusion does not apply to an appeal of a refund denial to district court—a distinction that may drive taxpayers to the courthouse.[13]

Finally, H.B. 2425 changes a taxpayer's deadline for giving notice to the Comptroller of any administrative or judicial final determination (typically an IRS determination) that affects the amount of the taxpayer's tax liability from 60 days to 120 days following the final determination.[14] After receiving notice, a taxpayer and the Comptroller each have up to one year to seek any resulting overpaid or underpaid tax.[15] If a taxpayer chooses not to timely notify the Comptroller, the Comptroller has up to one year after discovering the final determination to seek any resulting underpaid tax.[16] If the Comptroller seeks to collect the underpaid tax by issuing a final deficiency determination, then a taxpayer may file a refund claim (limited to the amount, items, and period for which the determination was issued) within 180 days after the determination is issued.[17]

Rider 11

Late in the regular session, the conference committee on the general appropriations bill (H.B. 1), without notice or opportunity for public comment[18], attached a special Rider 11 "Appropriation on Tax Refunds" to H.B. 1.[19] Rider 11 materially limits the ability of the Comptroller to pay large tax refunds during the 2004-2005 biennium. Although as of this writing the Texas Legislature in special session was considering the possible repeal of Rider 11[20], the likelihood of repeal is uncertain.

Rider 11 begins innocuously enough by appropriating to the Comptroller as much of the taxes and other revenues she administers and collects as may be necessary to pay refunds, interest costs, and attorney fees awarded. Among the conditions imposed, however, taxpayers are limited to a maximum tax refund of $250,000 on any claims, judgments, or settlements during the 2004-2005 biennium. Any refunds in excess of $250,000 must be specifically appropriated by the legislature, which might entail a wait of up to two years.[21]

The $250,000 cap is subject to certain exceptions and exclusions. For example, by its terms the cap is waived for refunds paid on certain orders, settlements, or decisions executed prior to Rider 11's "effective date." The Comptroller is taking the position that the effective date is June 22, 2003, the day the Governor signed the bill.[22]

More significantly, the Comptroller intends to mitigate substantially the harsh impact of Rider 11 by allowing refund amounts in excess of $250,000 to be taken as prospective credits on tax returns—even across different types of taxes.[23] Thus, taxpayers such as retailers that collect and remit substantial amounts of sales taxes should be able to capture quickly the economic benefit of large refunds by claiming credit offsets on monthly sales tax returns and remittances. Equally significantly, the Comptroller apparently intends to allow taxpayers freely to assign such credits for amounts disallowed by Rider 11, even between unrelated parties.[24] This policy creates the potential for development of a secondary market for trafficking in credits between taxpayers who cannot and those who can use credits on prospective tax returns. It would be ironic if the administrative burdens on the State and potential for abuses associated with a secondary market exceed the fiscal benefit associated with the much-criticized Rider 11. Finally, the Comptroller apparently will not extend the credit mechanism to refunds resulting from settlements or judgments in matters that are the subject of litigation.[25]

At least one taxpayer has already filed a judicial action to overturn Rider 11 on constitutional grounds.[26] This taxpayer's first amended original petition alleges that Rider 11's limitation on payment of tax refunds and judgments (i) violates the open courts provisions of the Texas Constitution by creating an unreasonable financial barrier to a remedy; (ii) violates the separation of powers doctrine of the Texas Constitution by limiting a court's power to render an enforceable judgment; and (iii) serves no reasonable governmental interest. More taxpayer challenges may already exist or are likely to follow, and it remains to be seen whether any court will uphold the limitations of Rider 11.

Enterprise Zone Incentives

Senate Bill 275[27] restructures the state's "Enterprise Zone Program" to enhance and modify existing incentive programs for enterprise projects, including tax refunds, to help encourage job creation and retention opportunities in the State of Texas. S.B. 275 stemmed from Texas' periodic "sunset" review of all state agencies, and its primary goal was the elimination of separate state agency status for the primary administering body for the Enterprise Zone Program (the Texas Department of Economic Development) and the consolidation of its functions under the Office of the Governor.[28] In addition, S.B. 275 streamlined and simplified the process under which enterprise zones are designated and "enterprise project" status is requested and certified.[29] More narrowly, S.B. 275 added two new, higher levels of enterprise projects, "double jumbo" and "triple jumbo" projects, which are subject to higher tax refund amount ceilings.[30] Generally, enterprise projects can qualify for state franchise tax and sales and use tax refunds and credit offsets, as well as local incentives, for expenditures for qualifying capital investments and job creation at a qualified business site[31]

Sales and Use Tax

Streamlined Sales Tax Compliance

The current patchwork multi-state sales and use tax system has been widely recognized by government and business as overly complex and unduly burdensome.[32] With this in mind, on November 12, 2002, thirty-three member states (including Texas) of the Streamlined Sales Tax Implementing States approved the terms of a Streamlined Sales and Use Tax Agreement (the "Agreement").[33] The Agreement seeks to simplify the nation's sales tax laws by establishing one uniform system to administer and collect sales taxes. Many states have begun passing legislation to bring their state system into compliance with the Agreement's provisions. Once the state is certified as being in compliance with the Agreement, the state can choose to enter into and be bound by the Agreement. However, even if entered into by the state, the Agreement is not binding, nor do its provisions take effect, until a minimum of 10 states consisting of 20 percent of the total population of states with a sales tax have entered into the Agreement. It appears that this threshold is close to being met.[34]

This session, the Texas Legislature passed legislation making statutory changes to the Texas Tax Code necessary to bring Texas into compliance with the terms of the Agreement, but the Legislature did not go so far as to actually enter into the Agreement. The legislation did, however, grant the Comptroller the power to enter into the Agreement on behalf of the State of Texas if the Governor, Lieutenant Governor, Speaker of the House, and the Comptroller unanimously agree that it would be in the best interest of the State of Texas to do so.[35] The legislation also authorizes the Comptroller to adopt rules as necessary to keep Texas in compliance with the Agreement.[36]

The statutory changes made to conform the Texas Tax Code to the Agreement include several material changes to the rules governing the collection of local sales and use taxes. The changes first lay the groundwork for a "destination source rule" by requiring a permitted retailer or any other seller in Texas to collect any applicable local use tax due from a purchaser, even if the seller is not engaged in business in the local jurisdiction into which the item is shipped or delivered.[37] Consistent with this directive, the legislation then creates a destination sourcing rule for collecting local taxes on sales of a taxable service[38], deeming such sales to be "consummated at the location at which the service is performed or otherwise delivered."[39]

However, the legislative changes failed to carry through and finalize a destination sourcing regime under which all local taxes are identified and collected based on delivery location. The Legislature did not change the current "origin sourcing" rule for sales of tangible personal property for local sales and use tax purposes, and, as a result, Texas' origin sourcing rule remains in conflict with the Agreement's destination sourcing requirements. This inconsistency may raise doubts as to whether Texas law is in compliance with the Agreement, and thus whether Texas will be eligible to enter into the Agreement.[40] The Legislature apparently is aware of these issues, as H.B. 2425 requires Comptroller to conduct a study of the economic and other costs to political subdivisions of Texas of changing the sourcing laws relating to the sale of tangible personal property to comply with the Agreement.[41]

Reversal of *Morton Buildings*

H.B. 2425 also contains legislation overturning the 1997 Court of Appeals decision in *Sharp v. Morton Buildings, Inc.*[42] In *Morton Buildings*, the Court of Appeals held that use taxes were not due on building components built out-of-state and brought into Texas to construct prefabricated buildings. According to the Court of Appeals, the building components were distinct from their constituent raw materials and were manufactured rather than purchased by the taxpayer.[43] The rationale in *Morton Buildings* has since been extrapolated by the Comptroller's office to exempt other taxpayers' self-constructed assets from use tax, including computers constructed out-of-state.[44] The new legislation aims to tax *Morton Buildings*-type transactions by extending the definition of "use," for purposes of whether use tax liability is incurred, to include tangible personal property (other than printed material) that has been processed, fabricated, manufactured, attached or incorporated into other property that is transported into the state.[45] Although a literal reading of the legislation leaves vague the scope of the "printed material" exception, we understand it was intended to preserve for retailers the benefit of millions of dollars in use tax savings each year for catalogs and circulars published out-of-state.[46]

Purchasing Arrangements

Legislation was also enacted to counter certain tax-advantaged purchasing arrangements. One purchasing arrangement that may be the focus of this legislation involves a taxpayer who contracts with another party in order to source ultimate customer sales for local sales and use tax purposes to such other party's tax-advantaged locality, where the taxpayer itself does not have a significant presence.[47] The arrangement may use a contractual agency relationship to create a "place of business of the retailer" for purposes of sourcing the seller's origin-sourced local tax collection obligations to the tax-advantaged locality from which customer sales are consummated. H.B. 3534 will make this arrangement more difficult by providing that certain locations do not qualify as a "place of business of the retailer." H.B. 3534 provides that an outlet, office, facility, or location that contracts with a business to process invoices or bills of lading onto which sales tax is added is not a "place of business of the retailer" if the Comptroller determines that the arrangement exists to avoid city sales tax or to rebate a portion of the city tax to the contracting business.[48] If the Comptroller makes such a determination, a sale is deemed to be made where the outlet, facility, or location "purchased the taxable item for resale."[49]

H.B. 2912 counters certain other purchasing arrangements by prohibiting the offering of an incentive payment to certain captive purchasing companies.[50] More specifically, H.B. 2912 provides that an industrial development corporation may not make an economic incentive payment to a business whose primary function is to purchase items for resale to a person or entity that owns at least 80% of the business.[51]

Comptroller's Technical Corrections Bill

H.B. 2424 is this session's version of the "technical corrections" bill recommended by the Comptroller each session to correct, conform, or facilitate the administration of Texas Tax Code provisions that contain technical errors, ambiguous language, or outdated section references.

As might be expected, only a few provisions in H.B. 2424 are of potentially broad significance. One such provision specifically excludes Internet advertisements from the definition of taxable data processing services. This provision apparently was intended to codify and validate Comptroller policy with respect to Internet advertisements.[52] The types of Internet advertisements excluded from tax comprise classified advertisements, banner advertisements, vertical advertisements, and links when displayed on an Internet website of another person.[53] A second significant provision in H.B. 2424 provides that contractors do not qualify for the manufacturing exemption from sales and use tax on items used in the performance of contracts to improve real property.[54]

H.B. 2424 also contains several more technical but still noteworthy provisions. First, telecommunications providers no longer are required to separate charges for taxable and nontaxable services, so long as the nontaxable portion of a single charge can be identified through the provider's books and records kept in the regular course of it business.[55] Second, in an example of one of several "rifleshot" provisions aimed at one or very few taxpayers, the bill creates a sales tax exemption for biotechnology and pharmaceutical cleanrooms and equipment that are installed as part of a new facility on which construction began after July 1, 2003 and prior to August 31, 2004, and that is valued at a minimum of $150 million.[56]

Custom Brokers

New legislation will also affect custom brokers who help foreign shoppers get sales tax refunds.[57] The legislation contained in H.B. 109[58] is intended to tighten the reporting and documentation of these refunds, including penalties for noncompliance and increased license fees and bonds. The law imposes new requirements that custom brokers must witness the goods (on which sales tax is refunded) being exported or verify that the goods are exported through a set of required documents.[59] H.B. 109 arose as an alternative to the Comptroller's recommendation to completely abolish the custom broker system, coming on the heels of a report issued earlier this year in which the Comptroller concluded that fraud in this arena deprived the state and border cities of at least $30 million in lost tax revenues.[60]

Texas Emissions Reduction Plan

H.B. 1365 revises the Texas Emissions Reduction Plan for complying with federal air-quality standards to provide for replacement funding sources from motor vehicles and equipment. The new funding sources replace the old $225 out-of-state vehicle registration fee found unconstitutional last year in state district court. The replacement funding sources include (*i*) doubling the sales tax surcharge from 1% to 2% on off-road, heavy-duty diesel equipment; (*ii*) making mining equipment subject to the sales tax surcharge; and (*iii*) extending the sales tax surcharge to the use, as well as purchase, of subject equipment.[61] The Comptroller has implemented these changes in a draft proposed rule that provides for an emergency amendment of Comptroller Rule 3.320.[62]

Franchise Tax

While the session did not end with the passage of any significant franchise tax legislation[63], the session was filled with a frenzy of bills and political jockeying focused on the franchise tax. The session opened with Comptroller Carole Keeton Strayhorn discounting her franchise tax revenue estimate by $360 million, citing an increasing use of the so-called "Delaware Sub" structure, a tax-avoidance technique that filters ownership of Texas operations through limited partnerships and out-of-state holding companies to virtually eliminate the tax.[64] The Comptroller declared that in order to recover this lost revenue, the Legislature would have to (*i*) close the Delaware Sub loophole; and (*ii*) enact so-called "anti-Geoffrey's"[65] provisions that would limit taxpayers' ability to take deductions for interest, royalties, and management fees arising under intercompany agreements.[66] Governor Perry also voiced his sentiments early on in the session by stating in his State of the State address that any legislation closing the Delaware Sub loophole should not be considered a "new tax."[67] This statement was crucial; as the Governor and most legislators had made the political promise that the session would not include any "new taxes." Lieutenant Governor Dewhurst also weighed in to support closing of the Delaware Sub loophole.[68] Following the Comptroller, Governor, and Lieutenant Governor's lead, the House and

Senate both put forward bills aimed at closing the Delaware Sub loophole.

H.B. 3146 was the House's attempt to close the Delaware Sub loophole, proposing an entity-level tax on all limited liability entities. Consistent with the Comptroller's call for anti-Geoffrey's provisions, H.B. 3146 also disallowed deductions for all payments of management fees, interest, or royalties to related parties. Needless to say, H.B. 3146 was a broad-based bill that would have brought a number of otherwise untaxed businesses into the franchise tax regime. Due to its broad-sweeping provisions, H.B. 3146 looked like a new tax to many House members, and as a result it never gained enough momentum to even make it out of the House Ways and Means Committee for a vote.[69]

The Senate took a narrower approach in its attempt to close the Delaware Sub loophole, adding a Delaware sub "fix" as an amendment to H.B. 2425 as it passed out of the Senate Finance Committee.[70] Instead of adopting an entity-level tax, H.B. 2425 contained provisions under which a limited partner interest would constitute "doing business" or nexus in Texas, essentially overruling the Comptroller's long-standing policy that merely owning a limited partner interest does not create nexus in Texas. The Senate's approach also contained less draconian anti-Geoffrey's provisions, disallowing deductions for payments of management fees, interest, or royalties to related parties only to the extent such payments do not have a legitimate business purpose. While the Senate approach was more narrowly targeted than the House approach, Senate members were concerned that these provisions would extend beyond taxing only those entities using the Delaware Sub structure, and thus would be considered a "new tax." As a result, the entire Senate voted the amendment down on the floor.[71]

While the regular session did not produce any legislation to close the Delaware Sub loophole, such legislation may be more likely to pass in a special session, during which the political promise of "no new taxes" may not apply.[72]

Motor Fuels Taxes

In brief, the Legislature enacted the following legislation related to motor fuels taxes:

- H.C.R. 82 requests Congress to increase the state's share of revenue from the federal fuel tax to 95 percent.

- H.B. 2425 provides that a motor vehicle air conditioning and heating system is not a "power take-off system." Accordingly, the fuel used in these systems is no longer eligible for a tax refund.[73]

- H.B. 2458 replaces the current motor fuel tax law contained in chapter 153 of the Tax Code with a new chapter 162. More specifically, H.B. 2458 moves the point of collection of motor fuel taxes from the distributor level to the terminal loading rack. Accordingly, motor fuel taxes will be collected and remitted to the Comptroller based on the net gallons of gasoline and diesel removed from the terminal rack. The tax-free purchase of diesel fuel for off-highway use will be limited to "dyed" diesel fuel. Refunds may be claimed only for "dyed" diesel fuel, and not "clear" diesel fuel, used for tax-exempt purposes. This legislation also affects many of the current motor fuel tax permits and returns. A primary objective of these changes was to reduce the number of persons collecting the tax by moving the point of collection to the highest point in the marketing chain.[74]

Oil and Gas Production Taxes

In brief, the Legislature enacted the following legislation related to oil and gas production taxes:

- H.B. 2425 provides that for applications submitted after January 1, 2004 for certification that a well produces high-cost gas, the total allowable severance tax credit or refund will be limited to the total tax paid on gas that was produced during the two-year period preceding the month in which the application is filed.[75]

- H.B. 2424 removes the following existing sunset date provisions (i) the September 1, 2010 sunset date for the completion of gas wells that can qualify for the severance tax reduction for producing high-cost gas; and (ii) the January 1, 2008 sunset date for filing an application for approval as an enhanced recovery project that qualifies for a reduced severance tax.[76]

- H.B. 3442 provides that certain oilfield cleanup fees are assessed without regard to any natural gas and crude oil production tax exemptions.

Cigarette Taxes

In brief, the Legislature enacted the following legislation related to cigarette taxes:

- H.B. 3139 requires that a cigarette excise tax be paid and customer age be verified on the delivery sale of cigarettes to non-permitted customers in Texas. Specific procedures for verifying age must be followed. Civil and criminal penalties are set forth for violations of these provisions, including forfeiture of cigarettes and other property of the seller.

- H.B. 3141 requires persons transporting cigarettes from Texas for sale in another state to either stamp or pay the other state's excise tax, in addition requiring that sellers file quarterly reports with the Attorney General documenting these sales.

Hotel Occupancy Taxes

In brief, the Legislature enacted the following legislation related to hotel and occupancy taxes:

- S.B. 234 allows a county that borders Lake Buchanan and has a population of at least 34,000 to impose a hotel occupancy tax.

- H.B. 1459 concerns the rate of hotel taxes imposed and the purposes of the spending of this revenue in certain municipalities with a population of less than 5,000.

- S.B. 1784 allows certain general-law coastal municipalities to increase the rate of municipal hotel occupancy taxes imposed and addresses the purposes of the expenditure of this increased revenue.

- H.B. 2076 concerns the rate of hotel taxes imposed and the purposes of the spending of this revenue in certain counties.
- H.B. 2162 concerns the authority of certain counties bordering Mexico or the Neches River to impose a hotel tax.
- H.B. 2322 addresses the authority of certain counties bordering Mexico or Lake Livingston to impose a hotel tax.
- H.B. 2424 provides that state hotel occupancy tax is owed when a room is rented for $15 or more per day.[77]
- H.B. 2424 provides that out-of-state colleges and universities no longer qualify as educational organizations exempt from state hotel tax.[78]
- H.B. 2424 provides that a hotel may accept, in good faith, a hotel occupancy tax exemption certificate when it is accompanied by certain supporting documentation.[79]
- H.B. 2424 provides that a bill that includes a charge for sports/community venue hotel tax must also separately list each applicable hotel tax and rate that is also charged on the bill.[80]
- H.B. 2718 addresses the allocation and purposes of the spending of municipal hotel taxes collected in certain municipalities bordering bays.
- H.B. 2961 provides for the allocation and purposes of the spending of municipal hotel taxes collected in certain municipalities.
- H.B. 3282 provides for the authority of certain counties bordering the United Mexican States and Falcon Lake to impose a hotel tax and the rate charged.

__Miscellaneous Tax and Related Provisions__

In brief, the Legislature also enacted the following tax related legislation:

- S.C.R. 1 requests Congress to restore the federal income tax deductibility of state and local sales taxes.
- H.C.R. 247 requests Congress to modify the Internal Revenue Code to allow retirees to pay for health care costs on a pre-tax basis.
- H.R. 526 and S.R. 373 address the prohibiting of courts from mandating states or political subdivisions to levy or increase taxes.
- S.B. 972 adds certain municipalities to the territory of a regional transportation authority.
- S.B. 1111 concerns the financing, construction, operation of, and records regarding venue projects in certain populous counties and the authority to finance through a tax rate of up to six percent.
- H.B. 1675 requires that the Comptroller provide an estimate of tax revenue that would be deposited in the Pan American Games trust fund if the games were held in the state.
- H.B. 3075 provides for local agreements to allow certain development corporations and taxing units to invest in and receive tax revenues from certain regional economic development projects.
- H.B. 3583 creates the Great Southwest Improvement District for the purpose of promoting certain portions of Arlington in Tarrant County, and grants the district the authority to impose a tax and issue bonds.
- H.B. 3588 addresses the construction, acquisition, financing, maintenance, management, operation, ownership, and control of transportation facilities and the progress, improvement, policing, and safety of transportation in the state; and imposes certain criminal penalties.

ENDNOTES

1 Of Counsel, Vinson & Elkins L.L.P.

2 Associate, Vinson & Elkins L.L.P. The authors would also like to thank John D. Christian, Of Counsel, Vinson & Elkins L.L.P., for his insightful comments and contributions.

3 This Article does not address legislation affecting insurance taxes, property taxes or other locally administered taxes and fees.

4 Tex. H.B. 2425, 78th Leg., R.S. (2003)("H.B. 2425").

5 *See, e.g.*, provisions overruling *Morton Buildings, infra*, introduced originally in H.B. 3269 by Rep. Pete Gallego, and later migrating to H.B. 2424 as a May 9, 2003 amendment introduced by Rep. Gallego.

6 H.B. 2425 §122(i); *see also* Taxability Ruling 200306964T (June 23, 2003).

7 *See* Taxability Ruling 200306964T (June 23, 2003).

8 H.B. 2425 § 86; *see also* Taxability Ruling 200306964T (June 23, 2003).

9 *See* __Fleming Foods of Texas, Inc. v. Rylander__, 6 S.W.3d 278 (Tex. 1999).

10 *See* TEX. TAX CODE ANN. § 151.430 (Vernon 2002)(the "Texas Tax Code").

11 H.B. 2425, § 86.

12 *Id.* § 87. The Comptroller recently stated that "HB 2425 codifies existing policy of the agency that an informal review of a refund does not toll the statute of limitations." Taxability Ruling 200306964T (June 23, 2003). In the authors' experience, however, the effect of an administrative review of a refund claim on the statute of limitations for the period and type of tax at issue has been a source of some confusion prior to H.B. 2425. *E.g.*, Letter Ruling 9510175L (Oct. 5, 1995)(superseded)("We consider an 'informal review' of a refund claim an administrative proceeding for purposes of tolling limitations under Sec. 111.207(d), Tex. Tax Code.").

13 *Id.* § 88. The text of the statutory change raises some interesting interpretive issues. The provision, added as new section 111.105(e) of the Texas Tax Code, reads:

> During the administrative hearing process, a person claiming a refund under Section 111.104 must submit documentation to enable the comptroller to

> verify the claim for refund. The comptroller may issue a notice of demand that all evidence to support the claim for refund must be produced before the expiration of a specified date in the notice. The specified date in the notice may not be earlier than 180 days after the date the refund is claimed. The comptroller may not consider evidence produced after the specified date in the notice in an administrative hearing. The limitation provided by this subsection does not apply to a judicial proceeding filed in accordance with Chapter 112.

Although this provision is found in a section of the Texas Tax Code dealing with administrative hearings on tax refunds, the second sentence arguably allows the issuance of a "notice of demand" before the refund is denied and a hearing requested. More troubling, the 180-day limit on the deadline is tied only to the filing date of the refund claim, not the progress of the hearings process. In the authors' experience, most refund claims do not become the subjects of administrative hearings until at least several months after the claims are filed, and frequently in excess of 180 days. This typical fact pattern raises the unsettling hypothetical of a refund that becomes the subject of an administrative hearing after 180 days, immediately after which the Comptroller issues of a notice of demand requiring the taxpayer to provide all remaining evidence within one week. To exacerbate the problem, assume that the development of the legal issues in the case creates a previously unforeseen need for additional minor, but crucial factual documentation—which the taxpayer would be irrevocably prohibited from providing (i.e., "the comptroller *may not* consider evidence produced after the specified date" (emphasis added)).

14 *Id.* § 90.

15 *Id.*

16 *Id.*

17 *Id.*

18 *See* William Hoffman, *Tax reg adds new kink to getting refunds*, Dallas Business Journal, June 23, 2003 <http://dallas.bizjournals.com/dallas/stories/2003/06/23/story6.html> ("Bill Allaway, president of the Texas Taxpayers and Research Association in Austin, said, 'It is pretty troubling' that Rider 11 was attached to the state budget with no public notice or debate.").

19 Tex. H.B. 1, 78th Leg., R.S. (2003).

20 *See* amendment to Tex. H.B. 3, 78th Leg., 2d C.C. (2003), introduced by Rep. Brian McCall on August 13, 2003.

21 Tex. H.B. 1, 78th Leg., R.S., Rider 11, subsection (b) (2003).

22 *See* Draft Amendment to 34 T.A.C. Rule 3.2 <http://www.ryanco.com/develop/Proposed_Amendment_to_General_Rule_3.2.html>.

23 *See, e.g., id*; Comptroller's Initial Policy Statement Regarding Rider 11 (July 14, 2003) <http://www.tipro.org/rider11policy.html>.

24 The Comptroller's refusal to extend the credit mechanism to settlements of litigation is questionable because arguably there is no substantive difference between a settlement agreement entered into before or after a contested matter has been removed from the agency to a court. Even though a settlement agreement may be reduced to a consent judgment in district court, it remains a contract between the parties that is interpreted and enforceable as such. *See* Wilson v. Uzzel, 953 S.W.2d 384 (Tex. App.–El Paso 1997, no pet.); Avila v. St. Luke's Lutheran Hosp., 948 S.W.2d 841 (Tex. App.–San Antonio 1997, pet. den.); Sanderlin v. Sanderlin, 929 S.W.2d 121 (Tex. App.–San Antonio 1996, pet. den.); Biaza v. Simon, 879 S.W.2d 349 (Tex. App.–Houston [14th Dist.] 1994, pet. den.); Wright v. Allstate Ins. Co., 285 S.W.2d 376 (Tex. Civ. App.–Dallas 1955, writ ref'd n.r.e.). The court does not adjudicate the claims on the merits, but merely functions as a scribe in setting down the parties' agreements. Accordingly, it might be more reasonable to interpret Rider 11 to allow a taxpayer to take credits against future liabilities as part of a compromise or settlement of a protest or refund suit, in the same manner as such credits are allowed in matters that have not been removed from the agency to a court.

25 *See, e.g.,* Draft Amendment to 34 T.A.C. Rule 3.2, *supra* note 22; Comptroller's Initial Policy Statement Regarding Rider 11, *supra* note 23.

26 *See* Apollo Paint & Body Shop, Inc. v. Strayhorn, Cause No. GN300886 (Dist. Ct. Travis County, filed June 27, 2003).

27 Tex. S.B. 275, 78th Leg., R.S. (2003)("S.B. 275").

28 *See* Sunset Advisory Comm'n of the State of Texas, Report to the 78th Legislature 83-88 (2003)(recommending abolition of the Texas Department of Economic Development).

29 *See, e.g.*, Texas Economic Development, Letter of June 11, 2003. <http://www.txed.state.tx.us/TexasEnterpriseZone/EZLEtter.doc> (summarizing programmatic changes resulting from S.B. 275).

30 *Id.* § 3.53.

31 *E.g., id.* §§ 3.15-.17, 3.52-.53; see also Tex. H.B. 2424, 78th Leg., R.S. §§ 44-50, 95 (2003)("H.B. 2424")(revising Texas Tax Code provisions granting franchise tax credits for enterprise zone investments).

32 *See* Keith R. Gercken et al., *Streamlined Sales and Use Tax System: Adoption of Landmark Multistate Agreement*, Pillsbury Winthrop LLP State & Local Tax Bulletin, November 2002, <http://www.pmstax.com/state/bull0211.shtml>.

33 *See* David Hardesty, *Streamlined Sales and Use Tax Agreement – Part 1*, E-Commerce Tax News, December 1, 2002, <http://www.ecommercetax.com/doc/120102.htm>.

34 *See* David Hardesty, *Streamlined Sales Tax Threshold Met*, E-Commerce Tax News, July 9, 2003, <http://www.ecommercetax.com/doc/070903.htm>.

35 H.B. 2425 § 94.

36 *Id.* § 95.

37 *Id.* § 100.

38 The rule does not apply to services used outside the state, which continue to be tax exempt under section 151.330(f) of the Texas Tax Code.

39 H.B. 2425 § 115.

40 *See* David Hardesty, T*exas Senate Passes Partial Streamlining Bill*, E-Commerce Tax News, May 18, 2003, <http://www.ecommercetax.com/doc/051803.htm>.

41 H.B. 2425 § 120.

42 953 S.W.2d 300 (Tex. App.—Austin 1997, pet. denied).

43 *Id.* at 303.

44 *See, e.g.*, Letter Rulings 9804482L (April 23, 1998); 9809829L (September 4, 1998).

45 H.B. 2425 § 97.

46 *See* Texas Retailers Association, *Texas Update*, Volume 10, Number 21, June 5, 2003, <http://www.txretailers.org/Texas%20Updates/2003~Session%20Wrap%20up.htm>.

47 *See* KPMG, *Texas: Refund Limitation, Other Measures are Enacted*, United States Tax News Flash, No. 2003-181, June 23, 2003, <http://www.us.kpmg.com/microsite/taxnewsflash/2003/jun/03181.html> (noting that "[t]his legislation appears to be aimed at correcting what were perceived to be 'loopholes'

that allowed businesses to situs their local tax receipts in a particular locality even if they did not have a significant presence in that locality").

48 Tex. H.B. 3534, 78th Leg., R.S. (2003).

49 *Id*.

50 *See* KPMG, *Texas: Refund Limitation, Other Measures are Enacted*, United States Tax News Flash, No. 2003-181, June 23, 2003, <http://www.us.kpmg.com/microsite/taxnewsflash/2003/jun/03181.html> ("Texas House Bill 2912 . . . prohibits the payment of an incentive payment to certain captive purchasing companies").

51 Tex. H.B. 2912, 78thLeg., R.S. § 12 (2003).

52 *See* Letter Ruling 200306993L (June 17, 2003)(explaining Comptroller policy).

53 H.B. 2424 § 16. Taxable "data processing services" as defined in section 151.0035 of the Texas Tax Code currently include "word processing, data entry, data retrieval, data search, information compilation, payroll and business accounting data production, the performance of a totalisator service with the use of computational equipment required by the Texas Racing Act (Article 179e, Vernon's Texas Civil Statutes), and other computerized data and information storage or manipulation." The actual text of H.B. 2424 merely adds the statement that "'Data storage,' as used in this section, does not include a classified advertisement, banner advertisement, vertical advertisement, or link when the item is displayed on an Internet website owned by another person," leaving open the textual argument that Internet advertising remains a taxable data processing service in instances where it qualifies as "other computerized data and information storage or manipulation." However, the authors' understanding is that the legislative intent was to make Internet advertisements nontaxable, without qualification.

54 H.B. 2424 § 18.

55 *Id.* § 99.

56 *Id.* §§ 106, 113. For other examples of what appear to be rifleshot relief provisions, see id. sections 34 and 47.

57 *See* Bill Analysis to H.B. 109 Engrossed Version.

58 Tex. H.B. 109, 78th Leg., R.S. (2003).

59 *Id.* § 2, adding new Texas Tax Code § 151.1575.

60 See Gary Scharrer, *Custom brokers may face tough sanctions*, El Paso Times, June 17, 2003, <http://www.borderlandnews.com/stories/business/20030617-126084.shtml>.

61 *See* Proposed Emergency Comptroller Rule 3.320, 28 Tex. Reg. 5489 (2003) (to be codified at 34 Tex Admin. Code §3.320) (proposed June 30, 2003).

62 *See id.* In addition to the items discussed in the text, the Legislature enacted several miscellaneous provisions affecting sales and use taxes. Tex. H.B. 164, 78th Leg. R.S. (2003) authorizes a municipality to charge a local-option sales and use tax for street maintenance at a rate of either (i) one-eighth of one percent; or (ii) one-quarter of one percent. Tex. H.B. 1088, 78th Leg. R.S. (2003) provides changes to how the Comptroller shares sales tax information with certain municipalities. Tex. S.B. 1705, 78th Leg. R.S. (2003) restructures the approval process for MTA repeal of the local sales and use tax exemption for telecommunications services. Tex. H.B. 1194, 78th Leg. R.S. (2003) provides that the surcharges originating from pipeline safety fees that the Railroad Commission charges natural gas distribution companies and master meter operators, who in turn pass such fees on to consumers in the form of the surcharges, are not subject to sales tax. Tex. H.B. 2386, 78th Leg. R.S. (2003) relates to the authority of certain municipalities or counties to impose a facility use tax to finance venue projects. Section 17 of H.B. 2424 broadens the definition of a sale or purchase to include sales of an extended warranty or service contract for the performance of a taxable service. Section 18 of H.B. 2424 provides that a contractor may not claim a manufacturing exemption on items used in the performance of a contract to improve real property. Section 19 of H.B. 2424 provides that intravenous systems, supplies, and replacement parts are exempt from sales tax when used in the treatment of humans. Section 21 of H.B. 2424 increases the price that a newspaper may charge and still receive a sales tax exemption from $.75 to $1.50. Section 23 of H.B. 2424 provides that labor to repair, remodel, or restore an improvement to certain historic property is exempt from sales tax. Section 25 of H.B. 2424 provides that a vehicle modified for an orthopedically handicapped person must be modified within two years of its purchase. Section 26 of H.B. 2424 precludes automobile dealers from advertising or telling customers or the public that the dealer will pay, refund, or not charge tax due on a motor vehicle sale or rental. Tex. H.B. 2519, 78th Leg. R.S. (2003) provides that certain bingo equipment is exempt from sales and use tax when purchased by a licensed bingo organization.

63 H.B. 2424 provides some amendments to the franchise tax statutes that represent clarifications of existing law. *See* H.B. 2424 §§ 31-32 (amending Tex. Tax Code § 171.001(a) & (b)(2) to provide that the holding of a Certificate of Authority is not sufficient in itself to subject a corporation or limited liability company to the franchise tax); H.B. 2424 § 39 (adding Tex. Tax Code § 171.110(k) to provide that dividends and interest received from federal obligations are excluded from earned surplus and gross receipts for earned surplus apportionment); H.B. 2424 § 40 (amending Tex. Tax Code § 171.110(b)-(c) to elaborate on the officer and director compensation add-back to disallow a subsidiary corporation from claiming an exclusion if the parent corporation that ultimately controls the subsidiary does not qualify for the exclusion); H.B. 2424 § 42 (adding Tex. Tax Code § 171.731 to prohibit the conveyance, assignment or transfer of the research and development credit to another entity unless all of the corporation's assets are conveyed, assigned or transferred in the same transaction); H.B. 2424 § 37 (adding Tex. Tax Code § 171.106(i) to provide that receipts from services performed in a defense economic zone by a defense readjustment project are not receipts from business done in this state); H.B. 2424 § 51 (adding a new Subchapter U for tax credits for title insurance holding companies); H.B. 2424 § 33 (amending Tex. Tax Code § 171.052 to clarify the franchise tax exemption provision for certain insurance organizations required to pay a gross premium receipts tax); H.B. 2424 § 34 (amending Tex. Tax Code § 171.084(c) to provide eligibility for the trade show exemption to tenants that lease space in a wholesale center); H.B. 2424 § 43 (amending Tex. Tax Code § 171.751(1) to expand the definition of agricultural processing to include cotton ginning); H.B. 2424 § 45 (amending Tex. Tax Code § 171.753 to provide timing guidelines for corporations eligible for the jobs creation credit); H.B. 2424 §§ 46-49 (clarifying Tex. Tax Code §§ 171.7541 & 171.802 - .804 to clarify time periods for establishing eligibility and reporting for corporations designated as an enterprise project or as a defense readjustment project eligible for the jobs creation and/or capital investment credits); H.B. 2424 § 95 (adding Tex. Tax Code § 171.8015 to elaborate on the definition of tangible personal property first placed in service in an enterprise zone); H.B. 2424 § 47 (effective October 1, 2003 adding Tex. Tax Code § 171.802(e) providing certain conditions for claiming the capital investment credit, or a carryforward credit, on certain qualified capital investments made on or after January 1, 2003); H.B. 2424 § 38 (effective January 1, 2004 adding Tex. Tax Code § 171.109(a-1) concerning the treatment of obligations related to the return of certain like-kind property); H.B. 2424 § 41 (effective January 1, 2004 adding Tex. Tax Code § 171.203(f) to add a signature and certification provision for certain electronic Public Information Report filings); H.B. 2424 § 50 (effective January 1, 2004 Tex. Tax Code § 171.853(c) to provide that the limitation for the credit for wages paid to persons with certain disabilities be based on the amount of franchise tax due before any other applicable tax credits, making this provision consistent with the computation of credit limitations for other franchise tax credits) *see also* Comptroller of Public Accounts, Tax Policy News, 2003 Legislative Issue, Volume XIII, Issue 7.

64 In one iteration of the technique, a corporation doing business in Texas and paying the tax forms two Delaware limited liability company subsidiaries (disregarded for federal tax purposes), which in turn form a limited partnership in which one of the LLCs that is domiciled strictly out-of-state owns a 99% or greater limited partner interest, and the other LLC holds the remaining interest as a general partner. The corporation pushes its business assets down to the partnership, which becomes the operating entity in Texas. If structured correctly, the corporation's Texas business activities attributable to the limited partner's interest will escape the franchise tax because under long-standing Comptroller policy, (i) owning a limited partner interest in a Texas limited partnership does not subject the out-of-state LLC to the franchise tax and (ii) any distributions from the out-of-state LLC to the corporate parent will be treated as non-Texas receipts for apportionment purposes based on Texas' "location of payor" rule for sourcing dividends and interest. For examples of authorities confirming this tax treatment, see Letter Rulings 9110L1229D08 (October 23, 1991); 9202L1231C02 (February 24, 1992); 9210L1262G04 (October 9, 1992).

65 The name derives from Geoffrey, Inc. v. South Car. Tax Comm'n, 313 S.C. 15, 437 S.E.2d 13 (1993), cert. denied, 114 S.Ct. 550, a seminal case testing the validity of a common tax avoidance structure that uses licensing payments to out-of-state intangibles holding companies to reduce the income tax base of in-state affiliates.

66 *See* Robert T. Garrett, *Business lobbyists thwarting efforts to close tax loophole*, Dallas Morning News, May 12, 2003, <http://www.dallasnews.com/sharedcontent/dallas/politics/state/stories/051203dntexfranchise.3dddc.html>.

67 *See id.*

68 *See id.*

69 *See* Texas Retailers Ass'n, *supra* note 46.

70 *See* H.B. 2425 Senate Committee Report, § 89. *Compare* H.B. 2425 Introduced Version (no section 89); H.B. 2425 Engrossed Version (no section 89); H.B. 2425 Enrolled Version (section 89 enacted without Delaware sub "fix" provisions).

71 *See* Texas Retailer Ass'n, *supra* note 46.

72 Pursuant to Tex. H.C.R. 280, 78th Legislature, R.S. (2003), the lieutenant governor and speaker of the house of representatives have created an interim Select Joint Committee on Public School Finance to "conduct a study of issues affecting the duty of the legislature to establish and make suitable provision for the support and maintenance of an efficient system of public free schools." The Committee will issue a report by March 15, 2004 addressing:

> (1) a review of the state's revenue system as it relates to the legislature's ability to provide for a constitutional school finance system;
> (2) an assessment of funding options that will sustain Texas schools for the long term and that will substantially increase the state's share of public school funding;
> (3) a determination of appropriate funding levels to enable high academic performance;
> (4) an analysis of legitimate student and school district cost differences;
> (5) a review of the appropriate role of the state in the provision of school facilities;
> (6) an examination of strategies and practices that contribute to high academic performance in schools; and
> (7) a review of possible incentives for improved student performance and cost-effective operation.

See Committee Charge, <http://www.senate.state.tx.us/75r/senate/commit/c880/c880.htm#InterimCharges>. This report might presage a Spring 2004 special session of the Texas Legislature to examine school finance issues, which could result in fundamental changes to the Texas tax system.

73 H.B. 2425 § 108.

74 *See* Texas Senate News (June 4, 2003) <http://www.senate.state.tx.us/75r/Senate/Archives/Arch03/p060403a.htm>.

75 *Id*. § 110.

76 H.B. 2424 §§ 52-53.

77 *Id*. § 28.

78 *Id*. § 29.

79 *Id*. § 30.

80 *Id*. § 89.

CORPORATE TAX: RECENT DEVELOPMENT

Ron Kerridge[1]

New Treasury Regulations under Section 338 simplify life after Rev. Rul. 2001-46

On July 9, 2003, the Treasury promulgated temporary and proposed regulations under Section 338 that address the availability of a Section 338(h)(10) election in certain multi-step acquisitions. (T.D. 9071, amending Treas. Reg. Sections 1.338-3 and 1.338(h)(10)-1.) These regulations follow up on the statement in Rev. Rul. 2001-46, 2001-2 C.B. 321, that the Treasury and the Internal Revenue Service were considering issuing such regulations. The temporary regulations confirm the major principles of Rev. Rul. 2001-46 and permit express electivity between tax-free and taxable treatment for certain multi-step acquisitions. The regulations also leave open some of the questions raised by Rev. Rul. 2001-46 and answer other questions in ways that are not completely intuitive. The regulations apply to stock acquisitions occurring on or after July 9, 2003.

Rev. Rul. 2001-46 dealt with two situations. In both fact patterns, a parent corporation acquired a target through a reverse triangular merger (i.e., a new merger subsidiary of the parent was merged into the target corporation, with the target surviving as a wholly owned subsidiary of the parent) (the "Acquisition Merger"), and subsequently, pursuant to an integrated plan, the target was merged into the parent (the "Upstream Merger"). In the first situation, the consideration was 70 percent voting stock of the parent and 30 percent cash. Because the boot exceeded 20 percent, this acquisition failed to qualify as a tax-free reorganization under Section 368(a)(2)(E). Prior to Rev. Rul. 2001-46, many tax lawyers thought was that such a transaction would be treated as a taxable stock purchase followed by a Section 332 liquidation. However, Rev. Rul. 2001-46 concluded that the step transaction doctrine applied to treat the Acquisition Merger and the Upstream Merger as an acquisition of the target's assets through a single statutory merger of the target into the parent that qualified as a tax-free reorganization under Section 368(a)(1)(A).

This result was somewhat surprising given Rev. Rul. 90-95, 1990-2 C.B. 67, which concluded that an all-cash reverse triangular merger followed by an upstream merger of the target into the parent would be treated as a qualified stock purchase for purposes of Section 338, followed by a Section 332 liquidation. Making the outcome in Rev. Rul. 2001-46 not altogether surprising was the venerable Rev. Rul. 67-274, 1967-2 C.B. 141, in which the parent acquired all the stock of the target in exchange for voting parent stock and then liquidated the target into itself. Rev. Rul. 67-274 applied the step-transaction doctrine to treat the transaction as a tax-free reorganization under Section 368(a)(1)(C), rather than as a Section 368(a)(1)(B) reorganization followed by a Section 332 liquidation.

In the second situation in Rev. Rul. 2001-46, the facts were identical to those in the first situation except that the consideration was solely voting stock of the parent. Consequently, the Acquisition Merger, viewed independently of the Upstream Merger, would qualify as a reorganization under Section 368(a)(2)(E). Consistent with its presumption in favor of application of the step transaction doctrine, Rev. Rul. 2001-46 treated this transaction as a single statutory merger of the target into the parent that qualified as a reorganization under Section 368(a)(1)(A) without regard to Section 368(a)(2)(E).

In favoring the step transaction approach over the approach that would give independent significance to the two mergers, Rev. Rul. 2001-46 took pains to examine the rationale that underlay Rev. Rul. 90-95. The rejection of step integration in Rev. Rul. 90-95 was explained as arising from Congress' intent that Section 338 replace any nonstatutory treatment of a stock purchase as an asset purchase under the doctrine of *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74, *aff'd per curiam*, 187 F.2d 718 (1951), *cert. denied*, 342 U.S. 827 (1951). That case treated a stock purchase followed by a prompt liquidation of the target into the parent as an asset purchase, permitting a step-up in asset basis. Rev. Rul. 2001-46 interpreted Rev. Rul. 90-95 as treating an Acquisition Merger followed by an Upstream Merger as a qualified stock purchase followed by a carryover basis transaction in order to preclude any nonstatutory treatment of the steps as an integrated asset purchase. Rev. Rul. 2001-46 concluded that this policy would not be violated by treating an Acquisition Merger and an Upstream Merger as a tax-free reorganization because such treatment results in carryover basis for the target's assets under Section 362, not cost basis.

Rev. Rul. 2001-46 was a real boon for parties seeking tax-free treatment of an Acquisition Merger followed by an Upstream Merger as part of an integrated plan. Transactions with more than 20 percent cash can qualify for reorganization treatment, as can all-stock acquisitions that have some other impediment to qualifying under Section 368(a)(2)(E) – such as a failure to acquire substantially all the target's assets – but meet the more lenient standards of Section 368(a)(1)(A).

But what of those parties seeking taxable treatment for the acquisition, and wanting to integrate the acquired company by promptly merging it into the parent? Prior to Rev. Rul. 2001-46, if a reverse triangular merger was a qualified stock purchase under Section 338, taxpayers would have expected Rev. Rul. 90-95 to permit a Section 338 election – either a Section 338(g) election or a Section 338(h)(10) election – given the ruling's holding that the Acquisition Merger constituted a qualified stock purchase. Rev. Rul. 2001-46 provided limited protection to pre-September 24, 2001 transactions for which a Section 338(g) or Section 338(h)(10) election was filed. Rev. Rul. 2001-46 went on to say that "the Service and the Treasury are considering whether to issue regulations that would reflect the general principles of this revenue ruling, but would allow taxpayers to make a valid election under section 338(h)(10) with respect to a step of a multi-step transaction that, viewed independently, is a qualified stock purchase if such step is pursuant to a written agreement that requires, or permits the purchasing corporation to cause, a section 338(h)(10) election in respect of such step to be made." The ruling requested comments regarding this approach.

The July 9, 2003 regulations are the fruit of these considerations and numerous comments made to the Service and the Treasury. The new regulations permit taxpayers to make a Section 338(h)(10) election with respect to an acquisition of target stock that is a qualified stock purchase notwithstanding that such acquisition is followed by a merger or liquidation of the target into the parent. These regulations do not contain the requirement, hinted at in Rev. Rul. 2001-46, that the Section 338(h)(10) election be made pursuant to a written agreement that requires or permits such an election. This is a sensible omission, given that authorization of such an election in the purchase or merger agreement is not required for a Section 338(h)(10) election to be valid.

The new regulations also make clear, by an example, that even if the acquisition step is a qualified stock purchase, if no Section 338(h)(10) election is made, an upstream merger pursuant to the plan that includes the acquisition will result in application of the step transaction doctrine when the result of such application is a Section 368(a) reorganization.

A further example clarifies that a Section 338(h)(10) election for the acquisition step will be respected when followed by a pre-planned brother-sister merger. Finally, a fourth example confirms that no Section 338(h)(10) election can be made for an all-stock Acquisition Merger followed by an Upstream Merger because the acquisition step is not a qualified stock purchase.

The new regulations do not directly answer some of the questions raised by Rev. Rul. 2001-46. Suppose that (i) the acquisition step is a qualified stock purchase, (ii) no Section 338(h)(10) election is made, and (iii) application of the step transaction doctrine would not result in a tax-free reorganization. Does Rev. Rul. 2001-46 transform a taxable stock sale into a taxable asset sale? Given the analysis in Rev. Rul. 2001-46 concerning Rev. Rul. 90-95 and Section 1.338-3(d) of the Regulations, the answer has to be no. The harder question arises when the acquisition step is a taxable stock sale but is not a qualified stock purchase, and application of the step transaction doctrine would not produce a tax-free reorganization. The better argument seems to be that the step transaction doctrine should not apply because *Kimbell-Diamond* has been entirely eclipsed by Section 338. But the new regulations pass on the opportunity to answer this question.

Some of the limitations in the new regulations are slightly disappointing. Where a qualified stock purchase is followed by an Upstream Merger and application of the step transaction doctrine would produce a tax-free reorganization, taxpayers can turn off the step transaction doctrine only by means of a Section 338(h)(10) election. It is not immediately obvious why the regulations should not permit a Section 338(g) election to have the same effect, especially given the protection that Rev. Rul. 2001-46 offers to Section 338(g) elections in connection with pre-September 24, 2001 transactions. Likewise, it is not clear as a matter of policy why an acquisition step that is a qualified stock purchase should not allow taxpayers to elect taxable stock sale treatment, rather than having to choose between a tax-free reorganization and a Section 338(h)(10) election (assuming the latter is available). Careful taxpayers can usually obtain the desired treatment in this context, but express electivity would reduce uncertainty and simplify the process of negotiating acquisition agreements.

Finally, the preamble to the new regulations included a trailer for the next sequel in the Section 338 epic. The Service and the Treasury, in addition to continuing to study the other comments received in response to Rev. Rul. 2001-46, are "considering whether any amendments to the portion of the regulations under section 338 related to the corporate purchaser requirement are appropriate."

ENDNOTE

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ESTATE AND INHERITANCE TAX CURRENT DEVELOPMENTS

Steve R. Akers[1] and Steve C. Simpson[2]

Assets Transferred to Family Limited Partnerships Included in Estate Under 2036

<u>Strangi v. Commissioner</u> Remand Summary; T.C. Memo 2003-145 (May 20, 2003)[I]

I. <u>CASE HISTORY</u>. The initial Tax Court decision held that the partnership would be respected for tax purposes despite non-tax motives for its creation, rejected any "gift on creation" for gift tax purposes, held that sections 2703 and 2704 did not apply, and determined the amount of discounts. 115 T.C. 478. The initial decision refused to allow the IRS to pursue a claim under section 2036 on procedural grounds. The Fifth Circuit Court of Appeals agreed with the Tax Court's rulings on the substantive issues but reversed on the procedural issue, and remanded the case for the Tax Court to consider the section 2036 claims by the IRS. 293 F.3d 279 (5th Cir. 2002). This is the consideration of the Section 2036 issue on remand by the Tax Court. This is a memo decision by Judge Cohen, and is not a decision reviewed by the full Tax Court.

