Winter 2015
Vol. 42, No. 2, Part 1
www.texastaxsection.org

The Texas Tax Lawyer

2015

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Chair's Message

I am pleased to announce the winter edition of the Tax Texas Lawyer. Please note the following Tax Section events on your calendar:

- April 13, 2015—Property Tax Conference, Austin, Texas
- June 19, 2015—Annual Meeting of the Tax Section, San Antonio, Texas

Website Update

Progress on the Tax Section's new website continues! We have established a color palette and selected a set of Texas-themed photographs to ensure we have an attractive site. The technical team is fine-tuning the site's overall format and organization, giving particular attention to navigation links. The new site will be easier to navigate, include more useful and current information, and will simplify the process to update content. Target time frame to launch the new site is during the first quarter of this year.

You may notice some work on the current site, also. We are updating and reorganizing existing content in preparation for transitioning to the new site. Vicki McCullough may contact you to review or edit committee pages or other content. If you see other content issues or updates to address, please be sure to share that information with Vicki.

As part of this technology and communications upgrade, we will launch Tax Section LinkedIn and Twitter accounts. Watch for more information about how to engage with Tax Section through these accounts.

2014 - 2015 Tax Section Leadership Academy

Congratulations to the recent Leadership Academy graduates. Over the past year, this group met in Dallas, Houston, Austin, and San Antonio to learn from leading Texas tax attorneys, develop leadership skills, and develop their professional networks. Completing the Leadership Academy program advances individual careers and strengthens the Tax Section.

Our thanks to Dan Baucum, Leadership Academy Committee Chair and Program Director, who led the planning and successful completion of the 2014 – 2015 program. We also are grateful for the contributions of David Colmenero, Program Director and Christi Mondrik, current Vice Chair and Chair-Elect for the 2016 – 2017 Leadership Academy. Special recognition goes to Susan House for attending to every program detail. The guidance and insights of committee members Ryan Gardner, Charolette Noel, and Ronald Rucker is appreciated.

Our next Leadership Academy will begin in 2016. Watch this publication and the Tax Section website for information and applications.

The 2014 – 2015 Leadership Academy graduates are listed below. For more information on these graduates, please refer to the professional biographies included in this publication of the Texas Tax Lawyer.

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- Brandon L. Bloom, Thompson & Knight, LLP
- John Steven (Steve) Britt, Scott Douglas & McConnico, LLP
- Lina G. Dimachkieh, Vinson & Elkins, LLP
- Kenneth S. Freed, Crady, Jewett & McCulley, LLP
- Jason B. Freeman, Meadows, Collier, Reed, Cousin, Crouch & Ungerman, L.L.P.
- Tiffany L. Hamil, Law Office of Tiffany L. Hamil, PLLC
- Amber N. Haque, Ericsson
- Justin J. Hepworth, Jones Day
- Faye Hoffman Hilpert, Jackson Walker, LLP
- Bryan L. Jepson, Sprouse Shrader Smith, PC
- Stephen W. Long, Baker & McKenzie
- Mel E. Myers, Chamberlain, Hrdlicka, White, Williams & Aughtry
- Joseph L. Perera, Strasburger & Price, LLP
- Rachael Rubenstein, Center for Legal & Social Justice of St. Mary's Univ. School of Law
- Michelle A. Spiegel, Mayer Brown, LLP
- Alexander ("Alex") D. Thomas, PricewaterhouseCoopers, LLP
- Meredith VanderWilt, Polsinelli, PC
- Lauren A. Waite, Haynes & Boone, LLP
- Robert L. ("Lee") Wilson, The Wilson Firm, PLLC

COGS Update

The Committee on Government Submissions (COGS) process is the Tax Section's means to provide comments on state and federal proposed rules and regulations. Sharing our experience and perspective can help improve tax laws and their administration. Providing comments also enhances the profile of the Tax Section and our members. Thank you to Bob Probasco for all his hard work and leadership in Chairing this very important committee of the Tax Section.

During the 2014 – 2015 year, COGS has filed seven comments letters and assisted the Real Estate Probate and Trust Law section with a draft bill for the Texas legislature. COGS has also participated in one public hearing and currently has three projects underway.

Recently submitted letters address (1) The Texas Comptroller's Proposed Rule 3.13 Relating to Timely Filing and Payment, (2) Texas Department of Insurance Draft Rules Regarding Professional Employer Organizations and Self-Funded Health Benefit Plans, (3) Proposed Texas Comptroller Rule 3.286 (Sales & Use Tax Responsibilities and Nexus), and (4) Proposed Texas Comptroller Rules 3.280 (Aircraft) and 3.285 (Sale for Resale).

Our thanks to Alyson Outenreath, Charolette Noel, Cindy Ohlenforst, David Cowling, Henry Talavera, Ira Lipstet, James Griffin, Karen Currie, Kirk Lyda, Riva Johnson, Sam Megally, and Sandi Farquharson for the review and comments.

Recently submitted comments are included in this publication. Current and previous comment letters are available on the Tax Section website at www.texastaxsection.org/TaxResources/GovernmentSubmissions/tabid/104/Default.aspx.

For more information about COGS, refer to COGS Chair Bob Probasco's article in this issue, *Have You Ever Met a Regulation That Could Be Improved*? To recommend a subject for, participate in, or lead a COGS project, please contact Bob Probasco at 214.335.7549 or robert.probasco@probascotaxlaw.com.

CLE Programs

Since our last issue the Tax Section has had two successful programs. The International Tax Symposium took place in Plano and Houston on November 6 and 7, 2014, respectively. Thank you to Austin Carlson for his work as Chair of the International Tax Committee and organizing these very well received programs.

Last year we launched a new program in Dallas called Tax Law in a Day. Due to its success, we decided to have the program again on February 6, 2015 in Dallas. A big thank you to Lora Davis for organizing the program this year. It was a basic tax CLE program covering property tax basics, Texas State and local tax overview, traps and tricks for S corporations, nuts and bolts of UBTI, what every tax lawyer needs to know about ERISA, tax planning for real estate, community property law, anatomy of a criminal case and federal income tax developments. Many thanks to our speakers Melinda Blackwell, Kirk Lyda, Daniel McCarthy, Terry Helge, Susan Wetzel, Chris Goodrich, Celeste Lawton, Bruce McGovern and David Gair.

Annual Meeting and Sponsorship

We have a terrific program lined up for our Annual meeting which will take place in San Antonio on June 19, 2015. This year's excellent program will headline Nina Olson the head of the IRS Taxpayer Advocate Service office. Other renowned speakers will include other representatives from the IRS and Justice Department as well as highly experienced practitioners addressing IRS enforcement initiatives, current areas of focus for criminal enforcement, an update on oil and gas tax litigation and avoiding unintended estate planning consequences. We will also be presenting our award of the Outstanding Texas Tax Lawyer who will be interviewed during our luncheon by Bill Elliott.

We are offering two sponsorship options in support of the Annual Meeting and other programs we offer throughout the year.

The $2,500 Platinum Sponsorship provides your firm these annual benefits:

- Three seats to the Tax Section Annual Meeting Speakers' Dinner
- Three tickets to the Tax Section Annual Meeting
- Recognition at the Tax Section Annual Meeting in the Chair's introductory remarks and program handouts
- Recognition on Annual Meeting e-blasts from Tax Section leadership to members of Tax Section
- Recognition throughout the year at Tax Section seminars and events
- Listing on the Tax Section website

The $1,500 Gold Sponsorship provides these annual benefits:

- Recognition at the Tax Section Annual Meeting in the Chair's introductory remarks and program handouts

- Recognition on Annual Meeting e-blasts from Tax Section leadership to members of Tax Section
- Listing on the Tax Section website

Conclusion

The Tax Section is busy and very active. The greatest benefit you can receive as a member, however, is to become involved with one or more of the Tax Section's activities. It will provide you with a great way to meet fellow tax professionals and make a lasting impact on the practice of tax law both in Texas and nationally. If you are not sure how to get involved, please don't hesitate to contact me at (713) 651-5482 or at andrius.kontrimas@nortonrosefulbright.com.

Andrius R. Kontrimas, Tax Section Chair

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TAX SECTION
OF
THE STATE BAR OF TEXAS
2014-2015
CALENDAR

June 2014	
1	**Deadline for Student Scholarship Applications**
11-13	**30th Annual Texas Federal Tax Institute – Hyatt Regency Hill Country Resort, San Antonio**
17	**COGS Call** Dial In: 866.203.7023 Conference Code: 7136515591# 9:00 am
26-27	**SBOT 2014 Annual Meeting - Austin Convention Center**
20	**Council Retreat** Hosted by: Norton Rose Fulbright (Andrius R. Kontrimas) 98 San Jacinto Boulevard, Suite 1100 Austin, TX 78701-4255 Telephone: +1 512 474 5201 2:00 pm – 5:00 pm
25-27	**Leadership Academy - Austin** Hosted by: Jackson Walker 100 Congress Avenue, Suite 1100 Austin, Texas 78701 Telephone: +1 512 236 2000
27	**Tax Section Annual Meeting** Austin Convention Center 8:00 am – 4:40 pm (post on website at least ***20 days in advance***; elect 3 new Council members)
July 2014	
22	**COGS Call** Dial In: 866.203.7023 Conference Code: 7136515591# 9:00 am
August 2014	
1	**Scholarship Program** Review and revise scholarship applications; submit changes to Tax Section for approval.

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1	**Bar Leaders Conference – New Chair and Treasurer Orientation** Westin Domain – Houston 10:30 a.m. – 2:30 p.m.
8-10	**ABA Annual Meeting** Boston, Massachusetts
19	**Officer Retreat** Hosted by: Norton Rose Fulbright (Andrius Kontrimas) 1301 McKinney Street, Suite 5100 Houston, Texas 77010-3095 Telephone No.: 713 651 5482 11:30 a.m. – 3:30 p.m.
19	**COGS Call** Dial In: 866.203.7023 Conference Code: 7136515591# 9:00 am
28-29	**32nd Annual Advanced Tax Law Course** co-sponsored by the State Bar of Texas Tax Section. Westin Galleria Hotel Dallas, Texas
September 2014	
5	**Council and Committee Chairs and Vice Chairs Meeting** **MANDATORY IN PERSON ATTENDANCE** Hosted by: Norton Rose Fulbright (Andrius Kontrimas) 1301 McKinney Street, Suite 5100 Houston, Texas 77010-3095 Telephone No.: 713 651 5482 10:30 a.m. – 12:30 p.m.
15-16	**Pro Bono Committee Calendar Call Assistance (regular and small case)** United States Tax Court Lubbock, Texas

18-19	**Pro Bono Committee Calendar Call Assistance (regular and small case)** United States Tax Court El Paso, Texas
18-20	**ABA Joint Fall CLE Meeting** Sheraton Downtown Denver, Colorado
23	**COGS Call** Dial In: 866.203.7023 Conference Code: 7136515591# 9:00 am
25 – 26	**Leadership Academy Meeting** Hosted by: Norton Rose Fulbright (Andrius Kontrimas) 1301 McKinney Street, Suite 5100 Houston, Texas 77010-3095 Telephone No.: 713 651 5482 8:15 a.m. – 4:45 p.m.
27	**Deadline for appointing Nominating Committee (list in Texas Tax Lawyer and on website)**
October 2014	
3	**Submission Deadline - Fall 2014 Issue of the Texas Tax Lawyer**
21	**COGS Call** Dial In: 866.203.7023 Conference Code: 7136515591# 9:00 am
24	**Council of Chairs Meeting** Texas Law Center in Austin 10:30 am – 2:30 pm
27	**Pro Bono Committee Calendar Call Assistance (regular case)** United States Tax Court San Antonio, Texas
November 2014	
1	**Scholarship Program** Verify email addresses of law school contacts and professors for purposes of creating the master distribution list.

3	**Pro Bono Committee Calendar Call Assistance (regular case)** United States Tax Court Houston, Texas
3	**Pro Bono Committee Calendar Call Assistance (regular case)** United States Tax Court Dallas, Texas
5	**Open nominations for Outstanding Texas Tax Lawyer. Nominations due January 15, 2015.**
6	**18th Annual International Tax Symposium – Plano, Texas** **The Center for American and International Law** **5201 Democracy Drive** **Plano, Texas 75024**
7	**18th Annual International Tax Symposium – Houston, Texas** **The Hess Club** **5430 Westheimer Road** **Houston, Texas**
7	**Council Meeting** Hosted by: Norton Rose Fulbright (Andrius Kontrimas) 1301 McKinney Street, Suite 5100 Houston, Texas 77010-3095 Telephone No.: 713 651 5482 10:30 a.m. – 12:30 p.m.
18	**COGS Call** Dial In: 866.203.7023 Conference Code: 7136515591# 9:00 am
December 2014	
1 and 8	**Pro Bono Committee Calendar Call Assistance (small case)** United States Tax Court Houston, Texas
1 and 8	**Pro Bono Committee Calendar Call Assistance (regular case)** United States Tax Court Dallas, Texas
16	**COGS Call** Dial In: 866.203.7023 Conference Code: 7136515591# 9:00 am

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31	**Scholarship Program** Verify email addresses of law school contacts and professors for purposes of creating the master distribution list.
January 2015	
15	**Leadership Academy Meeting** Dallas Bar Association – Belo Mansion Dallas, Texas
15	**Deadline for annual meeting program agenda** Nominations due for Outstanding Texas Tax Lawyer Open nominations for Officers and Elected Council (Council vote follows January 16th meeting)
20	**Scholarship Program** o Email applications to law schools; o Post application on Tax Section website; and o Email applications to tax law professors.
20	**COGS Call** 9:00 am
29	**Council and Committee Chairs and Vice Chairs Meeting** Hosted by: Norton Rose Fulbright (Andrius Kontrimas) 1301 McKinney Street, Suite 5100 Houston, Texas 77010-3095 Telephone No.: 713 651 5482 3:00 pm – 5:00 pm
29-31	**ABA Mid-Year Meeting** Hilton Americas Houston, Texas
February 2015	
6	**Submissions Deadline – Winter 2015 issue of the *Texas Tax Lawyer***
6	**Tax Law in a Day** Cityplace Dallas Tx
14	**Tax Court Pro Bono Program Annual Renewal**
17	**COGS Call** 9:00 am

20	**Council of Chairs Meeting** Texas Law Center in Austin 10:30 am – 2:30 pm
March 2015	
1	**Nominations deadline for Chair-Elect, Secretary, Treasurer, and 3 Elected Council Members**
24	**COGS Call** 9:00 am
April 2015	
1	**Nominating Committee's Report** due to Council (Must be submitted at least 10 days before April 17, 2015 Council meeting).
3	**Scholarship Program** Deadline for submission of completed applications.
10	**Scholarship Program** Scholarship Committee meets to discuss and select scholarship recipients.
13	**Property Tax Conference** Thompson Conference Center Austin, Texas
17	**Council Meeting** Hosted by: Norton Rose Fulbright (Andrius Kontrimas) 1301 McKinney Street, Suite 5100 Houston, Texas 77010-3095 Telephone No.: 713 651 5482 Elect Chair-Elect, Secretary, and Treasurer 10:30 a.m. – 12:30 p.m.
21	**COGS Call** 9:00 am
24	**Submissions Deadline – Spring 2015 issue of the Texas Tax Lawyer**

May 2015	o
1	**Scholarship Program** o Contact recipients of the scholarships; and Send email notifications to individuals not selected.

7-9	**ABA May Meeting** Grand Hyatt Washington, DC
19	**COGS Call** 9:00 am
June 2015	
18-19	**SBOT 2015 Annual Meeting – San Antonio, Texas**
18 or 19	**Scholarship Program** Award of Scholarships at State Bar Annual Meeting.
23	**COGS Call** 9:00 am
July & Aug 2015	
30-4	**ABA Annual Meeting** Chicago, Ill
Sept 2015	
17-19	**ABA Joint Fall Meeting** Sheraton Hotel & Towers Chicago, Ill

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2015 – 2015 LEADERSHIP ACADEMY GRADUATES

BRANDON L. BLOOM *brandon.bloom@tklaw.com*

Mr. Bloom is an associate at Thompson & Knight LLP. He focuses his practice on corporate and partnership tax, and he represents clients in private equity transactions and other business transactions involving corporations, partnerships and limited liability companies. He provides clients with federal and state tax planning advice on mergers and acquisitions, divestitures, and other corporate restructuring transactions, as well as the formation, operation and disposition of partnerships and limited liability companies. He also represents borrowers and lenders in connection with the tax aspects of financing transactions. He served as the Vice Chair of the Energy and Natural Resource Tax Committee in 2011-2012 and 2012-2013. Mr. Bloom received his LL.M. in Taxation from the University of Florida Levin College of Law and his J.D. from the University of Oklahoma College of Law.

JOHN STEVEN (STEVE) BRITT *sbritt@scottdoug.com*

Mr. Britt is an associate at Scott, Douglas & McConnico, LLP. He practices primarily in the firm's state and local tax litigation group representing large and small companies in administrative protests of tax assessments before various taxing authorities. He also litigates tax assessments in Texas district courts and advises clients concerning the tax implications of business transactions. Prior to joining SD&M, Steve was a high school teacher and a coach for ten years. Mr. Britt received his J.D., with honors, from the University of Texas School of Law.

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Mr. Cowan is the Senior Tax Counsel of Global Tax-Research and Planning with Hewlett-Packard. His practice focuses on both inbound and outbound international tax matters. He has worked on projects for small, growth-oriented start-ups as well as large and mature companies. He has assisted clients in the energy and oil & gas sector, manufacturing sector, construction sector and the private equity sector. Mr. Cowan has provided advice on acquisition and reorganization structuring, intellectual property planning and migration, financing structures, foreign exchange issues and the implication of the Foreign Investment in Real Property Tax Act on initial investments and restructuring. Prior to joining Hewlett-Packard, he was a Manager in Deloitte's Washington National Tax Office. He speaks fluent English, Spanish and French and is licensed to practice in Texas and Washington, D.C. He is the Co-Vice Chair of the State Bar of Texas Tax Section International Tax Committee. Mr. Cowan received his LL.M. in Taxation from Georgetown University Law Center and his J.D.

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Ms. Dimachkieh is an associate at Vinson & Elkins. Her practice consists primarily of planning to minimize federal income taxes imposed with respect to business transactions and investments involving partnerships, corporations, and individuals. She also has experience working on tax controversies with the Internal Revenue Service. She has represented many of the firm's clients in a variety of matters, including mergers and acquisitions, reorganizations, and capital market transactions. She received her J.D., magna cum laude, from Harvard Law School.

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Mr. Freed is an associate at Crady, Jewett & McCulley, LLP. His practice areas include tax, estate planning, business mergers, sales and acquisitions and general business representation. He has experience in the taxation of partnerships and corporations, including the taxation of U.S. businesses with foreign operations and foreign businesses with U.S. operations. In addition to tax matters, he assists clients with transactional issues including formation and structuring, mergers and acquisitions, corporate governance, contract negotiations, real estate and financial transactions. Prior to joining the firm, he spent three years in the International Tax Group of an international public accounting firm. Mr. Freed received his J.D. from The University of Houston Law Center.

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Mr. Freeman is an associate at Meadows, Collier, Reed, Cousins, Crouch & Ungerman, LLP. His practice concentrates on resolving federal and state tax controversies, and white collar crimes. He is an adjunct professor of Tax Law at Southern Methodist University School of Law. Mr. Freeman is a Certified Public Accountant. Prior to attending law school, he was a practicing CPA with an international accounting firm. He received his J.D., with high honors and Order of the Coif, from The University of Texas School of Law.

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Ms. Hamil has her own law firm. Her practice focuses on tax-related legal services for personal, corporate, and executive tax matters. Specifically, she focuses on Ad Valorem Taxation, OVDI Representation, IRS Audit and Collection Alternative Representation. Ms. Hamil is an adjunct professor in Texas Wesleyan's business school teaching undergraduate courses in Federal Income Taxation, Business Law I and II and graduate courses in Corporate Tax and Partnership Tax. She received her LL.M. in Taxation from the University of Florida Levin College of Law and her J.D., cum laude, from Texas Wesleyan School of Law.

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Ms. Haque is an in-house attorney and Contracts Manager with Ericsson in their Strategic Sourcing Department. She provides supplier agreement negotiation, drafting and processing assistance to Sourcing and internal Stakeholders. Prior to joining Ericsson, Ms. Haque was an associate with a tax litigation boutique in Dallas. Her practice concentrated on federal tax related controversy matters. She received her LL.M. in Taxation and her J.D. from Southern Methodist University Dedman School of Law.

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Mr. Hepworth is an associate at Jones Day. He is a member of the State and Local Tax practice. His practice focuses on tax transaction and controversy matters, assisting clients with multistate income, franchise, sales, and transfer tax issues. He advises on audit defense voluntary disclosure agreements, unclaimed property planning, and other controversy and compliance matters. Mr. Hepworth received his J.D., magna cum laude and Order of the Coif, from Tulane University Law School.

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Ms. Hilpert is an associate in the Wealth Planning practice group at Jackson Walker. Her experience includes assisting clients with matters related to wills, trusts, probate, intra-family transactions, and charitable giving. She works closely with attorneys in the Wealth Planning group and other practice areas to address the unique challenges that often arise in the course of estate planning, including tax, oil and gas, family, and probate matters. Prior to joining Jackson Walker, Ms. Hilpert served as a law clerk for the Honorable Maurice B. Foley of the United States Tax Court. Her previous experience also includes working in the oil and gas industry and for a boutique firm focused on estate planning. Ms. Hilpert received her LL.M. in Taxation from New York University School of Law and her J.D. from The University of Texas School of Law.

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Mr. Jepson is an associate at Sprouse Shrader Smith, PC. His practice focuses on all areas of federal income tax, as well as corporate and non-profit transactions. Prior to attending law school, Mr. Jepson was a loan officer in a not-for-profit banking group for almost four years. He received his LL.M. in Taxation from New York University School of Law and his J.D. from Texas Tech University School of Law.

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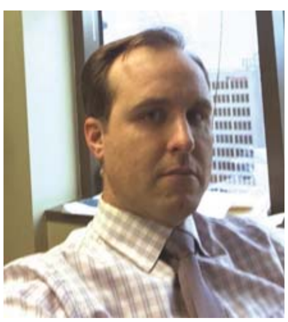
Mr. Long is an associate at Baker & McKenzie, LLP. He represents multinational companies during audit through administrative appeals, and in court. He also has experience in domestic and international structuring and tax planning. His practice focuses on federal and multistate tax controversy issues. He is experienced in resolving issues before the Internal Revenue Service and state tax authorities. Mr. Long received his LL.M. in Taxation from New York University School of Law and his J.D., cum laude, from the University of South Carolina School of Law.