II. <u>FACTS EMPHASIZED BY COURT</u>

1. 98% of decedent's wealth was contributed to partnership and corporation.
2. 99% limited partnership interest was retained by decedent.
3. 1% general partner was new corporation owned 47% by decedent and 53% by decedent's children. (Children subsequently gave 1% to a Foundation.)
4. Corporation entered management agreement with decedent's son-in-law (who was also decedent's attorney-in-fact under a power of attorney) to manage day-to-day business of the corporation and partnership—which the court interpreted to include making all distribution decisions.
5. Partnership agreement provided that income, after deducting certain listed expenses "shall be distributed at such times and in such amounts as the Managing General Partner, in its sole discretion, shall determine, taking into account the reasonable business needs of the Partnership (including plan for expansion of the Partnership's business)."
6. Various distributions were made to or for decedent or decedent's estate (including home health care, medical expenses of health care provider, funeral expenses, estate administration expenses, debts of decedent, specific bequest, and estate and inheritance taxes).

III. <u>HOLDINGS</u>

1. <u>Section 2036(a)(1)</u>. Section 2036(a)(1) applies to the corporation and partnership created by decedent.
   - Circumstances that generally suggest an implicit retained interest under §2036(a)(1) include: "transfer of the majority of the decedent's assets, continued occupation of transferred property, commingling of personal and entity assets, disproportionate distributions, use of entity funds for personal expenses, and testamentary characteristics of the arrangement."
   - Formalities recognizing the entity were followed ("the proverbial 'i's were dotted' and 't's were crossed'.")
   - Facts in this case indicating implicit retention of economic benefit:
     (1) Decedent contributed 98% of his wealth, including his residence. The fact that decedent possessed "liquefiable" assets to cover decedent's anticipated living needs over his short life expectancy did not matter. The relative dearth of liquefied as opposed to "liquefiable" assets reflect that the partnership and corporation would be the primary source of decedent's liquidity.
     (2) The decedent continued physical possession of his residence. The partnership charged rent to the decedent, but the court observed that the fact that the rent was merely accrued and not actually paid until over 2 years after decedent's death reflects that the rent was not arm's length. The court concluded that "accounting entries alone are of small moment in belying the existence of an agreement for retained possession and enjoyment."
     (3) While pro rata distributions were made to all partners, because interests held by others are de minimis, "a pro rata payment is hardly more than a token in nature."
     (4) Actual distributions reflect "a conclusion that those involved understood that the decedent's assets would be made available as needs materialized."
     (5) The partnership/corporation arrangement has more testamentary characteristics than a joint investment vehicle for

management of assets. Factors supporting this conclusion include the unilateral nature of the formation, the fact that contributed property included the majority of decedent's assets, and the decedent's advanced age and serious health condition.

(6) "[T]he crucial characteristic is that virtually nothing beyond formal title changed in decedent's relationship to his assets." The children did not have a meaningful economic stake in the property during decedent's life and made no objections or concerns when large sums were advanced to decedent or his estate.

2. Section 2036(a)(2). Section 2036(a)(2) applies to transfers to the corporation and partnership.

- Factors Causing 2036(a)(2) Inclusion. The court analyzed in detail the facts of this case compared to the Byrum case.

(a) Problematic Retained Powers. Decedent retained legally enforceable rights to designate who shall enjoy property and income from the partnership and corporation. The court emphasized that it is immaterial whether the documents and relationships create rights exercisable by decedent alone or in conjunction with other corporate shareholders and the corporation's president.

(1) Partnership income—the agreement gave the general partner "sole discretion to determine distributions."

(2) Partnership property—decedent can act together with the other shareholders to dissolve the partnership. (Under the partnership agreement, the partnership is dissolved by unanimous vote of limited partners and general partner. Under the corporation's bylaws, all of the corporation's shareholders must consent to dissolution of the partnership. Thus, decedent could act in his capacity as a limited partner and shareholder with the other owners to dissolve the partnership.)

(3) Corporation property and income—decedent "held the right, in conjunction with one or more other Stranco directors, to declare dividends."

(4) "Banding together" is sufficient. Taxpayers argued that if the mere fact that a decedent "could band together with all of the other shareholders of a corporation" is sufficient to cause inclusion under section 2036(a)(2), the Supreme Court could not have reached its decision in Byrum. The court responded with an analysis of the additional constraints in Byrum that are not present in this case.

(b) Comparison to Byrum. Additional constraints upon rights to designate in Byrum that are not present in this case:

(1) Independent Trustee. In Byrum, the decedent retained the right to vote stock, which could be used to elect directors, who decided what distributions would be made from the corporation. However, the stock was given to a trust with an independent trustee who had the sole authority to pay or withhold income. In this case, distribution decisions were made by the corporation. The decedent owned 47% of the stock and was the largest shareholder. All decisions were ultimately made by decedent's attorney-in-fact as the manager of the corporation and partnership. (OBSERVATION: In Byrum, a 2-step process was required to make distributions. First, the corporation had to distribute cash to the trust (and this decision was, under the court's analysis, made in connection with the decedent). Second, the independent trustee could decide to make distributions to beneficiaries. What if a partnership agreement provided a 2-step process to make distributions and the decedent could not participate at all in one of those 2 steps? If that would not cause a different result, is it really important that there was a second step in Byrum that could only be exercised by an independent trustee?) (Would there have been a different result if the limited partnership interests had been given to a trust with an independent trustee who made distribution decisions?)

(2) Economic and Business Realities. The flow of funds in Byrum was dependent on economic and business realities of small operating enterprises which impact the earnings and dividends. "These complexities do not apply to [the partnership or corporation], which held only monetary or investment assets."

(3) Fiduciary Duties. Fiduciary duties in Byrum were distinguished because there were unrelated minority shareholders who could enforce these duties by suit. "The rights to designate traceable to decedent through [the corporation] cannot be characterized as limited in any meaningful way by duties owed essentially to himself. Nor do the obligations of [the corporation's] directors to the corporation itself warrant any different conclusion. Decedent held 47 percent of [the corporation], and his own children held 52 of the remaining 53%. Intrafamily fiduciary duties within an investment vehicle simply are not equivalent in nature to the obligations created by the United States v. Byrum, supra, scenario." The fact that there was a 1% shareholder of the corporation was "no more than window dressing." "A charity given a gratuitous 1-percent interest would not realistically exercise any meaningful oversight." (OBSERVATION: The IRS made the argument that fiduciary duties negate the application of section 2036 only if there are unrelated parties to enforce the duties in Letter Ruling 8038014. Holding that fiduciary duties provide a limit on the right to designate who enjoys or pos-

sesses transferred property only if there are unrelated persons who can enforce those duties seems inconsistent with many cases that have held that very broad administrative powers retained by a donor as trustee do not invoke section 2036, primarily because of the restriction imposed by the fiduciary duties. Those cases involve trust transactions that do not involve any unrelated parties. E.g. Old Colony Trust Co. v. U.S., 423 F.2d 601, 603 (1st Cir. 1970)(broad trustee administrative powers that could "very substantially shift the economic benefits of the trust" did not invoke section 2036(a)(2) because such powers were exercisable by the donor-trustee in the best interests of the trust and beneficiaries, and were subject to court review); Estate of Gilman, 65 T.C. 296 (1975), *aff'd per cur.* 547 F.2d 32 (2nd Cir. 1976)(decedent was co-trustee with power to vote stock; there was active conduct of a business and 40% of voting shares of corporation were held by sisters and there was family disharmony); Estate of Cohen, 79 T.C. 1015 (1982)(§2036(a)(2) did not apply to decedent as co-trustee of Massachusetts real estate trust; because courts hold business trustees to a "fair standard of conduct," the decedent and his sons [as co-trustees] did not have the power to withhold dividends arbitrarily).)

3. Bona Fide Consideration Exception. The bona fide consideration exception under Section 2036 does not apply.
   - Strangi and two previous Tax Court memorandum decisions (as well as a decision of the federal district court of North Texas) have interpreted this exception in a partnership context as having two requirements. (See Estate of Thompson v. Commissioner, T.C. Memo. 2002-246; Estate of Harper v Commissioner, T.C. Memo. 2002-121; Kimbell v. U.S., 244 F. Supp. 2d 700 (N.D. Tex. 2003.) The two requirements are: (1) A bona fide sale, meaning an arm's length transaction, and (2) adequate and full consideration.

     (1) No bona fide arm's length transaction occurred. The decedent's attorney-in-fact prepared all documents without any meaningful negotiation or bargaining with other interest-holders.

     (2) Full and adequate consideration does not exist where there is a mere "recycling" of value through partnership or corporate solution. "Without any change whatsoever in the underlying pool of assets or prospect for profit, as, for example, where others make contributions of property or services in the interest of true joint ownership or enterprise, there exists nothing but a circuitous 'recycling' of value." Decedent contributed more than 99% of the total property and received back an interest "the value of which derived almost exclusively from the assets he had just assigned." (OBSERVATION: This analysis suggests the wisdom of having parties other than the decedent contribute substantial assets to the partnership.) The court distinguished the Church case, which was affirmed by the 5th Circuit Court of Appeals (which will hear the appeal of this case), because Church involved "contributions by other participants not de minimis in nature."

4. Effect of Applying Section 2036. The effect of applying section 2036 in the context of creation of the corporation and partnership is that 99% of the asset value of the partnership and 47% of the asset value of the corporation are included in decedent's estate. (These percentages are the same as decedent's ownership of the entities.) In effect, the existence of the partnership and corporation was ignored for estate tax purposes.

IV PLANNING IMPLICATIONS

1. Memo Decision. This is a memorandum decision, rather than a decision of the full Tax Court. That's interesting because the analysis under section 2036(a)(2) is novel and potentially far-reaching. However, it has not been reviewed by the full Tax Court.
2. Appeal to 5th Circuit. The IRS obtained all relief that it had been seeking in its notice of deficiency. There seems little doubt that the estate will appeal this decision to the 5th Circuit Court of Appeals. The 5th Circuit previously rejected a section 2036(a)(1) and 2036(a)(2) claim by the IRS on a partnership with a less than perfect fact situation in Church v. U.S., 268 F.3d 1063 (5th Cir. 2001)(unpublished opinion). (However, in that case the IRS only appealed a narrow issue—whether the failure to file the certificate of limited by the date of the gift was determinative.)
3. Section 2036(a)(1) Issues.
   a. Formalities Not Enough. Observing formalities was not sufficient to avoid section 2036(a)(1). (Many of the prior section 2036(a)(1) cases involved the failure to observe corporate and partnership formalities. E.g. Estate of Reichardt v. Commissioner, 114 T.C. 144 (2000); Estate of Schauerhamer v. Commissioner, T.C. Memo. 1997-242.)
   b. Retain Assets for Living Expenses. Retain sufficient liquid (not just "liquefiable") assets outside the partnership to provide anticipated living expenses.
   c. Residence. Do not transfer residence to partnership.
   d. Rentals. If taxpayer uses partnership assets, pay fair market value rental in an arm's length manner. Actually pay rent and do not just accrue rentals.
   e. Decisions Based on Personal Needs. The purpose of distributions should be based on business reasons of the partnership and not on personal desires of the taxpayer to cover personal cash needs.
   f. Contributions by Others. Having significant contributions by others helps. Making pro rata distributions to multiple partners does not

appear so much that taxpayer implicitly retained the ability to access partnership assets whenever desired. Avoiding a unilateral creation and seeking input from others about structural issues helps avoid a "testamentary" appearance.

4. Section 2036(a)(2) Issues.
   a. Dictum? Is all of the discussion about section 2036(a)(2) technically dictum, because the holding for the IRS under section 2036(a)(1) gave the IRS all of the relief that it requested? In the words of the court, "We address these arguments as an alternative to our conclusions concerning section 2036(a)(1)."
   b. Sole Discretion Over Cash Distributions. Perhaps critical to the court's analysis is that the partnership agreement gave the managing partner "sole discretion" over distributing income in excess of business needs rather than mandating distributions of all cash in excess of business needs. (Structuring the partnership agreement to mandate distribution of "excess cash" would help with respect to retained powers over income, but would not seem to help rebut an argument over the retained powers to liquidate and distribute the entire assets of the entity "in connection with" the other owners.)
   c. Narrow Interpretation of Byrum. The court interpreted Byrum very narrowly. In particular, it rejects a "fiduciary duty" analysis that renders section 2036(a)(2) inapplicable if retained administrative powers that impact distributions are held in a fiduciary capacity. The court views Byrum as being limited by special constraints on the donor's retained rights in that case, including (i) an independent trustee ultimately made distribution decisions, (ii) cash flow from the small operating enterprise in Byrum was subject to economic and business realities that do not apply to an investment partnership, and (iii) there were unrelated parties in Byrum (beyond just a de minimis 1% interest) who give rise to a realistic possibility for enforcement of fiduciary duties. That interpretation is far more restrictive than the IRS's published position on Byrum in Rev. Rul. 81-15, 1981-1 C.B. 457. (Interestingly, the court cites the IRS's unpublished rulings interpreting Byrum with respect to partnerships [PLRs 9415007, 9310039, & TAM 9136006] and discounts those rulings as having no precedential force, but does not cite the IRS's published position interpreting the fiduciary duty analysis in Byrum.) As discussed above, several previous Tax Court cases seem to give a broader interpretation to the fiduciary duty exception. Estate of Gilman, 65 T.C. 296 (1975), *aff'd per cur.* 547 F.2d 32 (2nd Cir. 1976); Estate of Cohen, 79 T.C. 1015 (1982).
   d. "In Conjunction With" Broad Application. The court, perhaps to a larger extent than any previous section 2036(a)(2) case, interpreted the "in conjunction with" language in the statute and regulations very broadly. The court's analysis, when pushed to its extreme, would mean that any family entity could be ignored under section 2036(a)(2) because the decedent—regardless how small of an interest that the decedent held—would hold the power, "in conjunction with others" to vote its interest as a member of the entity (i) to affect indirectly when income distributions would be made, and (ii) to liquidate the entity and distribute its assets. An extension of this analysis could ultimately lead to negating any fractionalization discounts where the other interests in an asset are held by family members. (For example, the taxpayer could act "in conjunction with" other family owners to sell the asset, thus avoiding or minimizing any minority or marketability discounts. This is basically yields the result—under section 2036 rather than under a valuation approach—that the Treasury Department has pushed in several different legislative sessions, but that has, so far, been rejected by Congress.) It seems very doubtful that courts will extend the application of section 2036 in this manner to negate fractionalization discounts.
   e. Prior Cases Have Limited Broad Application of "In Conjunction With" Provision. Section 2036(a)(2) was enacted with almost identical "in conjunction with" language as §2038. Several §2038 cases have limited the application of this provision in determining whether a decedent held a joint power to terminate a trust. For example, a power conferred by state law to revoke or terminate a trust with the consent of all beneficiaries is not taxable. Helvering v. Helmholz, 296 U.S. 93 (1935), aff'g 75 F.2d 245 (D.D. C. 1934) (reasoning that this power exists under state law in almost all situations, and to hold otherwise would cause all trusts to be taxable). Another example is Tully Estate v. Comm'r 528 F.2d 1401 (Ct. Cl. 1976). In Tully, decedent was a 50% shareholder. The corporation and decedent entered into a contract to pay a death benefit to the decedent's widow. Even though the beneficiary designation was irrevocable, the IRS argued that it could be amended because for several reasons, including that the decedent and the other 50% shareholder could cause the corporation to agree with the decedent to change the beneficiary. The court's analysis is analogous to the broad extension of §2036(a)(2) to FLPs:

      "A power to 'alter, amend, revoke or terminate' expressly exercisable in conjunction with others falls within section 2038(a)(1), but 'power' as used in this section does not extend to powers of persuasion. If section 2038(a)(1) reached the possibility that Tully might convince T & D and DiNapoli to change the death benefit plan, it would apply to speculative powers. Section 2038(a)(1) cannot be so construed. Harris, supra; Hinze, supra. In addition, if section 2038(a)(1) applies to situations where an employee might convince an employer to change a death benefit program, it would sweep all employee death benefit plans into the gross estates of employees. It would always be at least possible for an employee to convince the employer that it would be to their mutual benefit to modify the death benefit plan. In light of the numerous cases where employee death benefit plans similar to the instant plan were held not includable in the employee's gross estate, we find that Congress did not intend the 'in conjunction' language of section 2038(a)(1) to extend to the mere possibility of bilateral contract modification. Therefore, merely because Tully might have changed the benefit plan 'in conjunction' with T & D and DiNapoli, the death benefits are not forced into Tully's gross estate." 528 F.2d at 1404-05.

One commentator finds as self evident that the mere power of a limited partner to agree with other partners to terminate a partnership should not cause §2036(a)(2) to apply. "[A] "power" to persuade others to act, or join in acting, in a way that could affect possession or enjoyment of the transferred property is not considered to be a taxable power. This rule is not limited to the obvious situation where the transferor is not a member of the decision-making body (*if such were deemed to be a taxable power, nothing would be immune from §§2036(a)(2) and 2038*.) Dodge, Transfers With Retained Interests and Powers, 50-5th BNA Tax Management Portfolio, at 105 (2002) (emphasis added).

f. Planning Structure of General Partner. In light of the court's "in connection with" analysis, the most conservative structure to avoid section 2036(a)(2) would be for the taxpayer to own no interest in the general partner. (However, even that structure would not be immune from attack, under the court's reasoning, if the partnership can be liquidated with the consent of all partners; the decedent could then act "in connection with" other owners to liquidate the entity at any time and regain possession of his proportionate part of the assets in the entity.) Furthermore, if another individual serves as general partner, be wary of giving that individual a general power of attorney. The court gave little weight to fiduciary duties that the son-in-law held as manager of the partnership and corporation because he stood in a preexisting confidential relationship and owed fiduciary duties to decedent personally as his attorney in fact.

5. Consideration Exception to Section 2036.

a. Statutory Exception. Section 2036(a)(1) or (a)(2) only applies if the decedent has "made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth)."

b. Two-Step Analysis.

Four cases involving transfers to FLPs have now held that the consideration exception did not apply to the particular facts of those cases. See Estate of Harper, T.C. Memo. 2002-121 (distinguishing Harrison and Church because in those cases other partners made contributions not de minimis in nature and partnership was vehicle for genuine pooling of interests), Estate of Thompson, T.C. Memo. 2002-246 (transfer not made for legitimate business concerns, not transferred into a valid functioning business enterprise, and no true pooling of assets because each partner is allocated income attributable to assets by him or her), Kimbell v. U.S., 91 AFTR2d 2003-585 (N.D. Tex. 2003) (99% partner, "only a recycling of value"), Strangi II (over 99% of assets, mere recycling of value where no contributions by others "of property or services in the interest of a true joint ownership or enterprise").

These cases have suggested a two-step analysis. The first requirement is that there is a bona fide sale, meaning an arm's length transaction. Having other partners (even family members) and having negotiations in the structure decisions would help meet this requirement.

The second requirement is that there is "full and adequate consideration." The court holds that the receipt by the donor of limited partnership interests in return for the transfer of assets to the partnership is not "adequate and full consideration" even though the Tax Court has held on various occasions (including the initial Strangi decision) that the creation of the partnership does not result in a "gift on creation" for gift tax purposes. The court reasons that "full and adequate consideration" does not exist where there is merely a "recycling" of value through partnership or corporate solution. The court cited its explanation in Harper that there is a mere "recycling" where there is no change whatsoever "in the underlying pool of assets or prospect for profit, as, for example, where others make contributions of property or services in the interest of true joint ownership or enterprise." Thus, having other partners who make contributions to the "underlying pool of assets" would help in arguing that the full consideration exception applies.

6. Substantial Contributions by Others. Consider having other family members (or, if possible, nonfamily members) making significant contributions to the partnership at its creation in return for partnership interests pro rata to the values contributed. There are trade-offs in this decision.

Advantages. (1) Bolsters argument that "adequate and full consideration" exception of §2036 applies because the "underlying pool of assets or prospect for profit" is different from what is contributed by the taxpayer.

(2) Making proportionate distributions to multiple partners does not appear that the taxpayer implicitly retained the ability to access partnership assets whenever desired, and avoids the appearance of the entity's creation as a mere testamentary substitute, to counter §2036(a)(1).

(3) Avoiding a unilateral creation and seeking input from and negotiating with others about structural issues helps avoid a "testamentary" appearance, §2036(a)(1).

(4) Having other partners with more than a de minimis interest bolsters the fiduciary duty exception to the application of §2036(a)(2) if the parent

has any interest in the General Partner or Manager Member. There is an even stronger argument for the fiduciary duty exception if there are unrelated owners.

Disadvantages. If future courts adopt "gift on creation" argument, having other partners could lead to gift treatment by the mere creation of the partnership. Strangi I held that there was no gift on creation because (1) Strangi retained control and (2) Strangi's capital account reflected the values of properties contributed to the partnership. However, Estate of Jones also held there was no gift on creation, and in that case Jones did not retain any control of the partnerships—which would suggest that having pro rata capital accounts is sufficient to avoid gift on creation.

Kimbell v. U.S., 244 F. Supp 2d 700 (2003)[2]

Less than three months prior to her death, the decedent established a limited liability company (LLC) with her son and her son's wife. Fifty percent of the LLC was owned by decedent's revocable trust, twenty-five percent by her son, and twenty-five percent by her daughter-in-law. Three weeks later the revocable trust and the LLC created a family limited partnership whereby the revocable trust received a 99 percent limited partnership interest in exchange for its contribution, and the LLC received a one percent general partnership interest.

The assets that the decedent transferred to the partnership had a value of approximately $2.643 million prior to the transfer, and the estate of the decedent reported that value of her interest in the partnership was approximately $1.257 million. The IRS audited the estate, taking the position that Section 2036 of the Code was applicable and included the full value of the $2.643 million in the estate.

The court agreed with the IRS and held that the transfer by the decedent to the limited partnership was subject to Section 2036. Section 2036 includes in the gross estate the value of all property transferred during lifetime with respect to which a decedent retains the right to the use and enjoyment of the property. If the transfer of property is a bona fide sale for adequate and full consideration, the section is inapplicable. The court held that the formation of a limited partnership was not an arm's-length transaction because the decedent, by virtue of her interests in the trust and the LLC, "stood on both sides of the transaction." Because the decedent had the right to remove the general partner, she had the right to personally benefit from the income and/or to designate the persons who could enjoy the income. Furthermore, the court ruled that general partner had no fiduciary duty to the partnership that would have prevented the decedent from exercising those rights.

Gifts of Family Limited Liability Company Interests Do Not Qualify for Gift Tax Annual Exclusions

Hackl v. Comr., Nos. 02-3093 and 02-3094 (7th Cir. 7/11/03).[3]

The Seventh Circuit held that the parents' gifts of voting and nonvoting limited liability company interests to family members are not present interest gifts qualifying for gift tax annual exclusions.

In 1995, a husband and wife (H and W) purchased two tree farms worth approximately $4.5 million and contributed them, along with $8 million in cash and securities, to a limited liability company (LLC). As the LLC's manager, H can appoint a successor, dissolve the LLC, and control financial distributions. The manager's approval is needed if a member desires to sell shares or withdraw from the LLC. If a member transfers shares without such approval, the transferee receives the shares' economic rights but no membership or voting rights. The manager serves for life or until resignation, removal, or incapacity. The LLC has operated at a loss and has not made any shareholder distributions.

H and W made annual transfers of voting and nonvoting shares in the LLC to their children, their children's spouses, and a family trust. By early 1998, 51% of the LLC's voting shares were owned by the children and their spouses. H and W treated the transfers as annual exclusion gifts on their gift tax returns. However, the IRS determined that the transfers were future interests and ineligible for the gift tax exclusion, resulting in a gift tax deficiency. The Tax Court upheld the IRS's determination.

The Seventh Circuit affirmed the Tax Court, holding that H and W's gifts, while outright, were not gifts of present interests. According to the court, the LLC's operating agreement foreclosed the donees' ability to realize any substantial present economic benefit. Although the shares that H and W gave away had the same legal rights as the shares they retained, the court observed that the shares were essentially without immediate value to the donees because of the transfer restrictions. The court stated that the possibility that a shareholder could sell shares without the manager's approval to a transferee who would not have any membership or voting rights could hardly be called a substantial economic benefit.

ENDNOTE

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PROPERTY TAX: RECENT DEVELOPMENTS

by

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UNITED STATES COURTS OF APPEALS

TAX INJUNCTION ACT BARS SUIT IN FEDERAL COURT CHALLENGING CONSTITUTIONALITY OF RETROACTIVE PROPERTY TAX COLLECTION PENALTY.

Washington v. Linebarger, Goggan, Blair, Pena & Sampson, LLP, No. 02-30589 (5th Cir. July 11, 2003).

The City of New Orleans implemented a 30% retroactive delinquent property tax collection penalty payable to the attorneys representing the city in its collection efforts. A class action suit was filed in United States District Court challenging the constitutionality of the retroactive penalty. The federal district court dismissed the suit on jurisdictional grounds due to the Tax Injunction Act, and the taxpayers appealed. The appellate court upheld the dismissal, ruling that neither of the exceptions to the Tax Injunction Act had been established by the taxpayers. Contrary to the taxpayers' assertion, the court held that the penalty assessed was so inextricably intertwined with the tax assessment as to constitute a tax, and not a challengeable fee. It further ruled that the taxpayers had adequate remedies available to them in the state court, notwithstanding the significant procedural and substantive obstacles set forth in Louisiana law.

TEXAS SUPREME COURT

A STATE PROPERTY TAX CAN EXIST EVEN IF ONLY ONE OR A FEW TAXING DISTRICTS ARE IMPACTED; A STATE PROPERTY TAX IS CREATED WHEN A TAXING UNIT IS DENIED MEANINGFUL DISCRETION IN THE RATE SETTING PROCESS.

West Orange-Cove Consolidated Independent School District v. Alanis, 107 S.W.3d 558 (Tex. 2003).

Several school districts filed suit against the State of Texas alleging that the statutory scheme of utilizing *ad valorem* taxation to fund public education had resulted in the creation of an unconstitutional state property tax. The trial court dismissed the suit, ruling that the pleadings failed to state a viable cause of action. The Texas Supreme Court reversed, ruling that (1) a property tax could be deemed to be a state property tax even if it did not have state-wide effect, but only affected one or a few school districts; (2) that the constitutional prohibition against a state property tax would be violated whenever the state exercised such control over the taxing process as to deny a taxing authority "meaningful discretion" in setting its tax rates; (3) that the state was required to prove that school districts were not forced to tax at maximum rates to meet either state accreditation standards or the constitutional mandate of providing a general diffusion of knowledge; (4) that the school districts were entitled to prove that the existence of homestead exemptions did not afford them meaningful discretion in setting their tax rates; and (5) that the fact that the school districts were not actually taxing at the maximum rate of $1.50 per $100 of value did not necessarily prove that the school districts had meaningful discretion in setting their tax rates.

TEXAS COURTS OF APPEALS

TAXING AUTHORITIES ARE NOT ENTITLED TO A PRESUMPTION OF DELIVERY OF NOTICE WITHOUT EVIDENCE THAT NOTICE WAS DEPOSITED IN THE U.S. MAIL, POSTAGE PREPAID; TAXING UNITS ARE REQUIRED TO PLEAD WAIVER AS AN AFFIRMATIVE DEFENSE TO AVAIL THEMSELVES OF SUCH REMEDY; TAXING UNITS MUST FILE A VERIFIED PLEA TO CLAIM LACK OF CAPACITY.

WHM Properties, Inc. v. Dallas County, No. 10-00-136 (Tex. App. - Waco, August 4, 2003, no pet. h.). (to be published).

Taxing units sued taxpayer to collect delinquent taxes. Third party intervened into the lawsuit, paid the disputed taxes under protest and contested the legality of the taxes under the five year notification statute (which has since been repealed). The trial court entered judgment for the taxing units, and the third party intervenor appealed the judgment. The appellate court ruled that the taxing units were required to refund the monies paid by the intervenor because the taxing units had failed to prove that they had mailed the requisite five year notice to the taxpayer, by United States mail, postage prepaid. The taxing authorities argued that the testimony of the taxpayer that he did not receive notice from the taxing units was not credible. The court ruled that such was irrelevant because the presumption of delivery had not arisen in this case due to the lack of evidence of mailing by the taxing units. The taxing units further argued that the taxpayer had not timely demanded a refund of the tax amounts and that this evidence had not been contested by the taxpayer. The court rejected this argument, finding that the taxing units had failed to plead waiver as an affirmative defense to the demand for refund, and affirmative defenses which are not plead are waived. Finally, the taxing units contended that the intervenor lacked capacity to sue the taxing units because it had failed to sustain an injury. The court rejected this argument as well, ruling that claims of capacity must be raised in trial court pleadings under a verified plea, which the taxing units had failed to file in this case.

TAXING UNIT FILING CLAIM FOR DELINQUENT TAXES IN PROBATE COURT MUST OBSERVE PROBATE COURT FILING DEADLINES OR FORFEIT ITS RIGHT TO DELINQUENT TAX MONIES.

Andrews v. Aldine Independent School District, No. 14-02-01282 (Tex. App. - Houston [14th Dist] July 24, 2003, no pet. h.). (to be published).

Taxpayer died intestate owing $217,318 in delinquent taxes. Taxing unit filed a claim in probate court seeking payment of the taxes. The administrator did not respond to the claim within the statutory thirty day period and the taxing unit did not file suit within the ninety day claim period. The probate court dismissed the claim for tax monies and the taxing unit appealed to the Court of Appeals. The court rejected the taxing units' claim, ruling that "Once a claim against an estate is rejected, the claimant must file suit within 90 days or the claim is forever barred." The taxing units further argued that their claim was not a "claim for money" but was instead only a claim "in rem." The court was not swayed, ruling that claims for the payment of taxes are specifically included within the probate code section, and that the taxing units' claim was clearly one for money notwithstanding the taxing units' contentions. The taxing units also argued that the probate court provisions were unconstitutional releases of tax under Article VIII, Section 10 of the Texas Constitution. The court rejected this argument finding that "there were many statutes that restricted the time, place and manner of collections by taxing units." None of them, including the statute issue, are unconstitutional releases of taxes.

TAXPAYER CLAIMING BENEFITS OF LATE FILING DEADLINE MUST PROVE DATE ON WHICH APPRAISAL REVIEW BOARD CERTIFIED THE APPRAISAL ROLL; TAXPAYER MUST PRESENT EVIDENCE OR ARGUMENT BEFORE APPRAISAL REVIEW BOARD PRIOR TO RAISING CLAIM WITH DISTRICT COURT.

Quorum International v. Tarrant Appraisal District, No. 2-02-216-CV (Tex. App. - Fort Worth, June 26, 2003, no pet. h.). (to be published).

In 1999, taxpayer filed a belated freeport application on June 23 with a cover letter which stated that its late filing had been due to an oversight and requesting the appraisal district to accept the late filing. The appraisal district denied the late application, and the taxpayer appealed the denial to the appraisal review board. At the hearing, the taxpayer failed to present any evidence or argument as to good cause for the late filing. When the appraisal review board further denied the freeport application, the taxpayer appealed to district court. On appeal, the taxpayer argued that the subsequent amendment in 2001 to the Tax Code allowing belated filings of freeport applications through the "date the appraisal review board approves the appraisal records" should have been retroactively applied to extend the taxpayer's filing deadline. The court rejected this claim, ruling that the taxpayer had failed to prove the date on which the appraisal review board had actually approved the records and that the statutory deadline of July 20 was not sufficient in and of itself to establish this fact. The court further ruled that the taxpayer could not judicially challenge the failure of the chief appraiser to extend the deadline on "good cause" grounds due to the failure of the taxpayer to raise this issue before the appraisal review board.

CLAIMS OF IMPROPER DENIAL OF EXEMPTION MAY NOT BE RAISED IN DEFENSE OF A DELINQUENT TAX ACTION.

St. Joseph Orthodox Christian Church v. Spring Branch Independent School District, No. 14-01-00911-CV (Tex. App. –Houston [14th Dist.] April 24, 2003, no pet. h.). (to be published).

Taxpayer purchased a property in March 1997 and converted it to use as a church. It sought a belated exemption from the appraisal district. The taxing units sued the church to collect delinquent taxes for that year. The church defended on the grounds that it had been improperly denied a religious use exemption. The trial court entered judgment for the taxes, and the church appealed. The court of appeals upheld the judgment ruling that the exclusivity of remedies provisions of Section 42.09 of the Tax Code barred the church from raising a claim of exemption as a defense to the delinquent tax collection suit. Such claim should have been raised in a suit against the appraisal district after the church had exhausted its administrative remedies.

THE OWNER OF A POSSIBILITY OF REVERTER INTEREST IS NOT A PROPER PARTY TO A DELINQUENT TAX SUIT, AND AS SUCH THE CONTINGENT INTEREST MAY NOT BE FORECLOSED.

Cypress-Fairbanks Independent School District v. Glenn W. Loggins, Inc., No. 04-02-00513-CV (Tex. App.–San Antonio, July 2, 2003, no pet. h.). (to be published).

Taxing unit sued a taxpayer and the owner of a possibility of reverter for delinquent taxes. The owner of the possibility of reverter contended that it was not a proper party to the suit because its interest was nontaxable. The court agreed, ruling that any purchaser at a tax foreclosure sale would take title to the property subject to the contingent interest in the property.

TAXING UNITS DO NOT NEED TO OBTAIN PERMISSION TO FORECLOSE A PROPERTY FROM ASSIGNEES OF THE RESOLUTION TRUST CORPORATION; UNLESS THE JUDGMENT IS VOID, PROVISIONS IN A DELINQUENT TAX JUDGMENT MAY NOT BE COLLATERALLY ATTACKED; FAILURE TO OBJECT TO THE SALE OF MULTIPLE PROPERTIES TO SATISFY A DELINQUENT TAX JUDGMENT IN THE ORIGINAL SUIT WAIVES THE CLAIM; ATTORNEY'S FEES MAY NOT BE RECOVERED IN AN ACTION IN THE NATURE OF A SUIT FOR TRESPASS TO TRY TITLE.

Hawk v. E.K. Arledge, Inc., 107 S.W.3d 79 (Tex. App.–Eastland 2003, pet. filed).

In 1990, taxing units sued a taxpayer to foreclose two tracts of land for nonpayment of *ad valorem* taxes. The Resolution Trust Corporation was appointed receiver for the bank holding the notes on the tracts on February 1, 1990. The RTC subsequently transferred the property to another party and a series of further transfers ensued. The taxing units sued the RTC and later one of the subsequent transferees. A judgment of foreclosure was entered in 1997, and the excess proceeds from the foreclosure sale were paid to the original taxpayer. A subsequent transferee of the RTC sold the property at a deed of trust foreclosure sale in 1999, and a declaratory judgment suit was filed in an attempt to clarify the ownership of the property. The trial court found title in the purchaser through the tax foreclosure process and awarded attorney's fees to it. The purchaser who claimed title through the RTC appealed claiming (1) that the permission of the successor in title to the RTC was required under the provisions of the "Financial Institutions Reform, Recovery and Enforcement Act" (FIRREA), (2) that the sale of the two tracts together to satisfy the tax judgment violated the Texas Constitution; and (3) that the award of attorney's fees was not appropriate. The court ruled that the requirement of obtaining consent prior to foreclosing a property for delinquent taxes applied only to the RTC and not to "downstream assignees" of the RTC. It further ruled that a claim of improper sale of the two tracts together could not be raised in a new lawsuit as a collateral attack on the first judgment unless the judgment itself was void, and that any objections to the joint sale order were waived when the parties to the original suit failed to raise them. The court upheld the challenge to the award of attorney's fees ruling that attorney's fees were not recoverable in a Declaratory Judgment suit which was essentially a suit in trespass to try title.

TO CLAIM INTERSTATE ALLOCATION, A TAXPAYER MUST RENDER THE PROPERTY AND SPECIFY ITS USE IN INTERSTATE COMMERCE; INTERSTATE ALLOCATIONS OF AIRCRAFT VALUATION ARE NOT PROPER SUBJECTS OF MOTIONS TO CORRECT VALUATIONS UNDER SECTION 25.25(C)(3).

Harris County Appraisal District v. Texas Gas Transmission Corp., 105 S.W.3d 88 (Tex. App.–Houston [1st Dist.] 2003, pet. filed).

Taxpayer owned a business aircraft which it flew in interstate commerce. The taxpayer filed a rendition for the aircraft with the appraisal district in 1995, but did not specify its use in interstate commerce and did not contest the valuation of the aircraft during the normal appeals period. The taxpayer subsequently filed a motion to correct error pursuant to Section 25.25(c)(3) of the Texas Tax Code seeking to obtain a retroactive interstate allocation of the valuation of the aircraft reflective of its out of state travel for 1995. The court ruled that the taxpayer was prohibited from obtaining an interstate allocation because of its failure to include the interstate allocation data on its rendition, holding that the Tax Code required such by implication and the Comptroller rules required such expressly. It further ruled that Section 25.25(c)(3) of the Tax Code could not be utilized to obtain such retroactive relief because that provision applied only to situations in which property did "not have any physical location in Texas throughout the entire taxable year." It held that the granting of such relief would undermine the penalty provisions contained in Section 25.25(d) of the Tax Code. The court expressly overruled its prior decision in *Himont U.S.A. Inc. v. Harris County Appraisal District, 904 S.W.2d 740 (Tex. App. –Houston [1st Dist.] 1995, no writ).*

TO CLAIM INTERSTATE ALLOCATION AS A COMMERCIAL AIRCRAFT, A TAXPAYER MUST RENDER THE AIRCRAFT AND SPECIFY ITS USE AS SUCH IN INTERSTATE COMMERCE; TO QUALIFY FOR INTERSTATE ALLOCATION AS A COMMERCIAL AIRCRAFT, THE OPERATOR OF THE AIRCRAFT (NOT THE AIRCRAFT) MUST BE A CERTIFICATED AIR CARRIER.

SLW Aviation, Inc. v. Harris County Appraisal District, 105 S.W.3d 79 (Tex. App.–Houston [1st Dist.] 2003, pet. filed).

Taxpayer rendered its aircraft with the appraisal district and provided the district with information showing its use in interstate commerce. It subsequently complained that the interstate allocation granted by the district was insufficient because the district had not utilized the formula applicable to commercial aircraft. The court overruled the challenge finding that the taxpayer was not entitled to such application because the taxpayer had failed to inform the district of the commercial use contention in its rendition. It further ruled that the taxpayer was not entitled to commercial allocation because it had only established that the aircraft was utilized as a "certificated air carrier." Such proof was insufficient because the statute required evidence that the operator of the aircraft was a "certificated air carrier."

SUBSEQUENT PURCHASER MAY NOT CHALLENGE LACK OF NOTICE OF INCREASE IN APPRAISED VALUE IN PRIOR YEARS; FAILURE TO PAY TAXES VOIDS A CLAIM UNDER SECTION 41.411 OF THE TAX CODE.

Houston Land & Cattle Co. v. Harris County Appraisal District, 104 S.W.3d 622 (Tex. App. –Houston [1st Dist.] 2003, pet. filed).

A party purchased property from a taxpayer with knowledge that the taxes on the property were delinquent. The party filed a protest under Section 41.411 of the Tax Code claiming that the taxes for the prior 20 years were void due to the failure of the appraisal district to send notices of appraised values to the prior owner for those years, notwithstanding repeated increases in value. The court denied the claim ruling that protests under Section 41.411 of the Tax Code could only be filed by the taxpayer to whom notice should have been delivered, and that such claims are nullified by the taxpayer's failure to timely tender tax payments as required by Section 42.08 of the Tax Code.

NEW LEGISLATION

PROPOSED CONSTITUTIONAL AMENDMENTS

House Joint Resolution 16.

(To be submitted to the voters at the general election on September 16, 2003. If passed, it would be effective January 1, 2004.)

By vote of a governing body of a taxing unit, or by petition and vote of the voters of a taxing unit, the tax freeze currently available to the elderly for school district property taxes may be extended to taxes assessed by a county, city or junior college district.. Such relief shall also apply to persons who are disabled.

House Joint Resolution 21.

(To be submitted to the voters at the general election on September 16, 2003. If passed, it would be effective January 1, 2004.)

The tax freeze currently available to the elderly for school district property taxes is extended to persons who are disabled.

House Joint Resolution 51.

(To be submitted to the voters at the general election on September 16, 2003. If passed, it would be effective January 1, 2004.)

The tax foreclosure redemption period on mineral interests is extended from six months to two years.

House Joint Resolution 55.

(To be submitted to the voters at the general election on September 16, 2003. If passed, it would be effective January 1, 2004.)

Undeveloped land which is owned by a religious organization for purposes of expansion or construction of a new place of religious worship may be exempted by the legislature provided that the religious organization currently owns a place of religious worship. This property may not produce any revenue. Additionally, property owned by a religious organization which is leased to another person for use as a school may be exempted.

Senate Joint Resolution 25.

(To be submitted to the voters at the general election on September 16, 2003. If passed, it would be effective January 1, 2004.)

The provision authorizing local taxation of travel trailers is repealed except for personal property substantially affixed to real estate.

HOUSE BILLS

House Bill 136.

Effective: September 16, 2003 if House Joint Resolution 16 is passed by the voters.

By vote of a governing body of a taxing unit, or by petition and vote of the voters of a taxing unit, the tax freeze currently available to the elderly for school district property taxes shall be extended to taxes assessed by a county, city or junior college district. Such relief shall also apply to individuals who are disabled.

House Bill 179.

Effective: January 1, 2004.

Tax exemptions for county fair associations, once granted, need not be reclaimed annually.

House Bill 193.

Effective: January 1, 2004.

The appraisal district board of directors is given complete discretion in increasing the number of members of its appraisal review board over the minimum number of three.

House Bill 195.

Effective: September 1, 2003.

By no later than September 15, 2003, legal entities which are still collecting county education districts delinquent taxes are required to turn over to the appropriate school districts all collected funds under their control, less costs of collection, and all uncollected accounts.

House Bill 217.

Effective: September 16, 2003 if House Joint Resolution 21 is passed by the voters.

The tax freeze currently available to the elderly for school district property taxes is extended to persons who are disabled.

House Bill 335.

Effective: September 1, 2003.

A person may not bid on real property at a post-judgment execution sale or tax foreclosure sale without presenting to the sheriff a certificate from the tax office verifying that the person does not owe any delinquent taxes in that county. A person may not bid at such sales on behalf of another person. Sales conducted in violation of these provisions are void.

House Bill 390.

Effective: January 1, 2004.

In counties with a population of less than 500,000, for purposes of calculating tax rates, "new property value" does not include captured real property value that corresponds to the portion of a tax increment which the taxing unit has agreed to pay into a tax increment fund for a reinvestment zone.

House Bill 500.

Effective: September 1, 2003.

Driver's license numbers, social security numbers and personal identification numbers contained in exemption applications are confidential and not open to public inspection. Such information may only be released in the course of administrative or judicial proceedings involving the property or otherwise by subpoena, to the party who filed the application, to the comptroller's office, for statistical purposes without disclosing the party involved, and for inclusion in governmental records required by law. Violations of this statute are Class B misdemeanors.

House Bill 703.

Effective: January 1, 2004.

If the chief appraisers of appraisal districts valuing overlapping property cannot agree on a valuation of a property by May 1 of a tax year, they shall be required to enter on their appraisal roll, the lowest proposed value. If the value of overlapping property is lowered as a result of an administrative or judicial proceeding in any of the districts, the chief appraiser of that appraisal district shall notify the other appraisal districts of the results of the hearing. The lowest resulting valuation for the property shall be placed on all of the appraisal rolls.

House Bill 893.

Effective: September 1, 2003.

A chief appraiser is required to certify the results of a property tax appeal lawsuit to the affected taxing units by no later than 45 days after the judgment becomes final. The chief appraiser is irrebutably presumed to have complied with this provision.

House Bill 983.

Effective: June 20, 2003.

Appraisal districts may obtain criminal history records of their applicants for employment from the Texas Department of Public Safety unless they can obtain them in another manner.

House Bill 1082.

Effective: January 1, 2004.

If the chief appraisers of appraisal districts valuing overlapping property cannot agree on a valuation of a property by May 1 of a tax year, they shall be required to enter on their appraisal roll, the lowest proposed value. If the value of overlapping property is lowered as a result of an administrative or judicial proceeding in any of the districts, the chief appraiser of that appraisal district shall notify the other appraisal districts of the results of the hearing. The lowest resulting valuation for the property shall be placed on all of the appraisal rolls.

Effective: September 1, 2003.

The equity standard is clarified at the administrative and judicial level to allow challenges based on the appraised value of the properties. Administrative equity challenges are to be determined in favor of a taxpayer unless the appraisal district carries its burden of proof. Taxpayers challenging under multiple statutory theories of inequity shall be entitled to valuation based on the lowest valuation yielded under the competing theories. Equity challenges of appraised values for homesteads shall be based on the market values of the properties for purposes of comparison, not the "capped" values.

Telecommunications providers, persons regulated by the Railroad Commission, Federal Surface Transportation Board or the Federal Energy Commission whose property run through more than one county may appeal a determination of an appraisal review board to the district court of any county in which any portion of the property is located or operated.

House Bill 1117.

Effective: September 1, 2003.

If a county successfully claims a right to the operation of a county road over a taxpayer's property, no *ad valorem* taxes may be assessed against such property. If the person successfully contests the county's claim to the road, all underlying *ad valorem* taxes are revived. No collection efforts may be made until the taxing unit obtains a certificate from the county stating that it has ceased maintaining the road.

House Bill 1125.

Effective: September 16, 2003 if House Joint Resolution 51 is passed by the voters.

The tax foreclosure redemption period on mineral interests is extended from six months to two years.

House Bill 1223.

Effective: June 18, 2003.

Homestead tax exemptions are not lost if the residence is not occupied under any of the following circumstances: (1) the period is less than two years; (2) the owner was outside the United States on military duty; or (3) the owner was in a facility which provides services related to health, infirmity or aging.

House Bill 1278.

Effective: January 1, 2004 if House Joint Resolution 55 is passed by the voters.

Religious organizations, which own an actual place of religious worship, may exempt additional undeveloped property which they are holding for purposes of expansion or construction of a new place of religious worship. Contiguous property may be exempted without development up to six years. Noncontiguous property may be exempted for a maximum period of three years. To qualify, the property may not produce any revenue. A religious organization may lease its property to another person for the operation of a non-profit school without losing its exemption. A five year rollback tax is assessed with seven percent interest if the property is transferred to another person. No rollback tax shall be assessed if the property is transferred as a result of (a) a sale of a right of way; (b) a condemnation; (c) a transfer to the state for a political purpose; or (d) transfer to another religious organization which qualifies the property for religious exemption within the tax year of the transfer.

House Bill 1460.

Effective: January 1, 2004.

In utilizing the income approach to value, the chief appraiser shall analyze: (a) comparable rental data and the potential earnings capacity of the property to estimate the gross income potential of the property; (b) comparable operating expense data to estimate the operating expenses of the property; (c) comparable data to estimate the capitalization or discount rates; and (d) base projections of future rent or income potential and expenses on reasonably clear and appropriate evidence. The chief appraiser shall exclude from the valuation the effect of (a) tangible personal property including trade fixtures; (b) intangible personal property; and (c) other property not subject to appraisal as real property.

House Bill 2043.

Effective: June 20, 2003.

The chief appraiser shall submit for election to the board of directors of an appraisal district only the names of the individuals which were timely submitted. The taxing units shall submit their votes in this election by no later than December 15.

House Bill 2073.

Effective: June 18, 2003.

A hospital district that has a maximum tax rate of less than seventy-five cents shall schedule an election to raise the district's tax rate if a petition is filed containing the lesser of (a) 100 signatures of registered voters, or (b) signatures of 15% of the registered voters.

House Bill 2147.

Effective: June 20, 2003.

The deadline for filing a late homestead application is extended to one year after the delinquency date for the taxes on the homestead. (The earlier deadline of one year after the taxes were paid is repealed.)

House Bill 2148.

Effective: June 20, 2003.

Unless otherwise authorized by law, restrictions or conditions on tax payment checks attempting to limit the amount of delinquent taxes, penalties or interest to less than the amount stated on the delinquent tax roll are void.

House Bill 2383.

Effective: January 1, 2004.

Property which is owned by the government, that is leased to or otherwise used by a religious organization for religious worship, is exempt from taxation. The religious organization may apply for exemption on such property as if it was the owner.

House Bill 2416.

Effective: June 18, 2003.

The exemption period for property under construction is extended from three years to five years for the following organizations: (1) charitable organizations; (2) fraternal charitable organizations; (3) youth spiritual, mental and physical development associations; (4) religious organizations; (5) schools; (6) miscellaneous organizations; and (7) nonprofit wastewater companies. Effective January 1, 2006, the period is returned to three years. No open space land rollback tax shall be assessed if the use of the property is changed from agricultural to providing housing and related services to individuals who are 62 years of age or older without regard to their ability to pay.

House Bill 2726.

Effective: January 1, 2004.

An owner of inventory may waive the right to be valued under the special inventory valuation provisions at any time.

House Bill 2819.

Effective: June 20, 2003.

A victim of family violence (which resulted in a Class A misdemeanor or felony conviction) may opt to exclude his or her identity from the appraisal roll.

House Bill 2844.

Effective: June 20, 2003.

Licensed appraisers and real estate brokers and agents may provide property tax consulting services in connection with farms and ranches without obtaining a property tax consulting license.

House Bill 3075.