MEL E. MYERS *mel.myers@chamberlainlaw.com*



Mr. Myers is an associate at Chamberlain, Hrdlicka, White, Williams & Aughtry. He provides tax counsel to corporations, partnerships, and pass-through entities in their business transactions, tax planning, transfer pricing, tax compliance, audit, and tax controversy matters. Prior to joining Chamberlain Hrdlicka, Mr. Myers served as an assistant general counsel in Washington, DC representing the United States government before the United States Court of Federal Claims and the United States Civilian Board of Contract Appeals. He received his LL.M. in Taxation from Georgetown University Law Center and his J.D., cum laude, from American University-Washington College of Law.

JOSEPH L. PERERA *joseph.perera@strasburger.com*

Mr. Perera is an associate with Strasburger & Price, LLP. He represents clients on a variety of federal and state tax matters. He assists clients at every stage of federal tax disputes including IRS audits, IRS collection cases, cases at IRS Appeals, and cases before the United States Tax Court. Mr. Perera advises clients on employee benefit and executive compensation matters, including compliance under ERISA with the IRS and Department of Labor. He also represents clients in disputes with the Texas Comptroller of Public Accounts and the Texas Workforce Commission. Before joining Strasburger & Price, LLP, he was an attorney in the National Office of the Office of Chief Counsel, Internal Revenue Service. He received his LL.M. in Taxation from Georgetown University Law Center and his J.D. from Southern Methodist University Dedman School of Law.

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Ms. Rubenstein is a Senior Tax Fellow at the Center for Legal and Social Justice (CLSJ) at St. Mary's University School of Law. She focuses her attention on developing her chosen tax specialty in order to grow and diversify the tax education opportunities and services offered at the CLSJ. She was instrumental in bringing two federal Internal Revenue Service (IRS) grants to the University – the Volunteer Income Tax Assistance (VITA) grant and the Low Income Tax Clinic (LITC) grant. She supervises clinic students assigned to tax cases at the administrative level and in various federal courts. She also teaches clinic classes which focus on tax practice and procedure issues. She continues to participate in the year-round VITA program as a training instructor, technical consultant, and Saturday volunteer. Mr. Rubenstein received her J.D., cum laude, from St. Mary's University School of Law.

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MICHELLE A. SPIEGEL *mspiegel@mayerbrown.com*

Ms. Spiegel is a Tax Controversy associate with Mayer Brown. She represents clients in many types of tax disputes with taxing authorities on federal and state levels. Her tax controversy experience spans a wide range of areas including international withholdings, transfer pricing controversies, and tax shelter disallowances. She also advises foreign and domestic entities seeking corporate and tax advice in connection with various types of foreign and domestic transactions. She is the Vice Chair of the State Bar of Texas Tax Section, Communications - Newsletter Committee. Ms. Spiegel received her J.D. from Duke University School of Law.

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Mr. Thomas is a senior associate in PricewaterhouseCooper's State and Local Tax practice. His practice focuses on state and local tax controversy matters as well as federal and state employment tax consulting. Mr. Thomas' practice includes favorable representation of clients before various state Departments of Revenue in refund claims and audit defenses, with a focus on state tax controversy matters in Texas and Louisiana. He has successfully appealed state unemployment tax rate determinations and obtained federal and state employment tax refunds as the result of acquisitions and reorganizations. Mr. Thomas received his J.D. from Saint Louis University School of Law with a concentration in Taxation and Business Transactional law.

MEREDITH A. VANDERWILT *mvanderwilt@polsinelli.com*

Ms. VanderWilt is an associate in the Employee Benefits and Executive Compensation practice at Polsinelli, PC. She has worked in employee benefits since 2007. Her practice focus is a variety of employee benefits matters, including the design and implementation of qualified plans, health and welfare plans, and non-qualified compensation arrangements, as well as compliance with the Internal Revenue Code, ERISA, COBRA, HIPPA and PPACA. She is the Young Lawyer Liaison for the Defined Benefit Plan Subcommittee of the Employee Benefit Committee of the American Bar Association Tax Section. Ms. VanderWilt received her J.D. from Southern Methodist University Dedman School of Law.

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Ms. Waite is an associate in the Business Planning and Tax Practice Group at Haynes and Boone, LLP. She has experience working with partnerships, limited liability companies, private and publicly held corporations, and individual investors. Her areas of practice include federal, state, and local tax planning and controversy matters for various business entities and individuals. She received her J.D., summa cum laude and Order of the Coif, from Texas Tech University School of Law.

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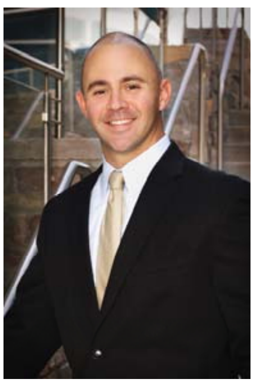

Mr. Lee has his own law firm. The focus of his tax practice is tax controversy matters at the federal, state, and local levels. He represents individuals and businesses before the Internal Revenue Service, the Department of Justice's Tax Division, the Texas Comptroller of Public Accounts, and various other state and local governmental taxing authorities. Mr. Wilson received his LL.M. in Taxation from the University of Florida Levin College of Law and his J.D. from Texas Tech University School of Law. While attending Texas Tech University School of Law, he was a member of the School's Law Review, President and Founder of the Tax Law Society and served as a member of the School's Low-Income Taxpayer Clinic.

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DON'T LEAVE MONEY ON THE TABLE! IRS [MIS]COMPUTATION OF INTEREST

By: Bob Probasco
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After resolving federal tax deficiencies or refunds, taxpayers and their representatives must still carefully examine IRS computations of interest, which are frequently wrong. This outline addresses the basis framework for interest computation, common IRS mistakes (for which the law is clear), disputed issues (for which the law is not entirely clear), and certain procedural issues.

1. Basic framework for interest computation

   a. Interest payable by taxpayers, on underpayments of tax.

      i. Note: underpayment interest is assessed, collected, and paid in the same manner as taxes, and it is included in most references to "tax" in the Code. But it is not subject to deficiency procedures. IRC § 6601(e)(1).

      ii. General rule – interest is payable on any amount "not paid on or before the last date prescribed for payment" from the last date prescribed for payment to "the date paid." IRC § 6601(a).

         1. Generally, this is the original due date for filing the return, without regard to any extensions and without regard to an installment agreement to pay the tax due. IRC § 6601(b)(1).

         2. But courts and the IRS recognize that sometimes there is no amount due as of the due date of the return, but an underpayment balance may arise later. In that case, the interest computation period starts when the "tax becomes both due and unpaid." *Avon Prods., Inc. v. United States*, 588 F.2d 342 (2d Cir. 1978). This can be later than the due date of the return if, for example, the cumulative amount paid drops below the tax due, as result of a refund or credit. See the discussion of "annual netting," 1.d below, and the discussion of "credit elect transfers," 2.a below, for examples.

         3. If the amount due is paid by crediting an overpayment due the taxpayer for another tax period, IRC § 6402(a), underpayment interest stops as of the later of:

a. The "last date prescribed for payment" of the underpayment

b. The date that interest would begin accruing on the overpayment.

IRC § 6601(f). The two provisions combine to stop underpayment interest in one period and overpayment interest in the other period at the same time. The actual date that the IRS processes the credit is irrelevant.

4. However, if the amount due is paid by crediting an overpayment due another taxpayer – at the taxpayers' request, since the IRS has no authority under IRC § 6402(a) to make such a credit – the date that the IRS makes the credit is considered the "date paid" for purposes of interest on the underpayment and the date refunded for purposes of interest on the overpayment. In effect, the credit is treated as a simultaneous refund of the overpayment and payment of the underpayment.

iii. Penalties

1. Interest on accuracy-related penalties, fraud penalties, and penalties for failure to file or failure to pay is computed from the return due date, including extensions, until the date paid. IRC § 6601(e)(2)(B).

2. Interest on other assessable penalties or additional amounts is computed only from the date of notice and demand until the date paid. But if payment is made within 21 days of notice and demand (10 business days if the amount is at least $10,000), no interest is due. IRC § 6601(e)(2)(A).

iv. Carrybacks – if there is a net operating loss carryback, capital loss carryback, foreign tax credit carryback, or business credit carryback to a taxable year, the resulting decrease in tax for that taxable year "shall not affect the computation of [underpayment] interest" for the period ending with the return due date (determined without regard to extensions) of the year in which the loss/credit arose and from which it was carried back. IRC § 6601(d).

1. This is an awkward way of saying that the tax balance in the year to which a loss/credit is carried back (the "carryback year") is treated as changing on the return due date of the year in which the loss/credit year arose (the "source year"), rather than the return due date of the carryback year.

2. This rule was originally developed through case law and was applied somewhat more broadly than what was eventually enacted in IRC § 6601(d), to cover not just carrybacks but also the secondary effects of the carrybacks. Any effect that is "directly attributable" to the carryback also is treated as changing the tax liability as of the return due date for the source year. *See* Rev. Rul. 85-65, 1985-1 C.B. 366; G.C.M. 39,359 (May 14, 1984).

   a. The most common such effect is "credit bumping." For example, if a loss/credit carryback from 2014 to 2012 triggers a credit carryback from 2012 to 2010, the effective date of the resulting change to the tax liability for 2010 is the return due date for 2014, not the return due date for 2012.

3. This rule regarding carrybacks applies in both directions – both a reduction in tax liability (and therefore a decrease in the underpayment balance) resulting from the original carryback, and an increase in tax liability (and therefore an increase in the underpayment balance) resulting from a reduction of the carryback on audit.

v. Restricted interest – situations in which the taxpayer need not pay interest on an underpayment of tax

1. Form 870 waiver: When resolving a tax dispute, the taxpayer may agree to sign Form 870 or Form 870-AD, consenting to an immediate assessment of the deficiency and waiving the 90-day period within which to petition the Tax Court. IRC § 6213(d). The expectation is that the IRS will immediately assess the deficiency and make notice and demand for payment. But if the IRS does not make notice and demand for payment within 30 days after the waiver is filed, underpayment interest is suspended for the period starting on the 31st day and ending when the IRS finally makes notice and demand. IRC § 6601(c).

2. Payment back-off period: For any amount that is paid within 21 calendar days (or 10 calendar days if the amount is $100,000 or more) of notice and demand, no underpayment interest is imposed for the period after notice and demand. IRC § 6601(e)(3).

b. Interest payable to taxpayers, on overpayments of tax

i. Note: Overpayment interest is **<u>not</u>** considered part of the tax liability. Further, if the IRS pays overpayment interest to the taxpayer and then

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determines that too much was paid – for example, because the overpayment was reduced by a later deficiency determined on audit – the IRS cannot use assessment procedures to collect that excessive amount. The only alternatives are an erroneous refund suit or offset against a refund for the same type of tax and the same tax period.

ii. General rule

1. If the overpayment is refunded, interest is payable for the period from the date of the overpayment to the date refunded, but with an interest-free period as discussed below. IRC § 6611(b)(2).