Effective: June 20, 2003.

A taxing unit may invest in a project of a municipal development corporation which is located outside the boundaries of the taxing unit.

House Bill 3419.

Effective: June 18, 2003.

In counties with a population in excess of 3,000,000 with the approval of the commissioners court, peace officers charged with selling property seized to satisfy delinquent tax obligations may enter into agreements with auctioneers for the disposal of such property. Auction agreements must be approved in writing by the tax assessor-collector for each taxing unit holding a lien on the property. Agreements properly approved shall be irrebutably presumed to be commercially reasonable. Proceeds from sales of seized properly shall be distributed in the following order: (1) to the auctioneer for the costs of the auction; (2) to the peace officer for the costs and expenses of the sale; (3) to necessary individuals to cover costs of advertising and storing the property; (4) to the court clerk for the costs of the warrant; and (5) to the tax offices for taxes, penalties and interest. The county commissioners court may designate a location other than the courthouse where sales of seized property may be conducted. The commissioners court may authorize the sale of seized property to be conducted in an on-line internet auction.

Improved and unimproved property which has been abandoned for more than one year may be seized by a taxing unit if the taxes are delinquent. The property is presumed abandoned if no lawful act of ownership has occurred on the property. Notice of the tax warrant shall be given to the owner of the property by (a) actual service as specified under Rule 21a of the Texas Rules of Civil Procedure; (b) publication; or (c) posting. Failure to give, provide or receive notice does not affect the validity of the sale. The attorney for the taxing unit is entitled to recover attorney's fees for this procedure even if the collection penalty has not ripened at the time of the seizure. Foreclosure proceeds shall be paid as follows: (a) the cost of advertising the sale; (b) attorney *ad litem* fees; (c) court costs; (d) fees of the officer conducting the sale; (e) taxing unit costs in identifying the owner and the legal description of the property; (f) the taxes, penalties and interest due under the judgment; and (g) any other amounts awarded to the taxing unit. If a taxing unit includes homeowner's association dues in the costs collected, such shall not be construed as a waiver of immunity by the taxing unit or a violation of the constitutional prohibition against making expenditures from public funds.

House Bill 3504.

Effective: September 1, 2003.

An elderly or disabled person may abate the collection of delinquent homestead property taxes and abate a foreclosure of the homestead. To abate a foreclosure, the person must deliver a copy of the deferral affidavit to the officer conducting the sale and the tax assessor requesting the sale or the chief appraiser or the attorney for the taxing unit at least five days prior to the date of the foreclosure sale. The abatement shall continue until 181 days after the person no longer owns and occupies the homestead. If the elderly or disabled person dies, the deferral shall continue on behalf of a surviving spouse.

House Bill 3540.

Effective: September 1, 2003.

If a tax collector is collecting for more than one taxing unit, the governing body of that taxing unit shall be responsible for approving erroneous tax refunds in excess of $2,500 on behalf of all of the units.

House Bill 3546.

Effective: January 1, 2004.

No community housing development organization exemptions under the existing law shall be granted after December 31, 2003 unless the organization received an exemption under that statute for any part of tax year 2003. To qualify for exemption as a community housing development organization after that date, an organization must meet the following criteria. It must have been exempt from federal taxation under Section 501(c)(3) of the Internal Revenue Code for at least three years. It must meet the charitable organization tax exemption technical requirements and have as one of its purposes "providing low income housing." A majority of the board of directors must reside in Texas and at least two positions on the board of directors must be reserved for low income individuals. The organization must have a formal policy for obtaining advice from low income individuals as to the design, siting, development and management of affordable housing projects. An organization which does not meet these criteria can nonetheless qualify if it is a limited partnership whose general partner qualifies or if it is a subsidiary corporation of a parent corporation which qualifies.

The organization must own the property for the purpose of constructing or rehabilitating the property and it must be (a) renting to individuals or families whose median income is not more than 60% of the area median family income or statewide median family income, whichever is greater. No exemption may be granted unless at least half of the units are reserved for individuals in this income strata. The annual rent charged may not exceed 30% of the area median family income.
Property under construction for this use qualifies for this exemption. A project completed prior to January 1, 2004 may not receive an exemption under these new provisions. To qualify under this section for rehabilitation (a) original construction on the property must have been completed at least ten years prior to the commencement of the rehabilitation project, (b) the owner must have owned the property for at least five years, (c) a certified statement must be provided to the chief appraiser showing that at least $5,000 was spent on the rehabilitation (or more if such was required for bond financing), and (d) the organization must maintain a reserve fund of at least $300 per unit. Commencing with tax year 2005, the $300

reserve fund shall be indexed by the cost of living adjustment as determined by the Internal Revenue Service.

A person constructing or rehabilitating property must be renting units to qualified individuals by no later than the third anniversary of the date of acquisition of the property. The chief appraiser shall utilize the income approach, considering the restrictions on the property, in determining its market value. The chief appraiser shall publish annually the capitalization rate to be used for such restricted properties.

In counties with a population of 1,400,000 or more (unless otherwise provided by the governing body of a taxing unit), the tax exemption shall be 50% of the appraised value. To obtain an exemption in a county with a population of 1,400,000 or more, the taxpayer must seek such exemption in writing from each taxing unit. The taxing units must act on such requests within 60 days and notify the chief appraiser of their determinations within 5 days thereafter. They may charge a fee for the application process.

Foreclosure of the property does not terminate the exemption if another qualified organization acquires the property and applies to the chief appraiser within 30 days of acquisition for the exemption. This deadline may be extended for good cause.

To qualify for the exemption, the organization must annually deliver to the chief appraiser and the Texas Department of Housing and Community Affairs an audited financial statement demonstrating its compliance with the requirements of these provisions. Such statements are confidential. If the project contains 36 or fewer units, the organization may submit its own detailed report and certification in lieu of audited financial statements.

Property owned by an organization providing low or moderate income housing through the use of tax credits shall be entitled to receive restricted valuation.

House Bill 3607.

Effective: January 1, 2004.

In calculating the average annual net income for wildlife management land, the chief appraiser may not consider the income due the owner of the land under a hunting or recreational lease.

SENATE BILLS

Senate Bill 173.

Effective: May 28, 2003.

Persons serving in the armed services during a war or national emergency may pay their property taxes belatedly without penalty. The deadline for doing so is 60 days after the earliest of the following: (1) the person's discharge from the military, (2) the person returns to Texas for more than 10 consecutive days, (3) the person returns to non-active duty reserve status, or (4) the war or national emergency ends

Senate Bill 200.

Effective: May 15, 2003.

In counties with a population in excess of 2,000,000 and a hospital district tax rate of 75 cents or less, the voters may approve the issuance of bonds for the improvement of the hospital system. *Ad valorem* tax revenues for the repayment of such bonds shall be applied as payment of current debt for purposes of calculation the district's rollback tax rate.

Senate Bill 276.

Effective: September 1, 2003.

The Board of Tax Professional Examiners is extended through September 1, 2015. One of the five members of the board must be a public citizen with no connection to the area of practice. License holders shall be required to take continuing education classes to maintain their licenses. The board shall develop a policy allowing the public to appear before them and enter complaints. It shall maintain a written file on all complaints filed against its registrants. In addition to the sanctions currently available, the board may place its registrants under probation for violating its rules.

Senate Bill 287.

Effective: June 20, 2003.

The membership of the Texas Commission of Licensing and Regulation is reduced from six to five. One member of the Board of Tax Professional Examiners must be a public citizen with no connection to the area of practice.

Senate Bill 340.

Effective: January 1, 2005 (or January 1, 2006 for counties with a population of 500,000 or less).

Agreements between the chief appraiser and property owners for communication electronically shall contain the property owners' e-mail address. The comptroller shall prescribe acceptable media, formats and methods for the exchange of electronic information between appraisal districts and taxpayers. Appraisal districts shall deliver notices of appraised value by e-mail if requested by a taxpayer whose property is included in 25 or more accounts. Electronic versions of all forms shall be made available.

Effective: January 1, 2004.

Renditions of nonexempt property shall contain, the name and address of the property owner, a description of the property by type or category, a description of each type of inventory and a general estimate of its quantity, the physical location of the property, and either a good faith estimate of the market value of the property or its historical cost and year of acquisition.

If the owner believes that the market value of its property is less than $20,000, the owner needs only to render the owner's name and address, a general description of the property and its location. Good faith estimates of value may not be used against the taxpayer at any subsequent hearings other than appraisal review board hearings pertaining to the property.

Taxpayers who file reports with the Public Utility Commission, Railroad Commission, Federal Surface Transportation Board and Federal Energy Regulation Commission may file such reports with the chief appraiser in lieu of a rendition, upon request by the chief appraiser. Such owners must also provide the chief appraiser with sufficient information to allocate the property among the counties in which it is located. Property owners whose properties are inspected by third parties on behalf of appraisal districts and who provide information regarding their property to such third parties do not need to file renditions. If a property loses or is denied exemption, the owner shall render the property within thirty days thereafter.

Upon 21 days written or electronic notice, a taxpayer shall provide to a chief appraiser a statement supporting an owner's opinion of value. The statement must summarize information sufficient to identify the property including its physical and economic characteristics, the source of information used, the date of the opinion of value and an explanation of the basis of the opinion. If a company has 50 employees or less, the owner may base the estimate of value on the depreciation schedules used for federal income tax purposes. Such statement may not be used against the taxpayer at any subsequent hearings other than appraisal review board hearings pertaining to the property. All such statements are confidential.

The Comptroller's office shall prescribe official forms which may permit, but not require, a taxpayer to furnish additional information not specified in the statute. The form shall contain an admonition to taxpayers warning of the criminal nature of false statements.

Upon request, chief appraisers are required to extend the rendition filing deadline to May 15. Delinquent renditions and delinquent responses to explanation for opinions of value shall be assessed a 10% tax fine. Fraudulent renditions and destruction of relevant records pertaining to renditions shall be punished with a 50% tax fine. The chief appraiser shall waive the fraud penalty if the taxpayer shows due diligence in substantially complying with the statute. Waiver requests must be filed within 30 days of receipt of notice of the imposition of the penalty. The chief appraiser is entitled to retain 20% of the amount of all fines to cover the costs of collecting the penalties.

A chief appraiser may not issue a notice of appraised value for business personal property until all deadlines for filing renditions have passed. Taxpayers who fail to file renditions shall bear the burden of proof before the appraisal review board. If they fail to carry that burden, their notices of protest shall be determined in favor of the appraisal district.

Effective: September 1, 2003.

If a taxpayer files a rendition for the 2003 tax year prior to December 1, 2003 and as a result thereof a chief appraiser discovers tangible personal property which was omitted from the 2001 and 2002 appraisal rolls, the chief appraiser may not utilize that rendered information as a basis for an omitted property assessment for tax years 2001 and 2002.

Senate Bill 353.

Effective: April 24, 2003.
The prohibition against taxing units located in Mexican border cities with populations in excess of 230,000 from being able to opt out of Tax Increment Financing zones is repealed.

Senate Bill 392.

Effective: September 1, 2003.

Water districts may not adopt tax rates without complying with notice requirements similar to those pertaining to other taxing units and without subjecting themselves to tax rollback elections in the event that they increase taxes by more than 8% over the prior year's amount.

Senate Bill 480.

Effective: June 20, 2003.

No agricultural rollback tax may be imposed when a change of use occurs as a result of transfer from the state, a political subdivision of the state, or an economic development corporation of the state located in a municipality with a population of 1,000,000 or more to a third party for purposes of economic development provided that the Comptroller certifies that the economic development is anticipated to deposit into the general fund of the state in the next biennium at least 20 times the amount of rollback tax which would be lost. The chief appraiser shall honor the Comptroller's determination. Within one year after the expiration of the biennium, the Comptroller shall audit the project to determine if it deposited sufficient funds into the general revenue fund and shall notify the chief appraiser of the results. If sufficient funds have not been deposited, the chief appraiser shall issue a rollback tax notice.

Senate Bill 510.

Effective: September 1, 2003 provided that Senate Joint Resolution 25 is passed by the voters.

The local option for taxation of travel trailers is repealed except for personal property substantially affixed to real estate.

Senate Bill 521.

Effective: January 1, 2004.

Creditors financing the sale of manufactured homes shall collect and escrow property taxes on the homes unless such creditors are federally insured and do not require escrows on their other residential real estate mortgages. Manufactured homes affixed to the real estate qualify for homestead exemption and shall be listed together on the appraisal roll if the owner has elected to treat the home as real property under the Occupations Code. The tax lien on a manufactured home which is moved "floats" with the property in the event it is detached from the land.

Senate Bill 657.

Effective: January 1, 2004.

A tax increment is not excluded from a tax rate calculation if there is no portion of the captured appraised value excluded from the value of property taxable by the unit under Section 26.03(c) of the Tax Code. Section 26.03 applies to all taxing units other than school districts.

Senate Bill 658.

Effective: June 20, 2003.

The tax exemption for leased vehicles is made permanent.

Senate Bill 671.

Effective: June 20, 2003.

In determining local value, the Comptroller shall apply a margin of error of five percent. Appraisal districts shall provide the Comptroller's office with their sales data. If the Comptroller's office determines that a school district's values are low, the comptroller may audit the operations of the appraisal district and make recommendations for changes. Should the appraisal district fail to implement the changes, a five member board of conservators shall be appointed by the local district judges to assume the operations of the appraisal district and implement the changes.

Senate Bill 725.

Effective: September 1, 2003.

The delinquency date on omitted property involving more than one year of retroactive taxation is postponed to the next February 1 after the bill is mailed which provides the taxpayer with 180 days to pay. Penalties and interest are postponed to such date as well. If a taxing unit or appraisal district errors cause a taxpayer's payment to become delinquent, the taxpayer must pay the tax within 21 days of learning of the error to avoid penalties. The waiver of interest under such circumstances is discretionary on the part of the taxing units.

Senate Bill 726.

Effective: July 1, 2003.

Appraisal districts are subject to the same purchasing and contracting requirements as a municipality.

Senate Bill 850.

Effective: September 1, 2003.

Cities, counties and school districts may adopt regulations which would allow them to reject successful contractual bids from taxpayers who are delinquent on their property tax payments.

Senate Bill 853.

Effective: September 1, 2003.

A person who solicits a homeowner offering to obtain a refund for the homeowner for a fee must disclose the name of the appraisal district or taxing unit in writing prior to executing a contract for those services. A violation of this provision is actionable under the Deceptive Trade Practices-Consumer Protection Act.

Senate Bill 902.

Effective: June 20, 2003.

After soliciting bids, appraisal districts may contract with a depository bank for a period of two years and may extend the depository contract for one additional two year period.

Senate Bill 948.

Effective: September 1, 2003.

The county commissioners court has the authority to adopt exemptions, tax property and exercise all other taxing powers belonging to a hospital district. The hospital district's board of directors have no authority over these matters.

Senate Bill 1452.

Effective: September 1, 2003.

Appraisal district employees and appraisal review board members commit a Class C misdemeanor if they violate the prohibitions against *ex parte* communications. This provision does not apply to communications which do not discuss specific properties, evidence, arguments, facts or merits pending before the appraisal review board, nor does it bar communication between the appraisal review board and its legal counsel.

Senate Bill 1472.

Effective: June 20, 2003.

In a county with a population in excess of 1,500,000, the county commissioners court may call an election to create a zoo board with the power to establish and operate one or more zoos. If approved by the voters, a property tax, not to exceed three cents per $100 of value, may be assessed to pay for the operations of the district.

Senate Bill 1646.

Effective: January 1, 2004.

Timber valuation shall be calculated by the Texas price per ton of large pine saw timber, small pine saw timber, pine pulpwood, hardwood saw timber, hardwood pulpwood, and other significant timber production. These numbers shall be based on the East Texas timber-growing region as determined by the U.S. Forest Service. Expenses shall be calculated on what a prudent manager of such land would expend. The capitalization rate utilized shall be the greater of the Farm Credit Bank of Texas rate plus 2 1/2% or the prior year's rate. In an initial year, if the capitalization rate equals or exceeds 10%, then the preceding formula shall be used. In subsequent years, the current year's rate shall be averaged with the four preceding years' rates to determine the capitalization rate

Senate Bill 1652.

Effective: June 21, 2003.

If a portion of property owned by an institution of higher education is used for public purposes and a portion for private purposes, the public portion shall be exempted from *ad valorem* taxation.

Senate Bill 1833.

Effective: January 1, 2005 (or January 1, 2006 for counties with a population of 500,000 or less).

Agreements between the chief appraiser and property owners for communication electronically shall contain the property owners' e-mail address. The comptroller shall prescribe acceptable media, formats and methods for the exchange of electronic information between appraisal districts and taxpayers. Appraisal districts shall deliver notices of appraised value by e-mail if requested by a taxpayer whose property is included in 25 or more accounts. Electronic versions of all forms shall be made available.

ENDNOTE

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PARTNERSHIP TAX: RECENT DEVELOPMENTS

Brandon Jones

Allocation of Partnership Liabilities in Deferred Like-Kind Exchanges

Until recently, it was somewhat of a mystery how and when adjustments would be made to a partner's tax basis in a partnership if the partnership engaged in a deferred like-kind exchange transaction involving leveraged properties that straddled two taxable years. In Revenue Ruling 2003-56, the IRS determined that if a partnership enters into an exchange that qualifies as a deferred like-kind exchange under Code Section 1031, in which property subject to a liability is transferred in one taxable year of the partnership and property subject to a liability is received in the following taxable year of the partnership, the liabilities are still netted for purposes of Code Section 752 even though the exchange straddles two taxable years. In such case, (i) the net decrease, if any, in a partner's share of partnership liability is taken into account for purposes of Code Section 752(b) in the first taxable year of the partnership, and (ii) the net increase, if any, in a partner's share of partnership liability is taken into account for purposes of Code Section 752(a) in the following taxable year of the partnership.

Revaluing Partnership Property and Partner Capital Accounts Upon the Contribution of Services

Except upon its contribution to a partnership, property is typically reflected on the partnership's books at its historical value. However, there are a few other instances when a partnership may "book-up" (or "book-down") its assets to their current fair market value. Specifically, pursuant to Treasury Regulation Section 1.704-1(b)(2)(iv)(f), the capital accounts of partners may be increased or decreased to reflect a revaluation of partnership property on the partnership's books (i) in connection with the contribution of money or property to the partnership by a new or existing partner for an interest in the partnership, (ii) in connection with the liquidation of the partnership or a distribution of money or other property by the partnership to a retiring or continuing partner as consideration for an interest in the partnership or (iii) under generally accepted industry accounting practices provided substantially all of the partnership's property consists of stock, securities, commodities and certain other types of property.

Recently, however, the IRS issued proposed regulations that would permit partner capital accounts to be adjusted to reflect a revaluation of partnership property when services are provided to a partnership by a partner. Specifically, Proposed Treasury Regulation Section 1.704-1(b)(2)(iv)(f)(5)(iii) would authorize an adjustment to the partners' capital accounts to reflect a revaluation of partnership property:

> "In connection with the grant of an interest in the partnership (other than a de minimis interest) on or after the date final regulations are published in the Federal Register as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner."

TAX CONTROVERSY: RECENT DEVELOPMENT

Josh O. Ungerman[1]

I. Three Year Statute Of Limitations In Section 6531 Does Not Apply To Section 7206(2) Violations And Trial Court Improperly Imposed "Inappropriate Sentence" Pursuant To 18 U.S.C. § 3553(a).

U.S. v. Hayes, 322 F.3d 792 (4th Cir. March 14, 2003).

The Appellant was initially indicted for preparing twenty-four income tax returns which fraudulently inflated tax deductions in violation of § 7206(2). The indictment was handed down on November 19, 2001, while the returns were filed between February 17, 1996 and April 15, 1999. The Appellant unsuccessfully moved at the Trial Court level to dismiss twenty of the twenty-four counts based upon his argument that § 6531 provided for a three-year statute of limitations.

Section 6531 provides that criminal tax violations are ordinarily subject to a three-year statute of limitations. Section 6531 provides eight specific carve-outs of tax offenses which carry a six-year statute of limitations. The six-year statute of limitations is found in § 6531(3). The Appellate Court compared §§ 6531(3) and 7206(2) and found that the two statutes were virtually identical, with the only substantive difference being that § 6531(3) omitted the requirement that a defendant's false statement relate to a "material matter". The Appellant argued that the "material matter" difference demonstrated that § 6531(3) did not apply to § 7206(2) violations. The Appellate Court noted that the Appellant's logic was flawed in that while some offenses could satisfy § 6531(3) without including all of the § 7206(2) elements, it is simply not possible to violate § 7206(2) without violating all of the requirements of § 6531(3). The Appellate Court held that the six-year statute of limitations under § 6531(3) applied to § 7206(2) violations notwithstanding the fact that § 6531 does not expressly refer to § 7206(2) or incorporate all of the elements of a § 7206(2) offense.

On another issue, the pre-sentence report bifurcated the tax loss into losses covered by the indictment of $75,814 and losses incurred but not included in the indictment of $199,017. The Appellant objected to the inclusion of the non-indictment loss figure in the pre-sentence report and argued that consideration of the indicted losses by themselves would result in an appropriate sentence pursuant to 18 U.S.C. § 3553(a). The government objected and offered to introduce evidence in support of the non-indictment losses. At the sentencing hearing the District Court did not provide the government an opportunity to present evidence regarding the non-indictment losses, but instead found that a tax loss amount limited to the indictment losses resulted "in a sentence sufficient, but not greater than necessary, to reflect the seriousness of the offense, provide just punishment for an adequate deterrence, and to protect the public, in satisfaction of § 3553(a)."

The Appellate Court held that the District Court improperly failed to make an inquiry into the adequacy of the Government's proffered evidence and simply made a personal assessment of what loss amount would result in an appropriate sentence without regard to the sentencing guidelines. As such, the Appellate Court remanded the case and ordered the trial court to apply United States Sentencing Guidelines § 1B1.3 to determine whether or not to treat some or all of the non-indictment losses as part of the Appellant's relevant conduct.

II. Tenth Circuit Joins Other Circuits In Extending The Section 7201 Six-Year Statute Of Limitations To Later Occurring Acts Of Evasion.

U.S. v. Anderson, 319 F.3d 1218 (10th Cir. February 10, 2003).

On March 24, 1999, the Appellant was indicted for violating § 7201 relating to his 1991 tax return filed on April 15, 1992. Specifically, during 1991, the Appellant received two $50,000 payments which were deposited in a Swiss bank account. The Appellant's 1991 return both failed to report the two $50,000 payments and failed to check the Schedule B box disclosing an interest in a foreign bank account. Additionally, the Appellant failed to check the Schedule B box on his 1993, 1994, 1995 and 1996 tax returns.

The Appellant argued that the § 7201 crime of tax evasion was complete when he filed his return on April 15, 1992, and accordingly, the March 24, 1999 indictment fell outside of the six-year statute of limitations for § 7201. The Appellee on the other hand argued that the indictment was timely based upon the false 1996 return. The Tenth Circuit joined other circuit courts in concluding that when a taxpayer commits a series of basic acts over several years after incurring a tax liability, the statute of limitations begins to run on the date of the last evasive act. The Tenth Circuit found that the subsequent filing of tax returns without checking the Schedule B box relating to an interest in a foreign bank account constituted additional evasive acts after incurring the initial tax liability which extended the duration of the offense and with it the statute of limitations.

III. Mere Travel Outside Of The United States Tolls The Section 7206(1) Six-Year Statute Of Limitations.

U.S. v. Yip, 2003 U.S.Dist. LEXIS 3615 (U.S. Dist. Court for the Dist. of Hawaii, March 4, 2003).

The Defendant was indicted for violating § 7206(1) based upon a false return filed on April 15, 1996. The six-year statute of limitations would normally have expired on April 15, 2002. The Defendant was indicted on May 30, 2002 for a § 7206(1) violation. Section 6531 provides a tolling provision for periods in which a taxpayer is outside of the United States. The Government asserted that between the period of time of filing of the false tax return on April 15, 1996 and the Defendant's indictment on May 30, 2002 he made twenty-two foreign trips and was outside the United States for at least eighty-seven days. Thus, the Government argued that the statute of limitations actually expired on July 11, 2002.

Instead of attacking the tolling provisions in § 6531 directly, the Defendant argued that the tolling provisions relating to travel outside of the United States in § 6531 violated his Fifth Amendment constitutional right to travel. The Defendant argued that the determination of whether a federal statute that withdraws a benefit from a United States citizen based upon international travel violates the equal protections of the Fifth Amendment must be analyzed on a rational basis standard of review. A rational basis standard of review would require a court to determine whether the law in question has a reasonable connection to achieving a legitimate and constitutional objective. The District Court found that the § 6531 tolling provision for travel outside of the United States was reasonably connected to the legitimate objective of ensuring that prosecutors serve legal process on taxpayers in a reasonable amount of time and without undue complication.

The Defendant interpreted an Eighth Circuit decision to read § 6531 as attempting to protect the Government when a taxpayer moved "beyond the reach of legal process." The Defendant next argued that the existence of international agreements have made it increasingly difficult for taxpayers to make themselves "safe from legal process" as anticipated by the statute. The District Court rejected the Defendant's interpretation of the Eighth Circuit precedent and instead held consistent with the Second Circuit that § 6531 was unambiguous on its face and that any claims of unconstitutionality, if applied to business or pleasure trips, were simply without merit. The District Court concluded that "outside of the United States" means *physically* outside of the boundaries of the United States and held that the statute clearly stated that time will be tolled for any travel outside of the United States in order to allow the Government to determine the exact period within which it must initiate formal proceedings. On a final note, the District Court also felt compelled to comment that the tolling and the statute of limitations did not "necessarily operate as a penalty against international travel."

IV. Motion To Suppress Statements Of Non-Represented Return Preparer Denied.

U.S. v. Sturgis, 2003 U.S.Dist. LEXIS 5281 (U.S. Dist. Court for the District of Delaware, March 31, 2003).

The Defendant was indicted for thirty-nine counts of willfully aiding and assisting tax fraud in violation of § 7206(2). This is a painful case to read and a dramatic example of why taxpayers should discontinue communications with IRS Special Agents after being read their rights and immediately secure experienced criminal tax counsel.

Despite the Defendant's Fifth Amendment objections, the District Court held that the Defendant had no Fifth Amendment right against self-incrimination as she was never in custody when she made incriminating statements because she was not deprived of her freedom of action in any way. Additionally, the District Court upheld the voluntary nature of the Defendant's statements and waiver of her Fourth Amendment rights regarding her records.

V. Sophisticated Means Enhancement Reversed.

U.S. v. Hart, 324 F.3d 575 (8th Cir. April 2, 2003).

In this case the Appellant pled guilty to one count of § 7201 tax evasion and the parties agreed that the District Court would calculate the amount of tax loss and determine whether any special offense characteristics applied. In doing so, the District Court applied the sophisticated means enhancement found in U.S. Sentencing Guidelines § 2T1.1(b)(2). The Appellant failed to file returns. The Appellant received commission checks which he directed to be made in the name of a company owned by the Appellant. When checks were made out to the company, the Appellant endorsed the checks to a third party who acted as a private banker for the Appellant. The checks were subsequently allocated to pay personal expenses. Finally, Appellant failed to keep records of the commissions. The District Court concluded that the Appellant's pattern of avoiding taxes and failure to keep any records in addition to the general scheme of having personal income paid to a corporation and then transferred to a private banker all indicated a sufficient level of sophistication to support the sophisticated means enhancement.

The Appellate Court agreed with the District Court's findings that the Appellant failed to keep even cursory records, devised a scheme of having personal income paid to a corporation and then transferred the income to a private banker. The Appellate Court however, disagreed with the District Court's application of these facts to the sophisticated means enhancement.

The Appellate Court initially began its analysis with the tenet that the mere failure to keep records, standing alone, cannot support a sophisticated means enhancement. The Appellate Court continued that it could think of no less sophisticated means of concealing a tax evasion offense than by simply failing to keep records of personal income.

The Appellate Court addressed that the instant case was not one in which a failure to maintain records could be combined with other factors to justify the sophisticated means enhancement. The Appellate Court emphasized that since the Appellant's company provided an employer identification number to the payor of the commissions, no concealment occurred because all of the commission payments were included on a Form 1099. The Appellate Court also concluded that the use of a private banker did not rise to the level of concealment regarding the unreported income because the unreported income was already clearly identified on the Form 1099.

VI. <u>**The District Court For The District Of Columbia Transfers Challenge To New Bureau Of Prison Policy Negatively Affecting Zone C Offenders To The Southern District Of Ohio, Eastern District.**</u>

Combs v. Attorney General, 2003 U.S.Dist. LEXIS 6230 (U.S. Dist. Court for the District of Columbia, April 16, 2003).

This case describes some of the procedural implications of the Bureau of Prisons "change in policy" for a Zone C offender who had already been sentenced with recommendations for community confinement to the Bureau of Prisons from the sentencing Judge.

VII. <u>**Different Solution To Bureau Of Prison's Change In Policy For Zone C Offenders Provides For Granting Of Motion For Downward Departure.**</u>

U.S. v. Serpa, 2003 U.S.Dist. LEXIS 3948 (U.S. Dist. for the District of Mass., March 12, 2003).

The Defendant pled guilty to three counts of filing false returns in violation of § 7206(1). At the time of the plea, November 26, 2002, the Bureau of Prisons was continuing to follow its long-standing policy honoring judicial recommendations to place Zone C offenders in community correction centers for the imprisonment portion of their sentence. The Defendant was scheduled for sentencing on January 14, 2003. However, on December 20, 2002 the Bureau of Prisons changed its policy and provided that Zone C offenders could no longer serve their time of imprisonment in community correction centers. The Defendant argued, and the court granted his Motion for Downward Departure based upon *ex post facto* violation concerns.

The District Court clearly expressed no view as to the advisability or desirability of the change. The District Court merely stated that the change raised *ex post facto* concerns with respect to the sentencing of Zone C offenders who pled guilty prior to the December 20, 2002 directive.

The Court initially noted that *ex post facto* concerns were satisfactorily addressed by a finding that a new regulation amounts to a correction of an erroneous statutory interpretation. As such, the District Court noted that some courts considering the *ex post facto* challenges to the December 20, 2002 directive rejected the claims based upon the correction theory. The Trial Court concluded that even if the change could be accurately characterized as a correction of an erroneous interpretation, nonetheless, the hint of an *ex post facto* violation still exists with respect to a defendant caught in the middle of the policy change.

The Court decided the following factors in favor of its *ex post facto* concerns: the length of time during which the prior policy was in effect, the nationwide scope and application of the prior policy, the Bureau of Prisons' explicit codification of the prior policy, and the widespread recognition and discussions of the prior policy by the Bureau of Prisons, Probation Office, U.S. Attorney's Office, the defense bar, and the judiciary. All of the above, when taken in combination, undermined any argument that the recent change was or should have been foreseeable to a defendant such as the one in this case, according to the District Court. The District Court held that the sentence did not make any allowances for the defendant's reasonable inability to foresee such a change when deciding whether to plead guilty and as such raised the specter of an *ex post facto* violation. The District Court finally relied on the First Circuit's admonition in <u>Maldonado</u>, 242 F.3d at 5, that any hint of an ex post facto sanction should be avoided. Finally the District Court bolstered its opinion in granting the downward departure by noting that a plea bargain is properly analyzed under contract principles and that in order for the good faith in the government not to be impugned, specific performance would be the proper remedy for a breach on the part of the government.

VIII. <u>**Downward Departure Granted.**</u>

U.S. v. Colp, 2003 U.S.Dist. LEXIS 4293 (U.S. Dist. Court of the Eastern District of Virginia, Alexandria Div., March 10, 2003).

The Court granted Defendant's Motion for Downward Departure because the Defendant was the sole caretaker for her disabled husband who suffered from seizures, had limited mental and physical capabilities, and required constant attention. The Court found that the Defendant's family circumstances were "exceptional" enough to warrant a downward departure. To that end, the Court departed downward from an offense level of twelve (10 to 16 months) to a period of probation for two years including home confinement. The Court held that any period of incarceration would serve as an undue hardship on the Defendant's husband, and as such, the Court ordered home confinement. The Court characterized the home electronic incarceration as restricting the Defendant's liberty while allowing her to continue to provide "humane and home nursing assistance to her debilitated husband at her own expense."

ENDNOTE

1 Josh O. Ungerman, former Chair, Tax Controversy Committee specializes in civil and criminal tax controversies and is a partner with the law firm of MEADOWS, OWENS, COLLIER, REED, COUSINS & BLAU, L.L.P., 901 Main Street, Suite 3700, Dallas, Texas 75202, (214) 744-3700, FAX (214) 747-3732, (800) 451-0093, e-mail: jungerman@meadowsowens.com, Web Site: www.meadowsowens.com

TAX-EXEMPT ORGANIZATIONS: RECENT DEVELOPMENTS

Tyree C. Collier[1]

The following is a summary of selected current developments in the law applicable to tax-exempt organizations, prepared by the Tax-Exempt Organizations Committee of the Section of Taxation. Unless otherwise indicated, all section references contained herein are references to the Internal Revenue Code of 1986, as amended (the "Code").[2]

A. LITIGATION

1. Litigation to be dropped after Service grants exemption to 50/50 joint venture participant. The nonprofit John Gabriel Ryan Association, affiliated with Seattle-based Providence Health System-Washington, has indicated that it will drop its pending case against the Service because the Service has granted the Association its 501(c)(3) exemption.[3] The Service had initially denied the Association exemption because of its ancillary joint ventures with for-profit organizations. According to court documents, the Association was involved in one joint venture that was managed by a committee controlled equally by the Association and the for-profit participant.[4]

2. Tenth Circuit affirms denial of exemption for health maintenance organizations. The Tenth Circuit affirmed on April 9, 2003, that the Service was correct in denying Section 501(c)(3) exemption to three health maintenance organizations affiliated with the Utah-based Intermountain Health Care System.[5] The court held that the three organizations were not operated primarily for the purpose of benefitting the community they served. This was because the organizations operated only for the benefit of their subscribers. The court was not convinced by the organizations' arguments that the community itself benefitted because those subscribers included many individuals eligible for Medicaid and that, according to the court, the organizations may have provided coverage to the general community at a discount. The court also rejected arguments by the organizations that they should be exempt as "integral parts" of the 501(c)(3) health care system. In ruling for the Service, the court upheld the 2001 decisions of the United States Tax Court.

B. REGULATIONS, IRS RULINGS, PROPOSED LEGISLATION, ETC.

1. Revenue Ruling 2003-49 (Political Organization Reporting and Disclosure Requirements). This revenue ruling supercedes Rev. Rul. 2000-49 and provides a series of 58 questions and answers for Section 527 political organizations regarding their reporting and disclosure requirements. The main topics addressed by the questions and answers are the Notice of Status that must be filed with the Service by some political organizations, requirements regarding annual returns, and other ongoing periodic reporting requirements.

2. IRS Information Letter 2003-0014 (Section 4958 Excess Benefit Transaction taxes on certain scholarships). The Service ruled in this non-binding information letter that a community foundation may award a scholarship to a family member of a person on the community foundation's board of directors. In the situation addressed by the letter, a separate donor-advised committee selects the recipients of the scholarship and the board of directors of the community foundation then approves the persons selected as recipients. The ruling was conditioned upon the relevant board member recusing himself or herself from the vote of the board of directors that approves the award. In particular, the Service ruled that the awarding of the scholarship would not be regarded as an excess benefit transaction. Although the information letter is narrowly-directed, it is helpful in providing guidance interpreting Rev. Rul. 56-403, which could otherwise be interpreted to prohibit any award of a scholarship to family members of any officer, director, or contributor to a charity.

3. Notice 2003-31 (Comments sought for Section 501(m) guidance). The Service announced in Notice 2003-31 that it intends to provide guidance in the form of regulations on the meaning of the term "commercial-type insurance" as used in Section 501(m) and that it is seeking comments from the public on the topic. Section 501(m) was enacted in 1986 in part to repeal the Section 501(c)(4) exemption of certain Blue Cross organizations and provides generally that an organization cannot qualify for Section 501(c)(3) or Section 501(c)(4) exemption if a substantial part of its activities is the provision of "commercial-type insurance." The topic should be of particular interest to nonprofit-affiliated health maintenance organizations.

4. Service seeks comments regarding international grant-making. The Service recently issued Announcement 2003-29, seeking comments from

the public on how to clarify requirements that international grants made by Section 501(c)(3) organizations must not be diverted to non-charitable purposes, including to support terrorist activities. The Service states in the announcement that previous guidance has tended to focus on what controls and steps should be taken to prevent such funds from being used for personal benefit. The Service is particularly interested in ideas for how existing rules, enumerated in the announcement, might be improved to preclude the diversion of such funds for other non-charitable purposes, such as terrorist activities. The Service is also interested in learning about other useful procedures and safeguards have been developed and put in place by particular organizations that might be helpful additions to its future guidance.

5. Working group makes recommendations for changes to Form 1023. A working group has announced its initial recommendations for the Service's project of revising Form 1023 and related procedures.[6] Some of the key recommendations include developing a fully-interactive electronic Form 1023, developing a "helpful hints" checklist for the form, developing a standard reclassification process for public charities, developing a simple name change process, adding links from the Service web site to the sites of state charity officials, development of a Form 1023 database to make Forms 1023 as publicly available as are Forms 990, and increasing the Form 1023 filing threshold for public charities from $5,000 to $25,000.

6. Service to halt examinations based on lobbying activities. According to a news release issued jointly by several national organizations, the Service has indicated that it will stop using the fact that an organization is engaged in some lobbying activities as a factor in determining which organizations to audit.[7] In a related release, however, the Service reiterated that it has not selected Section 501(c)(3) organizations for audit, and will not do so, simply because they have made an election regarding lobbying expenses under Section 501(h).

ENDNOTES

1 Jenkins & Gilchrist, P.C., 1445 Ross Avenue, Suite 3200, Dallas, Texas 75202, Phone (214) 855-4342.

2 References to the "Service" refer to the Internal Revenue Service.

3 Parties to Dismiss Joint Venture Challenge in Wake of IRS Decision to Grant Exemption, 12 BNA Health Law Reporter 1103 (July 10, 2003).

4 See 11 BNA Health Law Reporter 1569 (Nov. 7, 2002).

5 *IHC Health Plans, Inc. v. Commissioner*, 325 F.3d 1188 (10th Cir. 2003).

6 See 99 BNA Daily Tax Report G-9 (May 22, 2003).

7 85 BNA Daily Tax Report G-5 (May 2, 2003).

TEXAS NONPROFITS NAVIGATE INS AND OUTS OF TAX LAW

by Amy Gentry

The Latino Learning Center works to build affordable housing and economic opportunities for Latino communities in disadvantaged parts of Houston. But in April, director Joe Zepeda found himself with a troubling tax question on his hands: "Basically, we got this land. We weren't sure whether it had any restrictions on whether we could sell it, and whether that would mess up our 501(c)(3) status."

Hundreds of Texas community-based nonprofits face similar tax issues every year, as they go through complex real estate transactions and economic development activities that may put their 501(c)(3) tax exemptions at risk. Even after filing the paperwork and obtaining a 501(c)(3)–itself a daunting task for many incorporating nonprofits–many of these organizations don't fully understand the tax implications of their activities, and may hesitate to enter into new projects and fundraising activities because of their inability to afford legal advice from a tax attorney.

For Joe Zepeda, however, the answer came in the form of a volunteer attorney through Texas C-BAR.

Texas C-BAR, a three-year-old independent project of Texas Rural Legal Aid, provides community-based nonprofits with pro bono referrals for transactional business, real estate, and tax matters. Ashley Morgan at Baker Botts L.L.P., a Texas C-BAR volunteer, took on the Latino Learning Center's problem, researching the title and deed restrictions on the property. The end result? "The property was free and clear, and so long as we use what we get for it on activities related to our mission, we're okay," said Mr. Zepeda.

Other tax issues were addressed in Texas C-BAR's May newsletter, in a pull-out section called *The Legal Minute.* "The tax questions nonprofits have to deal with are complex and confusing," said Texas C-BAR legal services coordinator D'Ann Johnson. "Most lawyers don't understand them. How can a nonprofit be expected to get through this stuff without expert advice?"

In fact, Texas C-BAR has a marked need of tax attorney volunteers, says Ms. Johnson. Despite the organization's success in recruiting real estate and business law attorneys from some of the state's largest firms, complex tax issues "just require tax-specific expertise," she said.

"Ashley Morgan connected us with some really good people locally, and I was amazed at how fast they all worked for us," comments Mr. Zepeda. "It's always real easy to work with professionals. It's hard to get anything done when you don't know what's going on." For the Latino Learning Center, and other Texas nonprofits, getting things done means building healthy communities and improving lives–and that's something that every tax attorney can get excited about.

For more information about Texas C-BAR, and to volunteer, visit ***www.texascbar.org***.

NEW POLICIES WITH RESPECT TO THE BUSINESS PURPOSE REQUIREMENT FOR CODE SECTION 355 TRANSACTIONS

Shilpa N. Jariwala[1]

Code Section 355[2] provides for the tax-free treatment of a distribution of the stock of a controlled subsidiary to the distributing corporation's shareholders under certain circumstances. A transaction intended to qualify for tax-free treatment under Code Section 355 must satisfy the following four statutory requirements: (i) only the stock or securities of a controlled corporation may be distributed to shareholders with respect to a distributing corporation's stock, (ii) such distribution may not be a device for distributing the earnings and profits of the distributing corporation, the controlled corporation or both, (iii) both the distributing corporation and the controlled corporation must be engaged in an active business and (iv) all of the stock of the controlled corporation held by the distributing corporation just before the distribution, or an amount of such stock sufficient to constitute control of the controlled corporation, must be distributed in the distribution.

In addition to these statutory requirements, the judicial requirements of business purpose, continuity of business enterprise, and continuity of interest applicable to other reorganizations under the Code are applicable to transactions intended to qualify for tax-free treatment under Code Section 355. The business purpose requirement generally requires that, in order to qualify for tax-free treatment under Code Section 355, a transaction must be carried out for one or more corporate business purposes. The Treasury Regulations promulgated under Code Section 355 provide that the principal reason for the business purpose requirement is to provide tax-free treatment only to distributions that are incident to readjustments of corporate structures required by business exigencies and that effect only readjustments of continuing interests in property under modified corporate forms.[3] For these purposes, the Treasury Regulations further provide that a business purpose is a real and substantial non-federal tax purpose germane to the business of the distributing corporation, the controlled corporation, or the affiliated group including the distributing corporation.[4] Finally, a distribution is not carried out for a business purpose if such purpose can be achieved through a nontaxable transaction that does not involve the distribution of the controlled corporation stock and that is not impractical or unduly expensive.[5]

Because the business purpose requirement is based largely upon the facts and circumstances of a transaction, in determining whether this requirement is met, taxpayers and practitioners in the past have requested private letter rulings as to whether the particular facts and circumstances of a transaction qualify for tax-free treatment under Code Section 355. However, in an effort to reduce the resources expended in issuing private guidance, the Internal Revenue Service announced in Revenue Procedure 2003-48[6] that the National Office will not determine in response to a private letter ruling request (i) whether a proposed or completed distribution of the stock of a controlled corporation is being carried out for one or more corporate business purposes, (ii) whether the transaction is used principally as a device for the distribution of the earnings and profits of the distributing corporation, the controlled corporation or both or (iii) whether the distribution of stock of a controlled corporation is part of a plan or series of related transactions pursuant to which one or more persons acquired, directly or indirectly, stock representing a fifty percent or greater interest in the distributing corporation or any controlled corporation. In the Revenue Procedure, the Internal Revenue Service determined that, with regard to transactions that are intended to qualify for tax-free treatment under Code Section 355, it would adhere to its policies of refraining from issuing private letter rulings requesting determinations of issues that are primarily factual and refraining from issuing "comfort rulings" with regard to transactions the federal tax treatment of which is clearly and adequately addressed in published guidance, despite its liberal application of these policies in the context of letter ruling requests regarding transactions intended to qualify for tax-free treatment under Code Section 355. The "no ruling" policy of the Revenue Procedure applies to requests for private letter rulings postmarked or, if not mailed, received after August 8, 2003 and is intended to operate for at least one year, at which time the Internal Revenue Service may consider further changes.

By limiting the private letter rulings issued relating to Code Section 355 transactions, the Internal Revenue Service intends to better serve taxpayers by dedicating its resources to increasing the amount of published guidance regarding Code Section 355, including specifically the business purpose requirement. Pursuant to this endeavor, the Internal Revenue Service has published the following four Revenue Rulings with regard to the business purpose requirement: (i) Revenue Ruling 2003-52,[7] (ii) Revenue Ruling 2003-55,[8] (iii) Revenue Ruling 2003-74[9] and (iv) Revenue Ruling 2003-75.[10]

Revenue Ruling 2003-52 involves a domestic corporation that has been engaged for more than five years in a farming business including only breeding and raising livestock and growing grain. A family consisting of Father, Mother, Son and Daughter each own twenty-five percent of the outstanding stock of the corporation. Father and Mother participate in some major management decisions; however, Son, Daughter and other employees perform most of the management and all of the operational activities. Son and Daughter disagree over the future direction of the corporation's farming business. Son wants to expand the livestock business to which Daughter is opposed because it would require substantial borrowing by the corporation. On the other hand, Daughter would prefer to sell the livestock business and concentrate on the grain business. The disagreement between the siblings has prevented each from developing, as he or she sees fit, the business in which he or she is most interested. In light of the disagreement, Father and Mother would prefer to bequeath separate interests in the farm business to their children. In addition, for reasons unrelated to the corporation's farm business, Son and Daughter's husband dislike each other, and, although this has not impaired the corporation's farm activities to date, Father and Mother believe that requiring Son and Daughter to run a single business together is likely to cause family discord over the long run. To enable each child to devote his or her undivided attention to, and apply a consistent business strategy to, the farming business in which he or she is most interested, to further the estate planning goals of Father and Mother and to promote family harmony, the corporation transfers the livestock business to a newly formed, wholly-owned domestic corporation and distributes fifty percent of the subsidiary stock to Son in exchange for all of his stock in the corporation and distributes the remaining subsidiary stock equally to Father and Mother in exchange for half of their stock in the corporation. As a result, Daughter will manage and operate the corporation and have no stock interest in the former subsidiary, and Son will manage and operate the former subsidiary and have no stock interest in the corporation. Father and Mother will also amend their wills to provide that Son and Daughter will inherit stock only in the former subsidiary and the corporation, respectively. After the distribution, Father and Mother will still each own twenty-five percent of the outstanding stock of the corporation and the former subsidiary and will continue to participate in some major management decisions related to the business of each corporation. Apart from the issue of whether the business purpose requirement is satisfied, the distribution meets all of the requirements of Code Sections 368(a)(1)(D) and 355. The Internal Revenue Service reasoned that, although the distribution is intended in part to further the personal estate planning of Father and Mother and to promote family harmony, it is motivated in substantial part by the elimination of the disagreement between Son and Daughter to allow each sibling to devote his or her undivided attention to, and apply a consistent business strategy to, the farming business in which he or she is most interested with the expectation that each business will benefit, which is a real and substantial non-federal tax purpose that is germane to the business of the corporation. Thus, based upon these facts, the Internal Revenue Service ruled that the business purpose requirement is satisfied.

Revenue Ruling 2003-55 involves a publicly-traded corporation that directly conducts business A and business B and conducts business C through its wholly-owned subsidiary that needs to raise a substantial amount of capital in the near future to invest in plant and equipment and to make acquisitions. Its investment banker has advised the corporation that the best way to raise this capital is through an initial public offering of the subsidiary stock after the subsidiary has been separated from the corporation. Based on analysis of comparable situations and taking into account the current market climate, the investment banker believes that the offering would be more efficient than a stock offering by the subsidiary or the corporation without first separating. Relying on the investment bankers opinion, the corporation distributes the stock of the subsidiary to its shareholders, and the former subsidiary prepares to offer its stock to the public as soon as practicable, but with a target date approximately six months after the distribution; however, following the distribution but before the offering can be undertaken, market conditions unexpectedly deteriorate to such an extent that, in the judgment of the former subsidiary and its advisors, the offering should be postponed. One year after the distribution, conditions still have not improved sufficiently to permit the offering to go forward and the former subsidiary funds its capital needs through the sale of debentures. Apart from the issue of whether the business purpose requirement is satisfied, the distribution meets all of the requirements of Code Section 355. Based upon these facts, the Internal Revenue Service ruled that the business purpose requirement is satisfied if the distribution of the stock of the subsidiary is, at the time of the distribution, motivated in whole or substantial part by a corporate business purpose even though such purpose cannot be achieved as the result of an unexpected change in circumstances.

Revenue Ruling 2003-74 involves a publicly-traded corporation that directly conducts a software technology business and conducts a paper products business through its wholly-owned subsidiary. The corporation has one shareholder that owns eight percent of its outstanding stock and does not actively participate in the management or operations of the corporation or the subsidiary. The corporation originally developed around the software business, which remains its core operation. The paper products business, which is significantly smaller, was acquired five years ago to support the software business and grows at a slow to moderate rate mainly through increased efficiencies in productivity. The corporation's senior management devotes more of its time to the software business because it believes it presents better opportunities for growth, and, although it would like to concentrate solely on the software business, it is prevented from doing so by the need to service the paper products business. On the other hand, the management of the subsidiary believes that the disproportionate attention paid to the software business deprives the subsidiary of the management resources needed for full development of the paper products business. To enable the corporation's senior management to concentrate on the software business and the management of the subsidiary to concentrate on the paper products business, the corporation makes a pro rata distribution of the subsidiary stock to its shareholders. There is no other nontaxable transaction that would permit the corporation's senior management to concentrate on the software business and permit the paper products business to have a senior management that adequately serves that business, and the corporation's directors and senior management expect that each business will benefit in a real and substantial way from the separation. Following the distribution, no officer will serve both the corporation and the former subsidiary; however, two of the corporation's eight directors will also serve on the former subsidiary's six-person board. The first, whose term will expire after two years and who cannot seek reelection, will help with administrative aspects of the transition. The other, whose term will expire after six years and who may seek reelection, is recognized as an expert in corporate finance, and his presence on the board of the subsidiary is intended to reassure the financial markets by providing a sense of continuity. Both directors are officers of the corporation, but neither will be an officer or employee of the former subsidiary. Apart from the issue of whether the business purpose requirement is satisfied, the distribution meets all of the requirements of Code Section 355. Based upon these facts, the Internal Revenue Service ruled that the corporation's distribution of the subsidiary stock enabling the management of each entity to concentrate on its own business satisfies the business purpose requirement despite the limited overlap of the management of the entities.

Revenue Ruling 2003-75 involves a publicly-traded corporation that directly conducts a pharmaceuticals business and conducts a cosmetics business through its wholly-owned subsidiary. The corporation has one shareholder that owns six percent of its outstanding stock and does not actively participate in the management or operations of the corporation or the subsidiary. Both businesses require substantial capital for reinvestment and research and development. The corporation does all of the borrowing for both itself and the subsidiary and makes all decisions regarding the allocation of capital spending between the pharmaceuticals and cosmetics businesses. Because the corporation's capital spending in recent years for both the pharmaceuticals and cosmetics businesses has outpaced cash flow from the businesses, it has had to limit total expenditures to maintain its credit ratings. Although the decisions reached by the corporation's senior management regarding the allocation of capital spending usually favor the pharmaceuticals business due to its higher rate of growth and profit margin, the competition for capital prevents both businesses from consistently pursuing development strategies that the management of each business believes are appropriate. To eliminate this competition for capital, the corporation makes a pro rata distribution of the subsidiary stock to its shareholders. There is no other nontaxable transaction that would solve the competition problem because the total capital available to the two businesses would continue to be limited as long as the two businesses remained within the same corporate group. It is expected that both businesses will benefit from the separation and that the cosmetics business will benefit in a real and substantial way as a result of increased control over its capital spending and direct access to the capital markets. To facilitate the separation, the corporation and the former subsidiary will enter into transitional agreements that relate to information technology, benefits administration and accounting and tax matters. Other than the tax matters agreement, each agreement will terminate after two years absent extraordinary circumstances, in which case the affected agreement may be extended on arms-length terms for a limited period. Following the separation, there will be no cross-guarantee or cross-collateralization of debt between the corporation and the former subsidiary, and an arm's-length loan from the corporation to the former subsidiary for working capital will have a term of two years. Apart from the issue of whether the business purpose requirement is satisfied, the distribution meets all the requirements of Code Section 355. Based upon these facts, the Internal Revenue Service ruled that the distribution of the subsidiary stock to resolve a capital allocation problem between the corporation and the subsidiary satisfies the business purpose requirement despite the continuing contractual relationships between the corporation and the former subsidiary.

Of the four Revenue Rulings issued this year by the Internal Revenue Service regarding the business purpose requirement in a transaction intended to qualify for tax-free treatment under Code Section 355, only Revenue Ruling 2003-55 illustrates such qualification pursuant to a relatively general fact scenario. Although the remaining three Revenue Rulings provide examples of situations in which the business purpose requirement was met, each of such Revenue Rulings contains a very detailed set of facts and circumstances upon which the Internal Revenue Service relied in making its ruling. A taxpayer looking to rely on such Revenue Rulings for guidance will find it difficult to do so with comfort unless the facts of the transaction in question were practically indistinguishable – a reasonably unlikely coincidence.

Unlikely to be able to rely with certainty upon direction from the Internal Revenue Service due to a current lack of generally applicable published guidance and unable to obtain a private letter ruling due to the new policy set forth in Revenue Procedure 2003-48, taxpayers will look to tax counsel to provide assistance. Such assistance will likely be in the form of a written opinion providing reassurance similar to that which is accompanied by a private letter ruling. Furthermore, it may be difficult for tax counsel to render written opinions on this matter without sufficient published guidance upon which to rely. Until the Internal Revenue Service provides further guidance on the business purpose requirement, the refusal of the Internal Revenue Service to issue private letter rulings and the difficulty of tax counsel to render an opinion regarding the business purpose requirement in this context could have a chilling effect on Code Section 355 transactions.

ENDNOTES

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2 All section references contained herein are references to the Internal Revenue Code of 1986, as amended (the "*Code*").

3 *See* Treas. Reg. § 1.355-2(b)(1).

4 *See* Treas. Reg. § 1.355-2(b)(2).

5 *See* Treas. Reg. § 1.355-2(b)(3).

6 Rev. Proc. 2033-48, 2003-29 IRB 86, 06/24/2003.

7 Rev. Rul. 2003-52, 2003-22 IRB 960, 05/12/2003.

8 Rev. Rul. 2003-55, 2003-22 IRB 961, 05/12/2003.

9 Rev. Rul. 2003-74, 2003-29 IRB 77, 05/24/2003.

10 Rev. Rul. 2003-75, 2003-29 IRB 79, 05/24/2003.

PRE-IMMIGRATION TAX PLANNING-AVOIDING INSTALLMENT SALE TREATMENT

by William H. Newton, III[1]

The installment sale provides a means of deferring gain from United States income taxation. Specifically, absent an election out, installment sales treatment is automatic. Consistent therewith a portion of each payment is treated as in part gain and in part return of basis with the gain component then being subject to current United States income taxation.

From the perspective of a United States person (a citizen or resident) this treatment typically is beneficial. By contrast, for a nonresident alien ("NRA") who plans to immigrate to the United States, an installment sale of property located outside the United States would be detrimental. That is, deferred payments received after acquisition of residency status would become subject to United States income taxation. However, if the NRA were to elect out of installment sale treatment, the entire gain may then be considered realized and attributable to the year of sale and thus escape taxation entirely. Moreover, this is so even if deferred payments are received after acquisition of residency status.

Unfortunately, the Temporary Treasury Regulations do not specifically spell out the procedure for an NRA to elect out. They merely provide that a taxpayer who reports the full sales price as being subject to taxation on a duly filed return for the year of sale is deemed to have made an effective election. For the typical NRA this would be inapposite since the gain because foreign source, noneffectively connected would not be subject to tax in the first instance with no return thereby being required.

Even so, Priv. Ltr. Ruls. 8708002 and 9412008 conclude the NRAs therein were deemed to have elected not to report on the installment method. As in the general case, neither ruling indicates the NRAs were otherwise required to file a United States income tax return. Rather, it was only after acquisition of United States residency that a return filing obligation was addressed and apparently arose.

By contrast, if as a result of for example United States trade or business activity an extant return obligation is present for the year of sale, the NRA could then be perceived as being directly presented with an opportunity to elect out of installment sale treatment. Absent so doing the Internal Revenue Service could subsequently take the position installment sales treatment had been adopted with payments received after acquisition of residence being subject to taxation pursuant to the installment sales rules. Since unlike United States persons no specific procedure for this purpose exists, the general guidance spelled out in Priv. Ltr. Rul. 9214005 is perhaps informative:

> The doctrine of election as it relates to Federal tax law requires: a free choice between two or more alternatives; and an overt act by the taxpayer communicating the choice to the Commissioner.

Id. For this purpose a written statement setting forth the relevant facts and citing Priv. Ltr. Ruls. 8708002 and 9412008 may be sufficient.

If the underlying foreign sales transaction should be subject to significant contingencies, the Internal Revenue Service could conceivably assert applicability of the open transaction doctrine of Burnet v. Logan, 283 U.S. 404 (1931). In this regard, the legislative history to the Installment Sales Revision Act of 1980 indicates, perhaps because of its typical beneficial effect in this context for United States persons, that Congress intended to leave little room for application of the doctrine in any case. See generally, Goldberg, Open Transaction Treatment for Deferred Payment Sales After the Installment Sales Act of 1980, 34 Tax Law 605 (1981). Consistent with legislative history, Temp. Treas. Reg. §15A.453-1(d)(2)(iii) provides as follows:

> The fair market value of a contingent payment obligation shall be determined by disregarding any restrictions on transfer imposed by agreement or under local law. The fair market value of a contingent payment obligation may be ascertained from, and in no event shall be considered to be less than, the fair market value of the property sold (less the amount of any other consideration received in sale). *Only in those rare and extraordinary cases involving sales for a contingent payment obligation in which the fair market value of the obligation (determinable under the preceding sentences) cannot reasonably be ascertained will the taxpayer be entitled to assert that the transaction is "open"* [emphasis supplied]. Any such transaction will be carefully scrutinized to determine whether a sale in fact has taken place.

However, in a scenario in which a NRA is seeking to immigrate to the United States since application of the doctrine is detrimental the Internal Revenue Service could take a contrary position to protect the fisc, arguing that one of " . . . those rare and extraordinary cases . . ." warranting application of the doctrine exists. The potential result would be to tax the consideration on subsequent receipt-after acquisition of residency status. In this context if a return filing obligation were otherwise to arise perhaps use of Form 8275 could be appropriate in terms of electing out especially where there is concern with respect to potential imposition of the substantial understatement penalty. In any event, the preferable course of action irrespective of the existence or nonexistence of any contingency is for the nonresident alien involved personally to obtain a private letter ruling.

While no contingencies were at issue in Priv. Ltr. Ruls. 8708002 and 9412008, both interestingly involved sales on the installment basis in the relevant foreign jurisdictions. Indeed, Priv. Ltr. Rul. 8708002 even emphasized that an administrative ruling had even been issued by the tax authorities in the foreign jurisdiction that the "gain should be reported as the payments are received and not in the year of sale". *Id.*

Nevertheless, in addressing the impact of foreign taxation on the transaction Priv. Ltr. Rul. 8708002 provides:

> In the application of U.S. income tax laws, the concepts established by that body of law are controlling despite the fact that a particular transaction under consideration may have had its origin in a foreign country and, to that extent, may have been affected by a foreign income tax law. [citations omitted]. Based on this principle, in order to determine the application of the installment method rules to the contract payments in 1983 and 1984, it must be determined what the US tax treatment would have been in 1981 if taxpayer had been a resident at the time of the sale. *The treatment of this transaction under the tax laws of Country X is not relevant in determining US tax law consequences* [emphasis supplied].

In conclusion, while an NRA seeking to immigrate to the United States may avoid installment sale treatment, doing so requires consideration of the specific circumstances of the NRA at issue. These considerations include both whether a United States income tax return is currently being filed as well as the nature of the foreign sale itself and whether contingencies (e.g., whether definitive dates for and specific amounts of the payments are spelled out, etc.) exist. Other considerations such as whether the sale is a sham or façade may also arise.

ENDNOTE

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DISPUTES AMONG PARTNERS RESULTING IN THE SALE OF PARTNERSHIP ASSETS

Martin M. Van Brauman[1]

If significant disputes occur between a general partner and the limited partners in a partnership, the general partner may want to sell the assets to cash out of the partnership over the objections of the limited partners. The general partner may place the partnership into a receivership and dispose of all of the partnership property through a sale. This situation assumes that the general partner has the power under the partnership agreement to force such actions over the majority-in-interest held by the limited partners. This action would require the limited partners, who want to continue the partnership business, to purchase the partnership property at sale.

The concern is whether the continuing partners may face a taxable distribution from this sale with a termination of the old partnership. This article addresses these questions raised by an example of a sale of all of the partnership property and the liquidation through a receivership of the old partnership. This situation also represents inexperienced investors contributing to a limited partnership and being subject to an unfavorable partnership agreement.

Partnership Termination or Continuation

The first step in this analysis is to determine if a partnership termination has occurred for U.S. tax purposes. Under I.R.C. § 708(b),[2] a partnership is considered terminated only if (1) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or (2) within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

A receivership is a legal proceeding in which a receiver is appointed over usually an insolvent partnership for the protection of its assets and for its ultimate sale and distribution to creditors.[3] A partnership is not terminated upon entering into a receivership, but continues as a partnership for federal tax purposes until the winding up is concluded and there is a final accounting.[4] Likewise, a bankrupt partnership is not terminated for tax purposes, since a partnership is not treated as a separate taxable estate under bankruptcy proceedings.[5] Whether there is a termination of the partnership depends upon the facts and circumstances after the receivership has concluded.

In Rev. Rul. 66-264, as a result of litigation among equal partners of a five-person partnership, the court ordered all assets of the partnership to be sold at a judicial sale.[6] Three of the partners purchased all of the assets and continued the partnership's business through a new three-person partnership. The Internal Revenue Service (the "Service") concluded that the new partnership was a continuation of the old partnership and ignored the asset sale. The Service recast the transaction as either a sale or liquidation of the partnership interests of the two withdrawing partners, depending upon the facts and circumstances. Thus, the transaction was not considered a sale of partnership assets for the remaining partners, but was considered a sale or liquidation of the partnership interests of the withdrawing partners.

Priv. Ltr. Rul. 83-021-08 repeated the principle enunciated in Rev. Rul. 66-264, in which partnership properties were sold for valid business reasons at auction to the highest bidder.[7] The partners, representing more than 50 percent of the old partnership, acquired at auction the partnership property and contributed the property and their portion of the distributions from the sale to a new partnership. The transaction was not treated as a sale of partnership assets for the remaining partners, but was considered a sale or liquidation of the partnership interests of the withdrawing partners, depending upon the facts and circumstances for the withdrawing partners.

This analysis follows section 708(b)(1)(A), which provides for a termination only if no part of the partnership business is continued "by any of its partners in a partnership." In *Neubecker v. Commissioner*, two withdrawing members of a three-person equal partnership that was dissolved formed a new partnership.[8] The court held that, although the old partnership dissolved, it did not terminate within the meaning of section 708. The new partnership was a continuation of the original partnership.

The court drew an implicit distinction between dissolution and termination. A section 708 termination requires the complete cessation of business. The old partnership dissolved into the new partnership, but did not terminate.

Section 708(a) provides that an existing partnership is considered as continuing if it is not terminated and subsection (b)(1)(A) provides that a partnership is considered as terminated only if (1) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or (2) within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

The Service has denied sales treatment to transactions between related partnerships.[9] Under G.C.M. 33774, a sale between two partnerships, in which the partners of the buyer owned more than 50 percent of the capital and profits of the seller, was recast as a mere continuation of the seller partnership in the form of the buyer partnership, with some admissions and retirements of partners in the process. The terms of the sale as evidenced by a note and trust deed revealed that the initial capital contribution of the partners was the same as the purchase price of the real estate of which was paid with borrowed funds. The initial capital contribution was withdrawn within 15 months after the time they were made.

The Service contended that the partners of the old partnership who were considered the owners of the rental properties remained the owners of those properties as continuing partners in the new partnership despite the would-be "sale." The Service denied that the remaining partners (1) realized a capital gain from a "disposition," (2) acquired a new basis for those properties and (3) realized deductible losses by reason of the depreciation deduction determined with reference to such new basis.

The Service stated that the ostensible transfer of the real property assets lacked substance and was only a contrived formal attempt to secure the tax treatment of a step-up in basis for depreciation. The partners were attempting to create capital gain distributions and ordinary income deductions. The Service further stated that how can there be a sale by the partnership of its partnership assets when those assets will continue to be owned by a firm that is recognized as the same partnership for federal tax purposes?

Tax Consequences

The old partnership would not recognize gain or loss in the transaction under section 731(b)[10] and the remaining limited partners would not recognize any gain under section 731(a).[11] The cash received by the old partnership from the purchasing original partners under the sale transaction and allocated for distribution by the partnership agreement to the old partners is disregarded for purposes of determining the tax consequences of the transaction. The Service would not recognize the sale transaction as creating a distribution to the remaining limited partners.

Since the transaction is characterized as a purchase of the interest of the withdrawing general partner, section 751(b)[12] would not apply. The withdrawing partner would recognize gain or loss, since the transaction is a sale or exchange of a partnership interest under section 741,[13] subject to section 751(a).[14] With a sale or exchange of a partnership interest, adjustments for any liabilities would be made under section 752(d).[15] Thus, the withdrawing general partner would recognize gain or loss equal to the difference between the adjusted basis in his partnership interest and the sum of the cash received by the partner plus the partner's share of partnership liabilities included in his basis.

The transaction is treated as a sale of the partnership interest of the general partner to the limited partners. The amount paid by the limited partners for the interest of the general partner would be determined by taking the amount the limited partners paid to the partnership pursuant to the sale and subtracting the amount of the sale proceeds which are returned to the limited partners. This difference is the amount that they paid in order to acquire the interest of the general partner.

The basis of the limited partners in the interest of the general partner in the partnership would include the share of any partnership liabilities attributable to this interest.[16] Thus, the limited partners would have a total aggregate outside basis in their partnership interests equal to their basis in the partnership prior to the sale transaction increased by their basis in the interest of the general partner.

The inside basis of the partnership assets would not change under section 723,[17] since these assets are not being contributed to a new partnership. Following a sale or exchange of a partnership interest, inside and outside basis generally will no longer be similar because the purchaser (the limited partners) of the interest (of the general partner) is paying fair market value for the interest which becomes his outside basis under section 742,[18] but his share of the partnership's inside basis of the assets is not adjusted accordingly. Section 743(a) prevents the adjustment to the basis of partnership property as a result of a transfer of an interest in a partnership by sale or exchange, unless the partnership has made an election under section 754[19] for the adjustment to inside basis.

Conclusion

The partnership is not terminated upon entering into a receivership, but continues as a partnership for federal tax purposes until the winding up is concluded. The facts and circumstances with respect to the relationship of the partnership property to the partners, following the conclusion of the receivership, would determine subsequent partnership and tax consequences.

For federal tax purposes, this transaction does not cause a termination under section 708(b)(1)(A), since the business of the original partnership would be carried on by some of its partners in a partnership. This transaction does not cause a termination under section 708(b)(1)(B), since the continuing partners held more than 50 percent of the capital and profits interests in the original partnership.

Thus, the new partnership would be treated as a continuation of the old partnership. The asset sale would be ignored for federal tax purposes. The position of the Service is how can there be a sale by the partnership of its partnership assets when those assets will continue to be owned by a firm that is recognized as the same partnership for federal tax purposes.

The transaction would be recast as either a sale or liquidation of the partnership interest of the withdrawing general partner, depending upon the facts and circumstances. The transaction is treated as a sale of the partnership interest of the general partner to the limited partners.

ENDNOTES

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2 Except as noted, all statutory and section references herein are to the Internal Revenue Code of 1986 (26 U.S.C.), as amended, and all regulation references are to the U.S. Treasury Regulations.

3 *Black's Law Dictionary*, 1141 (5th ed. 1979).

4 Priv. Ltr. Rul. 94-360-32 (June 10, 1994); *see* Priv. Ltr. Rul. 94-500-12 (Sept. 15, 1994)(state regulatory agency takes possession of partnership business and property, appoints receiver to liquidate partnership; partnership not terminated until affairs completely wound up).

5 I.R.C. § 1398(b)(2).

6 Rev. Rul. 66-264, 1966-2 C.B. 248; *see also* Priv. Ltr. Rul. 83-021-08 (Oct. 15, 1982).

7 Priv. Ltr. Rul. 83-021-08 (Oct. 15, 1982).

8 Neubecker v. Commissioner, 65 T.C. 577 (1975).

9 G.C.M. 33774 (Mar. 22, 1968).

10 I.R.C. § 731(b)(no gain or loss is recognized to a partnership on a distribution to a partner, including money).

11 I.R.C. § 731(a)(treatment as the gain or loss from the sale or exchange of a partnership interest of the distributee partner).

12 I.R.C. § 751(b)(distributions of partnership property treated as a sales or exchange with respect to unrealized receivables or inventory).

13 I.R.C. § 741 (recognition of gain or loss as a capital asset except as provided by section 751 relating to unrealized receivables and inventory).

14 I.R.C. § 751(a)(sale or exchange of partnership interest with respect to unrealized receivables and inventory).

15 I.R.C. § 752(d)(treatment of liabilities on the sale of a partnership interest).

16 I.R.C. §§ 752 and 1012.

17 I.R.C. § 723 (the basis of property contributed to a partnership).

18 I.R.C. § 742 (the basis of the transferee partner's interest acquired other than by contribution is determined by its cost basis).

19 I.R.C. § 754 (electing optional adjustment to the basis of partnership property for transfers of a partnership interest or distributions of partnership property).

FROM THE GROUND UP: AN IN-DEPTH ANALYSIS OF BUILD-TO-SUIT AND RELATED PARTY EXCHANGES *

Bradley T. Borden[1]

I. INTRODUCTION

It is doubtful Congress envisioned the build-to-suit exchange when it enacted the predecessor to § 1031[2] in 1921.[3] Since that time, business exigencies demanded that the law evolve to allow taxpayers to sell property and reinvest the sale proceeds tax-free in improvements on other property. Alternatively, the taxpayer may desire to use sale proceeds to construct improvements on property owned by a person related to the taxpayer. Further, the taxpayer may wish to construct improvements on land already owned by the taxpayer.

Long-standing case law provides that such improvements may be constructed on property owned by a party who is not related to the taxpayer. Published September 15, 2000, Rev. Proc. 2000-37[4] provides a safe harbor for build-to-suit exchanges involving land owned by unrelated parties, providing assurance that certain exchange structures will obtain § 1031 nonrecognition treatment. More recently, in PLR 200251008,[5] the IRS approved an exchange structure that involved an exchange accommodation titleholder constructing improvements on property leased to it by a party related to the taxpayer as part of a transaction that satisfied the requirements of Rev. Proc. 2000-37. PLR 200251008 is significant because, as the IRS's first interpretation of the scope of Rev. Proc. 2000-37, it provides an example of a workable build-to-suit exchange involving property owned by a related party. The exchange structure in PLR 200251008 has added significance in light of Rev. Rul. 2002-83,[6] which addresses delayed multi-party exchanges involving a party related to the taxpayer.

Rev. Rul. 2002-83 reinforces the IRS's position that it believes related party exchanges deserve close scrutiny. Rev. Proc. 2000-37 and PLR 200251008, on the other hand, demonstrate the IRS's understanding that build-to-suit exchanges can be structured to qualify for § 1031 nonrecognition treatment, even if a related party is involved. The impact of these rulings is best demonstrated by considering them in the context of the various types of build-to-suit exchanges. The memorandum thus begins by considering the first rulings on build-to-suit exchanges. These rulings involved construction on replacement property that was owned by a third party not related to the taxpayer. The memorandum then turns to build-to-suit exchanges involving property owned by a party related to the taxpayer, including a discussion of PLR 200251008. Because the related party rules pose such a threat to these types of exchanges, the memorandum takes an in-depth look at § 1031(f) and rulings interpreting it, including Rev. Rul. 2002-83. After that, the focus turns to whether the existing law can be applied to build-to-suit exchanges involving construction on property owned by the taxpayer, and explores possible structures that should help such transactions qualify for § 1031 nonrecognition treatment. Finally, special consideration must be given to build-to-suit exchanges that do not satisfy the requirements of Rev. Proc. 2000-37 or that are structured as deferred exchanges.

II. BUILD-TO-SUIT EXCHANGE ON PROPERTY OWNED BY AN UNRELATED PARTY

For several years, taxpayers have had several models to rely on in structuring build-to-suit exchanges where the improvements were to be constructed on property owned by an unrelated party. With each model, the issue is the same, however: ensure the taxpayer is not the deemed beneficial owner of the underlying land or improvements before it receives title to the property. Now taxpayers, when possible, may structure exchanges under Rev. Proc. 2000-37 and be assured that they are not treated as the beneficial owner of the land or improvements prior to receiving title.

A. *J.H. Baird Publg Co. v. Comr.*

J.H. Baird Publg Co. v. Comr.[7] involved a real estate brokerage company who, at the taxpayer's direction, acquired land from a third party, built a building on the land according to the taxpayer's specifications, and transferred the land and completed building and some cash to the taxpayer in exchange for the taxpayer's land and building. The Tax Court framed the issue as whether the real estate brokerage company was the taxpayer's agent. The Tax Court held there was no agency and treated the brokerage company as the owner of the acquired land and building. Thus, the brokerage company's transfer of the land and building to the taxpayer in exchange for the relinquished property satisfied the § 1031 exchange requirement.

B. *Coastal Terminals, Inc. v. U.S.*

In *Coastal Terminals, Inc. v. U.S.*,[8] the taxpayer operated a deep water oil terminal, had an option to acquire three pieces of land from unrelated parties on which the taxpayer desired to build new inland terminal facilities, and owned 60% of a corporation (making it a related party) owning a separate inland terminal facility. The taxpayer assigned the option in the three properties to a prospective acquiror of the taxpayer's existing deep water facility. That acquiror purchased the inland facility from the related corporation, closed on the optioned land, built new facilities to the taxpayer's specifications on the land, and transferred the land and new facilities and the pre-existing inland facility to the taxpayer in exchange for the taxpayer's deepwater facilities. Since the acquiror was deemed the owner of the land purchased under option and the new facilities, the Fourth Circuit affirmed the District Court's conclusion that the taxpayer had entered into a valid like-kind exchange.

The Fourth Circuit did not address issues regarding the indirect receipt of property from a related party. Since the related party transferred its property to the acquiror as part of a prearranged plan within two years before the property was transferred to the taxpayer, the transaction would be scrutinized under § 1031(f)(4) if the transaction occurred today. As discussed below, it is uncertain what impact § 1031(f)(4) would have on this type of transaction. For example, would § 1031(f)(4) disqualify the entire transaction from § 1031 nonrecognition treatment because one property was indirectly acquired from a related party, or, would the transaction be bifurcated between an exchange involving property received from an unrelated party and an exchange involving property received from a related party? Would the basis-to-value ratio the related party had in the property affect the tax treatment of the transaction? As discussed below, no existing authority answers these questions, but it seems inappropriate to disqualify an entire transaction simply because one property is acquired indirectly from a related party as part of a prearranged plan. Furthermore, if the related party's basis-to-value ratio in its property was less than the taxpayer's basis-to-value ratio in the relinquished property, arguably, § 1031(f) would not impact the exchange.

C. Rev. Rul. 75-291

In Rev. Rul. 75-291,[9] an unrelated party purchased land from another unrelated party and constructed a building on the land pursuant to a written agreement with the taxpayer. The agreement required the party to transfer the land and new building to the taxpayer in exchange for other property owned by the taxpayer. The IRS ruled that this transaction qualified for § 1031 nonrecognition treatment because the unrelated party did not act as an agent of the taxpayer.

D. PLR 9149018

In PLR 9149018, the taxpayer, seeking to build on vacant land owned by an unrelated third party, entered into an agreement with another party who desired to acquire other real estate owned by the taxpayer. Pursuant to the agreement, the other party obtained an assignable ground lease of more than 30 years duration on the land selected by the taxpayer, constructed a building on that vacant land, and conveyed the ground lease and building to the taxpayer in exchange for the taxpayer's other real estate. The taxpayer supplied all the construction specifications to the other party; agreed, after the other party paid a specified minimum level of costs, to make a nonrecourse construction loan to the acquirer to cover the remaining construction costs; and, to that extent, bore the downside risk of loss during the construction period. Despite the retention of significant benefits and burdens of ownership by the taxpayer, the IRS ruled that there was a like-kind exchange. In ruling, the IRS stressed that the other party, prior to the exchange, had various risks of ownership, such as liability for the minimum costs before the taxpayer began to disburse the nonrecourse construction loan.

E. PLR 9413006

Another important aspect of build-to-suit exchanges is tracking the exchange proceeds and considering who will serve as construction contractor. In PLR 9413006, the IRS allowed a qualified intermediary to pay exchange proceeds to a party related to the taxpayer who was hired to construct improvements on property owned by an unrelated party. The IRS ruled that since "none of [the money paid to the related party] represents receipts from the transfer of . . . the relinquished property[,]" the related party was not treated as receiving exchange proceeds before the replacement property was acquired. This ruling demonstrates the IRS not only approves of build-to-suit exchanges, but also allows related parties to construct the improvements on the replacement property. Care must be taken in such exchanges, however, to ensure the taxpayer is not in constructive receipt of the exchange proceeds.

These cases and rulings establish that so long as the party constructing the improvements is not the taxpayer=s agent and bears some of the benefits and burdens of owning the land and improvements, the transaction may qualify for § 1031 nonrecognition treatment. Also, if properly structured, a related party may be paid out of exchange proceeds to construct improvements before the replacement property is acquired. Finding another party to facilitate the transaction may be difficult if that party must assume the burdens of owning the property. Additionally, taxpayers are generally hesitant to construct improvements on property controlled by an unrelated party. The IRS helped resolve these issues by publishing Rev. Proc. 2000-37.

F. The Use of Rev. Proc. 2000-37

Rev. Proc. 2000-37 provides a method for structuring build-to-suit exchanges involving property owned by an unrelated party, even though the taxpayer assumes the benefits and burdens of ownership of the land and improvements. So long as all of the requirements in Rev. Proc. 2000-37 are satisfied, the IRS will treat the accommodation titleholder as the beneficial owner of the property.[10] Thus, to accomplish a build-to-suit exchange involving land owned by an unrelated party, the taxpayer may direct an exchange accommodation titleholder to acquire land and construct improvements according to the taxpayer's specifications. Under the permissible agreements of Rev. Proc. 2000-37, the taxpayer may bear the benefits and burdens of ownership of the land and improvements and be paid by the exchange accommodation titleholder for managing the construction of the improvements.[11] Rev. Proc. 2000-37 thus simplifies the build-to-suit exchange for many taxpayers.[12]

III. BUILD-TO-SUIT EXCHANGE ON PROPERTY OWNED BY A RELATED PARTY

The issues become considerably more complicated when a build-to-suit exchange involves property owned by a party related to the taxpayer. Two general types of build-to-suit exchanges involve property owned by a related party: (1) a build-to-suit exchange involving property acquired by a related party in contemplation of an exchange; (2) a build-to-suit exchange involving property owned by a related party before the exchange is arranged. Because § 1031(f) poses a threat to any exchange involving a party related to the taxpayer, it must be considered before structuring a related-party build-to-suit exchange. After examining § 1031(f), consider possible exchange structures that save related-party build-to-suit exchanges from § 1031(f).

A. Section 1031(f)

Section 1031(f) was enacted in 1989[13] in an attempt to curtail certain abuses. Section 1031(f) was fashioned after § 453(e) (relating to the installment method of reporting gain), which accelerates the gain reportable by the original seller if an installment sale between related parties is followed by certain dispositions of the property by the transferee.[14] In enacting § 1031(f), Congress was concerned that:

> Because a like-kind exchange results in the substitution of the basis of the exchanged property for the property received, related parties have engaged in like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property in order to reduce or avoid the recognition of gain on the subsequent sale. Basis shifting also can be used to accelerate a loss on retained property. The committee believes that if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, "cashed out" of the investment, and the original exchange should not be accorded nonrecognition treatment.[15]

Therefore, the purpose of § 1031(f) is to prevent basis shifting and a subsequent tax-free cashing out.[16] As the discussion below demonstrates, the scope of § 1031(f) is still being explored by the IRS and practitioners.

B. Section 1031(f)(1)

Section 1031(f)(1) provides that if a taxpayer exchanges property with a related party in a transaction that qualifies for § 1031 nonrecognition treatment and within two years after the exchange, either the taxpayer or the related party transfers one of the exchange properties, "there shall be no nonrecognition of gain or loss under [§ 1031] to the taxpayer with respect to such exchange . . . ." The following example demonstrates the necessity and application of § 1031(f)(1).

Assume individual B owns Property B worth $1,000,000 with an adjusted basis of $200,000. Related party C owns Property C worth $1,000,000 with an adjusted basis of $950,000. If B were to sell Property B for cash, she would recognize gain of $800,000. B may try to avoid this gain by first transferring Property B to C in a § 1031 exchange for Property C. As a result of the exchange, C would take an adjusted basis in Property B of $950,000.[17] A subsequent disposition of Property B by C would allow B and C to avoid $750,000 of gain (B's $800,000 deferred gain less C's $50,000 recognized gain) by exchanging properties.[18] Section 1031(f)(1) prevents this result if either B or C transfers one of the properties within two years after the exchange with B.[19] If § 1031(f)(1) applies, the exchange will not qualify for § 1031 nonrecognition treatment. Thus, § 1031(f)(1) "bumps" the transaction out of § 1031, into § 1001. Under § 1001(c) "the entire amount of gain or loss, determined under [§ 1001], on the sale or exchange of property shall be recognized." The amount of such gain shall be equal to the difference between the basis each party had in his respective property and the respective property's fair market value.[20] Both the taxpayer and the related party recognize the gain caused by the § 1031 bump in the year of the subsequent disposition.[21]

C. Section 1031(f)(2)

Not all dispositions of exchange property following exchanges with a related party destroy § 1031 nonrecognition treatment. Section 1031(f)(2) provides that dispositions following the death of the taxpayer or the related party and certain involuntary conversions are not taken into consideration (*i.e.*, are treated as non-dispositions) for purposes of § 1031(f)(1).[22] The more challenging provision, § 1031(f)(2)(C), provides that if "it is established to the satisfaction of the Secretary that neither the exchange nor [the subsequent] disposition had as one of its principal purposes the avoidance of Federal income tax[,]" the subsequent disposition shall not be taken into account. Thus, to come within § 1031(f)(2)(C), the taxpayer must establish that it had a non-tax avoidance motive for both the exchange and the subsequent disposition.

Based on the legislative history discussed above, § 1031(f) was enacted to prevent taxpayers from entering into exchanges with related parties that resulted in basis shifting on the exchange, followed by tax-free cashing out on the subsequent disposition. Section 1031(f)(2)(C) thus appears to require that a taxpayer establish to the satisfaction of the Secretary that the exchange did not result in basis shifting and the subsequent disposition did not result in tax-free cashing out. If the taxpayer can establish these two items, § 1031(f)(1) should not impact the transaction. In considering various exchange scenarios, it is possible to imagine a tax-avoidance motivated exchange with no subsequent disposition, but, if the exchange does not have a tax-avoidance motive, it is difficult to imagine a subsequent disposition that could have a tax-avoidance motive. Conversely, with the exception of a tax-free subsequent disposition of the property, any subsequent disposition within the two-year period probably will have a tax-avoidance motive if the exchange has a tax-avoidance motive.

A transaction that appears to be outside the scope of § 1031(f)(1) may involve an abusive exchange without a subsequent disposition. For example, if taxpayer C owns raw land with a high basis and related party D owns an apartment complex of equal value with a low basis, C and D could exchange properties, allowing C to take depreciation deductions of the raw land's basis after it is carried over to the newly acquired apartment complex.[23] Because there is no subsequent disposition, this apparently abusive related party exchange does not appear to be subject to § 1031(f)(1), even though there is a direct exchange between related parties. Nonetheless, the House Report, discussed above, shows Congress intended § 1031 to apply to this type of transaction.

The exchange does not have a tax-avoidance motive (*i.e.*, there is no basis shifting), a subsequent disposition of one of the exchange properties should not have a tax-avoidance motive (i.e., there would be no tax-free cashing out). For example, assume taxpayer E owns raw land worth $1,000,000 with a basis of $500,000 and that related party F also owns raw land worth $1,000,000 with a basis of $500,000. If E and F exchange property, there would be no prohibited basis shifting, and a subsequent disposition of the exchange properties by either E or F would not cause a tax-free cash out. The Secretary should therefore be satisfied that there was no tax-avoidance motive on the exchange or subsequent disposition. This conclusion is supported by legislative history, which provides that the "non-tax avoidance exception generally will apply to . . . transactions that do not involved [sic] the shifting of basis between properties."[24]

In applying § 1031(f)(2), it is important to distinguish between what Congress considers to be a *non-disposition* and *non-abusive disposition*. For example, the House Report states:

> A disposition would include, however, all other transfers of the property, such as tax-free transfers to a corporation (pursuant to [§] 351) or to a partnership (pursuant to [§] 721), unless it is established to the satisfaction of the Secretary of the Treasury that neither the exchange nor the disposition had as one of its principal purposes the avoidance of Federal income tax."[25]

The Senate amendment, however, "provides that the non-tax avoidance exception generally will apply to . . . dispositions in nonrecognition transactions . . . ." [26] Thus, even though a subsequent nonrecognition disposition is treated as a disposition, the non-tax avoidance exception should apply to the transaction.

An example demonstrates how subsequent nonrecognition dispositions generally do not have a tax-avoidance motive. Taxpayer G owns real property worth $1,000,000 with a basis of $500,000. G transfers that property to related party H in exchange for H's real property that is worth $1,000,000, in which H had a basis of $1,000,000. Within two years after the exchange, H contributes the property received from G to an entity taxed as a partnership for federal income tax purposes. Since H has not cashed out, but has merely changed the form of ownership of the property,[27] the tax-free contribution to the partnership appears to have no tax-avoidance motive. If, however, H disposes of the partnership interest or the partnership disposes of the property for cash in a taxable transaction within two years after the exchange with H, such subsequent disposition would allow a cashing out and should not be disregarded in applying § 1031(f)(1). Otherwise, in the example, H would take a basis in the partnership interest of $1,000,000[28] and recognize no gain on the exchange or subsequent disposition. If such a disposition does not occur during the two-year period, no tax-avoidance motive should be imputed to the contribution.

1. *Section 1031(f)(1) Bifurcated Exchange*

The purpose of § 1031(f)(1) also supports bifurcating certain exchanges between § 1031 nonrecognition and § 1001 recognition treatment. Consider a situation in which a bifurcation approach appears to be appropriate: Assume taxpayer T owns Property C and Property D each worth $500,000 and each with an adjusted basis of $100,000. T transfers both properties to related party J in exchange for Property B (having a fair market value of $1,000,000 and a basis of $950,000). J takes a basis of $475,000 in each of Property C and Property D.[29] Within two years after the exchange, J sells Property C to an unrelated party for $500,000 cash, but holds Property D for the entire two-year period and T holds Property B for the two-year period. Because T and J have not cashed out the entire amount of T's low basis property, § 1031(f)(1) should not bump the entire exchange out of § 1031. Only the portion of the exchange attributed to the exchange and subsequent disposition of Property C should be bumped from § 1031. If this is the correct interpretation of § 1031(f)(1), T would recognize $400,000 of gain and J would recognize $25,000 of gain at the time Property C is sold.[30] Furthermore, because a § 1031(f) exchange is subject to § 1001, there should be no boot on the exchange and basis should offset the amount realized in computing the gain.[31]

2. *Non-Cash-Out Disposition*

In addition to using the bifurcation approach, a taxpayer should be able to rely on § 1031(f)(2)(C) to preserve § 1031 nonrecognition treatment on a related party transaction, if the related party recognizes gain on the subsequent disposition. Assume K owns Property D worth $1,000,000 with a basis of $200,000 and related party L owns Property E worth $1,000,000 and has a basis of $800,000. K and L exchange properties. K sells Property E for $1,000,000 within two years following the exchange, triggering $800,000 of gain, recognized by K. Because the most significant portion of the gain is recognized on the subsequent disposition, there is no prohibited basis shifting or cashing out, so K and L arguably had no tax-avoidance motive in structuring the exchange or subsequent disposition. Thus, the transaction should not be bumped from § 1031.

If an exchange with a related party is in part a cash-out, however, should § 1031(f)(2)(C) apply only to part of the transaction? For example, assume M owns Property B worth $1,000,000 with a basis of $200,000 and related party N owns Property C worth $1,000,000 with a basis of $500,000. M and N exchange properties and within two years following the exchange, N disposes of Property B in a § 1031(f) prohibited disposition. This transaction would result in a $300,000 cash-out (the difference between M's $200,000 basis and N's $500,000 basis). It appears § 1031(f)(2)(C) should apply to the portion of the transaction that was not a cash-out, (i.e., the $500,000 that N would have recognized had it sold Property C for cash). The best result thus appears to be to require M and N to recognize $300,000 and $500,000 of gain respectively at the time of the subsequent disposition.[32] Because there was not a complete cash out, M should not be required to recognize all $800,000 gain on the subsequent disposition, but together M and N should recognize all $800,000 of gain. The limited gain recognition reaches the same result that would obtain had M sold Property A to an unrelated party for cash.[33]

The bifurcation and non-cash out approaches find support in the § 453(e) model after which § 1031(f) was fashioned. Section 453(e) provides that if a sale of property to a related party is reported under the installment method, a subsequent disposition of the property by the transferee related party will trigger accelerated gain recognition to the transferor. Gain is accelerated by treating the transferor as receiving the amount realized by the transferee on the second disposition.[34] The limit on the amount the transferor is treated as receiving, however, is limited to the amount realized by the transferee on the subsequent disposition.35 Thus, if the transferee transfers only a portion of the property in a subsequent disposition, the transferor will be deemed to receive only a portion of the total installments due from the related party. In other words, the subsequent disposition of a portion of the transferred property does not trigger gain recognition on the entire transferred property. The same principle should apply to like-kind exchanges involving related parties.

3. *FSA 199931002*

In an effort to prevent basis shifting and cashing out, the Chief Counsel's Office has applied § 1031(f)(1) beyond its readily apparent scope. In FSA 199931002 the taxpayer engaged a qualified intermediary to facilitate an exchange in which the taxpayer transferred relinquished property to an unrelated party and directed the acquiror to transfer the proceeds to a qualified intermediary, who used them to acquire replacement property from a party related to the taxpayer. The Chief Counsel's Office advised that since the taxpayer sold the property received from the related party within two years after the exchange "in contravention of the requirements of [S]ection 1031(f)(1)(C)[,]" § 1031(f)(1) applied, and the taxpayer was required to recognize gain from the exchange in the taxable year of the subsequent disposition.

This FSA is important for two reasons. First, the IRS acknowledged that § 1031(f)(4) (discussed below) probably applied to the transaction, but "found nothing in the statutory language or in the legislative history to indicate that the applicability of [S]ection 1031(f)(4) precludes or supersedes the applicability of [S]ection 1031(f)(1)." This may be important if the statute of limitations is at issue. If a transaction falls within the purview of § 1031(f)(4), the year of exchange is the year for which tax can be assessed. On the other hand, if § 1031(f)(1) applies, gain is recognized in the year of the subsequent disposition. Thus, if the statute of limitations has run on the year of the exchange, but not the year of the subsequent disposition, the IRS is better served if § 1031(f)(1) applies.[36] In FSA 199931002, the IRS grants itself discretion, at least in some situations, to choose whether to rely on § 1031(f)(1) or (4).

Second, the FSA establishes that the IRS believes § 1031(f)(1) applies even if a qualified intermediary is interposed in a transaction wherein one property is disposed of to an unrelated party and the replacement property is acquired from a related party. This is an expansive reading of § 1031(f)(1), which on its face appears to require a direct exchange with a related party followed by a subsequent disposition of one of the exchange properties. As discussed below, in PLR 200251008 the IRS adopted this position in a build-to-suit exchange involving a related party.

If the statute of limitations is not a concern, § 1031(f)(1) may not impact the net tax effect of a subsequent disposition of exchange property. In such a situation, the taxpayer's subsequent disposition of the replacement property in a taxable transaction should trigger all of the deferred gain. If the value of the replacement property decreases following the exchange, § 1031(f)(1) would cause the property to have a higher basis resulting in an offsetting loss on the disposition of the replacement property. Section 1031(f)(1) may, however, affect the character of the recognized gain. For example, if the property appreciates in value and is sold within one year from the date of the exchange, the taxpayer would be deemed to have a short-term gain on the disposition that could affect the rate at which the gain is taxed. This issue is considered below in the discussion about PLR 200251008.

D. Section 1031(f)(4)

Section 1031(f)(4) provides that § 1031 "shall not apply to any exchange that is part of a transaction (or series of transactions) structured to avoid the purposes of [§ 1031(f)]."

> For example, if a taxpayer, pursuant to a prearranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within [two] years of the previous transfer in a transaction otherwise qualifying under [S]ection 1031, the related party will not be entitled to nonrecognition treatment under [S]ection 1031.[37]

In several recent rulings, the IRS has applied § 1031(f)(4) to other types of transactions.

1. *TAM 9748006*

In TAM 9748006, the taxpayer entered into a contract to sell a piece of property to an unrelated party. After entering into that contract, the taxpayer decided to dispose of the property as part of a § 1031 exchange. The taxpayer sought to acquire replacement property from another unrelated party, but could not complete negotiations with that party in time to complete the exchange. Realizing that he would be unable to acquire replacement property from an unrelated party, the taxpayer entered into an agreement to acquire replacement property from his mother, who had recently acquired the property and had a high basis in it. In an apparent attempt to circumvent § 1031(f), the taxpayer engaged a qualified intermediary to facilitate the exchange. The National Office advised that the "economic result of this series of transactions is identical to what would have occurred in a direct exchange of [properties] between Taxpayer and Related Party, followed by a sale of [the relinquished property to the unrelated party]." It further advised that "a qualified intermediary is not entitled to better treatment than the related party referred to in the House Report. Thus, the mere interposition of a qualified intermediary will not correct a transaction otherwise flawed under § 1031(f)(1)." This TAM appears to be a correct application of § 1031(f)(4) because the National Office advised that "[i]t is apparent that Taxpayer and Related Party utilized a qualified intermediary for the sole purpose of avoiding the related party rules of Section 1031(f)."

2. *TAM 200126007*

In TAM 200126007, the taxpayer entered into two different transactions. In both transactions the taxpayer sold relinquished property to an unrelated party and acquired replacement property from a related party. Both transactions were structured using a qualified intermediary, so neither transaction was a direct exchange with the related party. The National Office rejected five arguments espoused by the taxpayer and held that the transactions did not qualify for nonrecognition treatment because of § 1031(f)(4). First, the National Office advised that § 1031(f)(4) applies even though the transaction is not a direct exchange with a related party followed by a disposition. Second, the National Office confirmed that § 1031(f)(4) applies to multiparty exchanges that do not involve a direct exchange between the taxpayer and the related party. Third, the National Office advised that the transaction facilitates avoidance of the purposes of § 1031(f), i.e., "basis shifting (or identical consequences) between related parties; tax-free or tax-deferred cashing out of an investment by a taxpayer or a related party; reduction or avoidance of tax; acceleration of losses; etc." Fourth, even if § 1031(f)(2)(C) applies to multiparty exchanges, the taxpayer did not establish that tax avoidance was not one of the principal purposes of the exchange and the disposition. Fifth, a tax planning motive does not remove the transaction from § 1031(f)(4). This TAM confirms the position the National Office in TAM 9748006.

In TAM 200126007 the National Office also stated:

> Sections 1031(f)(1) and (2) address the consequences of a direct related party exchange and a subsequent sale of the property received in the exchange. The Taxpayer's multiparty exchanges are not within the scope of [S]section 1031(f)(1). However, even if the tax avoidance standard of [S]ection 1031(f)(2)(C) were applied to the Taxpayer's multiparty transactions, [the Taxpayer did not show lack of tax avoidance motive].

The National Office's statement that the multi-party exchanges in this TAM are not within the scope of § 1031(f)(1) appears to contradict the IRS's position in FSA 199931002. This suggests that the IRS also is not certain of the correct application of § 1031(f).

3. *Rev. Rul. 2002-83*

Most recently, in Rev. Rul. 2002-83,[38] the IRS formally adopted its position in TAM 9748006 by ruling that an exchange is subject to § 1031(f)(4) if, as part of a single transaction, a taxpayer receives high basis property from a related party through a qualified intermediary and the related party receives cash. In Rev. Rul. 2002-83, the taxpayer and related party each owned property of equal value ($150,000). The taxpayer's property had a 1:3 basis-to-value ratio, while the related party's ratio was 1:1. The taxpayer transferred his property to an unrelated party through a qualified intermediary. The qualified intermediary used the exchange proceeds from that disposition to acquire the replacement property from the related party one week after the taxpayer transferred the relinquished property. The IRS ruled that:

> Under the facts [of the ruling] a taxpayer who transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party is not entitled to non-recognition treatment under [§] 1031(a) . . . if, as part of the transaction, the related party receives cash or other non-like kind property for the replacement property.

In ruling that § 1031(f)(4) applied to the transaction, the IRS applied the step transaction doctrine's end result test. It stated,

> [T]he end result of the transaction is the same as if [the taxpayer] had exchanged property with [the related party] followed by a sale from [the related party] to [an unrelated party]. This series of transactions allows [the taxpayer] to effectively cash out of the investment . . . without the recognition of gain.

Finally the IRS found that the taxpayer's "exchange of property with QI, therefore, is part of a transaction structured to avoid the purposes of [§] 1031(f) and, under [§] 1031(f)(4), the non-recognition provisions of [§] 1031 do not apply to the exchange between [the taxpayer] and QI."