2. If the overpayment is credited to another tax period for which the taxpayer owes the government an underpayment, interest is payable for the period from the date of the overpayment to the due date of the underpayment for the other tax period. IRC § 6611(b)(1). There is a reciprocal provision regarding underpayment interest due on the underpayment in that other tax period, IRC § 6601(f), discussed above. The two provisions together result in stopping underpayment interest in one period and overpayment interest in the other period at the same time. The actual date that the IRS processes the credit is irrelevant.

3. Taxpayers typically make multiple payments on their tax liability, at different times. The "dates of the overpayment" for purposes of computing overpayment interest are the dates of: (a) the first payment resulting in cumulative payments in excess of the tax liability; and (b) all subsequent payments. Treas. Reg. § 301.6611-1(b). For any payments made early – return filed early, withholding, estimated tax, etc. – the date of the payment is considered to be the unextended return due date of the return. Treas. Reg. § 301.6611-1(d).

4. However, an overpayment can also begin after all payments by the taxpayer. For example, the tax liability may decrease, below the level of the amounts paid by the taxpayer, effective as of a later date because of a carryback. See following discussion. In such situations, overpayment interest begins to accrue as of the date when the tax liability as revised is less than the amount of payments before that date.

iii. Carrybacks – if there is a net operating loss carryback, capital loss carryback, foreign tax credit carryback, or business credit carryback to a taxable year, a resulting overpayment is deemed not to have been made before the unextended return due date for the taxable year in which the loss or credit carried back arose. IRC § 6611(f).

1. As with the equivalent provision for underpayment interest, this is an awkward of saying that the effective date of the tax balance doesn't change as a result of the carryback until the return due date of the source year, rather than the return due date of the year to which it is carried back. The original judicial rulings to this effect before the enactment of IRC § 6611(f) are somewhat broader. The IRS generally computes interest consistently with the case law, even when it is not clear that the situation falls within the literal terms of IRC § 6601(d). As with underpayment interest, the rule applies to both carrybacks (which reduce the tax liability and therefore increase the amount of an overpayment) and later recovery of such carrybacks (which increase the tax liability and therefore decrease the amount of an overpayment).

iv. Restricted interest – situations in which the government need not pay interest on an overpayment of tax

1. Refund back-off period: To give the IRS time to process refunds, no interest is due for a period "preceding the date of the refund check by not more than 30 days." IRC § 6611(b)(2). Under current administrative practice, IRM 20.2.4.7.1.1 (2) (9/30/2010), this interest-free period starts:

   a. Nine days before the refund check date for computer-generated refunds from Business Master File accounts.

   b. Thirteen days before the refund check date for computer-generated refunds from Individual Master File accounts.

   An additional seven days is added to the back-off period if the refund will be direct deposited. There is no refund back-off period for manual refunds.

2. No interest is payable on any overpayment that is refunded within 45 days after the later of: (a) the return due date, including extensions; or (b) the date the return is actually filed. IRC § 6611(e)(1).

3. If IRS refunds an overpayment within 45 days after the taxpayer filed the refund claim, no interest is payable on the overpayment for the period after the date the refund claim was filed. IRC § 6611(e)(2). However, overpayment interest is still due the taxpayer for the period from the unextended return due date for the taxable year until the date the refund claim was filed.

4. For IRS-initiated adjustments – refunds other than as requested by the taxpayer on a return or refund claim – there is an additional back-off period of 45 days before the date to which interest would otherwise be computed. IRC § 6611(e)(3).

c. Interest rates are determined and published by the IRS on a quarterly basis. IRC § 6621(b). The interest rates are:

i. For underpayments

1. General rate – the Federal short-term rate plus 3%.

2. For "large corporate underpayments," the applicable interest rate is the Federal short-term rate plus 5% for periods after the "applicable date." IRC § 6621(c)(1). This higher interest rate is often referred to as "hot interest" or "LCU interest."

a. A "large corporate underpayment" is an underpayment of tax by a C corporation that exceeds $100,000. IRC § 6621(c)(3)(A).

b. The "applicable date" is the 30th day after the earlier of the date of a 30-day letter or the date of a notice of deficiency. IRC § 6621(c)(2). If deficiency procedures did not apply to the particular underpayment, the date of the first notice of assessment or proposed assessment is substituted.

i. Once hot interest is triggered, it applies to all underpayments outstanding for periods after the applicable date. Thus, even if the taxpayer pays the balance due shown on the letter or notice, hot interest would apply to underpayment balances determined in future letters or notices.

ii. Hot interest is intended as an incentive for corporations to promptly pay any large underpayment balances due the government. Payment within 30 days avoids further interest charges, while if the taxpayer does not pay within 30 days, the interest rate is increased.

c. If the letter or notice is withdrawn by the IRS, that letter or notice does not trigger hot interest.

d. If, within 30 days of any such letter or notice, the taxpayer pays the amount due in full, that letter or notice is

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disregarded for purposes of hot interest. IRC § 6621(c)(2)(B)(ii).

e. Any such letter or notice is also disregarded if the amount of the proposed deficiency is not greater than $100,000. IRC § 6621(c)(2)(B)(iii).

f. The Regulations define a "threshold underpayment," equivalent to the excess of the tax liability for that period over the amount paid on or before the last day prescribed for payment, for purposes of determining whether hot interest is triggered. Treas. Reg. § 301.6621-3(b)(2)(ii). Thus, the proposed deficiency/underpayment may be less than $100,000 but still trigger hot interest, if the proposed deficiency would have been greater than $100,000 before a payment made by the taxpayer after the last day prescribed for payment, e.g., with an amended return.

g. The threshold underpayment is determined only when there is an eventual assessment. Treas. Reg. § 301.6621-3(b)(2)(iii)(A). Thus, even if the IRS issues a letter or notice with a proposed deficiency greater than $100,000, there is no threshold underpayment if the IRS later reduces that amount below $100,000 before assessment.

h. Similarly, if the federal court later reduces the amount of the tax liability, so that the threshold underpayment is reduced below $100,000, hot interest does not apply. Treas. Reg. § 301.6621-3(b)(2)(iv).

ii. For overpayments

1. General rate – the Federal short-term rate plus 2% for corporations, or the Federal short-term rate plus 3% for other taxpayers.

2. Overpayments of tax by a corporation that exceed $10,000 earn interest for periods after 12/31/94 at the Federal short-term rate plus 0.5%. IRC § 6621(a)(1), flush language. This lower interest rate is often referred to as "GATT interest." It was enacted by 103 Pub. L. 465 (12/8/94), § 713(a), as a revenue enhancer to offset the effects of implementing the Uruguay Round of the General Agreement on Tariffs and Trade.

iii. Interest is compounded daily. IRC § 6622.

iv. The difference between the overpayment interest rate and the underpayment interest rate

1. There is no difference for taxpayers other than C corporations – both the underpayment rate and the overpayment rate are the Federal short-term rate plus 3%.

2. For C corporations, the difference will range from 1% (if the general rate applies to both) to 4.5% (the difference between "hot interest" and "GATT interest").

d. "Annual netting"

i. There may be multiple changes to a taxpayer's tax liability for a particular year. After the original return is filed, there may be carrybacks from subsequent years, refund claim(s), deficiencies determined in an audit, etc.

ii. Initially, the IRS treated such changes – with related payments or refunds – as totally separate transactions and computed interest on each transaction in isolation.

iii. It is now widely accepted, however, that interest is properly computed not separately for each transaction but on the **balance** in the taxpayer's account for a given tax period. *See, e.g., Central Fibre Prods. Co. v. United States*, 115 F. Supp. 147 (N.D. Ill. 1953); *Avon Prods., Inc. v. United States*, 588 F.2d 342 (2d Cir. 1978); *May Dep't Stores Co. v. United States*, 36 Fed. Cl. 680 (1996), *acq.*, 1997-2 C.B. 1. All the transactions for that year are netted together, and interest is recomputed each time the tax liability changes or a payment or refund is made.

iv. As a result, even if no interest is due on an underpayment or overpayment transaction, for reasons noted above, the transaction can provide a **tax benefit** by reducing another balance on which interest is due. For example:

1. The taxpayer files its original return for the 2011 tax year on March 15, 2012, showing tax liability of $200,000, payments of $300,000, and a refund due of $100,000. The IRS pays the refund on April 28, 2012. The IRS does not pay overpayment interest on the refund because it was refunded within 45 days. IRC § 6611(e)(1). But there was an overpayment balance of $100,000 from the period from March 15, 2012, until April 28, 2012, when the refund was made.

2. The IRS later conducts an audit and determines that the proper tax liability was $290,000, resulting in a deficiency of $90,000. The taxpayer concedes and pays the deficiency on July 5, 2014.

3. The balance for the period from March 15, 2012, to April 28, 2012, is a net overpayment of $10,000.

    a. The revised tax liability is $290,000. The net amount paid, before the refund on April 28, 2012, is $300,000. Thus, until April 28, 2012, the taxpayer has overpaid its taxes by $10,000.

    b. This balance includes both the original overpayment of $100,000 (because not refunded until April 28, 2012) and the subsequent deficiency of $90,000.

4. The balance for the period from April 28, 2012, until the payment of the deficiency on July 5, 2014, is an underpayment of $90,000.

    a. The revised tax liability is $290,000. After the refund on April 28, 2012, the net amount paid is $200,000. Thus, after the refund, the taxpayer has underpaid its taxes by $90,000.

    b. This balance includes only the subsequently determined deficiency, because the overpayment was refunded on April 28, 2012.

5. Without annual netting, the taxpayer would pay underpayment interest on the $90,000 deficiency starting from March 15, 2012, even though there was no net underpayment balance until April 28, 2012, when the IRS refunded the overpayment shown on the return.

6. As a result of annual netting, the taxpayer instead pays underpayment interest on the balance of $90,000 only from April 28, 2012, to July 5, 2014. Although the original $100,000 overpayment does not earn overpayment interest during the period from March 15, 2012, to April 28, 2012, it does provide a **tax benefit** by reducing the amount of the underpayment balance that earns underpayment interest.

7. Annual netting also eliminates the difference between the underpayment interest rate and the overpayment interest rate on overlapping transactions for corporations, because there is only one net balance – overpayment or underpayment – during any period.

e. Global interest netting (aka "net interest rate of zero") – applicable to corporations only

i. As noted above, the interest rates for overpayments and underpayments may be different at any given time for a corporate taxpayer. The difference can range from 1% (based on the general rates) up to 4.5% (if both "hot interest" and "GATT interest" apply).

ii. Taxpayers often may have an underpayment balance in one tax year and an overpayment balance in another tax year (or for another type of tax), both outstanding for the same period of time. As a result of the difference in rates, even if the underpayment and overpayment balances were exactly the same, a corporate taxpayer could wind up owing the government more underpayment interest than the government owes the taxpayer for overpayment interest. Annual netting eliminates this problem only if both transactions involved the same type of tax and the same tax year.

iii. Congress enacted IRC § 6621(d) to solve this problem more broadly than annual netting. It provides: "To the extent that, for any period, interest is payable [on an underpayment] and allowable [on an overpayment] on equivalent underpayments and overpayments by the same taxpayer of tax . . . , the net rate of interest under this section on such amounts shall be zero for such period."

iv. IRC § 6621(d) applies to interest for periods beginning after July 22, 1998, the date of enactment. 105 Pub. L. 206, § 3301(a). (The IRS has interpreted "periods" as equivalent to calendar quarters; therefore, "periods **beginning after** July 22, 1998" means periods beginning October 1, 1998, or later. *See* Rev. Proc. 99-43.) There is a special transitional rule, 105 Pub. L. 206, § 3301(c)(2), that also allows global interest netting for earlier periods:

1. "Subject to any applicable statute of limitations not having expired with regard to either a tax underpayment or a tax overpayment," and

2. If the taxpayer reasonably identifies and establishes the periods for which global interest netting should apply, and

3. If the taxpayer filed a request by December 31, 1999, to apply IRC § 6621(d) to such periods.

v. Global interest netting is implemented by changing the interest rate used (for part or all of the balance) in one of the two years. For example, the IRS could increase the overpayment interest rate, in the year with an overpayment balance, to the higher underpayment interest rate. Or the

IRS could decrease the underpayment interest rate, in the year with an underpayment balance, to the lower overpayment interest rate. Under either approach, the interest rate would be the same in both years.

f. Deposits versus payments

i. Neither the Code nor the Regulations mention the concept of a "deposit," as opposed to a "payment." However, the IRS has recognized "deposits" as a matter of administrative practice for many years.

ii. The primary differences between a deposit and a payment are:

1. The IRS will return a deposit on request. The taxpayer must file a refund claim/suit, and prove the existence of an overpayment, to recover a payment.

2. If the IRS or a court finally determines that additional tax was due, both a deposit and a payment will prevent the accrual of underpayment interest from the date of remittance.

3. If the IRS or a court finally determines that there was no additional tax due, the IRS will refund the payment and pay overpayment interest on the refund. But there is no interest paid on the return of a deposit. In effect, the deposit was an interest-free loan to the government.

4. If a deposit is returned at the taxpayer's request, and the IRS later determines additional tax was due for that tax year, the deposit does not prevent the accrual of underpayment interest **even during the time that the IRS held the money**.

5. The distinctions are discussed and explained in *Ford Motor Co. v. United States*, 768 F.3d 580 (6th Cir. 2014).

6. The IRS procedures governing deposits, prior to the American Jobs Creation Act of 2004, are set forth in Rev. Proc. 84-58.

iii. In 2004, Congress enacted IRC § 6603, which provides statutory authority for the treatment of deposits.

1. It also, for the first time, required the IRS to pay interest on a deposit returned to the taxpayer on request. The applicable interest rate is the Federal short-term rate. IRC § 6603(c), (d)(4).

2. However, interest is paid only if the deposit was "attributable to a disputable tax" – the reasonable estimate, as of the date of the

deposit, of the maximum tax that would result from disallowing items with respect to which both the taxpayer and the IRS had a reasonable basis. IRC § 6603(d). The amount of a proposed deficiency in a 30-day letter automatically qualifies as a disputable tax.

3. The IRS procedures applicable to deposits under IRC § 6603 are set forth in Rev. Proc. 2005-18.

iv. Neither Rev. Proc. 84-58 nor Rev. Proc. 2005-18 contemplate that a taxpayer might initially make a deposit and later request that the deposit should be treated as a payment instead.

2. Miscomputation of interest – mistakes

a. "Credit elect transfers"

i. Taxpayers can elect on their return to have an overpayment applied to the next year's estimated taxes. IRC § 6402(b). In such cases, no overpayment interest is paid on the overpayment. Treas. Reg. §§ 301.6402-3(b)(5); 301.6611-1(h)(2)(vii).

ii. If the IRS subsequently determines a deficiency for the first year, underpayment interest depends on when the "tax becomes both due and unpaid." *Avon Prods., Inc. v. United States*, 588 F.2d 342 (2d Cir. 1978). When it becomes unpaid depends on the effective date of the transfer of the amount shown on the return to the next year's account for estimated taxes.

1. Taxpayer's return for 2012 shows tax liability of $150,000 and payments of $160,000. Taxpayer elects on the original return to have the $10,000 overpayment applied to 2013's estimated taxes.

2. Later, the IRS conducts an audit and determines that the correct tax liability for 2012 was $158,000. As of the original return due date, the tax was not due and unpaid, as Taxpayer had paid $160,000 – more than the revised tax liability.

3. The tax is "unpaid," and interest begins running on the deficiency of $8,000, only when the cumulative payments are reduced to $150,000 by the $10,000 credit transferring the original overpayment to the 2013 tax year. Therefore, we need to know the effective date of the credit elect transfer to know when underpayment interest should start. If the overpayment had been refunded, underpayment interest on the subsequently determined

deficiency would start as of the date of the refund – but what is the effective date of a credit elect transfer?

iii. Neither the Code nor the Regulations defined the effective date of such credit elect transfers. But the IRS treated the transfer as having been made on the due date of the first installment of estimated taxes for the following year (2013 in the example above). This starts underpayment interest on the deficiency (in the 2012 tax year in the example above) at the earliest possible date and thus maximizes the interest Taxpayer has to pay the IRS.

iv. In a series of cases, courts decided that the effective date of the credit elect transfer should instead be treated as the due date of the first installment of estimated taxes **<u>for which the transfer was required to avoid the penalty on late payment of estimated taxes</u>** under IRC §§ 6654, 6655. *May Dep't Stores Co. v. United States*, 36 Fed. Cl. 680 (1996), *acq.*, 1997-2 C.B. 1; *Kimberly-Clark Tissue Co. v. United States*, 1997 U.S. Dist. LEXIS 3100 (E.D. Pa. Mar. 18, 1997); *Sequa Corp. v. United States*, 1996 U.S. Dist. LEXIS 5288 (S.D.N.Y. Apr. 19, 1996). If the credit elect was not needed to satisfy any of its estimated tax payments, the effective date is treated as the return due date for the following year.

v. The correct way to determine the effective date thus is:

1. Determine the cumulative amount of estimated taxes required as of the due date for each installment.

2. Determine the cumulative amount paid by the taxpayer – without the credit elect transfer – as of the due date for each installment.

3. Treat the credit elect transfer as taking place as of the due date for the first installment(s) for which the cumulative amount paid is less than the cumulative estimated tax obligation.

vi. The IRS now applies this approach, which it sometimes refers to as "*May*/*Sequa*." But the IRS personnel computing interest usually won't have access to a Form 2210 or 2220 for the second year, so they have to make an assumption about the amount of estimated taxes due for each installment. Because there are alternative ways to calculate the required payment by installment, such as the annualized income method, or just because they forget to apply the "*May*/*Sequa*" approach, the IRS may use the wrong effective date for the transfer or may just treat it as effective as of the due date for the first installment. That usually will mean computing too much underpayment interest.

b. Carryback analysis

    i. As noted above, all changes to tax liability that result from or are attributable to a carryback are treated as effective on the unextended return due date for the year in which the loss/credit arose. The IRS reflects its timing analysis on Form 2285.

    ii. Particularly for complex situations with multiple carrybacks from multiple years, the IRS analysis or application of the effective dates may be incorrect.

    iii. Taxpayers or their representatives should always carefully review the IRS timing analysis, particularly if there have been multiple adjustments for that tax year.

c. Hot interest – corporations only

    i. The rules for hot interest (see above) are complex and depend on information that may not be reflected properly in the account transcript. Hot interest is often applied when it should not be or begins before it should. Taxpayers or their representatives should always carefully review any application of hot interest and verify the factual information on which it is based.

d. Credit transfers

    i. The IRS has the discretion to transfer an overpayment in one tax year to another tax year with an underpayment. But if the effective date of the transfer is not the same for both years, the taxpayer may not receive full benefit from the overpayment.

e. Refund check dates

    i. The IRS computer system normally computes interest properly on computer-generated refunds. However, the IRS must enter "transaction code 840" in the transcript to properly compute interest on manual refunds. The date of that transcript entry is often inaccurate. Taxpayers or their representatives should check the transcript date and the interest computations to ensure that interest is computed up until to the date of the wire transfer or the date on the manual check.

f. Suspensions of overpayment interest

    i. Refund back-off periods: For computer-generated refunds, overpayment interest is suspended for a specified period before the date of the refund check – nine days for Business Master File accounts and thirteen days for

Individual Master File Accounts. There is an additional back-off period of seven days if the refund is direct deposited. The IRS usually suspends overpayment interest for the back-off periods properly.

ii. Timely refunds: If the IRS refunds an overpayment shown on the return within 45 days of the later of the original due date or the actual filing date, no overpayment interest is paid. If the IRS refunds an amount shown on a refund claim within 45 days of the date the claim was filed, no overpayment interest is paid after the date the claim was filed.

iii. The IRS usually suspends overpayment interest properly for these periods. However, if a deficiency is later assessed, underpayment interest – on an underpayment up to the amount of the previous refund – should also be suspended during the same period. This is a basic consequence of the annual interest netting concept, described above. At one time, the IRS occasionally neglected to apply annual netting properly in these situations. This has been less of a problem in recent years, after the IRS changed its interest computation software, but taxpayers should still check to make sure this was handled properly.

g. Suspensions of underpayment interest

i. Timely payment: If the taxpayer pays an assessment within 21 calendar days (or ten business days if the assessment is greater than or equal to $100,000) from the date of notice and demand, no underpayment interest should be imposed from the date of notice and demand to the date of payment.

ii. Form 870 waivers: If the taxpayer consents to immediate assessment of a proposed deficiency, waiving the right to contest the deficiency in Tax Court, the IRS should make the assessment and issue notice and demand for payment within 30 days. If it does not, no underpayment interest should be imposed from 30 days after the date of the Form 870 until the date of notice and demand.

iii. Underpayment interest on the assessment amount should be, but is not always, suspended during these periods.

h. Penalties

i. Interest on accuracy-related penalties, fraud penalties, and penalties for failure to file or failure to pay is computed from the return due date, **including** extensions.

ii. Interest on certain other penalties is due only from the date of notice and demand, and no interest is due at all if the penalties are paid within 21 days of notice and demand (or 10 business days if the amount is at least $100,000).

iii. The IRS sometimes mistakenly computes interest from the return due date **<u>without</u>** extensions, which is the general rule for interest on tax liabilities, rather than from the extended return due date or the date of notice and demand.

i. Deposits

i. Because of the different treatment of deposits versus payments, taxpayers should carefully consider which is more appropriate for their circumstances and then verify that the remittance was properly classified in IRS interest computations.

3. Miscomputation of interest – disputed issues

a. Hot interest – corporations only

i. Neither the Code nor the Regulations address a situation in which a corporation initially underpays tax by more than $100,000 but then carries back a tax loss or other item, reducing the underpayment below $100,000. Is the threshold for hot interest measured *before* carrybacks (so that hot interest would apply in this situation) or measured *after* carrybacks (in which case hot interest would not apply)?

ii. The Tax Court addressed the issue in *Med James, Inc. v. Comm'r*, 121 T.C. 147 (2003) and concluded that for purposes of determining whether hot interest applied, the IRS must take into account carrybacks if the carrybacks were pre-assessment.

iii. The IRS Office of Chief Counsel disagreed with the Court's ruling, in CCA 201120026 (May 20, 2011), indicating that the IRS will continue litigating the issue. Chief Counsel concluded that a carryback is the same as a "payment," and payments after the return due date do not reduce the "threshold underpayment." This is a highly questionable conclusion.

b. Netting – corporations only

i. "Same taxpayer"

1. IRC § 6621(d) allows netting on equivalent underpayments and overpayments "by the same taxpayer," but does not define "same taxpayer."