4. *Open § 1031(f)(4) Issues*

The rulings on § 1031(f)(4) leave several questions unanswered. First, if the related party's basis-to-value ratio had been less than 1:1, would the entire exchange have been subject to § 1031(1)(4)? Second, if the taxpayer had received some replacement property from an unrelated party and had received replacement property of a lesser value but with a 1:1 basis-to-value ratio from a related party, would the bifurcation approach apply? Third, could the IRS choose to apply § 1031(f)(1) to the transaction if the taxpayer disposed of the replacement property within two years following the exchange? Fourth, can § 1031(f)(2)(C) save the transaction if the taxpayer is able to prove a non-tax avoidance motive? Fifth, what is the result if the related party transfers loss property, i.e., property with a greater than 1:1 basis-to-value ratio?

a. Basis-to-Value Ratio

If in Rev. Rul. 2002-83, the related party's basis-to-value ratio had been 2:3, the transaction would not have resulted in a 100% basis shift and cashing out. The related party's receipt of $150,000 of cash would cause the related party to recognize $50,000 of gain. To the extent the related party recognizes gain, the transaction does not create the equivalent of basis shifting and cashing out. Thus, the taxpayer should not be required to recognize all $100,000 gain on the exchange with the related party. Instead, the taxpayer should recognize only $50,000 of gain on the transaction (the difference between its economic gain and the gain recognized by the related party) and take a $100,000 basis in the replacement property.[39]

b. Bifurcated Exchange

If in Rev. Rul. 2002-83, the replacement property had included the related party's property and property from an unrelated party, the bifurcation approach would seem appropriate. Assume $100,000 of replacement property was acquired from an unrelated party and only $50,000 of replacement property (having a 1:1 basis-to-value ratio) was acquired from a related party, who received $50,000 of cash for the property. Since this exchange falls within § 1031(f)(4) only in part, only part of the transaction should be subject to § 1001 gain recognition. The bifurcation approach should treat the portion of the transaction involving the property received from the unrelated party as a § 1031 nonrecognition exchange. The remaining portion of the transaction should be a § 1001 exchange. The § 1031 nonrecognition exchange should involve two-thirds of the relinquished property. The § 1001 exchange should involve one-third of the relinquished property. Therefore, under the bifurcation approach, the taxpayer should recognize $33,333 of gain (one-third of the property's value, $50,000 less one-third of the property's basis, $16,667).

c. Section 1031(f)(1) Alternative

Rev. Rul. 2002-83 also leaves open the question of whether the IRS may apply § 1031(f)(1) to the transaction described in the ruling if the taxpayer sells the replacement property within two years following the exchange. Since the relinquished property has already been sold to an unrelated person, § 1031(f)(1) should not apply to the transaction. Also, to prevent the IRS from choosing between taxable years to assess a deficiency, § 1031(f)(1) should not be an alternative if § 1031(f)(4) applies to the transaction.

d. Section 1031(f)(2)(C)

Rev. Rul. 2002-83 does not answer whether the taxpayer can rely on § 1031(f)(2)(C) to argue that the transaction qualifies for § 1031 nonrecognition treatment. Rev. Rul. 2002-83 presupposes a tax avoidance motive in the transaction. Some practitioners argue that § 1031(f)(2)(C) will save the Rev. Rul. 2002-83 transaction if the taxpayer's decision to acquire replacement property from a related party was made after an unsuccessful attempt to acquire replacement property from an unrelated party.[40] Assume individual O transfers relinquished property to an unrelated party and a qualified intermediary receives the exchange proceeds. O identifies three properties as replacement property: Property 1, O's first choice, owned by an unrelated party; Property 2, O's second choice, also owned by an unrelated party; and Property 3, a property owned by a related party that is of no interest to O, except to use to complete the exchange, if necessary. O may argue that if it does have to acquire Property 3, § 1031(f)(2)(C) should save the nonrecognition treatment because at the time the relinquished property was transferred, O intended to acquire replacement property from an unrelated party.

This argument is not without merit. The example in the House Report of a series of transactions structured to avoid the purposes of § 1031(f)(1) specifically refers to a prearranged plan. Thus, if the taxpayer sells relinquished property through a qualified intermediary to an unrelated party with no thought at the time to acquire replacement property from a related party, the subsequent acquisition from the related party arguably is not part of a pre-arranged plan. The facts and the ruling in Rev. Rul. 2002-83 do not speak of a pre-arranged plan. Perhaps the IRS believes there was a pre-arranged plan because the replacement property was acquired one week after the taxpayer transferred the relinquished property. Or, perhaps the IRS is presuming that any time high basis replacement property is acquired from a related party (directly or indirectly), there is a pre-arranged plan to acquire it. The burden in such a situation would be on the taxpayer to show a lack of a pre-arranged plan, a seemingly difficult burden to satisfy.

Two other aspects of this type of transaction undermine the non-tax avoidance argument.[41] First, it is impossible to determine the taxpayer's intent at the time the relinquished property is transferred. A taxpayer may identify replacement properties in any order regardless of intent, so the order of identification is irrelevant. Efforts to acquire property from an unrelated party may be staged, so such efforts are unreliable. Because of the potential for abuse in this type of transaction, the IRS could not accurately monitor its application. Second, a delayed exchange spans the time period beginning with the disposition of the relinquished property and ending with the acquisition of the replacement property. Any action taken by the taxpayer during that period should be considered in determining the taxpayer's motive. Thus, an objective standard (*i.e.*, an examination of whether the transaction creates the equivalent of a basis shifting and cashing out) should be used to determine intent in a Rev. Rul. 2002-83 type transaction.

e. The Related Party Has Loss Property

Rev. Rul. 2002-83 does not address the result that would occur if the related party had loss property. For example, if, in the ruling, the related party's property had a $200,000 basis, would the transaction still be subject to § 1031(f)(4)? Because there is still potential for basis shifting and cashing out, a transaction in which loss property is received from a related party should be subject to § 1031(f)(4). Because these unanswered questions leave doubt as to the applicability of § 1031(f), taxpayers attempt to structure build-to-suit exchanges involving property owned by a related party in a manner that removes the transaction from the purview of § 1031(f).

5. *Interposition of Rev. Proc. 2000-37*

In all of the § 1031(f)(4) rulings, a qualified intermediary was interposed in an attempt to avoid § 1031(f). In each of those rulings, the IRS's position was that the use of the intermediary was evidence that the taxpayer was attempting to circumvent § 1031(f). Interposing an exchange accommodation titleholder in a Rev. Proc. 2000-37 related party parking arrangement likewise could be evidence that the taxpayer is attempting to circumvent § 1031(f). A transaction in which a related party sells property to an exchange accommodation titleholder for cash, who, within two years after acquisition, transfers the property to the taxpayer as part of an exchange, falls squarely within the example of a § 1031(f)(4) exchange described in the House Report.[42] If taxpayers were allowed to avoid the related party rules by interposing an exchange accommodation titleholder, every related party exchange would be structured in this manner. Since this would effectively eliminate § 1031(f), interposing an exchange accommodation titleholder should not overcome § 1031(f). Thus, a related party's mere transfer of high-basis property to an exchange accommodation titleholder in a build-to-suit exchange probably will not remove the entire transaction from the § 1031(f) influence. Other structures must be considered.

IV. BUILD-TO-SUIT EXCHANGE ON PROPERTY ACQUIRED BY A RELATED PARTY IN CONTEMPLATION OF THE EXCHANGE

Having examined § 1031(f), consider how it may be planned around in certain build-to-suit transactions. If a related party acquires property from an unrelated party in contemplation of an exchange, the taxpayer could argue that the property acquired by the related party and any improvements constructed thereon are not subject to § 1031(f) because this type of exchange does not involve basis shifting or cashing out.[43] Indeed the Tax Court, granted § 1031 nonrecognition treatment to such an exchange in *Fredericks v. Comr*.[44]

A. Fredericks v. Comr.

In *Fredericks v. Comr*, the taxpayer entered into an exchange agreement with a related party. Pursuant to the exchange agreement, the taxpayer transferred relinquished property to the related party. The related party sold the property to an unrelated party for cash and a promissory note. The related party used a portion of the cash proceeds to acquire other property and to construct improvements on that property. When the improvements were completed, the related party transferred the property and improvements to the taxpayer to complete the transaction. Based on facts that occurred before § 1031(f) was enacted, the Tax Court held that the transaction qualified for § 1031 nonrecognition treatment.[45] If the transaction occurred today, § 1031(f)(1) would apply to the transaction because there was a direct exchange with related party followed by a disposition of the exchange property within two years after the exchange,[46] but the exchange may still qualify for § 1031 nonrecognition treatment, under the § 1031(f)(2)(C) exception.

To avoid § 1031(f)(1) in a *Fredericks* transaction today, the taxpayer would have to show that the transaction did not have a principal tax-avoidance purpose. In *Fredericks*, the related party acquired the replacement property and constructed all improvements in contemplation of the exchange. Following the exchange, the related party had no more cash than it had prior to the exchange,[47] and the taxpayer had an equal amount of property. Therefore, there was no basis shifting or cashing out, and § 1031(f)(2)(C) should save this transaction today. Since the transaction does not have a tax avoidance motive, § 1031(f)(4) likewise should not apply. Thus, the taxpayer should be able to show lack of tax-avoidance motive and, *Fredericks* appears to be good law after the enactment of § 1031(f), so it is worthy of examination.

In *Fredericks*, the Court stated:

> For purposes of this case, the transaction will not be treated as an exchange if (1) the petitioner received or had control over the sale proceeds from the transaction . . . ; (2) the transfer of [the relinquished property] and receipt of the [replacement property] was not part of an integrated plan . . . ; or (3) [the related party] acted as the [taxpayer's] agent for purposes of the exchange . . . .

Stated affirmatively, the Fredericks three-prong test provides that an exchange with a related party qualifies for § 1031 nonrecognition treatment if: (1) the taxpayer does not have control of the sale proceeds before receiving the replacement property; (2) the relinquished property is transferred and the replacement property is received as part of an integrated plan; and (3) the related party does not act as the agent of the taxpayer.

1. *Control Over the Proceeds*

Interestingly, the Tax held that the taxpayer did not have control over the proceeds from the sale of the relinquished property and was therefore not in constructive receipt of the sale proceeds, even though the taxpayer was the sole shareholder of the related party. Constructive receipt would be avoided today using one of the safe harbors in the § 1031 regulations. As stated above, the IRS allows a qualified intermediary to distribute the proceeds from the sale of the relinquished property to pay a related party to construct improvements.

2. *Integrated Plan*

In *Fredericks*, the Tax Court focused on whether the acquisition of the replacement property was "substantially implemented" before the taxpayer structured the exchange. Concluding that the related party's acquisition of the replacement land was not substantially implemented before the exchange, the Tax Court held that the related party's acquisition of the land and construction of the improvements were part of an integrated exchange (i.e., acquired and constructed in contemplation of the exchange). Thus, the Tax Court held that the exchange qualified for § 1031 nonrecognition treatment. Likewise, if a related party acquires replacement property and transfers it to the taxpayer as part of an integrated exchange, § 1031(f) should not affect the exchange because there is no basis shifting or cashing out. If a taxpayer plans to rely on an integrated plan argument, it would be wise to document the date the exchange is arranged, and to ensure the related party acquires the replacement property sometime after that date.

3. *Non-Agency*

The Tax Court in *Fredericks* addressed the agency issue but provided little guidance in this area. The Tax Court held that although the related party accepted and sold the relinquished property, acquired the replacement property, and constructed the improvements at the taxpayer's direction and according to the taxpayer's specifications, the related party was not the taxpayer's agent. The Tax Court held that the related party was an active corporation carrying on business as a licensed building contractor and real estate developer. Apparently, the Tax Court was satisfied that the related party acted on its own behalf. The court also appears to be satisfied that related party bore the benefits and burdens of owning the replacement land and buildings and was therefore the beneficial owner of the property.

B. Related Party as Exchange Accommodator

Based on the decision in *Fredericks*, it appears a related party may act as exchange accommodator. To qualify, the related party would have to acquire the replacement property in contemplation of an exchange and could not be the agent of the taxpayer. If the related party acquires property prior to the exchange being arranged, § 1031(f)(4) would apply. The taxpayer and related party should clearly and unambiguously document that the related party is acquiring the property as part of a plan adopted by the taxpayer to use the property as replacement property in a § 1031 exchange. If the related party acquires replacement property and constructs improvements in contemplation of an exchange, the ultimate exchange should qualify for § 1031 nonrecognition treatment. Nonetheless, some may question the applicability of *Fredericks*, and the following issues may arise.

1. *Holding Period Limitation*

If a related party is used as an exchange accommodator, it is conceivable that it should be allowed to hold the property in contemplation of the exchange for no longer than 180 days. If the related party holds title for more than 180 days, the IRS may challenge whether the property was acquired in contemplation of the exchange (i.e., whether the acquisition by the related party is part of an integrated plan). Although the 180-day limitation appears to be arbitrary, Congress and the IRS have consistently applied it to non-simultaneous exchanges.[48] Furthermore, Congress considers transactions that take longer than 180 days to complete to be non-exchanges.[49] Thus, a conservative approach would ensure that the related party holds the property for no longer than 180 days.

2. *Establishing Non-Agency*

The Fredericks agency test appears to require that the related party be an active business entity carrying on a business, preferably as a contractor or developer. In Fredericks, the related party was a going concern before the exchange was arranged. If a related party did not exist prior to the exchange being arranged, the question arises whether one can be formed for the sole purpose of facilitating an exchange. If the sole purpose for forming the related party is to facilitate the exchange, the IRS may disregard the entity's transitory existence.[50] If a related party is already in existence and a going concern, a taxpayer should be able to structure an exchange based on the Fredericks decision, so long as the related party is not the taxpayer's agent and bears the benefits and burdens of owning the property.[51]

V. BUILD-TO-SUIT EXCHANGE ON A RELATED PARTY'S EXISTING PROPERTY

If willing to rely on the bifurcation approach and the Fredricks decision and unable to reinvest all of the exchange proceeds in improvements, a taxpayer arguably may structure a partial nonrecognition build-to-suit exchange involving a related party's existing land. Otherwise, a taxpayer would use the lease structure in PLR 200251008 to structure a build-to-suit exchange involving a related party's existing property.

A. Structure as a Bifurcated Exchange

Relying on the decision in *Fredericks* and the bifurcation approach, a taxpayer may choose to structure a build-to-suit exchange while the related party is the beneficial owner of the land on which the improvements will be constructed. To do so, the taxpayer must first ensure that the related party constructs the improvements in contemplation of the exchange so there is no basis shifting or cashing out with respect to the improvements. Second, assuming the taxpayer's land has a higher basis-to-value ratio than the taxpayer's relinquished property, the taxpayer must assume that the bifurcation approach applies to achieve § 1031 nonrecognition treatment, at least in part. If the taxpayer establishes these two elements, any gain triggered under § 1031(f) should apply only to the property owned by the related party before the exchange was arranged.

Under the bifurcation approach, if, prior to the exchange being arranged, the related party owns land worth $50,000 with a basis of $50,000 and the taxpayer intends to exchange into that land and a new building costing $100,000, gain recognized should be limited to that attributable the pre-existing property. Thus, $100,000 of the transaction would qualify for § 1031 nonrecognition treatment. The other $50,000 would be subject to § 1031(f)(4). The taxpayer would therefore recognize $33,333 of gain on the transaction (one-third of the $150,000 value less one-third of the taxpayer's $50,000 basis).

Alternatively, if the related party had a $25,000 basis in the $50,000 land (reducing its basis-to-value ratio to 1:2), the amount of the transaction subject to § 1031(f)(4) should be even less. Arguably, the taxpayer's recognized gain should be reduced by $25,000 because the related party recognizes that amount of gain on the transaction. If a taxpayer does not feel comfortable relying on the decision in *Fredericks*, she should be able to obtain this same result by first transferring the property to an exchange accommodation titleholder who will construct the improvements as part of Rev. Proc. 2000-37 exchange. Because the exchange accommodation titleholder will be treated as the beneficial owner of the property, the improvements should not be subject to § 1031(f)(4). On the other hand, interposing an exchange accommodation titleholder should not remove the related party's property from § 1031(f)(4). Thus, the bifurcation approach should be used to compute any gain recognized on the transaction.

B. Structure as a Leasehold Parking Transaction Under Rev. Proc. 2000-37

If the taxpayer plans to reinvest all of the exchange proceeds in improvements on property owned by a related party, PLR 200251008 provides a model for structuring the transaction so it qualifies for § 1031 nonrecognition treatment. In PLR 200251008, Taxpayer, an S corporation, operated a business on Relinquished Property. Taxpayer decided to relocate its business to B-Acres of land subleased to its related party, LLC-W. Under the sublease agreement, LLC-W had the right to use the land for 45years (with a 15-year renewal option) and had begun construction of new facilities to be used to operate the business. Taxpayer estimated that during a 180-day period it could reinvest the value of the relinquished property in improvements to be constructed on the subleased land. Because LLC-W entered into a sublease before the exchange was arranged, there was concern that the improvements would not qualify for § 1031(f) nonrecognition treatment if the improvements were constructed on land subleased to LLC-W, after which LLC-W would assign a portion of the sublease to Taxpayer.[52]

To avoid being subject to § 1031(f)(4), Taxpayer structured the transaction under Rev. Proc. 2000-37 using a thirty-two year sub-sublease (Sub-sublease) under which LLC-W sub-subleased D-Acres to Titleholder, a single-member limited liability company wholly owned by EAT, an exchange accommodation titleholder. The Sub-sublease gave Titleholder possession of D-Acres of the land for 32 years and allowed Titleholder to construct improvements thereon. The Sub-sublease agreement also required Titleholder to pay fair market rents to LLC-W. In addition to sub-subleasing the land from LLC-W, Titleholder entered into a management agreement with LLC-W under which LLC-W agreed to manage the construction of the improvements and receive fair market compensation for those services.

To finance the improvements, Titleholder executed a note payable to Taxpayer and borrowed funds from Taxpayer needed to pay construction draws requested by LLC-W. Taxpayer used its available funds, funds borrowed from Bank, and funds borrowed from Taxpayer's shareholders to lend the money needed to fund construction and rent payments.

Within 180 days after Titleholder entered into the Sub-sublease, Taxpayer sold Relinquished Property to Village. The disposition was structured as part of a § 1031 exchange using QI, a qualified intermediary. Thus, Taxpayer assigned its rights in the Relinquished Property sales contract to QI and directly deeded Relinquished Property to Village. Pursuant to the assignment agreement, Village transferred the sale proceeds to QI, which transferred them to EAT. EAT used the proceeds to repay the outstanding note executed by Titleholder to Taxpayer and to pay unpaid construction draws owed to LLC-W. Having assigned its rights in the exchange accommodation agreement to QI, Taxpayer directed that EAT transfer all of the interests in Titleholder directly to Taxpayer. Taxpayer used the proceeds from the repayment of Titleholder's note to repay its shareholders and outstanding loans to Bank.

The PLR 200251008 sub-sublease structure under Rev. Proc. 2000-37 allowed Taxpayer to avoid § 1031(f)(4). If LLC-W had simply assigned its interest in the sublease to Titleholder, the transaction would have been subject to § 1031(f)(4), at least in part, if LLC-W had a high basis-to-value ratio in the sublease interest. Because the Sub-sublease was entered into at arm's-length terms, LLC-W arguably transferred nothing more than a zero-value, zero-basis property to Titleholder and subsequently to Taxpayer. Therefore, there was no basis shifting or cashing out on the transaction and Taxpayer avoided issues that may have arisen had the sublease been assigned. Because the improvements were constructed on the land sub-subleased to Titleholder, who was the beneficial owner of the Sub-sublease, the improvements were never owned by LLC-W. Thus, the sub-sublease structure under Rev. Proc. 2000-37 allowed Taxpayer to avoid § 1031(f)(4).

As stated above, the Chief Counsel's office advised IRS ruled in FSA 199931002 that a transaction may come within § 1031(f)(1) even though the taxpayer sells relinquished property to an unrelated party and acquires replacement property from a related party through a qualified intermediary. Similarly, in PLR 200251008, the IRS ruled that the "proposed transaction is a parking transaction between related parties." In footnote 5, the IRS stated:

> Since both Taxpayer and the related parties continue to be invested in the exchange properties, and are not otherwise cashing out the interest, [§] 1031(f)(1) is not a concern for this transaction unless and until Taxpayer or the related parties dispose of their interests in the exchanged property within two years after the last transfer that was part of the exchange.

If the IRS's position is correct, and the transaction is subject to § 1031(f)(1), a subsequent disposition of the Sub-sublease by Taxpayer would destroy the § 1031 nonrecognition treatment. § 1031(f)(2)(C) may, however, preserve nonrecognition treatment. At first blush, however, the IRS appears to be incorrect in its statement that the related parties continue to be invested in the exchange proceeds. The relinquished property was clearly transferred to an unrelated party and LLC-W owns no exchange property following the exchange. The Sub-sublease and the improvements appear to be the only exchange properties still held by the parties. There appears to be no prohibited basis shifting on the exchange, and the subsequent disposition of either of those assets should not result in a cash-out. Therefore, it appears § 1031(f)(2)(C) would save this transaction.

If § 1031(f)(2)(C) does not apply, the application of § 1031(f)(1) by the IRS should not concern Taxpayer if the subsequent disposition is taxable. If Taxpayer disposes of the replacement property within two years after the exchange in a taxable transaction, any deferred gain will be triggered at that time. If the value of the replacement property decreases following the exchange, Taxpayer may recognize a loss on the subsequent disposition. Applying § 1031(f)(1) should produce the same net result. For example, if Taxpayer deferred $100 of gain on the transaction and the value of the property decreases $120 between the time of the exchange and the time of the subsequent disposition, a subsequent disposition will result in $20 of loss. If § 1031(f)(1) is applied, it appears the taxpayer will recognize $100 of gain and get a basis step up of $100,[53] under the § 1031(f)(1) bump, and recognize $120 of loss on the disposition. The net result is a $20 loss, the same result that would obtain if § 1031(f)(1) did not apply. Perhaps the significance of § 1031(f)(1) is that it affects the holding period of the replacement property. If the property is disposed of within one year following the exchange, gain in excess of the deferred gain should be a short-term gain and any loss should be short-term loss. Thus, with the exception of the holding period issue, the application of § 1031(f)(1) appears to lack practical significance in PLR 200251008.[54] In addition, since there was no direct exchange between Taxpayer and LLC-W, or any other related party, and since the Relinquished Property was sold to an unrelated party, the application of § 1031(f)(1) to the transaction is theoretically questionable.

1. *Lease and Sublease Treated as Like Kind*

Although § 1031(f) was the major issue in PLR 200251008, other issues deserve consideration. For example, LLC-W sub-subleased the underlying land to EAT for a thirty-two year term. The § 1031 regulations provide that a leasehold interest of at least thirty years in real property is like kind to a fee simple interest in real property,[55] and the IRS has previously ruled that a sublease of real property can be like kind to other real property.[56] PLR 200251008 implies that the IRS also believes a sub-sublease in real property of more than thirty years is like kind to a fee simple interest in real property.

2. *Basis Allocation Between Improvements and Leasehold Interest*

While PLR 200251008 provides a method for structuring build-to-suit exchanges with related parties, it does not provide how the basis of the relinquished property should be allocated between the improvements and the Sub-sublease interest. It appears, however, that the entire basis of the relinquished property should be allocated to the improvements. The replacement property in PLR 200251008 is the improvements and the 32-year Sub-sublease of the underlying land.[57] Since the Sub-sublease is a fair-market-value lease, the present value of the obligations should equal the present value of the future use of the land. Therefore, it arguably has no value. Having no value, no portion of the relinquished property should be allocated to the Sub-sublease under § 1031(d). Instead, all of the basis of the relinquished property should be allocated to the improvements.

3. *Depreciating Improvements and Leasehold Interests*

Another issue not discussed in the ruling is the manner in which the improvements and leasehold interest should be depreciated. Notice 2000-4[58] requires that MACRS replacement property be depreciated in the same manner, and using the same recovery period, as the MACRS relinquished property. Assuming both the relinquished property and the replacement property improvements are MACRS property, Taxpayer should depreciate the replacement property using the remaining recovery period of the relinquished property. Even if the remaining recovery period is greater than 32 years, the remaining recovery period, not the term of the lease, should be used to compute the depreciation deduction.[59]

4. *Related Party as Contractor*

PLR 200251008 also confirms the IRS's position that a party related to the taxpayer may be paid a fair market fee to manage the construction of improvements built on property held by an unrelated party. Since Rev. Proc. 2000-37 does not allow these payments to be other than at market value, the payments must reflect a bona fide management agreement.

5. *Continuing Construction Begun by a Related Party*

PLR 200251008 provides that LLC-W was subleasing B-Acres before the exchange was arranged. LLC-W had already begun to improve the B-Acres before it sub-subleased D-Acres to Titleholder. It appears that the D-Acres sub-subleased to Titleholder was land that had not yet been improved. Would the result be different if a related party leased partially-completed improvements to Titleholder who completed the improvements as a build-to-suit exchange and transferred the leasehold interest and improvements to the taxpayer?

To the extent an exchange accommodation titleholder leases partially-completed improvements at fair market value, as opposed to purchasing them from the related party or leasing only the underlying land, the replacement property will consist of (1) the improvements constructed by the exchange accommodation titleholder and (2) the lease of part of the improvements and underlying land. The exchange should therefore qualify for §1031 nonrecognition treatment. If, on the other hand, the exchange accommodation titleholder purchases partially-completed improvements from a party related to the taxpayer who had done the construction before the exchange was arranged, the taxpayer's acquisition of those improvements could destroy the exchange, at least in part, if the bifurcation method is applied. If Titleholder had leased only the land on which partially-completed improvements had been constructed by LLC-W, the IRS may have been able to characterize the transaction as an acquisition of improvements from a related party, who constructed the improvements before the exchange was contemplated. This may have destroyed the exchange in part. In PLR 200251008, Titleholder avoided these issues by sub-subleasing unimproved land to Titleholder.

6. *Filing Form 8824*

Knowing that the transaction qualifies for § 1031 nonrecognition treatment, Taxpayer must file a Form 8824 reporting the exchange. Because the IRS ruled that this is a related party parking arrangement, it appears Taxpayer must check "yes" on line 7.a. and file Form 8824 for the next two years. Since the IRS stated that Taxpayer and the related parties still hold the exchange parties, Taxpayer should check "no" on lines 9 and 10, indicating that the exchange properties have not been disposed of.

C. Structure as a Lease-Assignment Under Rev. Proc. 2000-37.

Since publishing PLR 200251008, the IRS has issued another ruling, PLR 200329021 on slightly different facts. That ruling involved a taxpayer who was the wholly-owned subsidiary of Parent. Parent had entered into a long-term lease (a 20-year initial period with four five-year renewal options) before the date the taxpayer contemplated disposing of its property (RQ) as part of a Section1031 exchange. Parent files a consolidated tax return that includes the taxpayer, as well as its other wholly-owned subsidiaries.

In PLR 200329021, the taxpayer wished to dispose of RQ and use the proceeds from the disposition to construct improvements on the property leased to Parent. To structure the transaction as a qualified exchange accommodation arrangement under Rev. Proc. 2000-37, Parent assigned the leasehold to a limited liability company (LLC) wholly-owned by an exchange accommodation titleholder. At the time of the assignment, the leased property was unimproved, except for demolition of the existing building on the site and rough grading (all performed by the landlord). At the time Parent assigned the lease to LLC, Parent also invoiced LLC for soft costs (i.e., engineering, surveys, etc.) associated with the LLC's construction of the improvements. Parent did not, however, invoice LLC for other costs incurred to enter into the lease.

Under Parent's direction, LLC constructed the improvements. The taxpayer disposed of RQ with the proceeds going to a qualified intermediary. The proceeds from the disposition of RQ that were held by the qualified intermediary were advanced to LLC to fund construction of the improvements. LLC used a portion of its first advance from the qualified intermediary to reimbursed Parent for the invoiced costs. It also paid the construction contractor for the costs of construction from advances received from the qualified intermediary.

Before the earlier of the date that was 180 days after Parent assigned the leasehold to LLC and the date that was 180 days after the taxpayer transferred RQ, the LLC assigned the leasehold with improvements to the taxpayer. The IRS ruled that to the extent the improvements were complete when the leasehold was assigned to the taxpayer, the transaction qualified for Section 1031 nonrecognition treatment.

There are three main facts that distinguish PLR 200329021 from PLR 200251008: (1) in PLR 200329021, the related party assigned all of its interest in the leasehold to an exchange accommodation titleholder, as opposed to subleasing the property to an exchange accommodation titleholder, as the related party did in PLR 200251008; (2) in PLR 200329021, most of the improvements were constructed on the leased property after the taxpayer sold the relinquished property, whereas the transaction in PLR 200251008 was a reverse exchange; and (3) in PLR 200329021, the IRS allowed LLC to reimburse Parent for soft costs incurred by Parent before the assignment to LLC.

The assignment of the lease in PLR 200329021 as opposed to the use of a sublease in PLR 200251008 could be a significant difference. For example, if contrary to fact, Parent had acquired the leasehold interest for a premium before the taxpayer had contemplated the exchange, Parent arguably would have had a high basis in the leasehold interest. If instead of assigning the interest for no consideration, Parent had sold the leasehold interest to LLC for fair market value, which may have been close to Parent's basis in the leasehold interest, the transaction would have resulted in basis shifting and cashing out, at least in part. Such a result would trigger gain recognition, at least in part, under Section 1031(f)(4). Subleasing property to the exchange accommodation titleholder helps ensure this does not happen.

Another significant aspect of PLR 200329021 is that the taxpayer disposed of the relinquished property prior to the improvements being completed. Thus, the proceeds from the sale of the relinquished property were used to fund construction of improvements on the property while leased to the LLC. There is no reason why exchange proceeds may not be used to fund construction of improvements on property held by an exchange accommodation titleholder, so long as the funds are closely tracked, used to pay for construction, and not returned to the taxpayer before the exchange is complete. As discussed below, from a practical perspective, the qualified intermediary must ensure that any advances it makes to an exchange accommodation titleholder are fully secured and the qualified intermediary has a perfected security interest in the improvements being constructed and the leasehold, and in the interest of the entity that holds title to the leasehold and improvements.

In PLR 200329021, an interesting issue is also raised by allowing LLC to reimburse Parent for soft costs incurred by Parent before the lease was assigned. If the taxpayer had been reimbursed for other than soft costs, arguably the taxpayer would have benefited from basis shifting and cashing out with a related party. This would occur, for instance, if Parent had completed a significant amount of the improvements prior to assigning the leasehold to LLC and had been reimbursed for all costs incurred in constructing the improvements. Costs incurred to construct improvements, must be capitalized, *i.e*, added to the basis of the property.[60] If the taxpayer had been reimbursed for costs to construct the improvements prior to the leasehold being assigned, such reimbursement would most likely be deemed a basis shift and a cashing out under Section 1031(f)(4). PLR 200329021 raises the question of what types of costs may be reimbursed to a related party. Perhaps the correct answer is to disallow the related party to be reimbursed for any capitalized expenditures, unless incurred in anticipation of the exchange.

PLR 200329021 also presents somewhat cryptic language relating to the application of Section 1031(f). It provides that both the taxpayer and the related party continue to be invested in exchange properties and will remain invested for a period of not less than two years following the exchange. Therefore, neither cashed out of their interests. While this is a position the IRS has taken on multiple occasions, this language addresses Section 1031(f)(1), but it is still doubtful whether Section 1031(f)(1) should be applied to this type of transaction.

VI. BUILD-TO-SUIT EXCHANGES INVOLVING THE TAXPAYER'S EXISTING LAND

If the taxpayer already owns the land on which the improvements will be constructed, the main issues are whether the "exchange" requirement and the "like-kind property" requirement in § 1031(a)(1) are satisfied. To some extent, taxpayers may look to existing positive authority in structuring such exchanges, including Rev. Proc. 2000-37, but they also must avoid existing negative authority.

A. Existing Negative Authority

Courts and the IRS have addressed build-to-suit exchanges involving property owned by the taxpayer. Case law on this issue establishes that if such exchanges are poorly structured, they will not qualify for § 1031 nonrecognition treatment. The IRS's private rulings, provide hope for structuring build-to-suit exchanges involving property owned by the taxpayer. This hope is bolstered if the exchange is properly structured using the Rev. Proc. 2000-37 safe harbor.

1. *Bloomington Coca-Cola Bottling Co. v. Comr.*

The difficulties of structuring improvements on property owned by the taxpayer can be traced to *Bloomington Coca-Cola Bottling Co. v. Comr*.[61] There, the taxpayer, in exchange for a contractor constructing a new plant on land already owned by the taxpayer, transferred to the contractor cash and the taxpayer's old plant and land on which the old plant was located.

The Seventh Circuit rejected the taxpayer's characterization of this as a like-kind exchange. The Seventh Circuit rationalized "this is not a case where the contractor exchanged a completed plant owned by the contractor for property and money, hence the contractor at no time had like property." In other words, the Seventh Circuit treated the taxpayer's transfer of property as compensation paid for the contractor's services and building materials. Thus, there was no like-kind exchange.

2. *PLR 8701015*

Bloomington was cited in PLR 8701015. In that ruling, the taxpayer proposed to place the relinquished property sale proceeds in an escrow account. The escrow account would be used to build a building on land already owned by the taxpayer. The IRS concluded that since the buyer of the relinquished property would not own the new building or convey it to the taxpayer, there was not a like-kind exchange.

3. *PLR 9031015*

In PLR 9031015, the taxpayer proposed to transfer vacant land to an escrow agent. The escrow agent would receive the selling price of other real estate owned by the taxpayer, and use those funds to build a building on the vacant land, and transfer the land and completed building to the taxpayer. In PLR 9031015, the IRS, citing *Bloomington*, ruled that the other party's payment of the construction costs through the escrow agent failed the § 1031 "exchange" requirement. In addition, however, the IRS concluded that the § 1031 "like kind" requirement failed because the building without land received was not like kind to the building with land surrendered.[62]

4. *DeCleene v. Com'r*.

In *DeCleene v. Com'r*.,[63] a taxpayer deeded vacant land it originally owned to the prospective acquiror of the relinquished property. That party then constructed a new building according to the taxpayer's specifications. The taxpayer, however, maintained the benefits and burdens of ownership during the pre-exchange period. For example, the taxpayer took back a non-recourse note for 100% of the purchase price of the sold land, guaranteed the construction loan, absorbed the pre-exchange property taxes and expenses relating to the property, and at the time of the original deed, had a binding contract to reacquire the land. The Tax Court held that in substance the taxpayer never transferred the land. Accordingly, the Tax Court, applying Bloomington, held there to be no like-kind exchange.

Nevertheless, it appears that *Bloomington, DeCleene*, and the other unfavorable rulings can be avoided if the taxpayer makes a bona fide sale of the land to, or enters into a long-term lease of the land with, an accommodation party.

B. Existing Favorable Authority

So long as the accommodation party has, or is treated as having, true economic benefits and burdens of ownership of the land or ground lease, and the building under construction, during the time the other party held them, commentators advocate,[64] and certain IRS rulings indeed treat, the other party as exchanging that property, thereby qualifying the transaction under § 1031. On at least three occasions, the IRS has granted § 1031 nonrecognition treatment to build-to-suit transactions on property owned by the taxpayer. These rulings show that the IRS is aware that such exchanges deserve § 1031 nonrecognition treatment if structured correctly.

1. *PLR 7823035*

In PLR 7823035, the taxpayer, seeking to have built and eventually own a building on vacant land it already owned, entered into an agreement with another party that desired to acquire other real estate owned by the taxpayer. Pursuant to this agreement, the taxpayer sold the vacant land to the other party, and the other party constructed a building on the vacant land, and conveyed the land and building to the taxpayer in exchange for the taxpayer's other piece of real estate. The taxpayer supplied all the construction specifications to the other party. The taxpayer also agreed to bear some of the burden of construction, by making a cash payment to the other party, of all the other party's costs of buying the vacant land from the taxpayer and constructing the building to the taxpayer's specifications, in excess of the agreed value of the taxpayer's other real estate. Finally, the taxpayer was to receive the benefit, by means of a cash payment, of any excess of the agreed value of the other real estate, over all the other party's costs of buying the vacant land from the taxpayer and building the building to the taxpayer's specifications. Despite the retention of significant benefits and burdens of ownership by the taxpayer, The IRS, in PLR 7823035, ruled there to be a like-kind exchange.

2. *PLR 8304022*

PLR 8304022 likewise involved a taxpayer seeking to have built and eventually own a building on vacant land it already owned. The taxpayer entered into an agreement with another party that desired to acquire other real estate owned by the taxpayer. Pursuant to this agreement, the taxpayer entered into a 35-year ground lease, rather than a sale, of the vacant land to the other party. Pursuant to that agreement, the other party constructed a building on that vacant land, and conveyed the ground lease (which presumably merged with the interests the taxpayer held in the land) and building to the taxpayer, in exchange for other real estate of the taxpayer. The taxpayer supplied all the construction specifications to the other party, and also agreed to a ground lease net cash rental of only $1 per year during the pre-exchange construction period. On the other hand, the other party agreed to be responsible for all other "taxes, costs, expenses and obligations," during the pre-exchange construction period, and further represented that it was constructing the building on its own behalf and not as an agent of the taxpayer. The IRS, in PLR 7823035, ruled there to be a like-kind exchange.

3. *PLR 8847042*

In PLR 8847042, a taxpayer owned a rental building the taxpayer wished demolished and sought to own a new building to be located on a portion of that land. Taxpayer entered into an agreement with a developer, who agreed to accept a deed for the entire parcel of land, demolish the existing building, build a new building on a portion of the land, and return to the taxpayer the new building and the portion of land under the new building. In exchange for incurring the construction costs for the taxpayer's building, the developer apparently retained a portion of the taxpayer's land. PLR 8847042, without discussing any issues relating to shifts of benefits and burdens of ownership, nor any issues relating to non-simultaneous exchanges, ruled there to be a like-kind exchange. PLR 8847042 was revoked, however, in PLR 8921058, with the IRS merely stating that, on further consideration, it was unwilling to rule on § 1031 qualification. Nonetheless, it appears from the other favorable rulings that the IRS believes a build-to-suit transaction involving the taxpayer's land may be structured to qualify for § 1031 nonrecognition treatment. Such possibilities should be increased with Rev. Proc. 2000-37.

4. *PLR 9243038*

In PLR 9243038, a taxpayer entered into several ground leases with an unrelated party. Pursuant to the ground leases, the unrelated party improved the leased land and then leased the improvements to third parties at market rates. The lessee approached the taxpayer to restructure the lease arrangements to improve its ability to finance the construction. This resulted in an exchange agreement pursuant to which the taxpayer agreed to transfer its fee interest in several parcels of land subject to the ground leases and two unimproved parcels to the lessee. In exchange, the lessee agreed to assign to the taxpayer its leasehold interests in four parcels subject to the ground lease and its ownership interest in all improvements located on those parcels. The exchange terminated all of the ground leases, so the taxpayer and the lessee each owned the respective properties in fee simple and the improvements on those parcels.

The IRS ruled that the exchange qualified for § 1031 nonrecognition treatment. In doing so, the IRS relied on Rev. Rul. 68-394[65] to rule that the assignment of a lease of greater than 30 years to the lessor may be like kind to a fee simple interest in other property owned by the lessor. The IRS also ruled that the step transaction did not apply to the transaction. "If [, however] these transactions were viewed as one transaction under the step transaction doctrine, . . . the transactions could be viewed as an exchange of the [taxpayer's property], for a building on land already owned by [the taxpayer]. Consistent with Rev. Rul. 67-255, such building is not like kind to the transferred property." Thus, while this ruling is favorable to the taxpayer, the discussion of the step transaction doctrine must be remembered when structuring build-to-suit exchanges involving property owned by the taxpayer.

C. Using Rev. Proc. 2000-37

Keeping in mind the cases and rulings discussed above, Rev. Proc. 2000-37 should help taxpayers satisfy the exchange requirement when improvements are to be constructed on property owned by the taxpayer at the time the exchange is arranged. Additional planning and a business purpose for such additional planning may, however, be needed to ensure that the like kind requirement is satisfied.

1. *The Exchange Requirement*

As the Court held in *Bloomington*, transferring real estate as consideration for the construction of a building does not satisfy the § 1031(a)(1) exchange requirement. The taxpayer must receive like-kind property from another person to satisfy the exchange requirement.[66] If, as part of a Rev. Proc. 2000-37 parking transaction, the taxpayer is able to acquire like-kind property from an exchange accommodation titleholder in exchange for relinquished property, the transaction should satisfy the exchange requirement. If the IRS follows its position in Rev. Proc. 2000-37, the exchange accommodation titleholder shall be treated as the beneficial owner of any improvements constructed on property to which it holds qualified indicia of ownership. Thus, the taxpayer may lease property to the exchange accommodation titleholder for at least 30 years, direct the exchange accommodation titleholder to construct improvements, and receive such leasehold interest with improvements from the exchange accommodation titleholder in satisfaction of the exchange requirement. This should place the transaction beyond the scope of *Bloomington*.

2. *The Like-Kind Property Requirement*

In constructing improvements on property already owned by the taxpayer, there is a possibility that the IRS will treat the replacement property as the building, with no land. As discussed above, the IRS has taken the position that a building without the underlying land is not like kind to other real property. Thus, in a build-to-suit exchange involving property already owned by the taxpayer, the taxpayer must ensure that the replacement property is the improvements and some interest in the underlying land that is treated as like kind to other real property.

One possible way to structure a build-to-suit exchange on property owned by the taxpayer is for the taxpayer to lease an interest in the existing land to an exchange accommodation titleholder who constructs the improvements on the property. The improvements should not be treated as owned by the taxpayer because the exchange accommodation titleholder is treated as the beneficial owner of the land on which the improvements are constructed. If, in completing the exchange, the exchange accommodation titleholder assigns the leasehold interest and improvements to the taxpayer, who is also the lessor of the land, the lease will merge with the taxpayer's other interests in the land and terminate the lease. After the transaction, the taxpayer will own property it owned prior to the exchange, but will now own an improvement constructed thereon using exchange proceeds. Relying on Rev. Rul. 76-391, the IRS may attempt to treat this as the transfer of real property in exchange for just a building that is not like kind to the transferred property. The taxpayer could avoid merger of title by requiring the exchange accommodation titleholder to establish a single-member limited liability company to lease the property from the taxpayer. The exchange accommodation titleholder could then assign all of its interests in the limited liability company to the taxpayer instead of assigning the lease. This will avoid merger of title, but it remains to be seen if the IRS will challenge the transaction under a substance-over-form argument.

3. *Creation of a Related Party*

To avoid the possibility of title merging and terminating the lease, the taxpayer may attempt to structure the transaction as a related party exchange. This could be accomplished by first transferring the unimproved property to a separate tax entity related to the taxpayer. That separate entity would lease the property to an exchange accommodation titleholder for longer than 30 years. Improvements would be constructed while the exchange accommodation titleholder was lessee. In completion of the exchange, the leasehold interest would be assigned to the taxpayer, but would not terminate or merge with the other interests in the land because the lease would still exist between the taxpayer and the related party. In form, this transaction resembles the transaction in PLR 200251008. If the form is respected, the transaction will qualify for § 1031 nonrecognition treatment. If the IRS disregards the transfer to the related party, it could argue that only a building was received as part of the transaction. It is not unusual, however, to have a business purpose for transferring property to a related party. For example, a taxpayer may transfer property to a limited partnership to facilitate a lifetime gift. Also, it is not unusual to transfer real property to a separate legal entity to provide liability protection. If the taxpayer can establish that there is a non-tax purpose for transferring the property to a related party prior to the exchange, the transfer and the transferee entity should be respected by the IRS even if the transfer to the related entity is in close proximity to a build-to-suit exchange.

4. *Bona Fide Transfer to Titleholder*

A significant concern in every build-to-suit exchange involving property owned by the taxpayer is the *DeCleene* decision. To avoid the outcome in *DeCleene*, the taxpayer must make a bona fide transfer to an exchange accommodation titleholder or other unrelated party. If the transaction involves leasing property to the exchange accommodation titleholder, the lease should be at arm's length terms. If property is sold to the accommodation titleholder, it should be a fair market value sale.

VII. STRUCTURING BUILD-TO-SUIT EXCHANGES OUTSIDE THE REV. PROC. 2000-37 SAFE HARBOR

If it will take more than 180 days to construct the improvements, the taxpayer may not rely on a Rev. Proc. 2000-37 structure. Instead, the taxpayer must rely on the case law addressing non Rev. Proc. 2000-37 exchanges. As stated above, the taxpayer must ensure that the accommodation party bears the benefits and burdens of ownership of the property on which the improvements are being constructed and is not the taxpayer's agent. As discussed above, a position could be taken that this requirement is satisfied even if a related party is the accommodation party.

VIII. DEFERRED BUILD-TO-SUIT EXCHANGES

With the exception of PLR 200329021, in the cases and rulings cited above, the build-to-suit exchange generally was a reverse exchange (*i.e.*, the accommodation party acquired the replacement property and constructed the improvements before the taxpayer transferred the relinquished property), so exchange proceeds were not used to originally acquire replacement land or construct the improvements. If exchange proceeds will be used to fund construction of the improvements, the transaction must be structured as a deferred exchange. In a deferred build-to-suit exchange, the taxpayer must ensure that (1) the taxpayer does not obtain any benefit of the exchange proceeds before receiving the replacement property; (2) the exchange agreement allows the qualified intermediary to distribute exchange proceeds for the construction; (3) the replacement property is properly identified; and (4) the replacement property is acquired within 180 days after the relinquished property is transferred.

A. Restricting the Taxpayer's Benefit of the Exchange Proceeds

Under Reg. §1.1031(k)-1(g)(6) the documents creating every safe harbor that allows another party to hold exchange proceeds for the taxpayer must restrict the taxpayer's "right to receive, pledge, borrow, or otherwise obtain the benefits of" the exchange proceeds. Section 4.03(4) of Rev. Proc. 2000-37 provides that the taxpayer may lease the parked property from the exchange accommodation titleholder at other-than-market rates. The taxpayer threatens to destroy a deferred build-to-suit exchange if it leases and takes possession of property that was acquired using exchange proceeds and on which improvements are being constructed using exchange proceeds. The IRS could take the position that although the exchange accommodation titleholder is the deemed beneficial owner of the property, the taxpayer benefits from the exchange proceeds by taking possession of the property while improvements are being constructed. This would likely place the taxpayer in constructive receipt of the proceeds and disqualify the transaction. To avoid this possibility with deferred build-to-suit exchanges, taxpayers should not take possession of property acquired with exchange proceeds until such property is transferred to the taxpayer to complete the exchange. Furthermore, the exchange accommodation agreement between the taxpayer and the exchange accommodation titleholder should restrict the taxpayer's right to receive, pledge, borrow, or otherwise obtain the benefit of property that is consideration received for the relinquished property.

B. Modifying the Exchange Agreement Language

Form exchange agreements used by many intermediary companies provide that the intermediary will hold the exchange proceeds in an escrow account for the taxpayer. If the intermediary distributes the proceeds to construct improvements, the intermediary may be in breach of contract. If the improvements lose value before the property is transferred to the taxpayer, or if for some reason the improvements are not transferred to the taxpayer, the taxpayer may instruct the intermediary to distribute the exchange proceeds in cash pursuant to the exchange agreement. If the exchange agreement does not provide that the intermediary may use the proceeds to fund the construction of the improvements, the taxpayer may arguably demand the cash be distributed from the escrow account. If the proceeds are to be used to construct improvements, the intermediary should require that the exchange agreement provide for such use and allow the intermediary to transfer those improvements or a note secured by the improvements and not cash, if the exchange does not close as planned.

Furthermore, the intermediary should retain a security interest in any improvements that are being constructed to help insure that its rights in the improved property is not subordinated to the rights of other creditors, further inhibiting its ability to successfully transfer replacement property to the taxpayer. These precautions will help the intermediary avoid a possible confrontation regarding the property it is to deliver to the taxpayer under the terms of the exchange agreement.

C. Identifying To-Be-Built Replacement Property

Care must be taken when replacement property is not in existence at the time the taxpayer identifies it.[67] Treas. Reg. §1.1031(k)-1(e)(2) provides that if replacement property is to be constructed before it is acquired, the identification may include a legal description of the underlying land and must include as much detail regarding the improvements as is practicable at the time of the identification. If the property is received before the construction is completed, the completed portion of the improvements should qualify as replacement property. Reg. §1.1031(k)-1(e)(3)(iii) provides that the incomplete improvement is substantially the same as the identified property if "had production been completed on or before the date the taxpayer receives the replacement property, the property received would have been considered to be substantially the same as identified." The example in Regs. § 1031(k)-1(e)(5) provides that a building that is only 20% complete is considered to be substantially the same as the identified building.

An issue related to receiving identified replacement property may arise if the taxpayer decides to construct improvements on identified property after the end of the identification period. A taxpayer may identify up to three replacement properties for any exchange.[68] Real property is generally adequately described by a legal description, street address, or distinguishable name.[69] In the build-to-suit context, suppose a taxpayer disposes of relinquished property worth $2,500,000 and with a basis of $800,000. The disposition is structured as the first leg of a transaction intended to qualify for § 1031 nonrecognition treatment. Consequently, the sale proceeds are received by a qualified intermediary who holds the proceeds on behalf of the taxpayer. Within 45 days after the date the relinquished property is transferred, the taxpayer identifies three properties as replacement properties: Property 1 estimated to be worth $1,800,000, Property 2 estimated to be worth $2,900,000, and Property 3 estimated to be worth $900,000. The taxpayer believes that it will be able to close on Property 2 or on Property 1 and Property 3 before the end of the 180-day exchange period. Shortly after the forty-fifth day, however, the taxpayer realizes that it will only be able to acquire Property 1 before the end of the exchange period. To avoid recognizing $700,000 of gain if Property 1 is the sole acquisition, the taxpayer considers causing $700,000 of improvements to be constructed on Property 1 before acquiring it. The taxpayer is concerned that Property 1 with the improvements will not be treated as substantially the same as the property it identified.

The property received by the taxpayer will be substantially the same as the identified property if the improvements do not alter the basic nature or character of the identified property. The regulations provide that the erection of a fence on real property subsequent to its identification does not alter the basic nature and character of the identified property.[70] Thus, if Property 1 is raw land at the time of identification and the improvements will consist of minor improvements (such as a fence), they should not adversely affect the exchange. It also appears that if Property 1 had an existing structure at the time of the identification, modifying, remodeling, or repairing the existing structure should not alter the nature or character of the identified property. Unfortunately, the regulations do not provide sufficient guidance to determine whether adding additional square footage to an existing structure would alter the nature or character of the identified property. On the far extreme, if a new building were constructed on Property 1, it is possible, although not certain, that the building would alter the nature and character of the identified property, causing it to fail to be substantially the same as the identified property. If, however, the building is only partially completed before it is transferred to the taxpayer, perhaps that would not alter the nature and character of Property 1.

Another issue would arise if the taxpayer were to demolish an existing structure following identification but before receipt of identified property. Again, the lack of guidance on this issue leaves some question about whether and to what extent demolition may affect the nature or character of identified property. If identified as property without any improvements, it would appear appropriate to include the cost of demolishing the property in the cost of the replacement property,[71] and the cost should not trigger gain recognition if paid with exchange proceeds.

D. The 180-Day Period

In a reverse build-to-suit exchange, it is possible to park property for more than 180 days while improvements are being constructed. In a deferred build-to-suit exchange that luxury does not exist. Once the relinquished property is transferred, the taxpayer has 180 days to acquire the replacement property, whether construction is completed or not. Thus, if more than 180 days are needed, the taxpayer should consider delaying the disposition of the relinquished property. Nonetheless, as stated above, to the extent partially completed property was adequately identified, it will qualify as like-kind replacement property.[72]

IX. CONCLUSION

Many taxpayers are in a position to use exchange proceeds to construct improvements on intended replacement property. Guidance exists related to several types of build-to-suit exchanges. Based on this guidance, a taxpayer may comfortably use exchange proceeds to construct improvements on property owned by an unrelated party or a related party. A taxpayer may draw upon the guidance regarding these two types of exchanges to structure a build-to-suit exchange involving property owned by the taxpayer. In every build-to-suit exchange, it is important to ensure that the party constructing the improvements is treated as the beneficial owner of the land or leasehold interest in the land of greater than thirty years at the time the improvements are constructed.

If the improvements are to be constructed on property owned by a related party before the exchange is contemplated, the improvements may qualify for § 1031 nonrecognition treatment, but the underlying land may not. On the other hand, if the related party acquires land, or a long-term leasehold interest in land, prior to an exchange being arranged, there is a theoretic basis for treating the land and property received from the related party as valid exchange property. The ultimate issue in every exchange involving a related party is whether the transaction results in basis shifting or cashing out. If not, the exchange should qualify for §

1031 nonrecognition treatment, even though a related party is involved. PLR 200251008 provides a model for constructing replacement property improvements on land owned by a related party.

The build-to-suit exchange on property owned by the taxpayer is ripe for additional guidance. Several rulings, including PLR 200251008, indicate that the IRS would approve such a transaction if the taxpayer is deemed to acquire more than just the improvements. With every build-to-suit exchange, the taxpayer must ensure that it is never in actual or constructive receipt of the exchange proceeds before the end of the exchange period. Keeping all of these factors in mind and otherwise carefully planning the build-to-suit exchange should ensure that it qualifies for § 1031 nonrecognition treatment.

ENDNOTES

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1 Bradley T. Borden is with the San Antonio, Texas, law firm of Oppenheimer, Blend, Harrison & Tate, Inc. Copyright 2003 by Bradley T. Borden.

2 All section references to are to the Internal Revenue Code of 1986, as amended, unless stated otherwise.

3 Revenue Act of 1921, ch. 136, § 202(c), 42 Stat. 227-230.

4 2000-2 C.B. 308.

5 Issued to the taxpayer on Sept. 11, 2002, and released to the public on Dec. 20, 2002. The author was involved in obtaining this favorable ruling.

6 2002-49 I.R.B. 1

7 39 T.C. 608 (1962), acq. 1963-2 C.B. 4.

8 320 F.2d 333 (4th Cir. 1963).

9 1975-2 C.B. 332.

10 Rev. Proc. 2000-37, 2000-2 C.B. 308, § 4.01.

11 See below for discussion about using exchange proceeds to construct improvements if the taxpayer has taken possession of the "parked" property.

12 The 180-day holding period limitation in § 4.02(4) and (5) of the Rev. Proc. 2000-37, however, makes it impractical for many build-to-suit exchanges.

13 P.L. 101-239, § 7601(a).

14 H.R. Rep. 101-247, 101st Cong. 2d Sess. 1339 (1990).

15 H.R. Rep. 101-247, *Id*. at 1340.

16 *See also* H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 613 (1989), ("If related parties engage in a like-kind exchange, tax basis is shifted between properties, which may result in the reduction of tax upon the subsequent disposition of a property.").

17 § 1031(d).

18 It is also possible that the IRS could challenge this transaction under the step transaction or the substance-over-form doctrines.

19 *But see* FSA 200137003 (Chief Council's Office held that the two year period is a safe harbor and any transfers thereafter do not trigger § 1031(f)(1), but the two-year period is suspended if either property holder's risk of loss with respect to the property is substantially diminished under § 1031(g)).

20 § 1001(a) and (b).

21 § 1031(f)(1) (flush language).

22 § 1031(f)(2)(A) and (B).

23 This example assumes that Notice 2000-4, 2000-1 C.B. 313, does not apply to exchanges involving land because the land is not MACRS property.

24 H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 613 (1989).

25 H.R. Rep. No. 247, 101st Cong., 2d Sess. 1341 (1990).

26 H.R. Conf. Rep. No. 386, 101st Cong. 1st Sess. 613 (1989).

27 *See Magneson v. Com'r*., 753 F.2d 1490, 1494 (9th Cir. 1985) ("The central purpose of both [S]ection 721 and 1031(a) . . . is to provide for nonrecognition of gain on a transfer of property in which the differences between the property parted with and the property acquired 'are more formal than substantial,' and 'the new property is substantially a continuation in the old investment still unliquidated.'").

28 § 722.

29 § 1031(d);. Regs. § 1.1031(j)-1(c).

30 § 1001(a) and (b) (the gain shall be equal to the difference between the "sum of any money received plus the fair market value of the property (other than money) received" and the basis in the property).

31 If the exchange properties received from the related party are treated as boot, § 1031(b) provides that gain is recognized to the extent of the value of the boot received. The basis of the relinquished property is not apportioned between the nonrecognition and recognition segments of the exchange. With § 1001 exchanges, basis is recovered before gain is recognized. Thus, a portion of the basis of the relinquished property would be applied to the amount realized from the receipt of property from a related party.

32 To produce the correct result, M's basis in Property B should be increased to $500,000 when N recognizes the gain.

33 This conclusion assumes M and N are in the same tax bracket. If N were in a lower tax bracket, the IRS may not be satisfied that there was no cashing out.

34 § 453(e)(1).

35 § 453(e)(3)(A)(i).

36 In FSA 199931002 the facts do not state that the statute of limitations had tolled on the year of the exchange, only that the year of the exchange was not subject to examination.

37 H.R. Rep. 101-247, 101st Cong. 2d Sess. 1341 (1990).

38 2002-49 I.R.B. 1.

39 § 1031(d) (because there is no non-like-kind property received, the carry-over basis in the replacement property should be increased by the gain recognized but would not be reduced by the value of other property received).

40 Levine, 507 T.M. *Taxfree Exchanges Under Section 1031*.

41 *See also* Cuff, "Related Party Exchanges – An Examination of Technical Advice Memorandum 9748006," 26 J. Real Estate Tax'n 155 (1999) ("There is no apparent basis – other than

wishful thinking – for the taxpayer's argument that the forbidden purpose must exist at the time at which he entered into the agreement to dispose of the relinquished property.").

42 H.R. Rep. No. 247, 101st Cong. 2d Sess. 1341 (1990).

43 "Subsequent Sale Cost Related Parties Like-Kind Exchange Treatment," 63 PRAC. TAX STRAT. 318 (Nov. 1999).

44 44 T.C. Memo 1994-27.

45 The taxpayer transferred the relinquished property on July 27, 1983 and received the last of the replacement property on September 15, 1986. Because § 1031(a)(3) is effective for transfers after July 18, 1984, the transaction was not subject to the 180-day exchange period. P.L. 98-369, § 77(a).

46 Because the transaction was a deferred exchange, it arguably was not complete until the taxpayer received the replacement property. Thus, the exchange property technically may not have been disposed of after the exchange.

47 The related party was paid a fee for constructing the improvements. While this increased the related party's post-exchange cash position, it was money received for services provided, not for property sold. Thus, there was no cashing out.

48 § 1031(a)(3)(B); Rev. Proc. 2000-37, 200-2 C.B. 308, §4.02(5) and (6).

49 H.R. Rep. No. 432 (11) 987th Cong,, 2d Sess. 1232 (1984), pt. 2 at 1232 (1984).

50 *See Gregory v. Helvering*, 293 U.S. 465 (1935).

51 *But see* Weller and Welch, "Life After Rev. Proc. 2000-37 . . . . Further Developments in Reverse Like-Kind Exchanges," 43 Tax Mgmt. Memo. 363 (9/9/092). ("[W]here the purchase of the replacement property is integrated with the sale of the relinquished property, reliance on an agency analysis is probably sufficient; if the transaction is not integrated, the structure of the parking arrangement may need to satisfy a more traditional benefits and burdens test."); PLR 200111025 (the IRS allowed a parking arrangement with an unrelated party applying an agency test, but not a benefits and burdens test).

52 It is unclear from the ruling what LLC-W's basis-to-value ratio was in the sublease. The possibility of it having a high basis-to-value ratio is another concern taxpayers may wish to avoid.

53 § 1031(d).

54 Because it appears the net result will be the same whether § 1031(f)(1) does or does not apply, the statute of limitations does not appear to be an issue in PLR 200251008.

55 Regs. § 1.1031 (a)-1(c)(2).

56 PLR 7806074.

57 *See* Kaster, "Separating a Building for Tax Purposes from the Land on Which it Rests," 80 Jrnl. of Tax'n 90 (February 1994) (discussing when courts deem a building purchased and the underlying land leased).

58 2000-1 C.B. 313.

59 § 168(i)(8)(A).

60 § 263(a).

61 189 F.2d 14 (7th Cir. 1951).

62 *See* Rev. Rul. 67-255, 1967-2 CB 255, *distinguishing* Reg. 1.1031(a)-1(c) (exchange of land and building for unimproved land qualifies as a like-kind exchange). *See also* Rev. Ruls. 76-390, 1976-2 CB 242, and 76-391, 1976-2 CB 243 (exchange of either improved or unimproved land for building on land already owned does not qualify as a like-kind exchange).

63 115 T.C. 457 (2000).

64 *See* Levine, 567-3rd T.M. *Taxfree Exchanges Under § 1031,* "Tax Court Disapproves a Pre-Safe Harbor Reverse Exchange," 94 J. of TAX'N. 188 (Mar. 2001); "Tax Clinic," *The Tax Adviser* 321 (1999).

65 1968-2 C.B. 338.

66 Regs. § 1.1002-1(d).

67 *See* Regs. § 1.1031(k)-1(d)(1)(ii) (requiring the property received to be substantially the same property as identified).

68 Regs. § 1.1031(k)-1(c)(4)(A).

69 Regs. § 1.1031(k)-1(c)(3).

70 Regs. § 1.1031(k)-1(d), Ex.2

71 *See* § 280B (any amount expended to demolish any structure shall be treated as properly chargeable to capital account with respect to the land on which the demolished structure was located).

72 *See* Regs. § 1.1031(k)-1(e)(3)(iii).

WHAT YOU SHOULD KNOW ABOUT YOUR GRAT (GRANTOR RETAINED ANNUITY TRUST)

Noel C. Ice[1]

What You Should Know About Your GRAT (Grantor Retained Annuity Trust)

DISCLAIMER: The "BASIC" section of this memo is a brief, perhaps over-simplistic, overview of some of the more frequently asked questions concerning grantor retained annuity trusts (GRATs), a subclass in the family of split-interest trusts, where the grantor retains an annuity and at the end of the term the remainder passes to the grantor/donor's beneficiaries. This memorandum should not be relied upon in any given situation without first consulting your tax advisor. The law in this area changes frequently, and I have not necessarily undertaken to keep this memo current, since that would be a full-time job.

STRUCTURE: The format I have chosen is question and answer. Further, I have divided this memo into two parts. The first part is entitled "BASIC," and the second is entitled "TECHNICAL." The BASIC part can serve as a client disclosure memorandum. The TECHNICAL part is worth reading, if you are a tax professional or if you simply want to know some of the issues, traps and other technicalities that must be confronted for a GRAT to be successful. The first part is also worth reading, whether you are a professional tax advisor, or a layperson who has or is contemplating establishing a GRAT. This memo may or may not have the TECHNICAL Section attached, but, if not attached, it will be produced upon request.

If you are a layperson (or client) who has or is contemplating establishing a GRAT, you are strongly advised to read this memo; again, with the proviso that before relying upon any specific statement, the layperson should run the issue by tax counsel, who can apply the law to the facts, and who can determine whether the matter treated is still current, given the fast pace of change in this area.

BASIC

WHAT IS A GRAT?

The acronym GRAT stands for grantor retained annuity trust.

HOW DOES A GRAT WORK?

The grantor/donor transfers property into a trust (a GRAT) that provides that the grantor will receive each year a fixed annuity, usually for a term of years.

WHAT ARE SOME EXAMPLES OF HOW A GRAT MIGHT WORK?

At the risk of putting the cart before the horse, perhaps before the reader fully understands how a GRAT works, and before I have discussed the *Walton*[2] case, I am going to give some examples.

In July of 2003, the §7520 rate was 3%. True, it is doubtful that it will ever be this low again, but since that is when this portion of the memo was written, I am going to use that rate.

WHAT IS THE THEORETICAL SIZE OF A REMAINDER INTEREST IN A $10 MILLION, 10-YEAR, GRAT, FOR A 65 YEAR OLD, IF THE ASSUMED AFTER TAX RATE OF RETURN IS 3%?

According to my calculations, if $10 million were placed in trust for 10-years, and if approximately $1.17 million per year were distributed to a 65 year old grantor, and if the assets earned 3% per year, year in and year out, the final payment of $1.17 million would equal the amount in the trust, and the remainder beneficiaries would get nothing.

Hence, if the government tax tables assumed a 3% rate of return, which was the §7520 rate for July, 2003, then one would expect that the value of the gift to the remainder beneficiaries would be zero, or close to it.

WHAT IS THE GIFT TAX VALUE OF THE REMAINDER INTEREST ACCORDING TO THE IRS?

Under the IRS' view, the GRAT just described would result in a taxable gift of **$1,028,064**. Why?

The "reason," according to the IRS, that the gift would be $1,028,064, instead of zero, is that the grantor might die prior to age 75, in which case the remaining payments of $1.17 million per year would pass to the grantor's estate, rather than to the grantor. The actuarial odds of this happening are factored into the equation, and the portion of the retained interest that represents this contingency is treated by the IRS as something other than a "qualified interest." In the IRS' view, it follows, somewhat bizarrely, that the interest passing to the estate of the grantor is "to be treated as" a gift to the remainder beneficiaries.

IS THE IRS' POSITION LOGICAL?

No, the IRS' position, as stated above, is not logical; although, following a convoluted line of reasoning, the IRS insists that it is mandated by the statute. Fortunately, the Tax Court, in *Walton*[3], had the good sense to disagree with this position, despite the fact that the IRS position is contained in the regulations (the infamous Ex. 5). *Walton*[4] declared the regulations invalid on this point.

WHAT IS THE VALUE OF THE GIFT TO THE REMAINDER BENEFICIARIES IF THE IRS IS RIGHT, AND WHAT IS THE VALUE IF THE TAX COURT IS RIGHT?

Simply put, under the example given, if the IRS is correct, there is a taxable gift of $1 million, due to the age of the grantor. If the Tax Court is right, the grantor's age is irrelevant, and the gift is zero, or close to it.

What the beneficiaries actually receive at the end of the term is the same, however, whether the Tax Court is right, or whether the IRS is right. The only difference is that if the IRS is right, the grantor's contingent remainder, where annuity payments are made to the grantor's estate instead of to the grantor, is treated (oddly enough) as a gift to the remainder beneficiaries.

WHAT IS A QUICK EXAMPLE OF WHAT THE REMAINDER BENEFICIARIES GET UNDER THE FACTS JUST RECITED?

It bears emphasizing that whether the IRS is right or the Tax Court is right, what the beneficiaries get is the same.

Under the example given, if the GRAT grew each year at precisely the **3%** §7520 rate used in the assumptions, there would be **no remainder** left at the end of the term.

If it grew at **5%,** the remainder would be **$1,543,814**.

At **10%**, the remainder jumps to **$7,253,895**.

At **14%**, the remainder jumps to a whopping **$14,402,997**!

Again (and at the risk of being overly redundant), these figures are the same whether the IRS is right or not. The only difference is that the gift is close to zero if the Tax Court is right, and is $1 million if the IRS is right.

CAN A PERSON MAKE A MULTI-MILLION DOLLAR GIFT WITHOUT PAYING GIFT TAX?

If the Tax Court is right, the above examples clearly demonstrates how a taxpayer can make a multi-million dollar gift without paying any gift tax. No, it is not a sure thing. What has to happen is that the return rate on the GRAT must exceed the §7520 rate. But that is all that is required -that, and a large transfer to the GRAT, all or a portion of which will be returned to the grantor over time in the form of an annuity, whose value is determined based upon an assumed rate of return equal to the §7520 rate.

ARE THERE TAX SAVINGS TO BE HAD, EVEN IF *WALTON* DOES NOT APPLY?

In the example given, a 3% rate of return results in no tax savings under a GRAT; and, in fact, costs the taxpayer money for which no benefit is obtained, if *Walton* does not apply (i.e., if the IRS is right). If *Walton* does apply (i.e., if the Tax Court is right), the remainder beneficiaries still get nothing, but the gift tax is nominal, and so all that is lost are the transaction costs.

One can argue that even if the IRS is right, a 5% return rate would result in a $250,000 transfer tax savings, that a 10% return rate results in a savings of $3.1 million, and that a 14% return rates saves $6.6 million in estate taxes. Whether the numbers given as representing tax savings are real or not depends on how you analyze the economics: whether the time-value of money is ignored or not, whether the tax is within the available applicable exclusion, etc.; but in any case, unless and until you are able to substantially outperform the §7520 rate, the savings, if any, are not striking. After the §7520 rate is exceeded, the savings can become dramatic, as the foregoing illustrates. The savings are obviously increased if *Walton* applies, because, for one thing, there is no up-front $1 million taxable gift.

HOW DOES A GRAT COMPARE WITH AN OUTRIGHT GIFT?

If a GRAT grew at precisely the §7520 rate, and *Walton* is good law, and the grantor outlives the term, the result of an outright gift of the gift tax value of the remainder ought to produce just about the same result as a GRAT, except for the virtually never noticed fact that the §7520 rate does not take income taxes into account, and an outright gift growing at the §7520 rate would grow tax free in a GRAT, in effect (i.e., as far as the remainder beneficiaries were concerned), but an outright gift would not.

Further, there is considerable downside risk in a GRAT. First, the GRAT may under-perform the §7520 rate. This could be a disaster if §25.2702-3(e), Ex. 5 is good law. However, if *Walton* is right, and Ex. 5 is invalid, then by reducing the value of the gift to close to zero, there is little to lose if the trust under-performs the §7520 growth rate, and everything to gain if it outperforms it.

Second, if the grantor fails to survive the term, the property is includible in the grantor's estate, and the beneficiaries achieve little or nothing. So, if there are limited assets to work with, the outright gift provides certainty, and the GRAT provides uncertainty, with little downside, and unlimited upside. The risk of a premature death can be offset by term insurance, by the way.

Most importantly, and as amply illustrated below, if a GRAT outperforms the §7520 rate, there is a multiplier effect, which makes it far superior to any outright gift.

WHAT ARE SOME EXAMPLES OF HOW AN OUTRIGHT GIFT MIGHT COMPARE TO A GRAT?

To see whether a GRAT makes sense, as well as to understand the dynamics involved, it may be useful to compare what would happen if the grantor simply made an outright gift of the $1,028,064 on which the grantor of the GRAT would be taxed under the IRS theory, pre-*Walton*. The results may surprise you.

An outright gift of $1,028,064 (the gift tax value of a 10-year, $10 million pre-*Walton* GRAT, established by a 65 year old), would produce $1,341,306, if it grew (tax free) at 3% for 10-years. That is distinctly better than a GRAT, which would produce nothing at the end of the term under these assumptions, and which, pre-*Walton*, would be treated as a $1 million gift to boot. On the other hand, if the Tax Court is right, the gift, if any, would be nominal. However, the amount passing to the remainder beneficiaries, would be the same (i.e, nothing), no matter who is right.

At 5%, the pot of money remaining in the case of an outright gift at the end of 10-years would be $1,594,765, which is not too far off what a GRAT would produce as well.

At a 10% rate of return, however, an outright gift of $1,028,064 would produce **$2,423,970** at the end of 10-years, **but the ending principal in a $10 million GRAT** (on which $1,028,064 was treated as a taxable gift) **would be $7,253,895!**

At a 14% rate of return, an outright gift of $1,028,064 would produce $3.3 million at the end of 10-years, but there would be **$14,402,997** in the GRAT!

So at the higher rates of return, even a pre-*Walton* GRAT is looking pretty good, and results in much more wealth being shifted transfer tax free than an outright gift.

WHAT SIZE OUTRIGHT GIFT WOULD PRODUCE A $7,253,895 AT THE END OF 10-YEARS, AT A 10% GROWTH RATE?

According to my calculations, if you made an outright gift of **$2,796,690**, and the donee was able to achieve a 10% (after-tax!) rate of return, the donee would have **$7,253,895**[5] at the end of the term. Under a GRAT, this same result would be achieved by making an adjusted taxable gift of **$1,028,064** under the IRS theory, **or zero**, under the Tax Court's position. This is pretty dramatic, when you think about it, and might make you wonder just how and why a GRAT will outperform an outright gift to such a astonishing extent under these rates of return.

WHY DOES THE MATH PRODUCE SUCH FAVORABLE RESULTS FOR A GRAT WHEN COMPARED TO AN OUTRIGHT GIFT, WHEN THE RETURN RATES SUBSTANTIALLY EXCEED THE §7520 RATE?

Why does the math work out so dramatically in favor of the GRAT, as compared to an outright gift, when the §7520 rate of return is substantially exceeded? The answer, I think, is that over the 10-year period in the examples, the grantor of the GRAT is continuing to draw down the annuity as if the principal were only growing at 3% per year; and since, in the examples, it is growing at 5%, 10%, or 14% per year, it is compounding geometrically at a rate greater than the §7520 rate assumed. The effects of this compounding are leveraged because the initial principal is $10 million, **not** $1,028,064[6] (!) as in the case of the outright gift. This makes a GRAT that outperforms the §7520 rate far superior to an outright gift (of the transfer tax value) even pre-*Walton*.

But it gets even better if *Walton* is good law, because the gift is not $1 million; it is zero, or close to it. So, one cannot even make a fair comparison between an outright gift equal to the transfer tax value of the remainder, because the transfer tax value of the remainder is zero, or close to it, making a post-*Walton* GRAT is something almost too good to be true.

WHAT ARE THE RESULTS OF A $10 MILLION 10-YEAR GRAT IF *WALTON* APPLIES, AND IF THE §7520 RATE IS 3%, AND IF THE GRANTOR SURVIVES THE 10-YEAR TERM?

As indicated above, the results improve dramatically, if *Walton*, discussed at length later, is good law, which it presumably is. In that case, using the assumptions stated in the question to the left, which are the same as under the previous example, except that this time the grantor's age is irrelevant, **the taxable gift is zero (instead of $1 million!)**.

All of the other gift tax savings stated in the previous examples are the same, except that this time, there is no (or virtually no) taxable gift, so that the downside potential for the GRAT is reduced to practically nothing and the upside remains the same, which is to say, the upside potential is unlimited but the downside potential is limited; and the limit is an extremely low figure at that.

In short, the amount of tax leveraging in a *Walton* GRAT is about as great as one can imagine.

By reducing the annuity from 11.72305% to 11.72000%, the taxable gift goes from zero to $2606. It is probably advisable to use an annuity rate that produces a small taxable gift, larger than zero, for reasons to be explained later.

WHY IS IT THAT THE VALUE OF THE REMAINDER UNDER A GRAT IS LESS IF THE INTEREST RATE ASSUMPTION IS LOWER?

Please permit me one extended digression in this and the next Q&A, which should perhaps be saved for the TECHNICAL Section of this memoranda, but which I want to discuss because the topic receives so little attention in the literature.

Here is a paradox of sorts: It is obviously true that the more the grantor receives, the less the value of the remainder. And yet, the lower the §7520 rate, the greater the value of the retained interest. Why is that?

The answer is that, since **the annuity rate is fixed** (i.e., it is not tied to the §7520 rate at all), the greater the current assumed rate of return, the less the value of the annuity, just like a 5% bond in a 10% market. Therefore, the greater the assumed rate of return, the greater the gift tax value of the remainder. **Although it is true that the more the grantor receives, the less the remainder beneficiaries receive, this is an altogether separate principle, unrelated to the rate of return.**

Think of it (subjunctively) this way: if the GRAT pays an annuity of 10% of the initial value, then ask yourself, **is your retained 10% interest worth more, or is it worth less, if current interest rates exceed 10%**? It is like the bond market. If the prevailing interest rate is 5% and you own a 10% bond, your 10% bond is worth more than if interest rates were 20%. Right?

To say the same thing conversely, if the prevailing interest rate is 20% (remember Jimmy Carter?) and you are getting 10% for your "investment" -your investment being the equivalent of the value of your retained interest in the GRAT-, your "investment" is worth less than if interest rates were lower than 10%. If the retained interest is worth less, the gift (i.e., the value of the remainder interest) is worth more.

Again, conversely, if the retained interest is worth more, the gift (i.e., the value of the remainder interest) is worth less. Thus, **if interest rates are low, a 10% (or any other percent) retained annuity is worth more than it would be if interest rates were higher.**

Accordingly, the lower the §7520 rate, the less size of the taxable gift, and that is what is desired in a GRAT.

WHY IS IT THAT THE VALUE OF THE REMAINDER UNDER A QPRT (HOUSE GRIT) IS LESS IF THE INTEREST RATE ASSUMPTION IS HIGHER?

A qualified personal residence trust (QPRT) or "House GRIT" produces a better gift tax result if the §7520 rate is higher, the opposite of a GRAT. Why?

In a GRAT, the interest rate is fixed, so the value of the annuity (the retained interest) is inversely related to the §7520 rate: i.e., the higher the §7520 rate relative to the annuity, the less valuable the retained interest and the more valuable the gift. A QPRT (or any GRIT for that matter) is also inversely related, but in reverse: **you have retained the income interest (in effect), and if the income interest is high, what you have retained is worth more** than if the prevailing interest rate is low.

Think of the theoretical rate of return being on an investment (in this case, it could be the rental value of your house). If interest rates are low, the return is low, and so is the value of what you retained. Like a GRAT, but in reverse, the value of the gift (the remainder interest) is inversely proportional to the value of the retained interest. So, the more valuable the retained interest (which is more valuable the higher the assumed rate of return or §7520 rate), the less the taxable value of the gift.

In point of fact, the kids get the house at the end of the term no matter what the §7520 rate was at the time the QPRT was established, and the parent(s) got to live in the house during the term with no obvious difference in the value of living there to them; so the whole economic analysis of true value is almost entirely theoretical. The real world value of living in the house is actually quite independent of the prevailing interest rates, unless selling, renting, or mortgaging the house and investing the proceeds is a real option. Therefore, all one really needs to know is that the higher the §7520 rate the lower the value of the remainder interest in a QPRT, which likewise means that the higher the §7520 rate the less size of the taxable gift.

WHY IS A GRIT MORE EFFECTIVE IF THE ACTUAL RATE OF RETURN IS LOW?

In a QPRT, the actual rate of return is zero -or maybe the rental value of the home, depending how you look at it. If interest rates are high, the value of a retained income interest is high, and the value of the remainder is commensurately lower. If the GRIT is investing in assets that produce growth at the expense of fiduciary accounting income, and if all that has been retained is the right to fiduciary accounting income, then, in effect, value is being shifted from the life tenant/grantor to the remainder beneficiaries. That is why GRITs were so popular, prior to the advent of Chapter 14, which effectively stopped this technique among applicable family members and except in the case of a QPRT. However, as will be mentioned again later (because it is worth repeating) GRITs are unaffected by Chapter 14 if all of the remainder beneficiaries are outside the class of applicable family members. "Significant others" come readily to mind as potential beneficiaries, as well as nephews, nieces and cousins.

HOW DO INCOME TAXES FIGURE INTO THE ECONOMIC ANALYSIS?

In making economic comparisons of different transfer tax strategies, it is often overlooked that the theoretical rates of return used for transfer tax purposes fail to take income taxes into account. It is as if it were assumed that the rate of return would be tax-free, and it seldom is. In a sense, this failure to account for income taxes in the assumed rates of return overstates the value of the expected rate of return. This error is multiplied if the assumed rate is treated as compounding over time, overstating the probable future value of an outright gift.

A GRAT, on the other hand, will be taxed to the grantor, to the extent that distributions are made to the grantor during the term, and perhaps even if not distributed, to the extent that the grantor is taxed under the grantor trust rules and not reimbursed for it. (On this point, there is an extended discussion later in the TECHNICAL Section.) Very dramatic examples can be given about the long term transfer tax savings of having the grantor pay the tax attributable to assets in a grantor trust (which makes the trust grow like an IRA); however, that discussion should perhaps be deferred, and placed in a memoranda devoted to that subject alone.

For now, suffice it to say that for purposes of determining value, it is assumed that the trust is growing at the §7520 rate. But that fails to account for the effect of income taxes, which could cut down what the trust is really earning by, say, one-third. The grantor's annuity is fixed, however, and the grantor is treated as having received the full amount, without reduction for taxes. Since the grantor is taxed on the distribution, this enhances the value to the remainder beneficiaries.

Ironically, this perhaps overstates the value of the retained interest (e.g., the grantor may really only be getting, say, 66% of the fixed annuity, after tax, but is getting credited with 100%). If true, it would seem to follow that the value to the remainder beneficiaries is understated commensurately for transfer tax purposes (which is a good thing), particularly if the taxes are paid by the grantor outside the trust. The paradox is that this is probably true even though, as stated above, the lower the §7520 rate, the greater the value of the retained interest. That is because even though the §7520 rate may be overstating the rate of return, the less the grantor receives, the more the remainder receives, which is why I made the point earlier about the fact that the assumed rate of interest and the actual rate of distribution are two separate arithmetical concepts, which should not be confused in making a financial analysis of the economics of the arrangement.

I mention all this in passing, since I think it is worth considering, but have elected to eschew for now giving it the full technical treatment that it deserves.

WHAT IS THE INTEREST RATE USED FOR GRAT TAX CALCULATIONS; i.e., WHAT IS THE §7520 RATE?

The interest rate used to compute the amount of a taxable gift to a GRAT is called the IRC7 §7520 rate, and it is 120% of the federal mid-term rate in effect at the time of the gift. This is computed-

> by using an interest rate (rounded to the nearest 2/10ths of 1 percent) equal to 120 percent of the Federal midterm rate in effect under section 1274(d)(1) for the month in which the valuation date falls.[8]

Note that the lower the federal mid-term rate, the smaller the gift.

Interestingly, if a *charitable deduction* is involved, §7520 gives the taxpayer a break:

> If an income, estate, or gift tax **charitable contribution** is allowable for any part of the property transferred, the taxpayer may elect to use such Federal midterm rate for either of the 2 months proceeding the month in which the valuation date falls for purposes of paragraph (2).[9] [Emphasis added.]

This 2-month period to choose the §7520 rate does **not** apply to a GRAT. I point this out, because some have confused the rules (including me, only briefly, thank goodness).

WHY IS A GRAT AN ATTRACTIVE ESTATE PLANNING TECHNIQUE?

A GRAT is an attractive estate planning technique for a number of reasons. The main reason is that although a GRAT is a gift, and is theoretically subject to gift tax, the gift is measured by the present value of the remainder interest.

If the remainder interest in a 10-year GRAT was expected to be $10 million, given current interest rate assumptions, the gift would not be $10 million; instead it would be the amount of money that would produce $10 million if invested (tax-free!) at the assumed interest rate. If the assumed rate of return was 3% (the §7520 rate in July of 2003), $7.4 million would produce $10 million at the end of 10-years, and therefore, so would an up-front gift of that amount; except that, interestingly, an up-front gift would not grow tax free. This is an often overlooked point worth considering.

With a GRAT, we can gamble that the rate of return will exceed the §7520 rate. If it does, we win, and can potentially win big. If the rate of return does not exceed the §7520 rate, we lose the gift tax on the value of the remainder. But if we make the annuity rate high enough, and rely on the *Walton*[10] case, the gift tax on the remainder will be negligible, meaning that if we lose, we lose little.

WHY IS IT IMPORTANT FOR GIFT TAX PURPOSES, THAT A RETAINED INTEREST BE A "QUALIFIED INTEREST"?

If a grantor transfers property in trust for the benefit of a "member of the family", and the grantor or "applicable family member", retains an interest in the trust, IRC §2702 provides that unless the interest is a "qualified interest," the grantor will be treated as having made a gift of the entire trust at the time of the transfer. In other words, unless the interest retained by the grantor is a "qualified interest," the government will ignore the value of the grantor's retained interest, treating the interest retained as worth zero, so that the gift made is the total value of the property transferred to the trust, rather than the value of the remainder (which was all that was actually transferred). The value of the remainder is obviously less than the value of the remainder plus the retained life estate.

WHAT IS THE "SUBTRACTION METHOD" FOR VALUING A GIFT?

The valuation method described immediately above is sometimes called the "subtraction method" because, if a beneficiary of a trust is a member of the family, §2702 treats the gift as being equal to the entire value of the transfer in trust, minus the value of any qualified retained interests. If a retained interest is not a "qualified interest," then there is nothing to subtract, which is usually not good.

The so-called "subtraction method" is derived from §2702(a)(1)&(2), which provide:

(a) Valuation rules.

(1) In general. Solely for purposes of determining whether a transfer of an interest in trust to (or for the benefit of) a member of the transferor's family is a gift (and the value of such transfer), the value of any interest in such trust retained by the transferor or any applicable family member (as defined in section 2701(e)(2)) shall be determined as provided in paragraph (2).

(2) Valuation of retained interests.

(A) In general. The value of any retained interest which is not a qualified interest shall be treated as being zero.

(B) Valuation qualified interest. The value of any retained interest which is a qualified interest shall be determined under section 7520.[11]

WHAT IS A GRIT AND HOW IS IT DIFFERENT FROM A GRAT?

A GRIT is a Grantor Retained Income Trust. Unlike a GRAT, the grantor does not retain a fixed annuity; but, rather, retains only the income from the trust, which could be very low, if the trust is invested in growth stocks or undeveloped real estate, for example. Another example of a GRIT, one of the few that is actually sanctioned by statute, is the Qualified Personal Residence Trust (QPRT), under which the grantor transfers the home, usually to the children, retaining a life estate in the home (the right to live there) for a term of years. This is an example of the principle that low income producing assets make the best GRITs, whereas the opposite is true of a GRAT.

GRITs were very popular for a while; so popular, in fact, that Congress responded by enacting the very complicated Chapter 14 of the IRC, 2701-2704. It is IRC §2702 that forces us to use a GRAT or some other form of "qualified interest" instead of a GRIT, where the remainder beneficiary is a member of the family (except in the case of a QPRT or "House GRIT").

Tax planning attorneys were able to manipulate the system by investing the GRIT in low dividend high growth stocks, or even in undeveloped real estate, which produced little "income" but nevertheless appreciated in value. Sometimes the appreciation in value was due to the fact that little "income" was produced. This is certainly the way growth stocks often work. Obviously this technique favored the remainder beneficiaries over the life beneficiary, which was just fine, since the life beneficiary's objective was to inflate the value of the retained income interest for gift tax purposes.

HOW IS A GRIT TAXED FOR TRANSFER TAX PURPOSES IF A BENEFICIARY IS A MEMBER OF THE FAMILY ?

Because the grantor's retained income interest under a GRIT is not a "qualified interest," it will be taxed for transfer tax purposes as if the grantor had retained nothing, if any beneficiary of the trust is a "member of the family."

WHO IS AN APPLICABLE FAMILY MEMBER?

An "applicable family member" is a person who is either (a) the transferor's spouse, (b) an ancestor of the transferor or the transferor's spouse, or (c) the spouse of any such ancestor.[12]

WHO IS A MEMBER OF THE FAMILY?

A "member of the family" means the individual's spouse, any ancester or lineal decendant of the individual or the individual's spouse, any brother or sister of the individual, and any spouse of the foregoing.

WHAT IF NONE OF THE BENEFICIARIES OF THE GRIT IS A MEMBER OF THE FAMILY?

If no member of the family is a beneficiary, then a gift under a GRIT is determined by measuring the value of the remainder using the current interest assumptions found in §7520. **A GRIT, therefore, is still a useful technique to consider if the beneficiary is not a member of the family; for example, if the beneficiary is a "significant other" to whom the grantor is not married, or a nephew, niece or cousin.**

WHAT EXACTLY IS A GRAT?

A GRAT is basically a trust into which the grantor transfers property, retaining "the right to receive fixed amounts payable not less frequently than annually"[13] (a/k/a a "qualified annuity interest") for a term of years. After the expiration of the term, the annuity ends, and what is left is used for the benefit of family members.

A qualified annuity interest is a species of qualified retained interest; thus, if a GRAT is used, the value of the gift to the remainder beneficiaries can be determined by subtracting the value of the annuity retained by the grantor from the value of the property transferred to the trust.

WHAT IS A QUALIFIED ANNUITY INTEREST?

Technically, term "qualified annuity interest" is one that meets all of the requirements specified in Treas. Reg. §25.2702-3(b) and (d). These requirements are too numerous to mention or to discuss in detail here (although they are quoted, almost verbatim, in the TECHNICAL Section of this memo). In general, however, the annuity must be a fixed amount payable no less frequently than annually.

WHY DID CONGRESS REQUIRE THE ANNUITY TO BE A FIXED RATE?

The requirement that the annuity be fixed was intended to discourage grantors from using low income assets (as was common in GRITs) to artificially inflate the true value of the remainder, in contrast to the computed value of the remainder, which then, as now, was determined by applying an assumed interest rate tied to federal rates that are redetermined monthly.

WHAT HAPPENS IF THE GRANTOR DIES PRIOR TO THE EXPIRATION OF THE TERM INTEREST?

Probably the single greatest downside to creating a GRAT is that, if the grantor fails to survive the term, either all of the

GRAT corpus is includible in the estate of the grantor under IRC §2039,[14] or a portion of it is includible under §2036.

The IRS believes that both §§2036 and 2039 apply here.[15] Arguably, only §2036 applies. If true, then less than the entire corpus would be includible. The amount includible would presumably be computed under the principles annunciated in Rev Ruls. 76-273 and 82-105,[16] meaning that the portion of the value of the trust includible in the grantor's gross estate at death would be the amount necessary to generate the annuity amount per year, determined using the §7520 rate in effect at the date of the grantor's death.

It is also possible that §2038 would apply if a power of appointment were retained; and, of course, §2033 would apply to the portion of the GRAT payable to the grantor's estate.

IN LIGHT OF *WALTON*, WHAT SHOULD HAPPEN TO THE GRAT UPON THE SETTLOR'S DEATH?

Some GRAT forms provide that if the Settlor dies prior to the expiration of the term the amount includible in the Settlor's estate should be paid over to the Settlor's estate. This may be desirable, but not necessarily sufficient. In light of *Walton*, I suggest that the GRAT ought to at least provide that:

> If the Settlor dies prior to the expiration of the Term, payments of the annuity amounts shall continue to be paid to the Settlor's personal representative (executor/administrator) as a part of the Settlor's general probate estate.

Whether or not the document should additionally provide that such payments shall be increased or augmented as necessary to cover any estate taxes attributable to the payments is another matter.

DOES §2035 APPLY TO A 2-YEAR GRAT, IF THE GRANTOR SURVIVES THE 2-YEAR TERM, BUT DIES WITHIN 3-YEARS?

I am not positive about whether §2035 would operate to require a grantor to survive for another year after the termination of a two year GRAT, but at the moment this strikes me as a distinct possibility.

IRC §2035(a) provides:

> (a) Inclusion of certain property in gross estate. If-
>
> **(1) the decedent made a transfer (by trust** or otherwise) of an interest in any property, or relinquished a power with respect to any property, **during the 3-year period ending on the date of the decedent's death, <u>and</u>**
>
> (2) the value of **such property** (or an interest therein) **would have been included in the decedent's gross estate under section 2036**, 2037, 2038, or 2042 if such transferred interest or relinquished power had been retained by the decedent on the date of his death,
>
> **the value of the gross estate shall include the value of any property** (or interest therein) **which would have been so included.**[17] **[Emphasis added.]**

WHAT IS THE §2001(b)(2) ADJUSTMENT?

As indicated above, if the grantor dies within the term, all or a portion of the GRAT will be includible in the grantor's estate for estate tax purposes; however, in that case, the grantor's estate should be entitled to an IRC §2001(b)(2) adjustment - explained below-, reducing the grantor's adjusted taxable gifts.

> **(b) Computation of tax.** The tax imposed by this section shall be the amount equal to the excess (if any) of-
>
> (1) a tentative tax computed under subsection (c) on the sum of-
>
> (A) the amount of the taxable estate, and
>
> (B) **the amount of the adjusted taxable gifts**, over
>
> * * * *
>
> For purposes of paragraph (1)(B), the term "adjusted taxable gifts" means the total amount of the taxable gifts (within the meaning of section 2503) made by the decedent after December 31, 1976, **other than gifts which are includible in the gross estate of the decedent**. [18]

Adjusted taxable gifts are gifts that would otherwise be added to the taxable estate when determining the estate tax. The §2001(b)(2) adjustment ameliorates the effect of having the GRAT included in the estate, but the taxpayer is still out the time-value use of the money used to pay any gift tax, which tax was, in effect, paid early. Of course, if no gift tax was paid, because the value of the gift *and all future gifts remain* within the grantor's lifetime applicable exclusion amount, then there is, obviously, no loss of the time-value use of the money.

WHO CAN BE THE TRUSTEE OF A GRAT DURING ITS INITIAL TERM?

There is no rule, specifically applicable to GRATs alone, that would restrict who can be the trustee of a GRAT. For example, there is no prohibition against the grantor serving as trustee. If the GRAT consists of voting stock in a closely held business, however, care is called for.

IRC §2036(b)(1)&(2) provide:

> **(1) In general.** For purposes of subsection (a)(1), the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be considered to be a retention of the enjoyment of transferred property.
>
> **(2) Controlled corporation.** For purposes of paragraph (1), a corporation shall be treated as a controlled corporation if, at any time after the transfer of the property **and during the 3-year period ending on the date of the decedent's death**, the decedent owned (with the application of section 318), or had the right (either alone or in conjunction with any person) to vote, stock possessing at least 20 percent of the total combined voting power of all classes of stock.19 [Emphasis added.]

What this means is that if the GRAT holds stock in a "controlled corporation," the grantor may have to survive not only the term, but three years after the term, in order to avoid inclusion under §2036.[20]

WHO CAN BE THE TRUSTEE OF A GRAT AFTER THE INITIAL TERM?

Whether or not the grantor should serve as trustee after the expiration of the term interest, depends on whether the grantor's powers are sufficiently limited to avoid including the trust property in the grantor's estate under §2036. Presumably, an ascertainable standard would suffice (according to sparse case law); but, unlike §2041, there are no explicit regulations under §2036 that can be relied upon.

CAN THE ANNUITY IN A GRAT INCREASE EACH YEAR?

Treas. Reg. §25.2702-3(b)(1)(ii) states that it is permissible for the annuity amount to increase by up to 120% per year.

> **(ii) Fixed amount.** A fixed amount means-
>
> **(A)** A stated dollar amount payable periodically, but not less frequently than annually, but only to the extent the amount does not exceed 120 percent of the stated dollar amount payable in the preceding year; or
>
> **(B)** A fixed fraction or percentage of the initial fair market value of the property transferred to the trust, as finally determined for federal tax purposes, payable periodically but not less frequently than annually, but only to the extent the fraction or percentage does not exceed 120 percent of the fixed fraction or percentage payable in the preceding year.[21]

This may be useful, especially in the case of a heavily discounted closely held corporation where it is expected that income might initially exceed the annuity payments, because the build up can serve as leverage. In any case, if the GRAT outperforms the §7520 rate, as hoped, the extra amount left in the trust is not only outperforming the §7520 rate but it is earning additional dollars for the remainder beneficiaries at the higher rate while doing so.

CAN THE ANNUITY IN A GRAT DECREASE EACH YEAR?

Treas. Reg. §25.2702-3(e), Ex. (3) clearly allows the annuity to decrease without apparent limit:

> **Example (3).** S transfers property to an irrevocable trust, retaining the right to receive $50,000 in each of years 1 through 3 and $10,000 in each of years 4 through 10. S's entire retained interest is a qualified annuity interest.[22]

It may be the decreases must be made in two year increments, at a minimum, on the theory that what you have is a series of annuities, and that an annuity must be for more than one year. However, this is unclear, since increasing the annuity each year, within the 120% ceiling, does not pose a problem.

A decreasing annuity might result in less of an estate tax inclusion if the grantor dies during the term and if the taxpayer is successful in arguing that inclusion is limited to §2036(a)(1)[23] rather than §2039, which unfortunately is a position with which the Service is unlikely to agree.[24]

WHAT IS THE INFAMOUS EXAMPLE 5?

Treas. Reg. §25.2702-3(e), Ex. (5) states:

> **Example (5)**. A transfers property to an irrevocable trust, retaining the right to receive 5 percent of the net fair market value of the trust property, valued annually, for 10 years. If A dies within the 10-year term, the unitrust[25] amount is to be paid to A's estate for the balance of the term. A's interest is a qualified unitrust interest to the extent of the right to receive the unitrust payment for 10 years or until A's prior death.[26]

The last five words of that example "or until A's prior death" were construed by the Service (IRS) to mean that in valuing the qualified interest retained (the value of which is subtracted from the entire transfer in trust in order to obtain the amount of the gift for gift tax purposes), the possibility that A might die would have to be factored in as an unqualified interest. This meant that the value of A's retained interest (under the subtraction method) would be reduced by the actuarial likelihood of A's dying during the term. For an older person, this possibility could substantially decrease the value of the retained interest, thus substantially and commensurately increasing the value of the gift of the remainder. This is the position that the IRS took, and lost, in the celebrated *Walton*[27] case, in which the full Tax Court (theoretically as many as 19-members) unanimously held Example 5, as interpreted by the IRS, to be invalid.

IF EXAMPLE 5 IS GOOD LAW, CAN THE GIFT EVER BE REDUCED TO ZERO?

If Example 5 is good law, the gift of the remainder interest will always have at least some value, because there will always be the possibility that the grantor will not survive the term, and this possibility, according to Ex. 5, has a value that cannot be subtracted from the gift to the trust in arriving at the value for gift tax purposes. Thus, the gift can never be zero. In fact, PLR 9444033 and Rul. 77-454, 1977-2 C.B. 351 suggest that even if Ex. 5 is not good law, some minimal actuarial value (close to zero, but not zero or less) may be necessary to assure that the GRAT is still good. This is the basis for the "exhaustion test" discussed later.

WHAT WERE THE FACTS IN THE WALTON CASE?

The facts as stated in the *Walton* opinion were, in the words of the Court, as follows:

> Prior to April 7, 1993, petitioner was the sole owner of, and held in her name, 7,223,478 shares of common stock of Wal-Mart Stores, Inc., a publicly traded entity. Then, on April 7, 1993, petitioner established two substantially identical GRAT's, each of which had a term of 2 years and was funded by a transfer of 3,611,739 shares of the above Wal-Mart stock. The fair market value of the Wal-Mart stock on that date was $27.6875 per share, and the consequent initial fair market value of each trust was $100,000,023.56.
>
> According to the provisions of each GRAT, petitioner was to receive an annuity amount equal to 49.35 percent of the initial trust value for the first 12-month period of the trust term and 59.22 percent of such initial value for the second 12-month period of the trust term. In the event that petitioner's death intervened, the annuity amounts were to be paid to her estate. The sums were payable on December 31 of each taxable year but could be paid up through the date by which the Federal income tax return for the trust was required to be filed. The payments were to be made from income and, to the extent income was not sufficient, from principal. Any excess income was to be added to principal.

Upon completion of the 2-year trust term, the remaining balance was to be distributed to the designated remainder beneficiary. Petitioner's daughter Ann *Walton* Kroenke was the beneficiary so named under one trust instrument; petitioner's daughter Nancy *Walton* Laurie was named in the other.

* * * *

The assets of each GRAT **were exhausted upon the final payment of stock in June of 1995, as all income and principal had been distributed to petitioner pursuant to the scheduled annuity payments. Since the aggregate amount of annuity payments called for by each trust instrument was $108,570,025.58 (49.35 percent x $100,000,023.56 + 59.22 percent x $100,000,023.56), each GRAT resulted in a $14,465,475.01 shortfall in annuity payments to the grantor and left no property to be delivered to the remainder beneficiary. . . .**

Petitioner now concedes on brief that the gift occasioned by each GRAT should be valued at $6,195.10, while respondent asserts that the taxable value of each gift by petitioner is $3,821,522.12.[28]

So, the grantor owed either (a) $3.8 million , or (b) $6000 (times 2) and change, depending on whether or not Ex. 5 was good law. This is a significantly different outcome, one which amply illustrates the importance of the decision. Since the beneficiaries got nothing, by virtue of the fact that the stock depreciated over the two year period, resulting in a $30 million shortfall in the annuity payments, it was a rather good outcome. Paying almost $4 million in gift tax where the beneficiaries received nothing would certainly have been a high price to pay. GRATs are a gamble in any case, but the odds improve considerably if the cost of losing is $6000 instead of $3.8 million!

WHAT WAS THE ISSUE IN THE WALTON CASE?