2. The IRS initially interpreted "same taxpayer" broadly, in FSA 200212028:

    a. Consolidated groups:

        i. An overpayment by subsidiary A (e.g., on an excise tax return) and an underpayment by the consolidated group cannot be netted if the group's underpayment arose prior to A joining the group, because subsidiary A was not jointly and severally liable for the consolidated group's underpayment. *Situations 3 and 4*. This implies that an overpayment by a subsidiary can be netted against the group's underpayment if the subsidiary was part of the group for the tax year in which the underpayment arose.

        ii. It is "theoretically possible" that an underpayment by subsidiary A and an overpayment by the consolidated group could be netted if facts and circumstances showed that the overpayment is attributable to the subsidiary A. *Situations 1 and 2*.

        iii. An underpayment of the consolidated group cannot be netted against overpayments by a subsidiary that is not a member of the consolidated group, because the subsidiary is not jointly and severally liable for the group's underpayment. *Situations 8 and 9.*

    b. Mergers:

        i. An overpayment by company A and an underpayment by company B, both prior to the A-B merger, can be netted if B is no longer in existence, because A assumed B's liabilities as a matter of law. *Situations 5 and 7*.

        ii. If A and B both survived the merger, however, their pre-merger overpayments and underpayments cannot be netted, because they remain separate taxpayers. *Situation 6*.

3. The IRS also addressed the possibility of netting a consolidated group's overpayment with a subsidiary's underpayment in CCA 200411003. The CCA concluded that the subsidiary would be considered the "same taxpayer" with respect to its own

underpayment and its "share" of the group's overpayment. This went beyond the "theoretically possible" statement in FSA 200212028. It implied that all that was necessary was that the facts and circumstances supported allocation of a certain part of the group's overpayment to the subsidiary.

4. The IRS later issued CCA 200707002, which undermined both FSA 200212028 and CCA 200411003. It concluded that a subsidiary could not net its own underpayment against the group's overpayment: "Given that a consolidated return is a combined return for multiple corporations, all of which are liable for the associated tax, and any overpayment is not deemed an overpayment of any single member, there does not appear to be a basis to treat a member with a separate underpayment as the same taxpayer responsible for a consolidated overpayment."

5. In recent litigation, the government has taken the position that netting is only permissible if both the overpayment and the underpayment are for tax returns filed under the same TIN. In fact, the government has suggested that a consolidated group cannot net its overpayment for one tax year against its underpayment for another tax year unless the consolidated group is **exactly identical** – that is, the same subsidiaries are included in the group – in both years. Effectively, this radical position would eliminate the benefits of global interest netting for many large consolidated groups. However, no courts have accepted this view to date.

6. In *Energy East Corp. v. United States*, 645 F.3d 1358 (Fed. Cir. 2011), the consolidated group sought to net its underpayment for the 1999 tax year with overpayments by two subsidiaries in 1995-97. However, the subsidiaries did not join the consolidated group until 2000 and 2002.

    a. Under FSA 200212028, netting would have been permissible if the underpayment by the consolidated group had **arisen** in tax years after the subsidiaries had joined the group. The basis for that conclusion was that the subsidiaries are jointly and severally liable for the group's underpayment. However, the government has retreated from that interpretation.

    b. The taxpayer argued for an extension of the principle under the FSA: that netting would be permissible if the overpayment and underpayment balances were **outstanding** while the subsidiaries were part of the consolidated group. The court disagreed and ruled for the government.

7. In *Magma Power Co. v. United States*, 101 Fed. Cl. 562 (2011), the taxpayer sought to net its underpayment (for a year in which it was an independent corporate entity) with the overpayment of a consolidated group for a year in which the taxpayer had been included in the group. The court held that the subsidiary and consolidated group should be considered the same taxpayer "to the extent the consolidated group's overpayment can be traced to the company."

    a. This conclusion is consistent with the analysis in FSA 200212028, Situations 1 and 2, and CCA 200411003.

    b. As with those earlier rulings by the IRS, the court's decision did not directly decide whether the facts and circumstances in this particular case would support a conclusion that the consolidated group's overpayment was attributable to the subsidiary. But the court did allow the principle.

8. In *Wells Fargo v. United States*, 2014 WL 5318260 (Fed. Cl. Oct. 20, 2014), the court addressed netting of balances by predecessors of the surviving corporation in a statutory merger. The taxpayer argued for netting because the entities became one and the same entity as a matter of law. The court rejected the government's argument that "same taxpayer" meant the same TIN at the time the overpayment or underpayment balances arose.

    a. This conclusion is consistent with the analysis in FSA 200212028, Situations 5 and 7.

    b. In this amended opinion – the original opinion is at 117 Fed. Cl. 30 (June 27, 2014) – the court certified the "same taxpayer" question for immediate appeal. We may have guidance from the Federal Circuit on this issue soon.

ii. Direction of netting

1. Global interest netting requires that the interest rates, in the two years netted against each other, be equalized. But the Code does not specify how interest rates are to be equalized.

2. This could be accomplished by either increasing the rate for overpayment interest in one year or decreasing the rate for

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underpayment interest in the other year. Logically, the change can be accomplished in either year, as long as the relevant statute of limitations is still open.

3. Under Rev. Proc. 99-43 and 2000-26, the IRS will generally equalize by decreasing the rate for underpayment interest. The IRS will only equalize by increasing the rate for overpayment interest if, when the netting claim is filed, the statute of limitations is open for the tax year with the overpayment balance and closed for the tax year with the underpayment balance.

4. There is no statutory authority for the IRS preference, if the statutes of limitations are open for both years, to equalize by decreasing the rate for underpayment interest. Depending on the circumstances, it may be to the taxpayer's benefit to equalize the overpayment rate instead.

iii. Use of closed tax years (transitional rules)

1. Global interest netting involves two different tax periods – one with an overpayment balance and one with an underpayment balance.

2. For periods beginning after July 22, 1998, netting is permitted as long as the statute of limitations (for a refund of underpayment interest or recovery of additional overpayment interest) is still open for **<u>either</u>** of the two tax periods.

3. For periods beginning before July 22, 1998, the transitional rule states that netting is permitted "[s]ubject to any applicable statute of limitations not having expired with regard to either a tax underpayment or a tax overpayment."

4. The IRS interprets this as meaning the applicable statute of limitations must be open for **<u>both</u>** tax periods to allow netting for period beginning before July 22, 1998.

5. The Federal Circuit agreed that both statutes of limitation must be open, in *Fed. Nat'l Mortg. Ass'n v. United States*, 379 F.3d 1303 (Fed. Cir. 2004).

6. But more recently the Second Circuit concluded that only one of the two statutes of limitation must be open, in *Exxon Mobil Corp. v. Comm'r*, 689 F.3d 191 (2d Cir. 2012).

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iv. Use of interest-free periods

1. Netting equalizes the interest rates in the tax years being netted. If overpayment balances on which interest was not allowed can be netting against underpayment balances on which the taxpayer paid interest, the taxpayer would save the entire amount of underpayment interest paid for the period of overlap rather than just the differential between the overpayment rate and the underpayment rate.

2. The Court of Federal Claims concluded, in *Computervision Corp. v. United States*, 62 Fed. Cl. 299 (2004), that netting is only permitted if interest is "payable" on an underpayment and "allowable" on an overpayment. Thus, if the IRS refunded an overpayment without interest, that balance cannot later be used for global interest netting.

3. Although there is no case law supporting netting against an interest-free period, under appropriate circumstances it may be worthwhile for a taxpayer to argue for this approach.

c. Credit application ordering

i. Annual netting is well established, but those cases did not resolve a question that sometimes arises when there is a net overpayment balance resulting from multiple transactions, including a refund without interest, a refund with interest, and an assessment. For example:

1. The taxpayer timely files its 2008 tax return on 9/15/09, showing tax liability of $320,000, payments of $370,000, and an overpayment of $50,000. The IRS refunds the $50,000 on 10/15/09, within the 45-day period, without interest.

2. The taxpayer files a refund claim on 5/15/11 and the IRS abated tax of $60,000, refunded on 6/5/11. (That is, the proper tax liability was $260,000.) Because the refund was within 45 days of the refund claim, interest is payable from 3/15/09 to 5/15/11 but not from 5/15/11 to 6/5/11.

3. On 8/20/12, there was a tax assessment of $75,000. (That is, the proper tax liability was $335,000).

4. For the period from 3/15/90 to 10/15/90, before the refunds, there was a net overpayment balance of $35,000 (proper tax liability of $335,000 and payments of $370,000). This net overpayment balance includes or is composed of:

a. The $50,000 overpayment on the original return, which did not earn interest because it was refunded timely.

b. The $60,000 overpayment, which did earn interest during the period 3/15/90 to 10/15/90.

c. The $75,000 underpayment, on which underpayment interest would be due.

5. When recomputing interest for the tax year, is overpayment interest due the taxpayer for the $35,000 net balance for the period from 3/15/90 – 10/15/90? Is the net overpayment balance part of the $50,000 overpayment on the original return (in which case the government would not pay overpayment interest on the net overpayment balance)? Or is it part of the later $60,000 overpayment (in which case the government should pay overpayment interest on the net overpayment balance)?

ii. There is no clear answer to this questions and no neutral ordering rule that would determine which overpayment transaction is the source of the net balance.

iii. The government takes the position that in these situations, it must pay the taxpayer overpayment interest only on the portion of the net balance in excess of the amount of the overpayment transaction that was not entitled to interest when originally refunded. In other words, the assessment is applied first against the overpayment transaction that is entitled to interest and the net balance comes first from the overpayment transaction that is not entitled to interest.

iv. To date, two cases in the Court of Federal Claims have addressed this issue, with different results. In *Soo Line R.R. Co. v. United States*, 44 Fed. Cl. 760 (1999), the court ruled for the government, while in *Coca-Cola Co. v. United States*, 87 Fed. Cl. 253 (2009), the court ruled for the taxpayer. It is questionable whether the factual differences in the cases were really sufficient to explain the different results.

v. This is still a relatively unsettled issue and taxpayers may want to pursue under appropriate circumstances.

d. Deposits

i. There is no clear authority for the treatment of an amount that a taxpayer remits as a deposit but later converts to a payment. In *Ford Motor Co. v. United States*, 768 F.3d 580 (6th Cir. 2014), the taxpayer sought

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overpayment interest from the original date of remittance rather than from the date of designation as a payment.

ii. The Sixth Circuit first ruled against the taxpayer in *Ford Motor Co. v. United States*, 508 Fed. Appx. 506 (6th Cir. 2012). The Sixth Circuit relied on the canon of statutory construction that a waiver of sovereign immunity is construed narrowly. Interpreting IRC § 6611, which is the money-mandating statute, as a waiver of sovereign immunity led the court to rule for the government.

iii. The taxpayer filed a petition for a writ of certiorari, challenging whether IRC § 6611 was a waiver of sovereign immunity. Most of the discussion in the petition and reply focused on this question, although the government also raised a question regarding whether the District Court in Michigan even had jurisdiction to hear the case.

iv. The Supreme Court granted certiorari and remanded the case for consideration of the jurisdictional issue.

v. On remand, the Sixth Circuit declined to reconsider its decision in *E.W. Scripps Co. v. United States*, 420 F.3d 589 (6th Cir.2005), which held that District Courts have concurrent jurisdiction with the Court of Federal Claims over suits for overpayment interest in excess of $10,000.

1. Both courts have jurisdiction, without any restrictions as to amount, over tax refund suits. 28 U.S.C. §§ 1346(a)(1); 1491.

2. Both courts have jurisdiction over suits under the Tucker Act for recovery of amounts due under the Constitution, statutes, regulations, or contracts. The District Courts' jurisdiction is limited to suits for $10,000 or less; the Court of Federal Claims' jurisdiction is not limited. 28 U.S.C. §§ 1346(a)(2); 1491(a)(1).

3. Overpayment interest is not considered equivalent to "tax." *Alexander Proudfoot Co. v. United States*, 454 F.2d 1379 (Ct. Cl. 1972); *see also* additional discussion below. The *Scripps* court concluded that District Courts have jurisdiction over suits for additional overpayment interest because 28 U.S.C. § 1346(a)(1) provides jurisdiction for suits seeking recover not only of tax alleged to have been erroneously or illegally assessed or collected but also "any sum alleged to have been excessive or in any manner wrongfully collected under the internal-revenue laws." Failure to pay the taxpayer the amount of overpayment interest properly due means that the government has retained more money than it is due – an "excessive sum."

vi. The Sixth Circuit then concluded that in fact IRC § 6611 was not a waiver of sovereign immunity; therefore the canon of narrow construction did not apply. But the court still ruled against the taxpayer on the merits. *Ford Motor Co. v. United States*, 768 F.3d 580 (6th Cir. 2014).

vii. It is uncertain at this point whether the case will return to the Supreme Court for consideration of:

1. Whether the District Court and the Sixth Circuit had jurisdiction to hear the case at all.

2. Whether IRC § 6611 is a waiver of sovereign immunity to be construed narrowly.

3. Whether, on the merits, a taxpayer is entitled to overpayment interest on a deposit converted to a payment from the date of remittance or only from the date of conversion.

e. GATT interest – corporations only

i. An issue arises in the computation of GATT interest because the lower overpayment interest rate only applies to overpayments in excess of $10,000.

ii. The IRS separates an overpayment, from the time it arose, into two buckets: the first $10,000 and the remainder. Interest accrues on both buckets at the standard overpayment rate through 12/31/94. Starting 1/1/95, the IRS accrues interest on the first bucket (including accrued interest) at the standard overpayment rate and accrues interest on the second bucket at the lower GATT rate.

iii. The issue concerns compounding of the accrued interest in the second bucket after 1/1/95, specifically whether the lower GATT rate applies only to the tax or also to the pre-1/1/95 accrued interest.

1. Under the IRS's original method ("Old GATT"), applied from 1995-1998), all interest that had accrued before 1995 compounded at the higher standard rate.

2. Under the IRS's current method ("New GATT"), previously accrued interest in the second bucket begins to compound at the lower GATT rate on 1/1/95.

3. When the IRS switched from "Old GATT" to the less taxpayer-favorable "New GATT" in 1999, the IRS made a policy decision

that it would not recapture overpayment interest already allowed under the old methodology.

4. The Federal Circuit rejected a taxpayer's claim for interest computed using the "Old GATT" methodology, in *General Electric Co. v. United States*, 384 F.3d 1307 (Fed. Cir. 2004). *See also Exxon Mobil Corp. v. Comm'r*, 484 F.3d 731 (5th Cir. 2007).

5. Taxpayers may be able to argue for "Old GATT" under various different theories, depending on the forum.

4. Procedural issues

a. Statutes of limitation

i. Underpayment interest

1. Taxpayer seeking refund of excessive underpayment interest. Underpayment interest is treated as part of the tax to which it relates. Therefore, it is subject to the same statutes of limitation for refund claims and refund suits. IRC §§ 6511, 6532(a). Taxpayers should not rely on the IRS to correct interest computations; they must file refund claims, and possibly refund suits, to preserve their rights to challenge the computations.

2. Government seeking additional underpayment interest. The IRS can assess and collect deficiency interest for ten years after the underlying tax has been assessed. IRC §§ 6601(g), 6502(a).

ii. Overpayment interest

1. Taxpayer seeking additional overpayment interest. Overpayment interest is not treated as part of the overpayment to which it relates. In fact, payment of overpayment interest is not a "tax refund" at all. It is instead a debt owed by the government. *Sunoco, Inc. v. Comm'r*, 663 F.3d 181 (3d Cir. 2011); *Alexander Proudfoot Co. v. United States*, 454 F.2d 1379 (Ct. Cl. 1972). Therefore, the refund claim procedures do not apply and filing a refund claim does not preserve the taxpayer's right to challenge interest computations. The taxpayer may file a claim for additional overpayment interest in an effort to resolve the issue administratively. But if that effort is unsuccessful, the taxpayer must file suit within six years from the date the overpayment was scheduled in order to preserve its rights. 28 U.S.C. §§ 1491(a)(1), 2401(a), 2501; IRC § 6407.

2. <u>Government seeking recovery of excessive overpayment interest</u>. If the government claims that it paid the taxpayer excessive overpayment interest, it cannot recover the excess by the assessment procedures, since overpayment interest is not part of the tax. Instead, it must either file an erroneous refund suit within two years of the date the overpayment interest was paid, IRC § 6532(b), or offset the excess amount paid against a refund claim by the taxpayer for the same year. *Fischer v United States*, 80 F.3d 1576 (Fed. Cir. 1996); *Lewis v. Reynolds*, 284 U.S. 281 (1932).

   a. In *Pacific Gas & Electric Co. v. United States*, 417 F.3d 1375 (Fed. Cir. 2005), the court decided that recovery of excessive overpayment interest by offset is subject to the same two-year statute of limitations as recovery by an erroneous refund suit. .

   b. The IRS agrees that its only recourse to recover excessive overpayment interest paid to a taxpayer is through an erroneous refund suit or by offset against a refund claim for the same year. TAM 201335013. However, the IRS contends that recovery by offset is not subject to a two-year statute of limitations and therefore will not follow the decision in *PG&E*, even in cases appealable to the Federal Circuit. AOD 2006-02.

b. Tax Court Rule 155 computations

   i. At one time, it was common for the parties in a Tax Court case to wait to resolve any issues concerning interest computations until after entry of the Tax Court's decision.

   ii. Deficiency decisions cannot include interest, which must be determined by a supplemental proceeding after the decision. IRC § 7481(c); Tax Court Rules 260 and 261.

   iii. But that approach can create problems if the Tax Court is making an overpayment determination. In *Estate of Smith v. Comm'r*, 123 T.C. 15 (2004), the court held that an "overpayment" by the taxpayer is reduced by any underpayment interest. (Account balances may fluctuate over time, so the final balance may be an overpayment even though there was an interim underpayment balance that accrued interest.) Thus, the court's final decision cannot be changed to adjust the amount of underpayment interest.

   iv. The taxpayer benefited in this case, because the government was not able to reduce the amount to be funded by additional deficiency interest. But the same principle would apply if the government had accrued too much underpayment interest; the taxpayer could no longer challenge that determination.

v. Taxpayers should always carefully review any underpayment interest included in the IRS's proposed Rule 155 computations that determines an overpayment and resolve disputes concerning interest before submitting the computations to the court.

HOW TO IDENTIFY, PREPARE FOR AND SUCCEED IN AN IRS EGGSHELL EXAMINATION

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I. INTRODUCTION

Any IRS exam can be a nerve-wracking experience for a tax advisor. If there is a large mistake or pattern of mistakes, an ordinary exam may become an eggshell exam requiring much thought and skill to come through the exam unscathed. This article will address the IRS exam areas that can lead to IRS eggshell exams, the IRS tactics and, finally, steps a tax advisor can take to minimize the negative consequences.

II. RECENT IRS FOCUS: WHY ARE WE HERE?

A. DOMESTIC EMPHASIS

In the last decade, coverage rates and audit rates for small business entities and high-net-worth individuals have grown significantly. In the last 10 years, for example, audit rates for pass-through entities, such as S Corporations, have increased nearly 300% and Partnership examinations have increased nearly 240%.[1] Indeed, it seems this trend will continue. Former Commissioner of the Small Business/Self-Employed Division of the Internal Revenue Service (IRS), Faris Fink, confirmed in 2013 that the audit coverage at the Small Business/Self-Employed Division of the IRS (SB/SE) is at a recent high, and that SB/SE will "continue [to heavily audit] the high income/high wealth group."[2]Another focus of the IRS is seen through the Global High Wealth Industry Group, also known as the "Wealth Squad."[3] This group targets individuals with $10 million or more in income or assets and conducts each examination of these high-net-worth individuals holistically, by examining all the taxpayer's investments, including

[1] Internal Revenue Service Fiscal Year 2013 Enforcement and Service Results, *available at* http://www.irs.gov/PUP/newsroom/FY%202013%20Enforcement%20and%20Service%20Results%20--%20WEB.pdf (applies to all bullets under "Entity Examinations" Heading).

[2] T. Steel Rose, *A Sit Down with IRS Commissioner Faris Fink*, CPA Magazine (December/March 2013), *available at* http://www.cpataxmag.net/cover-stories/56-decembermarch-cover-story/484-a-sit-down-with-irs-commissioner-faris-fink46.

[3] *See Holistic Audits: The Price of Being Rich*, Tax Practice, Kathryn Keneally and Charles P. Rettig page 18.

related business enterprises. Moreover, the IRS has also expressed a continued focus on documented abusive transactions and has published listed transactions labeled "Recognized Abusive and Listed Transactions," for which it is always on the lookout.[4]

B. INTERNATIONAL EMPHASIS

The Foreign Account Tax Compliance Act (FATCA) was enacted in March 2010 by the United States Congress as part of the Hiring Incentives to Restore Employment (HIRE) Act.[5] Congress' main purpose in passing FATCA was to target and combat non-compliant U.S. taxpayers that utilize foreign or offshore accounts to hold undeclared assets.[6] Under FATCA, Foreign Financial Institutions (FFIs) are required to report information on their U.S. account holders to the IRS, and other foreign entities must provide information regarding their beneficial owners to U.S. withholding agents.[7] However, because FFIs in jurisdictions such as Switzerland, the Cayman Islands, and Dubai have a long history of zealously protecting the identity of their banking clients as required by their sovereign law[8], individuals have asked why businesses in these countries would feel compelled to abide by FATCA. The answer is relatively simple: "Because "FFIs that do not sign an IRS agreement will face withholding on U.S.-source interest

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[4] IRS, *Recognized Abusive and Listed Transactions*, http://www.irs.gov/Businesses/Corporations/Listed-Transactions---LB&I-Tier-I-Issues.

[5] FATCA refers to sections 1471-74 of the Internal Revenue Code (1986) as amended. I.R.C. §§ 1471-74 (2012).

[6] *See* Department of the Treasury, http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx. Indeed, sections 1471-1474 fall under "Chapter 4—Taxes to Enforce Reporting on Certain Foreign Accounts" of Subtitle A of the Internal Revenue Code.

[7] *See generally* Reporting and Withholding by FFIs, Prop. Treas. Reg. §1.1471-1, 77 Fed. Reg. 9022 (Feb. 15, 2012).