Again, using the words of the Court:

[A]ccording to respondent, only the value of an annuity payable for the shorter of 2 years or the period ending upon petitioner's death may be subtracted from the fair market value of the stock in calculating the value of the taxable gift made by reason of petitioner's establishment of the GRATs. Respondent concludes that the present value of the retained qualified interest in each GRAT was $96,178,501.88 and the taxable gift $3,821,522.12 (consisting of the estate's contingent interest of $2,938,000.00 and the remainder interest of $883,522.12).

Conversely, petitioner maintains that for valuation purposes under section 2702, each GRAT is properly characterized as creating only two separate interests: (1) A retained annuity payable for a fixed term of 2 years, and (2) a remainder interest in favor of her daughter. Petitioner further asserts that the former, in its entirety, is a qualified interest within the meaning of the statute. Accordingly, it is petitioner's position that the retained interest to be subtracted in computing the amount of the taxable gift occasioned by each GRAT is to be valued as a simple 2-year term annuity, without regard to any mortality factor. Using this method, petitioner calculates the retained annuity as having a value of $99,993,828.90, such that each GRAT effected a gift of $6,195.10.

To the extent that Example 5 would appear to suggest otherwise, petitioner avers that the example is an invalid and unreasonable interpretation of section 2702. Petitioner argues that the example is unsupported by statutory language or legislative history and is inconsistent with other regulations and examples, especially section 25.2702-3(d)(3), Gift Tax Regs. In the alternative, petitioner claims that even if Example 5 is a permissible interpretation of the statute on substantive grounds, it is procedurally invalid as issued in violation of the notice and comment provisions of the Administrative Procedures Act, 5 U.S.C. sec. 553 (1994).[29]

WHAT WAS THE HOLDING OF THE WALTON CASE?

A unanimous decision of the full Tax Court (possibly as many as 19 judges) found Ex. 5[30] to be invalid.

[B]ecause petitioner could not as a matter of law give an interest in property to her estate, she by default retained all interests in the 2-year term annuities set forth in the trust documents. Such interests thus were, as required by the regulations, "held by the same individual both before and after the transfer in trust." Sec. 25.2702-2(a)(3), Gift Tax Regs.[31]

* * * *

[W]e decline respondents invitation to treat term annuities payable to a grantor or the grantor's estate as having two separate "holders" for purposes of the regulatory requirement of section 25.2702-3(b)(1)(i), Gift Tax Regs., that the annuity amount "be payable to (or for the benefit of) the holder of the annuity interest for each taxable year of the term."[32]

* * * *

We hold that Example 5 is an unreasonable interpretation and an invalid extension of section 2702 [fn2] ***. . . Accordingly, the qualified interest retained by petitioner in each GRAT here is an annuity payable for a specified term of 2 years.***[33]

WHAT IS THE EFFECT OF THE WALTON CASE ON THIS MEMO?

Because the case was unanimously decided by the full Tax Court, I am assuming that Walton will not be overturned by the courts. I could be wrong. As long as there is a risk that *Walton* will be reversed, you should run the numbers under both scenarios, in order to appreciate the size of the downside risks, and project them. However, because factoring mortality into the equation considerably complicates things, I have elected not to discuss, at least not in the "BASIC" section of this memo, the technical issues that it presents.

Sometimes, it is thought, the adverse effects of example 5 can be ameliorated by making the GRAT a joint GRAT with a spouse. This is a complicated issue that is not treated in the "BASIC" portion of the memo. It is also one in which the Service has reversed itself.[34] The issue is discussed at greater length in the section of this memo under the heading "TECHNICAL," if that portion is attached.

CAN A GRAT BE AMENDED?

The IRS position, as reflected in TAM 9717008,[35] is that it would violate public policy to allow a GRAT to be amended, even if only to satisfy the IRC and the regulations regarding GRATs. This probably does not mean that the inclusion of such a provision, even if ineffective according to the IRS, is necessarily a bad idea.

CAN A GRAT SATISFY THE ANNUITY WITH A PROMISSORY NOTE?

> Issuance of a note, other debt instrument, option, or other similar financial arrangement, directly or indirectly, in satisfaction of the annuity amount does not constitute payment of the annuity amount.[36]

However, there does not appear to be any prohibition against the GRAT borrowing money from an unrelated party to pay the annuity. Such third-party borrowing should not be an indirect borrowing from the grantor, which might be the case if the grantor guaranteed or secured the debt with his or her own assets.

IS IT PERMISSIBLE TO HAVE A GRAT WHERE THE ANNUITY EXCEEDS 50% OF THE INITIAL VALUE OF THE GRAT CORPUS, OR WHERE THE REMAINDER IS LESS THAN 10% OF THE INITIAL VALUE?

The IRS will not ordinarily issue a ruling on a GRAT where the annuity exceeds 50% of the initial fair market value of the GRAT corpus, or where the remainder is less than 10% of that value.[37] This is an indication that it may be impermissible to have such provisions in a GRAT, and it makes me wonder whether a two-year nonincreasing GRAT is possible, if the annuity in any year is designed to exceed 50% of the initial fair market value of the GRAT, as one would imagine it would. The same is true of a "zeroed out" GRAT.

One supposes that the Service's reasoning might be similar to its concerns expressed in Rev. Rul. 77-454,[38] that if the probability of exhaustion is so great that there is theoretically no gift of anything (other than the potential for appreciation in excess of the assumptions), then there is no gift of a remainder interest; and consequently, the interest retained is not a qualified interest. That form of reasoning is a stretch, admittedly, but does find support in Rev. Rul. 77-454, discussed below. However, just because an annuity will exceed 50% of the initial fair market value of the GRAT corpus does not mean that it will be exhausted, even if the corpus grows at no more than the §7520 rate.

Treas. Reg. §25.2702-3(b)(ii)(A) specifically defines a "fixed amount" as including "a stated dollar amount." However, because of the possibility of revaluation, it might be better to define the retained interest as a fixed percentage, so that one does not run afoul of the issue just discussed.

MIGHT THE RULING PROVISION JUST DISCUSSED BECOME THE BASIS FOR FUTURE LEGISLATION?

Allow me to speculate that the ruling position just described could easily be converted to a statutory amendment that would go a long way toward closing the door opened by *Walton*. You will recall that something similar happened to charitable remainder trusts, which now are required to reserve a remainder for the benefit of charity actuarially equal to at least 10% of the initial corpus, contrary to what was the law for a long time. Although it took a while, it finally became well know that under prior law a charitable remainder trust would qualify as tax exempt, even if all that charity was actuarially expected to get was $1. It was only then that Congress reacted. This could easily happen to the GRAT, though naturally I would be disappointed.

WILL A GRAT QUALIFY IF THE ACTUARIAL ASSUMPTIONS LEAD TO THE CONCLUSIONS THAT THE GRAT WILL BE EXHAUSTED?

PLR 9444033 interprets Rev. Rul. 77-454[39] as supporting the conclusion that-

> [W]here a fixed amount to be paid from a trust in the form of annuity to the grantor may exhaust the corpus of the trust prior to the maximum stipulated term of the annuity, the value of the retained annuity interest is no greater than the present value of the payments receivable until the exhaustion of the fund. Rev. Rul. 77-454, 1977-2 C.B. 351.[40]

What exactly this means is not clear to me, but it may mean that the value of the retained annuity cannot be greater than the amount transferred, or the GRAT will not qualify.

HOW IS A GRAT TAXED FOR INCOME TAX PURPOSES?

How a GRAT is taxed for income tax purposes may depend, in theory, on whether the GRAT is wholly (entirely) or partly a "grantor trust." Under the grantor trust rules, the grantor is taxed on the income of the trust, as if the trust did not exist. If the GRAT is a grantor trust as to ordinary income, then the grantor will be taxed on the ordinary income, whether it exceeds the annuity or not. In practice, the annuity will usually exceed the ordinary income. If an amount equal to all of the distributable net income (DNI) is distributed in cash each year, that income will be taxed to the grantor/annuitant whether the GRAT is a "grantor trust" or not.

If the GRAT is a "grantor trust" as to corpus, then the grantor will be taxed on the capital gains too.

It is important to know whether your GRAT is a grantor trust or not, and if so, whether it is a grantor trust as to income or as to income and corpus (i.e., capital gains and loss purposes). If you are unsure about the status of your GRAT as a grantor trust, ask your tax advisor for an opinion. The grantor trust issue is discussed at greater length in the section of this memo headed "TECHNICAL," if that section is attached.

IS A GRAT A GRANTOR TRUST?

If you read PLR 9449012 and the several others like it, discussed in the TECHNICAL Section, you would conclude that a GRAT is virtually always a grantor trust in its entirety, under §677(a), both as to income and corpus, so long as the annuity is paid out of income and if income is insufficient, out of corpus, which is almost always the case. Unfortunately, the subject is more complicated than the PLRs suggest, and they cannot be relied upon with impunity. It is probably safe to conclude, as did the IRS, that virtually all GRATs are grantor trusts in their entirety, but that conclusion is not without some doubt; and if this is a matter of utmost importance, you might want to ask your attorney to take extra measures to increase the odds that grantor trust treatment will be wholly achieved.

HOW ARE GRATS TAXED?

A GRAT is probably a "grantor trust" under Subpart E of Subchapter J[41] of the IRC, at least with respect to the income of the GRAT, and probably for all purposes, since corpus must be used if necessary to satisfy the fixed annuity payments. Thus, the trust will not pay income taxes on the income; instead, the grantor will, because a "grantor trust" is ignored for income tax purposes.[42] If the annuity exceeds the income, then it will not make any difference whether the trust is a grantor trust or not, since income is generally carried out and taxed to the distributee under normal trust income tax rules. However, if ordinary income exceeds the annuity payment, the grantor would owe taxes on it if the trust is a grantor trust.

CAN A GRAT REQUIRE THAT THE GRANTOR BE REIMBURSED FOR INCOME TAXES ATTRIBUTABLE TO THE ANNUITY?

The Service has ruled that an interest is a qualified interest despite a provision that permitted the grantor to be reimbursed for federal income taxes attributable to trust income in excess of that otherwise distributable.[43] As you might expect, such a clause will not decrease the gift tax value of the remainder.

MUST A GRAT REQUIRE THAT THE GRANTOR BE REIMBURSED FOR INCOME TAXES ATTRIBUTABLE TO THE ANNUITY?

There are informal indications that the Service will insist on a provision requiring the trust to reimburse the grantor for income taxes before it will issue a favorable private letter ruling. This position is reflected in the fact that most of the recent rulings have involved trusts that expressly contain just such a provision.[44]

IS THE FAILURE TO REIMBURSE THE GRANTOR FOR INCOME TAXES A GIFT TO THE TRUST?

Most tax practitioners believe that if the grantor trust rules compel the grantor of a grantor trust to pay income taxes on trust income, and the grantor does so, that the grantor has in no meaningful sense of the word made a "gift" in doing what the IRC compels the taxpayer to do. However, the Service, while not yet prepared to formally commit to the proposition, apparently believes that there may be an issue here. PLR 9444033 had the following paragraph, which may perhaps reflect the Service's position:

> Further, each proposed Trust agreement requires the trustee to distribute to the grantor, each year during the trust term, the amount necessary to reimburse the grantor for the income tax liability with respect to the income received by the trustee and not distributed to the grantor. Under this provision, a grantor will not make an additional gift to a remainderperson in situations in which a grantor is treated as the owner of a trust under sections 671 through 679, and the income of the trust exceeds the amount required to satisfy the annuity payable to the grantor. Ordinarily, if a grantor is treated as the owner of a trust under section 671 through 679, the grantor must include in computing his tax liability the items of income (including the income in excess of an annuity), deduction, and credit that are attributable to the trust. **If there were no reimbursement provision, an additional gift to a remainderperson would occur when the grantor paid tax of any income that would otherwise be payable from the corpus of the trust.** Accordingly, since there is a reimbursement provision, we rule that, if the income of either trust exceeds the annuity amount, the income tax paid by the grantor on trust income not paid to the grantor will not constitute an additional gift to the remainderpersons of the Trust.

However, the IRS partially retracted its position as reflected in 9444033 when it issued 9543049, which provided:

> [A]fter reconsidering the language addressing the gift tax consequences of the reimbursement clause in each trust, the Service has decided to delete the second full paragraph on page 6 of the ruling.

I believe that the second full paragraph on page 6 of the ruling is the one referred to in the immediately preceding quotation; however, the deletion was made only after an additional reiterative finding that there were reimbursement provisions in the instrument, and so the effect of this change is still unclear.

WHAT ARE THE ARGUMENTS THAT COULD BE MADE FOR DISQUALIFYING A GRAT BECAUSE IT HAS AN INCOME TAX REIMBURSEMENT CLAUSE, OR BECAUSE IT DOES NOT HAVE SUCH A CLAUSE?

The taxpayer is sort of in a damned if you do and damned if you don't position here. It could be argued that the extra payments to the grantor by the trust do not fall within the definition of "qualified payments," because it is not a "fixed amount."

True, the Service seems disinclined to raise this argument,[45] but it is there nevertheless. One could argue that the statute imposes limits on excess payments made by a GRAT to the settlor over the "fixed amount" called for by the statute; but, one presumes, since the extra payments are in derogation of the remainder interest, and thus disfavor the taxpayer, the government has understandably been very liberal in this area.

On the other hand, the failure to include such a clause (or to otherwise reimburse the grantor) has from time to time been considered by the IRS to be the equivalent of a gift to the trust.[46] If such failure to reimburse the trust were considered an additional gift, the GRAT could be disqualified under Treas. Reg. §25.2702-3(b)(5) which provides:

> **(5) Additional contributions prohibited.** The governing instrument must prohibit additional contributions to the trust.[47]

Now, if the governing instrument contains a clause prohibiting additional contributions, and if the failure to reimburse the grantor is an additional contribution, then the governing instrument already says all it needs to say to be qualified on its face; and, arguably, the trust terms would be sufficient to authorize, or perhaps compel, the trustee to make such reimbursement. With that thought in mind, it might be best to leave the instrument silent regarding the reimbursement issue, thus leaving all options open.

WHEN MUST THE ANNUITY BE PAID?

> **(4) Payment of the annuity amount in certain circumstances.** An annuity amount payable based on the anniversary date of the creation of the trust must be paid no later than 105 days after the anniversary date. An annuity amount payable based on the taxable year of the trust may be paid after the close of the taxable year, provided the payment is made no later than the date by which the trustee is required to file the Federal income tax return of the trust for the taxable year (without regard to extensions). If the trustee reports for the

> taxable year pursuant to §1.671-4(b) [Grantor Trust] of this chapter, the annuity payment must be made no later than the date by which the trustee would have been required to file the Federal income tax return of the trust for the taxable year (without regard to extensions) had the trustee reported pursuant to §1.671-4(a) of this chapter.[48]

WHY WAIT TO PAY THE ANNUITY?

Since the Service allows a deferral of 105 days or three and half months, depending on whether annual payments are on a calendar year or a fiscal year, why not take advantage of the delay? After all, it only means that more interest is potentially accruing for the benefit of the remainder beneficiaries in the interim. This seems to me to be one very good reason for making the payments no more frequently than annually.

CAN THE ANNUITY BE PAID AS OF THE ANNIVERSARY DATE OF THE CONTRIBUTION, RATHER THAN AS OF THE END OF TRUST'S TAXABLE YEAR?

The annuity amount may be paid on a date or dates based on the anniversary date of the trust's creation, rather than on the basis of the trust's taxable year.[49]

WHEN MUST AN ANNUITY BE PAID, IF THE ANNUITY IS PAYABLE MORE FREQUENTLY THAN ANNUALLY?

If the annuity is to be paid more frequently than annually, as is expressly allowed,[50] it is not clear to me whether a grace period is allowed.

WHAT HAPPENS IF THE IRS DISAGREES WITH THE INITIAL VALUE PLACED ON THE TRUST ASSETS?

> **(2) Incorrect valuations of trust property.** If the annuity is stated **in terms of a fraction or percentage** of the initial fair market value of the trust property, the governing instrument must contain provisions meeting the requirements of §1.664-2(a)(1)(iii) of this chapter (relating to adjustments for any incorrect determination of the fair market value of the property in the trust).[51] [Emphasis added.]

This is one reason why it is inadvisable to state the annuity in terms of a dollar amount. Interestingly, Treas. Reg. §1.664-2(a)(1)(iii), which is cross-referenced, does refer to a "stated dollar amount."

1.664-2(a)(1)(iii) provides, in part:

> If the stated dollar amount is so expressed and such market value is incorrectly determined by the fiduciary, the requirement of this subparagraph will be satisfied if the governing instrument provides that in such event the trust shall pay to the recipient (in the case of an undervaluation) or be repaid by the recipient (in the case of an overvaluation) an amount equal to the difference between the amount which the trust should have paid the recipient if the correct value were used and the amount which the trust actually paid the recipient. Such payments or repayments must be made within a reasonable period after the final determination of such value.

MUST PRORATION OF THE ANNUITY AMOUNT TAKE PLACE FOR THE FIRST SHORT TAXABLE YEAR OR IF THE LAST PAYMENT IS FOR A SHORT PERIOD?

Proration of the annuity amount is required for the first short taxable year, if there is one, or if the last payment is for a short period. The procedure is described in Treas. Reg. §25.2702-3(b)(3):

> **(3) Period for payment of annuity amount.** The annuity amount may be payable based on either the anniversary date of the creation of the trust or the taxable year of the trust. In either situation, **the annuity amount may be paid annually or more frequently, such as semi-annually, quarterly, or monthly**. If the payment is made based on the anniversary date, proration of the annuity amount is required only if the last period during which the annuity is payable to the grantor is a period of less than 12 months.
>
> If the payment is made based on the taxable year, proration of the annuity amount is required for each short taxable year of the trust during the grantor's term. The prorated amount is the annual annuity amount multiplied by a fraction, the numerator of which is the number of days in the short period and the denominator of which is 365 (366 if February 29 is a day included in the numerator).[52] [Emphasis added.]

MAY ADDITIONAL CONTRIBUTIONS BE MADE TO A GRAT?

> **(5) Additional contributions prohibited.** The governing instrument must prohibit additional contributions to the trust.[53]

WHAT IS A GRUT, AND WHY IS IT NOT POPULAR?

A GRUT is like a GRAT except that the annuity is revalued every year as a fixed percentage of the then present value of the trust. The reason it is not popular, and not discussed in this memo, is that the GRAT is more effective than a GRUT if the trust corpus appreciates. (If the trust does not appreciate, neither type of trust is effective.) If the trust appreciates, then under a GRUT, much of that appreciation is shifted back to the grantor, which is not exactly the point of the exercise. Thus, the remainder beneficiaries of the GRUT will almost always receive less than the remainderman of the GRAT, even if the value for transfer tax purposes is the same. If the estate planning point is to shift as much growth to the remainder beneficiaries without increasing the transfer tax, a GRAT is preferable to a GRUT.

I will not belabor this issue here.

WHAT ASSETS GIVE A GRAT THE MOST UPSIDE POTENTIAL?

Multiple short-term GRATs, consisting of volatile assets with little or no diversity, obviously make the most of the potential leveraging. The only arguments that the Service could raise is that the failure to diversify somehow is not permissible, and that multiple GRATs should be merged and averaged. The authority for this position is presently not convincing.

WHAT IS THE EFFECT OF THE GRANTOR'S HEALTH ON THE UTILITY OF A GRAT?

If the grantor dies during the GRAT term, the GRAT, or a portion of it, is included in the grantor's estate, meaning that the grantor loses the time-value of any gift tax paid, and otherwise derives little or no estate tax benefits from the technique. A healthy grantor has a greater likelihood of getting the most out of a GRAT, obviously, since the healthier the grantor, the more likely the grantor will outlive the term.

The likelihood of death within the term can be mitigated by using a short-term, followed by re-Gratting for another short-term. Two years is probably the shortest term allowable. Term life-insurance can also be employed to mitigate the risks.

IS A SALE TO AN INTENTIONALLY DEFECTIVE GRANTOR TRUST (AN IDGT)A VIABLE ALTERNATIVE TO A GRAT?

We have talked about grantor trusts above, and they are discussed at length in the TECHNICAL Section of this memo (if one is attached). Estate planners lately have been going to lengths to "intentionally" create trusts that are treated as grantor trusts. In the old days it would have been appropriate to label such a trust as defective, since at one time grantor trust treatment was to be avoided. Now that it is often desirable to have a trust taxed as a grantor trust -because of the lower rates, for one thing-, it is perhaps inappropriate to call such a trust "defective," but we do so any, but make it clear that we know what we are doing by calling it intentionally so.

As previously indicated, a GRAT is probably a grantor trust in its entirety, whether we want it to be so or not. (We usually want it to be so, however). As an alternative to a GRAT, many estate planners simply set up an "intentionally defective grantor trust" (an IDGT), and have it buy an asset (such as an interest in a heavily discounted closely held business) on an installment sale basis. Under the principles of Rev. Rul. 85-13,[54] the sale should not result in capital gains.

This is no different than a gift to a GRAT, but in an IDGT there is no rule that says that one must use 120% of the Federal Mid Term rate as the rate of interest on an installment note. The rate of interest must be reasonable, but most people think 100% (not 120%) of one of the IRC §1274 rates should be reasonable.[55] Furthermore, if the grantor dies during the term, only the remaining payments on the note should be includible in the estate. Finally, there is no additional mortality factor to contend with of the Ex. 5 variety. (Although I hate to mention it, it is coincidentally true that there is no 709 Gift Tax Return reported on the sale to an IDGT, and so, it is unlikely to attract a reexamination at death.)

Like Buridan's ass who, after being placed equidistant between two bales of hay, starved to death, I, for a long time, was torn between whether to use a GRAT or an IDGT in any given situation. I have finally listed toward the GRAT (avoiding starvation) for several reasons.

The first is that the GRAT is a technique specifically sanctioned by a statute (§2702), and I know what interest rate to use. Further, if I under-value the assets transferred to the GRAT, the regulations specifically allow (require) me to adjust the payout rate. Finally, *Walton* probably is effective to dispense with my worries about Ex. 5.

On the other hand, in an IDGT, I have to guess at what is a reasonable rate of interest; and, if I guess too low at the interest rate or at the value of the asset transferred, I run the risk of having made a gift with a retained interest. I also have to make sure that there is enough security in the IDGT (10% of the value of the asset sold?) to support the installment sale as a bona fide sale and not a gift.

It is important that there be no gift involved, because the interest retained is by definition not a "qualified interest" (since it is not a GRAT); and if it is not a qualified interest and it is a gift, then it is a gift of the entire interest, since the retained interest is valued at zero under the subtraction method mandated by §2702. Finally, the Service, on audit, has recently recharacterized a sale to an IDGT as a gift (treating the note to be equity I am told); this in a transaction that looks to me to be fairly conventional. The upshot of the audit is that a petition has been filed by the taxpayer to the Tax Court.[56] This is one to watch. So, on the whole, and for now, I favor the GRAT over the IDGT, but it is admittedly a close call.

WHAT SHOULD BE DONE WITH THE REMAINDER?

The GRAT could continue as an intentionally defective grantor trust following the term, so that the grantor could pay the income taxes on the trust, gift tax free. Or at least that would be the hope. It might even be possible for the grantor to continue to be a discretionary beneficiary if the trust were established in a jurisdiction where the grantor's creditors could not reach the assets. In most states, if the grantor is a potential beneficiary, the trust would be considered self-settled, and if self-settled, then reachable by creditors, and if reachable by creditors, it would presumably be included in the grantor's estate.

WHAT SHOULD BE THE TAXABLE YEAR OF THE TRUST?

Under IRC §644(a) the taxable year of a trust is required to be the calendar year. (It is somewhat uncertain whether that would apply to a wholly owned grantor trust.)

As indicated previously, annual annuity payments may be paid on the anniversary of the contribution, or the calendar year.

TECHNICAL

WHAT DOES RETAINED MEAN?

"Retained means held by the same individual both before and after the transfer in trust. In the case of the creation of a term interest, any interest in the property held by the transferor immediately after the transfer is treated as held both before and after the transfer."[57]

WHAT DOES INTEREST MEAN?

"An interest in trust includes a power with respect to a trust if the existence of the power would cause any portion of a transfer to be treated as an incomplete gift under chapter 12 [i.e., the gift tax]."[58] If the grantor retained an interest in the trust, that portion would not be a completed gift.

WHAT IS A QUALIFIED INTEREST UNDER THE STATUTE?

According to the regulations, the term "qualified interest means a qualified annuity interest, a qualified unitrust interest, or a qualified remainder interest."[59] The statute itself describes a "qualified interest" as follows:

> **(b) Qualified interest.** For purposes of this section, the term "qualified interest" means-
>
> > **(1)** any interest which consists of the right to receive fixed amounts payable not less frequently than annually,

(2) any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually), and

(3) any noncontingent remainder interest if all of the other interests in the trust consist of interests described in paragraph (1) or (2).[60]

WHAT IS A QUALIFIED ANNUITY INTEREST UNDER THE REGULATIONS?

Treas. Reg. §25.2702-3 should perhaps be added *in toto* as an appendix instead of putting only (b) and (d) here; but as (b) and (d) are to me the more relevant, I reproduce them in full below, for the curious. "Qualified annuity interest means an interest that meets all the requirements of §25.2702-3(b) and (d),"[61] which provide:

(b) Special rules for qualified annuity interests. An interest is a qualified annuity interest only if it meets the requirements of this paragraph and paragraph (d) of this section.

(1) Payment of annuity amount.

(i) In general. A qualified annuity interest is an irrevocable right to receive a fixed amount. The annuity amount must be payable to (or for the benefit of) the holder of the annuity interest at least annually. A right of withdrawal, whether or not cumulative, is not a qualified annuity interest. Issuance of a note, other debt instrument, option, or other similar financial arrangement, directly or indirectly, in satisfaction of the annuity amount does not constitute payment of the annuity amount.

(ii) Fixed amount. A fixed amount means-

(A) A stated dollar amount payable periodically, but not less frequently than annually, but only to the extent the amount does not exceed 120 percent of the stated dollar amount payable in the preceding year; or

(B) A fixed fraction or percentage of the initial fair market value of the property transferred to the trust, as finally determined for federal tax purposes, payable periodically but not less frequently than annually, but only to the extent the fraction or percentage does not exceed 120 percent of the fixed fraction or percentage payable in the preceding year.

(iii) Income in excess of the annuity amount. An annuity interest does not fail to be a qualified annuity interest merely because the trust permits income in excess of the amount required to pay the annuity amount to be paid to or for the benefit of the holder of the qualified annuity interest. Nevertheless, the right to receive the excess income is not a qualified interest and is not taken into account in valuing the qualified annuity interest.

(2) Incorrect valuations of trust property. If the annuity is stated in terms of a fraction or percentage of the initial fair market value of the trust property, the governing instrument must contain provisions meeting the requirements of § 1.664-2(a)(1)(iii) of this chapter (relating to adjustments for any incorrect determination of the fair market value of the property in the trust).

(3) Period for payment of annuity amount. The annuity amount may be payable based on either the anniversary date of the creation of the trust or the taxable year of the trust. In either situation, the annuity amount may be paid annually or more frequently, such as semi-annually, quarterly, or monthly. If the payment is made based on the anniversary date, proration of the annuity amount is required only if the last period during which the annuity is payable to the grantor is a period of less than 12 months. If the payment is made based on the taxable year, proration of the annuity amount is required for each short taxable year of the trust during the grantor's term. The prorated amount is the annual annuity amount multiplied by a fraction, the numerator of which is the number of days in the short period and the denominator of which is 365 (366 if February 29 is a day included in the numerator).

(4) Payment of the annuity amount in certain circumstances. An annuity amount payable based on the anniversary date of the creation of the trust must be paid no later than 105 days after the anniversary date. An annuity amount payable based on the taxable year of the trust may be paid after the close of the taxable year, provided the payment is made no later than the date by which the trustee is required to file the Federal income tax return of the trust for the taxable year (without regard to extensions). If the trustee reports for the taxable year pursuant to §1.671-4(b) of this chapter, the annuity payment must be made no later than the date by which the trustee would have been required to file the Federal income tax return of the trust for the taxable year (without regard to extensions) had the trustee reported pursuant to §1.671-4(a) of this chapter.

(5) Additional contributions prohibited. The governing instrument must prohibit additional contributions to the trust.[62]

* * * *

(d) Requirements applicable to qualified annuity interests and qualified unitrust interests.

(1) In general. To be a qualified annuity or unitrust interest, an interest must be a qualified annuity interest in every respect or a qualified unitrust interest in every respect. For example, if the interest consists of the right to receive each year a payment equal to the lesser of a fixed amount of the initial trust assets or a fixed percentage of the annual value of the trust assets, the interest is not a qualified interest. If, however, the interest consists of the right to receive each year a payment equal to the greater of a stated dollar amount or a fixed percentage of the initial trust assets or a fixed percentage of the annual value of the trust assets, the interest is a qualified interest that is valued at the greater of the two values. To be a qualified interest, the interest must meet the definition of and function exclusively as a qualified interest from the creation of the trust.

(2) Amounts payable to other persons. The governing instrument must prohibit distributions from the trust to or for the benefit of any person other than the holder of the qualified annuity or unitrust interest during the term of the qualified interest.

(3) Term of the annuity or unitrust interest. The governing instrument must fix the term of the annuity or unitrust interest. The term must be for the life of the term holder, for a specified term of years, or for the shorter (but not the longer) of those periods. Successive term interests for the benefit of the same individual are treated as the same term interest.

(4) Commutation. The governing instrument must prohibit commutation (prepayment) of the interest of the term holder.

(5) Use of debt obligations to satisfy the annuity or unitrust payment obligation.

(i) In general. In the case of a trust created on or after September 20, 1999, the trust instrument must prohibit the trustee from issuing a note, other debt instrument, option, or other similar financial arrangement in satisfaction of the annuity or unitrust payment obligation.

(ii) Special rule in the case of a trust created prior to September 20, 1999. In the case of a trust created prior to September 20, 1999, the interest will be treated as a qualified interest under section 2702(b) if-

(A) Notes, other debt instruments, options, or similar financial arrangements are not issued after September 20, 1999, to satisfy the annuity or unitrust payment obligation; and

(B) Any notes or any other debt instruments that were issued to satisfy the annual payment obligation on or prior to September 20, 1999, are paid in full by December 31, 1999, and any option or similar financial arrangement issued to satisfy the annual payment obligation is terminated by December 31, 1999, such that the grantor receives cash or other trust assets in satisfaction of the payment obligation. For purposes of the preceding sentence, an option will be considered terminated only if the grantor receives cash or other trust assets equal in value to the greater of the required annuity or unitrust payment plus interest computed under section 7520 of the Internal Revenue Code, or the fair market value of the option.[63]

HOW ARE RETAINED INTERESTS VALUED?

Under the "subtraction method," which the statute appears to require, the value of the gift of the remainder interest is the value of the entire gift to the trust, minus the value of the retained interest. Thus, it is important to know the value of the retained interest.

(b) Valuation of retained interests.

(1) In general. Except as provided in paragraphs (b)(2) and (c) of this section, the value of any interest retained by the transferor or an applicable family member is zero.

(2) Qualified interest. The value of a qualified annuity interest and a qualified remainder interest following a qualified annuity interest are determined under section 7520. The value of a qualified unitrust interest and a qualified remainder interest following a qualified unitrust interest are determined as if they were interests described in section 664.[64]

HOW IS THE VALUE OF THE REMAINDER INTEREST DETERMINED?

The value of the remainder and the value of the retained interest are complementary of each other, adding up to the value of the property transferred to the gift. However, because the Service interprets the statute as mandating the subtraction method, the remainder is valued by reference to the value of the retained interest, rather than the other way around.

The value of the retained interest (the annuity) must be subtracted from the gift to the trust in order to determine the value of the remainder for gift purposes. The value of the annuity (the retained interest) is determined under IRC §7520, which provides:

For purposes of this title, the value of any annuity, any interest for life or a term of years, or any remainder or reversionary interest shall be determined -

(1) under tables prescribed by the Secretary, and

(2) by using an interest rate (rounded to the nearest 2/10 this of 1 percent) equal to 120 percent of **the Federal midterm rate in effect under section 1274(d)(1)** for the month in which the valuation date falls.

If an income, estate, or gift tax charitable contribution is allowable for any part of the property transferred, the taxpayer may elect to use such Federal midterm rate for either of the 2 months preceding the month in which the valuation date falls for purposes of paragraph (2). In the case of transfers of more than 1 interest in the same property with respect to which the taxpayer may use the same rate under paragraph (2), the taxpayer shall use the same rate with respect to each such interest.[65] [Emphasis added.]

As previously noted, the lower the federal mid-term rate, the smaller the gift.

For how the value for gift tax purposes is actually determined, including taking the Dash 3 Ex. 5 mortality factor into account (which *Walton* says we can ignore) **see PLR 9253031**.

DO THE §2702 GRAT RULES APPLY TO A GRIT FOR A SPOUSE?

The rules under §2702 do not apply to a GRIT for a spouse, if the grantor retains no interest.

> **25.2702-2(d) Example (3).** D transfers property to an irrevocable trust under which the income is payable to D's spouse for life. Upon the death of D's spouse, the trust is to terminate and the trust corpus is to be paid to D's child. D retains no interest in the trust. Although the spouse is an applicable family member of D under section 2702, the spouse has not retained an interest in the trust because the spouse did not hold the interest both before and after the transfer. Section 2702 does not apply because neither the transferor nor an applicable family member has retained an interest in the trust. The result is the same whether or not D elects to treat the transfer as a transfer of qualified terminable interest property under section 2056(b)(7).[66]

This is not all that good a deal, however, because the grantor has made a gift of the entire property anyway. True, the gift to the spouse should qualify for the marital deduction under the lifetime QTIP rules of IRC §2523(f)(2); but, if so, the entire remainder interest, plus unconsumed distributions made during the spouse's lifetime, will be in the spouse's estate.

DOES §2702 APPLY TO A GIFT THAT IS WHOLLY INCOMPLETE FOR GIFT TAX PURPOSES?

§2702 does not apply to a gift that is wholly incomplete for gift tax purposes.

> **25.2702-2(d) Example (4).** A transfers property to an irrevocable trust, under which the income is to be paid to A for life. Upon termination of the trust, the trust corpus is to be distributed to A's child. A also retains certain powers over principal that cause the transfer to be wholly incomplete for federal gift tax purposes. Section 2702 does not apply because no portion of the transfer would be treated as a completed gift.

As was the case with a gift to a spouse, this is not such a good deal either, since the entire remainder interest will be in the grantor's estate under IRC §2026, and any unconsumed distributions made during the grantor's lifetime will be includible under §2031 as in the case of any other assets. Note that if the gift is partially complete (i.e., not wholly incomplete) then §2702 will apply.

IS A POWER TO REVOKE A QUALIFIED INTEREST OF THE GRANTOR'S SPOUSE A QUALIFIED INTEREST?

"Retention of a power to revoke a qualified annuity interest[67] (or unitrust interest) of the transferor's spouse is treated as the retention of a qualified annuity interest (or unitrust interest)."[68] This is a very puzzling and peculiar rule, and what it means exactly has been the subject of much uncertainty.

Recall that the rules under §2702 do not apply to a GRIT for a spouse, if the grantor retains no interest. "Section 2702 does not apply because neither the transferor nor an applicable family member has retained an interest in the trust." [69] As best I can tell, given the Service's evolving/changing position, the spouse's interest can qualify if the grantor has retained a predecessor interest, if the spouse's interest is not contingent on surviving the grantor. The contingency that it may be revoked is another matter, and seems to be required, which is one reason that this whole area remains a mystery, at least to me.

ARE THERE ANY REGULATORY EXAMPLES OF A POWER TO REVOKE A QUALIFIED INTEREST OF THE GRANTOR'S SPOUSE?

A power to revoke an interest in a spouse is not something mentioned in the statute, but it is mentioned in the regulations, and it has caused much confusion, to many, including me. Two examples in the regulations address this issue:

> ***Example (6).*** A transfers property to an irrevocable trust, retaining the right to receive the income for 10 years. **Upon expiration of 10 years, the income of the trust is payable to A's spouse for 10 years if living.** Upon expiration of the spouse's interest, the trust terminates and the trust corpus is payable to A's child. **<u>A retains the right to revoke the spouse's interest.</u> Because the transfer of property to the trust is not incomplete as to all interests in the property (i.e., A has made a completed gift of the remainder interest), section 2702 applies.** <u>A's power to revoke the spouse's term interest is treated as a retained interest for purposes of section 2702</u>. Because no interest retained by A is a qualified interest, the amount of the gift is the fair market value of the property transferred to the trust.
>
> ***<u>***Example (7).</u>*** The facts are the same as in Example 6, except that both the term interest retained by A and the interest transferred to A's spouse (subject to A's right of revocation) are qualified annuity or unitrust interests. *The amount of the gift is the fair market value of the property transferred to the trust reduced by the value of both A's qualified interest and the value of the qualified interest transferred to A's spouse (subject to A's power to revoke).*[70]

Just how these examples are to be interpreted has never been clear to me. We know from Treas. Reg. §25.2702-2(d) Example (3) that the rules under 2702 do not apply to a GRIT for a spouse, if the grantor retains no interest. We also know that the last sentence of Treas. Reg. §25.2702-2(a)(5) states that the "[r]etention of a power to revoke a qualified annuity interest (or unitrust interest) of the transferor's spouse is treated as the retention of a qualified annuity interest (or unitrust interest)."[71]

But, is it safe to say that term "qualified interest" includes the retention of a power to revoke a qualified interest of someone other than the spouse? At one time the IRS indicated as much in a private letter ruling, but it has since backed off that position. See immediately below.

WHAT EFFECT DOES A POWER TO REVOKE AN INTEREST IN A SPOUSE HAVE ON THE VALUE OF THE GIFT?

Apparently, under the *Cook*[72] case (perhaps in *dictum*)[73], it is fine to have a revocable spousal successor interest not contingent on surviving the grantor, but that only the grantor's single life expectancy can be considered, not the joint life expectancy of the grantor and the grantor's spouse, which is only relevant if Example 5 under the Dash 3 regulation is valid. Under *Walton*,[74] Example 5 is not valid, which makes the whole issue moot if Walton is correct.

On the other hand, in *Schott v. Com.*[75], the Ninth Circuit reversed the Tax Court and held that the joint life expectancy of the grantor and the grantor's spouse could be used, where the GRAT was structured as a two-life annuity, where the only contingency was the right of the grantor to revoke the spouse's interest.

Note that if the power to revoke is exercised, there could be a completed gift to the remainder beneficiaries at that time. Query how the marital deduction figures in all this, if at all.

If one assumes that example 5 (Treas. Reg. §25.2702-3(e), Ex. 5) is good law (meaning that *Walton* is not), then a married grantor would want to provide for an annuity interest in the grantor's spouse, applicable if the grantor dies during the term, which successor interest is subject to a testamentary power to revoke. However, if Walton is good law, then this may be a bad idea, since *Walton* may hinge on the unexpired term interest being payable to the grantor's estate in the event the grantor dies prior to the end of the term.

HOW MIGHT THE GRAT RULES AND MARITAL DEDUCTION OPERATE IF THE GRANTOR RETAINS THE RIGHT TO CONVERT THE GRAT INTO A QTIP TRUST?

What if the GRAT provides that if the grantor dies prior to expiration of the retained term interest (or if the trust is otherwise includible in the grantor's estate) the GRAT will become a QTIP[76] trust.? In that case, the trust should qualify for the marital deduction, but would that contingency disqualify the GRAT. Perhaps not, and perhaps that is the whole point behind §25.2702-2(d) Examples (6) and (7).

In any case, there are at least two Private Letter Rulings where the Service ruled that a trust, designed as a GRAT that would convert into a QTIP on the grantor's death during the term if the grantor did not revoke it, was not only a valid GRAT, but would qualify for the marital deduction if the conversion occurred. The GRATs (which incidentally also qualified as grantor trusts in their entirety) provided:

> [I]f the grantor dies during the term of the annuity, the annuity is continued to the grantor's spouse or if the grantor's spouse is deceased, to his estate, subject to revocation by the grantor prior to his death.[77]

The taxpayers requested a ruling:

> If the grantor dies during the trust term and has not revoked the interest for the grantor's spouse, the assets passing to the marital trust will qualify for the marital deduction under section 2056 in the estate of the grantor.

The Service concluded:

> Under the terms of the marital trusts, the trustee is required (assuming the grantor has not revoked during the grantor's life this right) to pay all trust income to the surviving spouse. The grantor's surviving spouse will have the power to withdraw the entire trust corpus at any time. Accordingly, we conclude that, if by reason of the grantor's death, the spouse succeeds to the described beneficial interest in the trust with the result that the trust property is includible in the grantor's gross estate, then property passing to the marital trusts will be deductible under section 2056(a).[78]

FROM WHERE WAS THE INCOMPLETE GIFT RULE DERIVED?

The incomplete gift rule, which provides that §2702 does not apply to a gift that is wholly incomplete, is derived from §2702(a)(3):

> **(3) Exceptions.**
>
> **(A) In general.** This **subsection** shall not apply to any transfer-
>
> **(i)** if such transfer is an incomplete gift,
>
> **(ii)** if such transfer involves the transfer of an interest in trust all the property in which consists of a residence to be used as a personal residence by persons holding term interests in such trust, or
>
> **(iii)** to the extent that regulations provide that such transfer is not inconsistent with the purposes of this section.
>
> **(B) Incomplete gift.** For purposes of subparagraph (A), the term " incomplete gift" means any transfer which would not be treated as a gift whether or not consideration was received for such transfer.[79] [Emphasis added.]

WHAT DOES "HELD IN TRUST" MEAN?

According to the statute:

> **(c) Certain property treated as held in trust.** For purposes of this section-
>
> **(1) In general.** The transfer of an interest in property with respect to which there is 1 or more term interests shall be treated as a transfer of an interest in a trust.
>
> **(2) Joint purchases.** If 2 or more members of the same family acquire interests in any property described in paragraph (1) in the same transaction (or a series of related transactions), the person (or persons) acquiring the term interests in such property shall be treated as having acquired the entire property and then transferred to the other persons the interests acquired by such other persons in the transaction (or series of transactions). Such transfer shall be treated as made in exchange for the consideration (if any) provided by such other persons for the acquisition of their interests in such property.
>
> **(3) Term interest.** The term "term interest" means-
>
> **(A)** a life interest in property, or
>
> **(B)** an interest in property for a term of years.
>
> **(4) Valuation rule for certain term interests.** If the nonexercise of rights under a term interest in tangible property would not have a substantial effect on the valuation of the remainder interest in such property-
>
> **(A)** subparagraph (A) of subsection (a)(2) shall not apply to such term interest, and

> **(B)** the value of such term interest for purposes of applying subsection (a)(1) shall be the amount which the holder of the term interest establishes as the amount for which such interest could be sold to an unrelated third party.[80]

HOW DOES THE STATUTE DEFINE APPLICABLE FAMILY MEMBER?

§2702(a)(1) provides:

> Solely for purposes of determining whether a transfer of an interest in trust to (or for the benefit of) a member of the transferor's family is a gift (and the value of such transfer), the value of any interest in such trust retained by the transferor or any applicable family member (as defined in section 2701(e)(2)) shall be determined as provided in paragraph (2). [Emphasis added.]

As can be seen, therefore, §2702(a)(1) defines "applicable family member" by cross-reference to §2701(e)(2), which in turn provides:

> **(2) Applicable family member.** The term "applicable family member" means, with respect to any transferor-
>
> **(A)** the transferor's spouse,
>
> **(B)** an ancestor of the transferor or the transferor's spouse, and
>
> **(C)** the spouse of any such ancestor.[81]

HOW DOES THE STATUTE DEFINE MEMBER OF THE FAMILY?

Recall that it is retention by *an applicable family member*, followed by a transfer to *a member of the family*, that triggers §2702.

§2702(e) defines "member of the family" by cross-reference to §2704(c)(2), which in turn provides:

> **(2) Member of the family.** The term "member of the family" means, with respect to any individual-
>
> **(A)** such individual's spouse,
>
> **(B)** any ancestor or lineal descendant of such individual or such individual's spouse,
>
> **(C)** any brother or sister of the individual, and
>
> **(D)** any spouse of any individual described in subparagraph (B) or (C).[82]

IS A NEPHEW OR NIECE A MEMBER OF THE FAMILY?

Note that member of the family would not encompass nephews or nieces.

ARE THERE OTHER DEFINITIONS OF MEMBER OF THE FAMILY FOUND IN CHAPTER 14 THAT DO NOT APPLY TO 2702?

It is somewhat interesting that Chapter 14 contains two definitions of "member of the family," one in §2704(c)(2), just quoted, and a slightly different definition in IRC §2701(e)(1), with which we are not directly concerned. For the curious, the IRC §2701(e)(1) definition reads:

> **(1) Member of the family.** The term "member of the family" means, with respect to any transferor-
>
> **(A)** the transferor's spouse,
>
> **(B)** a lineal descendant of the transferor or the transferor's spouse, and
>
> **(C)** the spouse of any such descendant.83

This would not include a sibling or ancestor.

WHO IS A MEMBER OF THE FAMILY UNDER THE REGULATIONS?

The regulations, for once, are more straight forward than the statute: "With respect to any individual, member of the family means the individual's spouse, any ancestor or lineal descendant of the individual or the individual's spouse, any brother or sister of the individual, and any spouse of the foregoing."[84]

WHAT IF AN INTEREST IS RETAINED ONLY WITH RESPECT TO A PORTION OF PROPERTY?

The Statute provides:

> **(d) Treatment of transfers of interests in portion of trust.** In the case of a transfer of an income or remainder interest with respect to a specified portion of the property in a trust, only such portion shall be taken into account in applying this section to such transfer.[85]

CAN A GRAT PROVIDE THAT THE GRANTOR WILL RETAIN THE GREATER OF AN OTHERWISE QUALIFIED INTEREST OR THE INCOME?

A GRAT may provide that the grantor will retain the greater of an otherwise qualified interest or the income; however, the value of the retained interest will not be increased as a result.[86] Of course decreasing the potential amount passing to the remainder beneficiaries, while not decreasing the size of the gift for gift tax purposes, is not something that a good estate plan would ordinarily seek to achieve.

CAN THE TRUST PREPAY THE ANNUITY?

Treas. Reg. §25.2702-3(d)(4) specifically requires that "[t]he governing instrument must prohibit commutation (prepayment) of the interest of the term holder." What does this mean? It certainly means that the trustee cannot prepay the grantor's interest (i.e., payoff the grantor early by giving the grantor an amount of money equivalent to the value grantor's retained annuity). However, it is not certain that such a provision would be effective under state law.[87]

HOW ARE GRANTOR TRUSTS TAXED?

If the GRAT is wholly a "grantor trust" its existence is basically ignored for income tax purposes and all of the income, gains and losses are reported on the grantor's Form 1040 in all events (or on the Form 1041 of a person treated as the grantor under §678). This treatment is mandated by IRC §671, if any of the conditions found in §§673-679 apply.

WHY MIGHT IT BE ADVANTAGEOUS FOR A GRAT TO BE TREATED AS A GRANTOR TRUST, AND WHAT DISADVANTAGES MIGHT THERE BE IF IT IS NOT?

It should be noted that a trust may be a grantor trust as to income, or as to corpus, or both. The grantor trust rules have been interpreted to mean that, if a grantor trust is a grantor trust for all purposes, then all transactions between the grantor and the trust are ignored, including transactions that would otherwise be treated as a taxable sale or exchange, which means that capital gains and losses cannot be recognized on transactions between a grantor and a grantor trust.[88]

Further, if the grantor pays the income taxes of the trust, in an amount exceeding distributions, most practitioner do not think that this is a taxable gift, even though the trust may be augmented gift tax free as a result. The Service does not necessarily agree, and this issue is somewhat problematic in the case of a GRAT for special reasons that were discussed in the "BASIC" section of this memo.

A gift to a trust, that is not a sale, should not result in gain or loss either, although there are some cases that cause concern in this area.[89]

Even if a GRAT is not a grantor trust, a distribution to the beneficiary (in this case the grantor) will carry out DNI, resulting in a deduction to the trust and income to the annuitant/grantor. Usually, the distribution will exceed the ordinary income, making the issue somewhat moot regarding that income. However, if the trust sells assets, or is treated as having sold them, then the question of who pays the capital gains becomes important.

If a distribution is made in kind (in non-cash assets), and the trust is not entirely a grantor trust, it is possible that such distribution could trigger capital gain, if viewed as a distribution in satisfaction of a pecuniary obligation of the trust, in much the same way as a distribution of assets to a creditor in satisfaction of a debt would trigger gain to the trust. Since it is very likely that a GRAT, especially a short-term GRAT, will have to distribute (back to the grantor) some of the original assets contributed, in order to satisfy its obligation to make the annuity payments, it would be a great disadvantage if gain were recognized on such a transfer.

IS A GRAT A GRANTOR TRUST?

If you read PLR 9449012, discussed in the next question, you would conclude that a GRAT is virtually always a grantor trust in its entirety, under §677(a), both as to income and corpus, so long as the annuity is paid out of income and if income is insufficient, out of corpus, which is almost always the case.

WHAT TRUST TERMS WILL CAUSE THE GRAT TO BE TREATED AS A GRANTOR TRUST?

The intricacies of the grantor trust rules should properly be the subject of a separate memo of about the same size as this one, so the subject is not being given its full due here. What I will do is try to briefly hit various sections of the IRC that might apply, and comment briefly upon some of them.

WILL A GRAT BE TREATED AS A GRANTOR TRUST UNDER §673(a)?

Under §673(a):

> The grantor shall be treated as the owner of **any portion** of a trust in which he has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest **exceeds 5 percent of the value of such portion**.[90]

If the grantor retained a reversion in the grantor's estate in the event that the grantor dies before the GRAT term is out, and if, at the time of conversion, that reversion was worth more than 5% of the value of property contributed to the GRAT then §673(a) may do the trick.[91] However, here, as elsewhere in Subpart E, it is impossible to say with absolute certainty just how the grantor trust sections of the IRC will ultimately be interpreted.

It may be too early to say what is the best strategy for a GRAT post *Walton*, but I am presently thinking that I would want to follow the *Walton* pattern fairly closely, which means that although I would want the annuity payments to continue to the estate in the event of death of the grantor prior to the end of the term, I am not sure that I would any longer want to simply provide for a complete reversion in the event the GRAT was included in the grantor's estate. This would make the 5% test a little harder to meet, even if we had regulations telling us how to compute the test, which we don't.

WILL A GRAT BE TREATED AS A GRANTOR TRUST UNDER §674(a)?

In 200001013, and 200001015, discussed below, the IRS ruled that the grantor was the owner of the income under §671, and was the owner of the corpus under §674(a) IRC §674(a) provides:

> **(a) General rule.** The grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable **by the grantor <u>or a nonadverse party</u>,** or both, **without the approval or consent of any adverse party**.[92] [Emphasis added.]

§674(a) was interpreted in PLR 9152034:

> Under the terms of the of Trust, Taxpayer will receive an annuity payable first from income, and to the extent accumulated income is insufficient, from principal. In addition, during the Trust term, the trustee (a nonadverse party) will have the sole discretion to pay the Taxpayer all of the Trust's net income (if there is any remaining after payment of the annuity). Therefore, under section 677, Taxpayer will be treated as the owner of the income portion of the Trust during the Trust term. **Additionally, capital gains are accumulated and added to corpus and Taxpayer has a general testamentary power exercisable only by will to appoint the accumulated amounts. Therefore, under section 674(a), Taxpayer will be treated as the owner of the corpus portion of the Trust during the Trust term.** Accordingly, Taxpayer will be treated as the owner of the Trust for purposes of section 671 during the Trust term.[93]

This makes one wonder whether 677 is sufficient after all to cause the trust to be a grantor trust regarding income and corpus, without the aid of 674 or some other Subpart E section.

WHAT EXCEPTIONS TO §674(a) MIGHT THWART GRANTOR TRUST TREATMENT?

The rule in IRC §674(a), which provides that-

> [t]he grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable **by the grantor** **<u>or a nonadverse party</u>**, or both, **without the approval or consent of any adverse party**[94]

is followed by a page and a half or so of exceptions, in 674(b)-(d) (see Appendix B), which in many cases swallow the rule. For instance, under §674(c):

> **(c) Exception for certain powers of independent trustees**. Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor —
>
> > **(1)** to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries; or
> >
> > **(2)** to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries).
>
> A power does not fall within the powers described in this subsection if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children. For periods during which an individual is the spouse of the grantor (within the meaning of section 672(e)(2)), any reference in this subsection to the grantor shall be treated as including a reference to such individual.

In a number of PLRs where the grantor retained a general testamentary power of appointment if death was prior to expiration of the term, the Service ruled that the GRAT was a grantor trust regarding corpus, under §674(a).[95]

§674 may be the most certain way to be assured of achieving grantor trust status is the grantor can find a suitable non-adverse party to hold the power to add beneficiaries within a class (other than after-borns), but at the risk of having the power exercised. The class can be narrow, but it must be large enough so that its existence is not threatened. Unlike 675(4)(C), this power can be held in a fiduciary capacity.

In any case, particular care must be taken to avoid any of the other many exceptions to 674(a).

WILL A GRAT BE TREATED AS A GRANTOR TRUST UNDER §675(4)(C)?

Under **IRC §675(4):**

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

This power is elucidated further in Treas. Reg. §1.675-1(b)(4)(iii):

> **(iii)** A power to reacquire the trust corpus by substituting other property of an equivalent value. If a power is exercisable by a person as trustee, it is presumed that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. This presumption may be rebutted only by clear and convincing proof that the power is not exercisable primarily in the interests of the beneficiaries. **If a power is not exercisable by a person as trustee, the determination of whether the power is exercisable in a fiduciary or a nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration.**[96]

One would think that a circumstance that would be dispositive on the question of whether the power is exercisable in a fiduciary capacity or not would be one where the power is specifically stated to be non fiduciary[97]; but, for some bizarre and inexplicable reason, the Service has insisted at times that even such an explicit statement is not enough.[98] In PLR 9416009, the facts stipulated included the following statement:

> Section 15 of the proposed trust agreement provides that during the annuity term, the grantor, if living, in her sole discretion and without consent of the trustees, shall have the power **in a non- fiduciary capacity** to ***acquire***[99] the trust corpus by substituting other property of an equivalent value. [Emphasis added.]

This was apparently not clear enough for the Service, though it boggles the imagination why:

> Section 675(4) provides that the grantor shall be treated as the owner of any portion of a trust in respect of which a power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. For purposes of this section, the term "power of administration" means any one or more of the following powers: A) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; B) a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stock or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or C) a power to reacquire the trust corpus by substituting other property of an equivalent value.
>
> Section 1.675-1(b)(4) of the Income Tax Regulations provides, in part, that if a power is not exercisable by a trustee, the determination of whether the power is exercisable in a fiduciary or nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration.

> Accordingly, the circumstances surrounding the administration of Trust will determine whether Taxpayer holds the power of administration in a nonfiduciary capacity. This is a question of fact, the determination of which must be deferred until the federal income tax returns of the parties involved have been examined by the office of the District Director where the returns are filed. **Therefore, we cannot determine at this time whether Taxpayer would be treated as the owner of Trust under section 675(4). Provided that the circumstances indicate that Taxpayer holds a power of administration exercisable in a nonfiduciary capacity, Taxpayer will be treated as the owner of the proposed trust under section 675.**[100] [Emphasis added.]

There are a couple of possible problems with the reacquisition or substitution power. One issue might be whether the gift is complete in such case. I find that hard to take seriously. Another issue is whether the power is a retained §2036 power. If so, that would not be fatal, but it might require (via §2035) that the grantor not only survive the term, but survive an additional three years as well. Finally, I am not sure whether there is a difference between reacquiring assets transferred initially, and acquiring new assets whose form has changed (presumably the proceeds of assets initially transferred).

WILL A GRAT BE TREATED AS A GRANTOR TRUST UNDER §677(a)?

It seems clear that the trust would be a grantor trust as to income under 677(a), but whether it is also a grantor trust as to corpus under that section alone is problematic. Nonetheless, in addition to PLRs 9449012, 9449013, quoted and discussed elsewhere, there are a bevy of PLRs under which the Service seemed quite satisfied that a GRAT would be wholly a grantor trust by virtue of 671(a) alone, if the annuity was payable from income and, if income was insufficient, from principal.[101]

IRC §677(a) provides:

> **(a) General rule.** The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income **without the approval or consent of any adverse party** is, or, in the discretion of the grantor or a nonadverse party, or both, ***may be*** —
>
> > **(1)** distributed to the grantor or the grantor's spouse;
> >
> > **(2)** held or accumulated for future distribution to the grantor or the grantor's spouse; or
> >
> > **(3)** applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse (except policies of insurance irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions)). [Emphasis added.]
>
> This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished.

PLRs of 9449012 and 9449013 found in favor of grantor trust treatment of a GRAT because-

> The grantor is the owner of the entire trust under section <u>677(a)</u> because article I(B) provides that the annuity installment is to be paid from income and, to the extent income is not sufficient, from principal. **<u>Therefore, the grantor will be considered the owner of the entire trust for purposes of section 671</u>** until the earlier of the grantor's death or the termination of the trust.[102]

It would be nice if that were all we needed to know, or if we could rely on the Service's holding and reasoning in these PLRs. Unfortunately, the story may or may not be quite as simple as the above quoted material would have one believe, and so a more extended discussion of the issue is called for, and to some extent has already been given.

Under §677, the trust would be entirely a grantor trust if a nonadverse party can distribute corpus to the grantor after the term, but that would put the trust into the estate of the grantor in most states, since such a trust would be self-settled and in most cases therefore reachable by the creditors of the grantor's estate.

WHAT IS AN EXAMPLE OF A GRAT THAT THE SERVICE FOUND TO BE WHOLLY A GRANTOR TRUST UNDER §677(a), FOLLOWED BY §678 ALONE?

There are many Private Letter Rulings where the Service has found a GRAT to be entirely a grantor trust. In PLR 9449012, and its twin, 9449013 (discussed above for their holding that a revocable QTIP provision in the GRAT did not disqualify the trust as a GRAT, and that if the QTIP provision was not revoked that the trust would qualify for the marital deduction), the Service found the trust(s) were entirely grantor trusts. In so ruling, the Service discussed the grantor trust issue fairly thoroughly, and in a manner that sets forth the issues and the law well enough to bear quoting from at length:

> Section 671 provides that when the grantor or another person is treated as the owner of any portion of a trust, there shall be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust that are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 of the Code in computing the taxable income or credits against tax of an individual.
>
> Sections 673 through 677 specify the circumstances under which the grantor is regarded as the owner of a portion of a trust.
>
> Section **677(a)(1)** provides that the grantor shall be treated as the owner of any portions of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed to the grantor.
>
> Section 678(a) provides that a person other than the grantor shall be treated as the owner of any portion of a trust with respect to which (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or (2) such person has previously partially released or otherwise modified such a

> power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.
>
> Rev. Rul. 85-13, 1985-1 C.B. 184, holds that if a grantor is treated as the owner of an entire trust, the grantor is the owner of the trust's assets for federal income tax purposes. Therefore, a transfer of trust assets to a grantor who owns the entire trust is not recognized as a sale for federal income tax purposes.
>
> Based on the facts submitted and the representations made we conclude as follows with respect to each of the five trusts:
>
> * * * *
>
> Pursuant to section 678(a), the power granted the grantor's spouse under article III to withdraw all or any portion of the assets of the marital trust, following the death of the grantor, will result in the spouse being treated as the owner of the marital trust created under article III. Therefore, if a marital trust is established for the grantor's spouse, the grantor's spouse would be considered the owner of the entire marital trust for purposes of section 671.
>
> In accordance with the holding set forth in Rev. Rul. 85-13, we conclude that neither the grantor nor the trust will recognize any gain or loss as a result of the grantor's transfer of property to fund the trust, or as the result of the transfer from the trust to a grantor in payment of an annuity, or as the result of the substitution by the grantor of assets of the grantor for assets of the trust. In addition, no gain or loss will be recognized by the spouse of a grantor or by the trust upon a transfer from the trust to the grantor's spouse in payment of an annuity or upon the distribution of income or principal to the grantor's spouse.[103] [Emphasis added.]

Despite the allusion to the §678 power in the grantor's spouse, the real basis for the ruling was that the GRAT was a grantor trust in its entirety, during the grantor's life, by virtue of 677(a), to which we now (again) turn our attention.

IF THE GRANTOR OR THE GRANTOR'S SPOUSE CAN RECEIVE DISCRETIONARY DISTRIBUTIONS OF INCOME AND PRINCIPAL WITH THE CONSENT OF A NONADVERSE PARTY, IS THE TRUST AUTOMATICALLY ENTIRELY A GRANTOR TRUST?

As previously quoted above, §677(a) provides that the grantor will be treated as the owner of any portion of a trust whose income **without the approval or consent of any adverse party** is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed to the grantor or the grantor's spouse or held or accumulated for future distribution to the grantor or the grantor's spouse.

The statute (§677(a)(3)) provides the same rule if, under the same conditions, income can be "applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse." Notwithstanding the literal wording of the statute, there are several cases that held (under a predecessor statute), perhaps charitably if illogically, that this rule only applies to the extent that the income is so used.[104] If that principle is true, then there is absolutely no reason to believe that the "only to the extent so used" rule would not apply to the rest of Subpart E; but, for reasons that baffle the mind and "puzzle the will," the "only to the extent so used" rule has so far been applied only to §677(a)(3).

In any case, one presumes that if, after termination of the GRAT term, the grantor's spouse is a discretionary beneficiary of income and principal, "without the approval or consent of any adverse party," the trust would be wholly a grantor trust (as to income and principal) during the grantor's spouse's life.

CAN S-CORPORATION STOCK BE CONTRIBUTED TO A GRAT?

If the GRAT was grantor trust for all purposes, the contribution ought not to jeopardize the S-election,[105] at least during the term; however, when the term expires, and the trust ceases to be a grantor trust, the S-corporation status could become a very real issue, depending on whether the assets go outright to the beneficiaries, and if not, whether the trust provisions following the initial term would meet either the QSST[106] or ESBT[107] rules.

WHAT HAPPENS IF THE GRAT CEASES TO BE A GRANTOR TRUST AFTER THE TERM EXPIRES?

Once the GRAT ceases to be a grantor trust, great care would be needed if the trust was relying on grantor trust status to keep S-Corporation stock in the trust qualified. Perhaps, if the trust is to continue, it could continue as an QSST[108] or ESBT[109]. See PLR 200227022 in the case of a QSST.

WHAT GENERATION SKIPPING TRANSFER TAX CONSIDERATIONS SHOULD THE DRAFTER OF A GRAT BE CONCERNED ABOUT.

IRC §2756(f)(1) provides that if

> **(A)** an individual makes an inter vivos transfer of property, and
>
> **(B)** the value of such property would be includible in the gross estate of such individual under chapter 11 if such individual died immediately after making such transfer (other than by reason of section 2035),
>
> [then] any allocation of GST exemption to such property shall not be made before the close of the estate tax inclusion period (and the value of such property shall be determined under paragraph (2)). If such transfer is a direct skip, such skip shall be treated as occurring as of the close of the **estate tax inclusion period [ETIP]**.

The ETIP is

> . . . any period after the transfer described in paragraph (1) during which the value of the property involved in such transfer would be includible in the gross estate of the transferor under chapter 11 if he died. Such period shall in no event extend beyond the earlier of-
>
> > **(A)** the date on which there is a generation-skipping transfer with respect to such property, or
> >
> > **(B)** the date of the death of the transferor.[110]

IRC §2756(f)(4) provides:

> Except as provided in regulations, any reference in this subsection to an individual or transferor shall be treated as including a reference to the spouse of such individual or transferor.

What this boils down to is that so long as the grantor or grantor's spouse is a beneficiary of the trust (i.e., during the term, in the case of the grantor), the GSTT exemption cannot be allocated, which means that the value cannot be effectively frozen within the available $1.1 million exemption.[111] After the grantor and spouse cease to have an interest in the GRAT, the exemption could be allocated, but if the GRAT works, it will have appreciated in value, and so much leveraging will be lost.

CAN THE GRANTOR SELL THE RETAINED INTEREST?

What if instead of having the trust prepay the grantor the value of the grantor's interest, the grantor sells the interest to a third party? Is that a commutation (prepayment)? Presumably not, though the IRS might not agree with this conclusion.

There are no governing instrument requirements in the regulations that require the GRAT to explicitly preclude a sale of the annuity. However, Treas. Reg. §25.2702-3(b)(1) states:

> The annuity amount must be payable to (or for the benefit of) the holder of the annuity interest at least annually.

More importantly, perhaps, Treas. Reg. §25.2702-3(d)(2) provides:

> The governing instrument must prohibit distributions from the trust to or for the benefit of any person other than the holder of the qualified annuity or unitrust interest during the term of the qualified interest.

If the governing instrument contained the §25.2702-3(d)(2) and 25.2702-3(b)(1) language (as it ought to), would it be reasonable, as a matter or ordinary common law contract construction, to construe it as precluding a sale of the right to receive the payments? Probably not, especially if the annuitant acted as a conduit for the sale proceeds. In that case the trustee would not even have to know about the sale, since disclosure of the sale would not be required under the statute or the regulations.

Would it be reasonable to construe such language as permitting the trustee to make distributions from the trust to someone other than the holder or the annuity? I find that question a little harder to answer in the affirmative. Perhaps an adequate rejoinder would be another question: Who is the "the holder of the qualified annuity . . . interest" after the sale? If it is the buyer, then the regulations would not prohibit distributions to that person.

CAN THE GRAT REMAINDER BENEFICIARIES SELL THEIR INTEREST TO A GSTT PROTECTED TRUST, AND SOLVE THE PROBLEM THAT WAY?

This subject deserves an article of its own, and as there is a two part seminal article on the subject already that says more than I could ever say on or add to the subject, I refer the reader to "The GRAT Remainder Sale," by David A. Handler and Steven J. Oshins, Trusts & Estates, December 2002, beginning at page 33, and its predecessor by the same authors, entitled "GRAT Remainder Sale to a Dynasty Trust," Trusts & Estates, December 1999, beginning at page 20.

WHAT WOULD BE THE CONSEQUENCES OF A SALE CAUSING THE GRAT TO CEASE TO QUALIFY UNDER §2702?

What happens if a GRAT ceases to qualify under §2702, perhaps because a sale of the annuity is deemed to violate §25.2702-3(b)(1) or §25.2702-3(d)(2), discussed above? Under IRC §2702(a)(2)(B) "[t]he value of any retained interest which is a qualified interest shall be determined under section 7520." If the interest ceases to be "retained"[112] or ceases to be a "qualified interest," and if the value is not determined under §7520, then just how is it valued?

WHAT ARE THE INCOME TAX CONSEQUENCES OF A SALE?

The tax consequences of a sale are intriguing. If the sale was to the GRAT, and if the GRAT were a grantor trust, as to income and corpus there should not be any income recognition[113]; however, a sale to the trust would resemble a prepayment, which, as we know, is not permitted.[114] What if the sale were to another grantor trust, of the intentionally defective variety, one that would not be otherwise includible in the grantor's estate? Now there is an idea.

A sale to a third party would, one presumes, be taxable. The seller's basis would be relevant. How is that determined? IRC §1001(e) could be relevant too. It provides:

> **(e) Certain term interests.**
>
> > **(1) In general.** In determining gain or loss from the sale or other disposition of a term interest in property, that portion of the adjusted basis of such interest which is determined pursuant to section 1014, 1015, or 1041 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded.
> >
> > **(2) Term interest in property defined.** For purposes of paragraph (1) , the term "term interest in property" means-
> >
> > > **(A)** a life interest in property,
> > >
> > > **(B)** an interest in property for a term of years, or
> > >
> > > **(C)** an income interest in a trust.
> >
> > **(3) Exception.** Paragraph (1) shall not apply to a sale or other disposition which is a part of a transaction in which the entire interest in property is transferred to any person or persons.

Would the GRAT continue to be a grantor trust after the sale to a spouse or other third party? Maybe yes; maybe no. It would depend on what provision of Subpart E was triggering grantor trust treatment. This line of thought leads to other interesting possibilities which will not be explored here.

The sale could be made to a spouse. That would be tax-free under IRC 1041(a)(1). If the spouse died during the term, there should be no inclusion under §§2036-2039 because the spouse was not the transferor.

CAN THE INTEREST BE SOLD IF THE TRUST CONTAINS SPENDTHRIFT PROVISIONS?

A spendthrift provision would be ineffective in most states to prevent creditor's from reaching the grantor's interest, because the trust would be self-settled. However, it might prevent the grantor from selling the interest nevertheless, unless the purchaser was considered a creditor against whom the spendthrift provision was inoperable. Perhaps it would be best to explicitly exempt the grantor from the operation of any spendthrift clause, if a sale is to be kept as an option.

IF THE GRANTOR HAS SOLD THE RETAINED ANNUITY, WHAT IS INCLUDED IN THE GRANTOR'S ESTATE, IF THE GRANTOR DIES DURING THE TERM?

If the grantor has sold the retained interest, §2039 would not apply, because the annuity was not payable at death. If the grantor dies within three years of the transfer, however, it may be that §2035 operates to bring all or a portion of the property back into the estate because "the value of such property (or an interest therein) would have been included in the decedent's gross estate under section 2036 [or] 2038 . . if such transferred interest or relinquished power had been retained by the decedent on the date of his death."[115] But if the sale takes place more than three years after the sale, perhaps nothing is included, other than the sales proceeds remaining.

If the grantor retained a contingent reversion, which was not also sold, then §2033 would be the only statute needed to bring the interest back into the estate.

CAN THE BENEFICIARIES SELL THE REMAINDER INTEREST? AND CAN THE GRANTOR PURCHASE IT?

Why would the grantor want to purchase the remainder? Perhaps because the grantor believes that he or she may not survive the term. Of course, if the grantor is terminally ill, the standard mortality tables cannot be relied upon,[116] but short of imminent death, it may be that the standard tables can be used.

A sale of the remainder to the grantor should be income tax free, if the GRAT is a grantor trust as to income and corpus, but a sale to anyone else will result in gain being recognized, either by the GRAT, if the GRAT is not a grantor trust, or by the grantor if the GRAT is a grantor trust.

Might, ironically, a sale by the trust to the grantor be treated as a transfer by the remainder beneficiaries to an applicable family member (this time the grantor), in which an interest is retained by the remainder beneficiaries both before and after the transfer?

WHAT IS THE §2001(b)(2) ADJUSTMENT?

If all or a portion of the GRAT is includible in the grantor's estate (e.g., because the grantor dies prior to the expiration of the term), and if the grantor has paid gift tax previously on the transfer, the grantor's estate should be entitled to an IRC §2001(b)(2) adjustment. This was discussed previously in the BASIC Section, but it perhaps bears additional consideration in light of the next question. Further, the adjustment is important in any analysis of the economics of a GRAT that fails.

The IRC §2001(b)(2) adjustment operates to reduce what would otherwise be treated as lifetime adjusted taxable gifts (gifts which are added back to the taxable estate when determining the estate tax) by any portion of the GRAT that is included in the estate. This ameliorates the damage done (as a result of bringing the property back into the estate), by putting the taxpayer back into a position similar to the position the taxpayer would have been in had the GRAT never been established. The economic effect, however, is that the grantor is still out the time-value use of any gift tax previously paid, because there is no adjustment for the interest lost on the tax which was paid prematurely. But this is true only if gift tax was paid on the GRAT or on future gifts.

IS THERE ANY VALUE IN USING A "POOR PERSON'S GRIT" USING THE §2001(b)(2) ADJUSTMENT AS A BACKSTOP?

Query how the §2001(b)(2) adjustment would operate in the case of a GRIT in favor of an applicable family member, particularly one that did not result in a gift tax, because the decedent's lifetime taxable gifts were lower than the applicable exclusion amount. Consider, for example, what would happen if I transferred a remainder interest in a $1 million ranch to an applicable family member, retaining the right to the income for 10 years. True, I would have made a $1 million gift, unreduced by my retained 10-year term interest. But there would be no tax. If I made no further gifts, and outlived the term, I would at least have managed to transfer the appreciation tax free. If I failed to survive the term, the ranch would be back in my estate (as it would have been had I not made the gift), but the §2001(b)(2) adjustment would operate to reduce my $1 million adjusted taxable gift.

APPENDIX A

INTERNAL REVENUE CODE IRC §2702 (IT'S OWN SELF)

§ 2702 Special valuation rules in case of transfers of interests in trusts.

(a) Valuation rules.

(1) In general. Solely for purposes of determining whether a transfer of an interest in trust to (or for the benefit of) a member of the transferor's family is a gift (and the value of such transfer), the value of any interest in such trust retained by the transferor or any applicable family member (as defined in section 2701(e)(2)) shall be determined as provided in paragraph (2).

(2) Valuation of retained interests.

(A) In general. The value of any retained interest which is not a qualified interest shall be treated as being zero.

(b) Valuation of qualified interest. The value of any retained interest which is a qualified interest shall be determined under section 7520.

(3) Exceptions.

(A) In general. This subsection shall not apply to any transfer-

(i) if such transfer is an incomplete gift,

(ii) if such transfer involves the transfer of an interest in trust all the property in which consists of a residence to be used as a personal residence by persons holding term interests in such trust, or

(iii) to the extent that regulations provide that such transfer is not inconsistent with the purposes of this section.

(B) Incomplete gift. For purposes of subparagraph (A), the term " incomplete gift" means any transfer which would not be treated as a gift whether or not consideration was received for such transfer.

(b) Qualified interest. For purposes of this section, the term "qualified interest" means-

(1) any interest which consists of the right to receive fixed amounts payable not less frequently than annually,

(2) any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually), and

(3) any noncontingent remainder interest if all of the other interests in the trust consist of interests described in paragraph (1) or (2).

(c) Certain property treated as held in trust. For purposes of this section-

(1) In general. The transfer of an interest in property with respect to which there is 1 or more term interests shall be treated as a transfer of an interest in a trust.

(2) Joint purchases. If 2 or more members of the same family acquire interests in any property described in paragraph (1) in the same transaction (or a series of related transactions), the person (or persons) acquiring the term interests in such property shall be treated as having acquired the entire property and then transferred to the other persons the interests acquired by such other persons in the transaction (or series of transactions). Such transfer shall be treated as made in exchange for the consideration (if any) provided by such other persons for the acquisition of their interests in such property.

(3) Term interest. The term "term interest" means-

(A) a life interest in property, or

(B) an interest in property for a term of years.

(4) Valuation rule for certain term interests. If the nonexercise of rights under a term interest in tangible property would not have a substantial effect on the valuation of the remainder interest in such property-

(A) subparagraph (A) of subsection (a)(2) shall not apply to such term interest, and

(B) the value of such term interest for purposes of applying subsection (a)(1) shall be the amount which the holder of the term interest establishes as the amount for which such interest could be sold to an unrelated third party.

(d) Treatment of transfers of interests in portion of trust. In the case of a transfer of an income or remainder interest with respect to a specified portion of the property in a trust, only such portion shall be taken into account in applying this section to such transfer.

(e) Member of the family. For purposes of this section, the term "member of the family" shall have the meaning given such term by section 2704(c)(2).

APPENDIX B

THE GRANTOR TRUST RULES: SUBPART E OF SUBCHAPTER J OF THE INTERNAL REVENUE CODE

§671. TRUST INCOME, DEDUCTIONS, AND CREDITS ATTRIBUTABLE TO GRANTORS AND OTHERS AS SUBSTANTIAL OWNERS.

Where it is specified in this subpart [E] that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual. Any remaining portion of the trust shall be subject to subparts A through D. No items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart.

§672. DEFINITIONS AND RULES.

(a) Adverse party. For purposes of this subpart, the term "adverse party" means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust.

(b) Nonadverse party. For purposes of this subpart, the term "nonadverse party" means any person who is not an adverse party.

(c) Related or subordinate party. For purposes of this subpart, the term "related or subordinate party" means any nonadverse party who is —

(1) the grantor's spouse if living with the grantor;

(2) any one of the following: The grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.

For purposes of subsection (f) and sections 674 and 675, a related or subordinate party shall be presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on him unless such party is shown not to be subservient by a preponderance of the evidence.

(d) Rule where power is subject to condition precedent. A person shall be considered to have a power described in this subpart even though the exercise of the power is subject to a precedent giving of notice or takes effect only on the expiration of a certain period after the exercise of the power.

(e) Grantor treated as holding any power or interest of grantor's spouse.

(1) In general. For purposes of this subpart, a grantor shall be treated as holding any power or interest held by —

(A) any individual who was the spouse of the grantor at the time of the creation of such power or interest, or

(B) any individual who became the spouse of the grantor after the creation of such power or interest, but only with respect to periods after such individual became the spouse of the grantor.

(2) Marital status. For purposes of paragraph (1)(A), an individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married.

(f) Subpart not to result in foreign ownership.

(1) In general. Notwithstanding any other provision of this subpart, this subparagraph shall apply only to the extent such application results in an amount (if any) being currently taken into account (directly or through 1 or more entities) under this chapter in computing the income of a citizen or resident of the United States or a domestic corporation.

(2) Exceptions.

(A) Certain revocable and irrevocable trusts. Paragraph (1) shall not apply to any portion of a trust if —

(i) the power to revest absolutely in the grantor title to the trust property to which such portion is attributable is exercisable solely by the grantor without the approval or consent of any other person or with the consent of a related or subordinate party who is subservient to the grantor, or

(ii) the only amounts distributable from such portion (whether income or corpus) during the lifetime of the grantor are amounts distributable to the grantor or the spouse of the grantor.

(B) Compensatory trusts. Except as provided in regulations, paragraph (1) shall not apply to any portion of a trust distributions from which are taxable as compensation for services rendered.

(3) Special rules. Except as otherwise provided in regulations prescribed by the Secretary —

(A) a controlled foreign corporation (as defined in section 957) shall be treated as a domestic corporation for purposes of paragraph (1), and

(B) paragraph (1) shall not apply for purposes of applying section 1296.

(4) Recharacterization of purported gifts. In the case of any transfer directly or indirectly from a partnership or foreign corporation which the transferee treats as a gift or bequest, the Secretary may recharacterize such transfer in such circumstances as the Secretary determines to be appropriate to prevent the avoidance of the purposes of this subsection.

(5) Special rule where grantor is foreign person. If —

(A) but for this subsection, a foreign person would be treated as the owner of any portion of a trust, and

(B) such trust has a beneficiary who is a United States person,

such beneficiary shall be treated as the grantor of such portion to the extent such beneficiary has made (directly or indirectly) transfers of property (other than in a sale for full and adequate consideration) to such foreign person. For purposes of the preceding sentence, any gift shall not be taken into account to the extent such gift would be excluded from taxable gifts under section 2503(b).

(6) Regulations. The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection, including regulations providing that paragraph (1) shall not apply in appropriate cases.

§673. REVERSIONARY INTERESTS.

(a) General rule. The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds 5 percent of the value of such portion.

(b) Reversionary interest taking effect at death of minor lineal descendant beneficiary. In the case of any beneficiary who —

(1) is a lineal descendant of the grantor, and

(2) holds all of the present interests in any portion of a trust, the grantor shall not be treated under subsection (a) as the owner of such portion solely by reason of a reversionary interest in such portion which takes effect upon the death of such beneficiary before such beneficiary attains age 21.

(c) Special rule for determining value of reversionary interest. For purposes of subsection (a), the value of the grantor's reversionary interest shall be determined by assuming the maximum exercise of discretion in favor of the grantor.

(d) Postponement of date specified for reacquisition. Any postponement of the date specified for the reacquisition of possession or enjoyment of the reversionary interest shall be treated as a new transfer in trust commencing with the date on which the postponement is effective and terminating with the date prescribed by the postponement. However, income for any period shall not be included in the income of the grantor by reason of the preceding sentence if such income would not be so includible in the absence of such postponement.

§674. POWER TO CONTROL BENEFICIAL ENJOYMENT.

(a) General rule. The grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

(b) Exceptions for certain powers. Subsection (a) shall not apply to the following powers regardless of by whom held:

(1) Power to apply income to support of a dependent. A power described in section 677(b) to the extent that the grantor would not be subject to tax under that section.

(2) Power affecting beneficial enjoyment only after occurrence of event. A power, the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that a grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished.

(3) Power exercisable only by will. A power exercisable only by will, other than a power in the grantor to appoint by will the income of the trust where the income is accumulated for such disposition by the grantor or may be so accumulated in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

(4) Power to allocate among charitable beneficiaries. A power to determine the beneficial enjoyment of the corpus or the income therefrom if the corpus or income is irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions).

(5) Power to distribute corpus. A power to distribute corpus either —

(A) to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries) provided that the power is limited by a reasonably definite standard which is set forth in the trust instrument; or

(B) to or for any current income beneficiary, provided that the distribution of corpus must be chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary as if the corpus constituted a separate trust.

A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

(6) Power to withhold income temporarily. A power to distribute or apply income to or for any current income beneficiary or to accumulate the income for him, provided that any accumulated income must ultimately be payable —

(A) to the beneficiary from whom distribution or application is withheld, to his estate, or to his appointees (or persons named as alternate takers in default of appointment) provided that such beneficiary possesses a power of appointment which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate, or

(B) on termination of the trust, or in conjunction with a distribution of corpus which is augmented by such accumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument.

Accumulated income shall be considered so payable although it is provided that if any beneficiary does not survive a date of distribution which could reasonably have been expected to occur within the beneficiary's lifetime, the share of the deceased beneficiary is to be paid to his appointees or to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children.

(7) Power to withhold income during disability of a beneficiary. A power exercisable only during —

(A) the existence of a legal disability of any current income beneficiary, or

(B) the period during which any income beneficiary shall be under the age of 21 years,

to distribute or apply income to or for such beneficiary or to accumulate and add the income to corpus. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

(8) Power to allocate between corpus and income. A power to allocate receipts and disbursements as between corpus and income, even though expressed in broad language.

(c) Exception for certain powers of independent trustees. Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor —

(1) to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries; or

(2) to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries).

A power does not fall within the powers described in this subsection if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children. For periods during which an individual is the spouse of the grantor (within the meaning of section 672(e)(2)), any reference in this subsection to the grantor shall be treated as including a reference to such individual.

(d) Power to allocate income if limited by a standard. Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor or spouse living with the grantor, to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, whether or not the conditions of paragraph (6) or (7) of subsection (b) are satisfied, if such power is limited by a reasonably definite external standard which is set forth in the trust instrument. A power does not fall within the powers described in this subsection if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children.

§675. ADMINISTRATIVE POWERS.

The grantor shall be treated as the owner of any portion of a trust in respect of which —

(1) Power to deal for less than adequate and full consideration. A power exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party enables the grantor or any person to purchase, exchange, or otherwise deal with or dispose of the corpus or the income therefrom for less than an adequate consideration in money or money's worth.

(2) Power to borrow without adequate interest or security. A power exercisable by the grantor or a nonadverse party, or both, enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security.

(3) Borrowing of the trust funds. The grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence shall not apply to a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor. For periods during which an individual is the spouse of the grantor (within the meaning of section 672(e)(2)), any reference in this paragraph to the grantor shall be treated as including a reference to such individual.

(4) General powers of administration. A power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. For purposes of this paragraph, the term "power of administration" means any one or more of the following powers:

(A) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control;

(B) a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or

(C) a power to reacquire the trust corpus by substituting other property of an equivalent value.

§676. POWER TO REVOKE.

(a) General rule. The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under any other provision of this part, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a nonadverse party, or both.

(b) Power affecting beneficial enjoyment only after occurrence of event. Subsection (a) shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that a grantor would not be treated as the owner under section 673 if the power were a reversionary interest. But the grantor may be treated as the owner after the occurrence of such event unless the power is relinquished.

§677. INCOME FOR BENEFIT OF GRANTOR.

(a) General rule. The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be —

(1) distributed to the grantor or the grantor's spouse;

(2) held or accumulated for future distribution to the grantor or the grantor's spouse; or

(3) applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse (except policies of insurance irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions)).

This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished.

(b) Obligations of support. Income of a trust shall not be considered taxable to the grantor under subsection (a) or any other provision of this chapter merely because such income in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income for the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661(a) and shall be taxed to the grantor under section 662.

§678. PERSON OTHER THAN GRANTOR TREATED AS SUBSTANTIAL OWNER.

(a) General rule. A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

(1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or

(2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject to grantor of a trust to treatment as the owner thereof.

(b) Exception where grantor is taxable. Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section.

(c) Obligations of support. Subsection (a) shall not apply to a power which enables such person, in the capacity of trustee or co-trustee, merely to apply the income of the trust to the support or maintenance of a person whom the holder of the power is obligated to support or maintain except to the extent that such income is so applied. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income of the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661(a) and shall be taxed to the holder of the power under section 662.

(d) Person other than grantor treated as substantial owner. Effect of renunciation or disclaimer. Subsection (a) shall not apply with respect to a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence.

(e) Cross reference. For provision under which beneficiary of trust is treated as owner of the portion of the trust which consists of stock in an electing small business corporation, see section 1361(d).

§679 FOREIGN TRUSTS HAVING ONE OR MORE UNITED STATES BENEFICIARIES.

(a) Transferor treated as owner.

(1) In general. A United States person who directly or indirectly transfers property to a foreign trust (other than a trust described in section 6048(a)(3)(B)(ii)) shall be treated as the owner for his taxable year of the portion of such trust attributable to such property if for such year there is a United States beneficiary of any portion of such trust.

(2) Exceptions. Paragraph (1) shall not apply —

(A) Transfers by reason of death. To any transfer by reason of death of the transferor.

(B) Transfers at fair market value. To any transfer of property to a trust in exchange for consideration of at least the fair market value of the transferred property. For purposes of the preceding sentence, consideration other than cash shall be taken into account at its fair market value.

(3) Certain obligations not taken into account under fair market value exception.

(A) In general. In determining whether paragraph (2)(B) applies to any transfer by a person described in clause (ii) or (iii) of subparagraph (C), there shall not be taken into account —

(i) except as provided in regulations, any obligation of a person described in subparagraph (C), and

(ii) to the extent provided in regulations, any obligation which is guaranteed by a person described in subparagraph (C).

(B) Treatment of principal payments on obligation. Principal payments by the trust on any obligation referred to in subparagraph (A) shall be taken into account on and after the date of the payment in determining the portion of the trust attributable to the property transferred.

(C) Persons described. The persons described in this subparagraph are —

(i) the trust.

(ii) any grantor or beneficiary of the trust, and

(iii) any person who is related (within the meaning of section 643(i)(2)(B)) to any grantor or beneficiary of the trust.

(4) Special rules applicable to foreign grantor who later becomes a United States person.

(A) In general. If a nonresident alien individual has a residency starting date within 5 years after directly or indirectly transferring property to a foreign trust, this section and section 6048 shall be applied as if such individual transferred to such trust on the residency starting date an amount equal to the portion of such trust attributable to the property transferred by such individual to such trust in such transfer.

(B) Treatment of undistributed income. For purposes of this section, undistributed net income for periods before such individual's residency starting date shall be taken into account in determining the portion of the trust which is attributable to property transferred by such individual to such trust but shall not otherwise be taken into account.

(C) Residency starting date. For purposes of this paragraph, an individual's residency starting date is the residency starting date determined under section 7701(b)(2)(A).

(5) Outbound trust migrations. If —

(A) an individual who is a citizen or resident of the United States transferred property to a trust which was not a foreign trust, and

(B) such trust becomes a foreign trust while such individual is alive,

then this section and section 6048 shall be applied as if such individual transferred to such trust on the date such trust becomes a foreign trust an amount equal to the portion of such trust attributable to the property previously transferred by such individual to such trust. A rule similar to the rule of paragraph (4)(B) shall apply for purposes of this paragraph.

(b) Trusts acquiring United States beneficiaries. If —

(1) subsection (a) applies to a trust for the transferor's taxable year, and

(2) subsection (a) would have applied to the trust for his immediately preceding taxable year but for the fact that for such preceding taxable year there was no United States beneficiary for any portion of the trust,

then, for purposes of this subtitle, the transferor shall be treated as having income for the taxable year (in addition to his other income for such year) equal to the undistributed net income (at the close of such immediately preceding taxable year) attributable to the portion of the trust referred to in subsection (a).

(c) Trusts treated as having a United States beneficiary.

(1) In general. For purposes of this section, a trust shall be treated as having a United States beneficiary for the taxable year unless —

(A) under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a United States person, and

(B) if the trust were terminated at any time during the taxable year, no part of the income or corpus of such trust could be paid to or for the benefit of a United States person.

(2) Attribution of ownership. For purposes of paragraph (1), an amount shall be treated as paid or accumulated to or for the benefit of a United States person if such amount is paid to or accumulated for a foreign corporation, foreign partnership, or foreign trust or estate, and —

(A) in the case of a foreign corporation, such corporation is a controlled foreign corporation (as defined in section 957(a)),

(B) in the case of a foreign partnership, a United States person is a partner of such partnership, or

(C) in the case of a foreign trust or estate, such trust or estate has a United States beneficiary (within the meaning of paragraph (1)).

(3) Certain United States beneficiaries disregarded. A beneficiary shall not be treated as a United States person in applying this section with respect to any transfer of property to foreign trust if such beneficiary first became a United States person more than 5 years after the date of such transfer.

(d) Regulations. The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section.

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2 *Audrey J. Walton v. Commissioner*, 115 T.C. 589 (2000).

3 *Walton, supra.*

4 *Walton, supra.*

5 As indicated elsewhere, the 10% rate of return would actually have to be after-tax in an outright gift, but would only need to be pre-tax in a GRAT, making the differential even more remarkable.

6 The IRS' view of what the gift should be.

7 All references herein to the "IRC" are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

8 §7520(a)(2).

9 IRC §7520(a)

10 *Audrey J. Walton v. Commissioner*, 115 T.C. 589 (2000).

11 IRC §§2702(a)(1)&(2).

12 IRC §§2702(a)(1) via §2701(e)(2).

13 IRC 2702(b).

14 FSA 200036012, TAM 200210009, PLRs 9451056 and 9345035. Treas. Reg. §20.2039-1(b)(2), Ex. 1.

15 Rev. Rul. 82-105, 1982-1 C.B.; 133. PLR 9345035; FSA 200036012, and TAM 200210009.

16 Rul. 76-273, 1976-2 C.B. 268 and Rev. Rul. 82-105, 1982-1 C.B. 133.

17 IRC §2035(a).

18 IRC §2001(b)

19 IRC §2036(b)(1)&(2).

20 *Cf.* the discussion of IRC §2035(a) above.

21 Treas. Reg. §25.2702-3(b)(1)(ii).

22 Treas. Reg. §25.2702-3(e), Ex. (3).

23 See Rev. Rul. 82-105 1982-1 C.B. 133.

24 See, for example, PLRs 9345035 and 9451056.

25 The fact that it is a unitrust in the example rather than an annuity trust appears to have no bearing on the principle.

26 Treas. Reg. §25.2702-3(e), Ex. (5).

27 *Audrey J. Walton v. Commissioner*, 115 T.C. 589 (2000).

28 *Walton, id*, at 591-592.

29 *Walton, id*, at 594-595.

30 Treas. Reg. §25.2702-3(e), Ex. (5).

31 *Walton, id*, at 597.

32 *Walton, id*, at 603.

33 *Walton, id*, at 605.

34 TAMs 9707001, 9848004 and 200230003, and *Cook v. Com*,.269 F.3d 854 (7th Cir. 2001). *Cf.* PLRs 9352017 (modified by 199937043), 9451056, 9449013 (modified by PLR 199951032) , and 9416009.

35 Which cited *Comr. v. Procter*, 142 F.2d 824 (4th Cir.1944); *Harwood v. Comr.*, 82 T.C. 239(1984), aff'd per curium, 786 F.2d 1174 (9th Cir. 1986).

36 Treas. Reg. §25.2702-3(b)(1)(i).

37 Rev. Proc. 2003-3, 2003-1 I.R.B. 113, §4.01(49). In the list of the areas where the IRS will not ordinarily rule is found:

(49) Section 2702.-Special Valuation Rules in Case of Transfers of Interests in Trusts.-Whether annuity interests are qualified annuity interests under § 2702 if the amount of the annuity payable annually is more than 50 percent of the initial net fair market value of the property transferred to the trust, or if the value of the remainder interest is less than 10 percent of the initial net fair market value of the property transferred to the trust. For purposes of the 10 percent test, the value of the remainder interest is the present value determined under § 7520 of the right to receive the trust corpus at the expiration of the term of the trust. The possibility that the grantor may die prior to the expiration of the specified term is not taken into account, nor is the value of any reversion retained by the grantor or the grantor's estate.

38 Rev. Rul. 77-454, 1977-2 C.B. 351.

39 Rev. Rul. 77-454, 1977-2 C.B. 351.

40 PLR 9444033.

41 IRC §§671-769.

42 Subpart E of Subchapter J was passed back when trust income tax rates were lower than individual rates. At the moment, trust rates are higher, not lower, than the individual income tax rates, and so the grantor trust rules are more of a boon than an impediment for most taxpayers.

43 PLRs 9352007, 9352004, 9351005, 9345035.

44 PLRs 9519029, 9504021, 9451056, 9449012, 9449013, 9444033.

45 PLRs 9352007, 9352004, 9351005, 9345035.

46 PLRs 199951031, 199951032, 9444033 and 9404021. But see PLR 9543049, 9449012 and 9449013.

47 Treas. Reg. §25.2702-3(b)(5).

48 Treas. Reg. §25.2702-3(b)(4).

49 Announcement 2000-100, 2000-51 I.R.B. 591.

50 Treas. Reg. §25.2702-3(b)(3).

51 Treas. Reg. §25.2702-3(b)(2).

52 Treas. Reg. §25.2702-3(b)(3).

53 Treas. Reg. §25.2702-3(b)(5).

54 Rev. Rul. 85-13, 1985-1 C.B. 184.

55 See *Frazee v. Commissioner*, 98 T.C. 554(1992); PLR 9535026.

56 *Karmazin v. Commissioner*, Tax Court Docket No. 2127-03.

57 Treas. Reg. §25.2702-2(a)(3).

58 Treas. Reg. §25.2702-2(a)(4).

59 Treas. Reg. §25.2702-2(a)(5), first sentence.

60 IRC §2702(b).

61 Treas. Reg. §25.2702-2(a)(6).

62 Treas. Reg. §25.2702-3(b).

63 Treas. Reg. §25.2702-3(d).

64 Treas. Reg. §25.2702-2(b).

65 IRC §7520(a)

66 Treas. Reg. §25.2702-2(d) Example (3).

67 The term "qualified interest" as used here is somewhat circular.

68 Treas. Reg. §25.2702-2(a)(5), second (and last) sentence.

69 TAMs 9707001, 9848004 and 200230003, and *Cook v. Com*,.269 F.3d 854 (7th Cir. 2001). Cf. PLRs 9352017 (modified by 199937043), 9451056, 9449013 (modified by PLR 199951032) , and 9416009.

70 §25.2702-2(d) Examples (6) and (7).

71 Treas. Reg. §25.2702-2(a)(5), second (and last) sentence.

72 *Cook v. Com*, 115 T.C. 15 (2000) , aff'd, 269 F.3d 854 (7th Cir. 2001).

73 *This dictum*, if that is what it was, was expressly referred to approvingly in *Walton, supra* as being good law even if Ex. 5 did not apply.

74 *Audrey J. Walton v. Commissioner*, 115 T.C. 589 (2000).

75 *Schott v. Com.*, 319 F.3d 1203 (9th Cir. 2003), rev'g, T.C. Memo 2001-110. Compare TAM 200319001.

76 Qualified Terminal Interest Property under IRC §2056(b)(7).

77 PLRs 9449012 and its twin 9449013.

78 *Id.*

79 IRC §2702(a)(3).

80 IRC §2702(c).

81 IRC §2701(e)(2).

82 IRC §2704(c)(2).

83 IRC §2701(e)(1).

84 Treas. Reg. §25.2702-2(a)(1).

85 IRC §2702(d).

86 Treas. Reg. §25.2702-3(e), Ex. 1.

87 Restatement (Second) of Trusts §§155, 157 (1959).

88 See Rev. Rul. 85-13, 1985-1 C.B. 184. PLRs 9519029, 9504021, 9451056, 9444033, 9449013, 9449012, 9441031, 9352017, 9352007, 9351005, 9345035, 9239015.

89 *Diedrich v. Com.*, 102 S. Ct. 2414 (1982); and the infamous *Com. v. Tufts*, 103 S. Ct. 1826 (1983).

90 IRC §673(a).

91 PLR 9152034.

92 IRC §674(a).

93 PLR 200001013. See also 9625021.

94 IRC §674(a).

95 PLR 200227022, 200001013 and 200001015.

96 Treas. Reg. §1.675-1(b)(4)(iii)

97 See PLRs 9239015, 9352017, 9351005, 9345035, and 200030010.

98 9416009. *Cf.* PLRs 9352007, 9352004, 9248016.

99 Query: Is there a meaningful difference between "acquire" and "reacquire."

100 PLR 9416009.

101 PLRs 9444033, 9448018, 9451056, 9504021. *Cf.*, 200001013, and 200001015.

102 PLRs 9449012 and 9449013.

103 PLRs 9449012 and 9449013.

104 *Rand v. Comr.*, 40 B.T.A. 233 (1939), *acq.*, 1939-2 C.B. 30, *aff'd*, 116 F.2d 929 (8th Cir. 1941) *cert. denied*, 313 U.S. 594 (1941); *Iversen v. Comr.*, 3 T.C. 756 (1944); *Weil v. Comr.*, 3 T.C. 579 (1944), *acq.*, 1944 C.B. 29; and *Moore v. Comr.*, 39 B.T.A. 808 (1939), *acq.*, 1939-2 C.B. 25. *Cf.*, *Chandler v. Comr.*, 41 B.T.A. 165 (1940), *aff'd on other grounds*, 119 F.2d 623 (3d Cir. 1941); and *Garland Est. v. Comr.*, ¶43,339 P-H T.C. Memo (1943).

105 PLRs 200227022, 200001015, 200001013, 9504021, 9448018, 9444033, 9416009, 9352007, 9352004, 9351005, 9345035. Cf., 9449012, 9449013.

106 IRC §1361(d)(3).

107 IRC §1361(e)(1).

108 IRC §1361(d)(3).

109 IRC §1361(e)(1).

110 IRC §2642(f)(3).

111 PLR 200227022.

112 As defined in Treas. Reg. §25.2702-2(a)(3).

113 Rev. Rul. 85-13, 1985-1 C.B. 184. But see *Rothstein v. Comr.*,735 F.2d 704 (2d Cir. 1984), which is *contra*.

114 Treas. Reg. §25.2702-3(d)(4).

115 IRC §2035(a)(2). Cf., Allen v. U.S., 293 F.2d 916 (10th Cir. 1961).

116 Treas. Reg. §25.7520-3(b)(3).

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❏	**Website/E-Communications**	G. Walter McCool Brusniak McCool & Blackwell, P.C. 17400 Dallas Parkway, Suite 112 Dallas, TX 75287 (972) 250-6363 (972) 250-3599 (fax) mccool@txtax.com

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