[8] *See generally* Emily Wang, *The Opaque Future of Tax Information Sharing Between the United States and China: An Analysis of Bank Secrecy Laws and the Likelihood of Entrance into a Tax Information Exchange Agreement*, 35 **Hastings Int'l & Comp. L. Rev.** 411, 414-25 (2012) (describing how offshore accounts facilitate tax evasion especially in foreign jurisdictions that have strict bank secrecy laws).

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and dividends, gross proceeds from the disposition of U.S. securities, and pass-thru payments."[9]

The withholding amount is *significant*: 30% on all U.S. and certain non-U.S. payments, and it is treated as a tax.[10] One need not be an astute businessman to know that a 30% "tax" in addition to regular taxes paid by an entity is unbelievably cumbersome. Indeed, "[s]anctions for FATCA noncompliance are so severe that failure to undertake the requisite reporting and disclosure can conceivably result in penalties in excess of the unreported foreign assets."[11] As a result, it is unsurprising that FATCA has caught the attention of international banks. Assuming that an FFI bites the bullet and agrees to enter into an agreement with the IRS, thereby avoiding the imposition of a 30% withholding tax, the FFI is now faced with an affirmative obligation to provide a bevy of information to the U.S. Government.[12] Under this obligation, FFIs must submit the name, address, and TIN of each account holder and, in the case of any account holder which is a United States owned foreign entity, the name, address, and TIN of each substantial United States owner of such entity, the account number, the account balance, and the gross receipts and gross withdrawals or payments from the account (in such manner as the Secretary may provide).[13]

Foreign countries and their constituent corporate entities are now stuck between two unappealing alternatives: give over client information which their sovereign law deems to be confidential, or attempt to avoid the FATCA altogether by ridding themselves of all U.S. clients

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[9] Behrens, Frederic. Comment. *Using A Sledgehammer to Crack A Nut: Why FACTA Will Not Stand*, 2013 **WIS. L. REV.** 205 (2013).

[10] 26 U.S.C. § 1472(a)(1)-(2) (2012).

[11] NATIONAL TAXPAYER ADVOCATE, 2013 ANNUAL REPORT TO CONGRESS at 238, *available at* http://www.taxpayeradvocate.irs.gov/2013-Annual-Report/full-2013-annual-report-to-congress/.

[12] 26 U.S.C. § 1471(a), (c).

[13] 26 U.S.C. § 1471(c)(1)(A)-(D).

and investments.[14] Unfortunately, some FFIs are choosing the latter and, as a result, are shedding those customers required to file U.S. tax returns. Indeed, in the wake of FATCA, some notable FFIs, such as DeutcsheBank, HSBC, and ING have begun purging the foreign accounts held at their institutions by those subject to U.S. tax reporting.[15] These FFIs are simply weighing the cost of the client versus the significant costs of compliance with the unwieldy regulation. Therefore, similar to FFIs, taxpayers with foreign account holdings are now faced with a new reality – report their holdings to the IRS or be reported by their banks.

C. DOMESTIC & OFFSHORE VOLUNTARY DISCLOSURE PROGRAMS

Nevertheless, taxpayers need not fear that past noncompliance with reporting requirements leaves them with no option but to wait for an IRS examination or investigation. Rather, the IRS has adopted a voluntary disclosure process, the Offshore Voluntary Disclosure Initiative (OVDI), which was first announced in March 2009. Though this article will not discuss the requirements for participation in the OVDI, it is beneficial for individuals and their representatives to know there is an option to "get a pass" for past noncompliance.

The OVDI allows U.S. taxpayers with unreported foreign accounts the opportunity to be in compliance with U.S. tax laws, avoid criminal charges, and reduce civil penalties by voluntarily disclosing foreign account holdings to the IRS.[16] After this temporary program was

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[14] Alison Bennett, *Tax Legislation: Dozens of Stakeholders from around Globe Raise Concerns on FATCA Regime*, 29 TAX MGMT. WKLY. REP. 1535 (2010).

[15] Rowan Morrison, *When Banks Pay the Price*, **Editions Financial** (Aug. 30, 2012), *available at* http://www.editionsfinancial.co.uk/2012/08/30/when-banks-pay-the-price/; *see also* Sofia Yan, *Banks Lock out Americans Over New Tax Law*, **CNNMoney** (Sept. 15, 2013), available at http://money.cnn.com/2013/09/15/news/banks-americans-lockout.

[16] *See* IRS, *Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers* (June 26, 2012), http://www.irs.gov/Individuals/International-Taxpayers/Offshore-Voluntary-Disclosure-Program-Frequently-Asked-Questions-and-Answers.

met with success in 2009, the IRS and Department of Justice determined that a similar program would be available in 2011.[17] The success of the OVDI from 2009-2011 was tangible – over 33,000 U.S. taxpayers avoided criminal prosecution and participated in 2009 and 2011, resulting in the collection of over $5 billion in unpaid taxes, interest, and penalties.[18] The IRS continues to run an offshore voluntary disclosure program today.

Similar to the OVDI, taxpayers who have underreported or failed to report income items to the IRS can benefit from enrollment in the Domestic Voluntary Disclosure Program (DVDP).[19] Enrollment in this program requires a submission of a taxpayer's identification information to the IRS Criminal Investigation (CI) Division, and is usually recommended when a taxpayer has engaged in willful conduct that may subject them to the 75% fraud penalty or criminal prosecution.

D. SOURCES THAT CAN TRIGGER IRS EXAMS

There are a myriad of ways in which a taxpayer can find themselves subject to IRS examination or investigation, whether through bad luck, poor decisions, or hidden informants.[20] Informants come in all varieties, and include old-fashioned revenge informants, such as ex-spouses or disgruntled employees, that can alert the IRS of a taxpayer's failure to report income. Similarly, greedy informants, also known as "whistleblowers," motivated by a reward of up to 10% of the tax and penalty ultimately recovered by the IRS under I.R.C. § 7023 also exist. As

[17] *See generally* Kevin E. Packman, *IRS Renews Its Focus on Unreported Foreign Accounts and Assets: The 2011 Disclosure Program*, 114 **J. Tax.** 197 (Apr. 2011).

[18] IR-2012-64, *IRS Says Offshore Effort Tops $5 Billion, Announces New Details on the Voluntary Disclosure Program and Closing of Offshore Loophole* (6/26/12), available at www.irs.gov/uac/IRS-Says-Offshore-Effort-Tops-$5-Billion,-Announces-New-Details-on-the-Voluntary-Disclosure-Program-and-Closing-of-Offshore-Loophole).

[19] http://www.irs.gov/uac/How-to-Make-a-Domestic-Voluntary-Disclosure

[20] IRM 4.16.1.4.2, Internal Revenue Manual (June 14, 2011).

seasoned tax advisors know, revenge informants and greedy informants are not mutually exclusive. Moreover, a taxpayer or tax preparer can find themselves under investigation after being the subject of "sting" cases, such as the old business buyer trick and/or through a hidden video camera in the tax preparer's office. Additionally, an examination of a taxpayer can be intensified when a civil examination is referred through a Fraud Technical Advisors (FTA) or a civil collection case is referred through a FTA.[21] Finally, an exam can be conducted by the Special Enforcement Program (SEP) exam team of SB/SE from initiation[22], or commence as a result of (1) a spinoff from another taxpayer's IRS formal/loud voluntary disclosure, (2) Lead Development Centers (newspapers, internet articles, court filings), or (3) a referral from other Government agencies.[23]

E. VOLUNTARY DISCLOSURE TIMING ISSUES

Taxpayers can also make a voluntary disclosure to the IRS before they are confronted by IRS examination. A voluntary disclosure must be truthful, timely, and complete.[24] Moreover, the taxpayer must be cooperative in determining the appropriate tax liability, and also make a good faith effort to pay the tax, interest, and penalties in full.[25] Furthermore, the general rule is that a voluntary disclosure is not timely if the IRS has initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer that it intends to commence an examination or investigation.[26] However, a voluntary disclosure is still timely when it is a

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[21] IRM 25.1.6.2, Internal Revenue Manual (Oct. 30, 2009).

[22] IRM 4.16.1.3.1, Internal Revenue Manual (June 14, 2011).

[23] IRM 4.16.1.4.2, Internal Revenue Manual (June 14, 2011).

[24] IRM 9.5.11.9, Internal Revenue Manual (Dec. 2, 2009).

[25] *Id.*

disclosure made by an individual who has not filed tax returns after the individual has received a notice stating that the IRS has no record of receiving a return for a particular year and inquiring into whether the taxpayer filed a return for that year.[27] On the other hand, a voluntary disclosure is not timely if it is made by a taxpayer who is not currently under examination or investigation, or omitted gross receipts from a partnership, but whose partner is already under investigation for omitted income skimmed from the partnership.[28] This is not deemed to be a voluntary disclosure because the IRS has already initiated an investigation which is directly related to the specific liability of this taxpayer, and the conclusion would be the same whether or not the taxpayer knew of the ongoing investigation.[29] As such, it is more important than ever for taxpayers to be proactive in reporting past noncompliance with reporting obligations.

III. INCREASED FREQUENCY OF EGGSHELL AUDITS AND TAXPAYER'S GOALS IN AN EGGSHELL AUDIT

Eggshell audits are expected to increase in light of the continuing efforts of the IRS to mine sources of information for potential fraudulent activities. The return preparer in these cases will become aware of the problems that will likely be discovered by an IRS examiner.[30] The main goals of an eggshell audit are to avoid a criminal referral to the IRS Criminal Investigation (CI) division, avoid the 75% civil fraud penalty[31] under I.R.C.§ 6663, and ensure that a

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[26] *Id.*

[27] *Id.*

[28] *Id.*

[29] *Id.*

[30] Larry A. Campagna, Caroline D. Ciraolo, & Eric L. Green, *The Eggshell Audit Part I: A Primer*, J. Tax Prac. & Proc., June-July 2012, at 29.

[31] *See Ward v. Comm'r*, T.C. Memo. 2013-133 (May 29, 2013), which details the factors utilized by the court in determining whether a 75% civil fraud penalty applies.

reasonable tax deficiency assessment does not unduly take advantage of the taxpayer's current "eggshell" situation.

IV. INVESTIGATING FRAUD: WHAT WILL THE IRS DO?

A. OVERVIEW

The IRS has a multitude of weapons at their disposal in investigating improper actions by taxpayers. However, taxpayers and their representatives have one distinct advantage when it comes to predicting the moves of the IRS. This advantage is found in the Internal Revenue Manual (IRM). Because the IRS should follow the protocol detailed in the IRM, and that protocol is published, taxpayers and their representative can understand the IRS examination process more fully. Indeed, the "Overview" section of each "Part" of the IRM will provide that the IRM handbook is a guide for IRS employees. For example, in regards to examination of fraud under the IRS' National Fraud Program, the applicable section of the IRM states that "[t]his handbook is a comprehensive guide for IRS employees service-wide in the recognition and development of potential fraud issues; referrals for criminal fraud; duties and responsibilities in joint investigations; civil fraud cases; and other related fraud issues."[32] Additionally, the IRM provides that "[t]he primary objective of the fraud program is to foster voluntary compliance through the recommendation of criminal prosecutions and/or civil penalties against taxpayers who evade the assessment and/or payment of taxes known to be due and owing."[33]Moreover, the IRM guides IRS examiners that "[t]he discovery and development of fraud are the result of effective investigative techniques."[34]

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[32] IRM 25.1.1.1, Internal Revenue Manual (Jan. 23, 2014).

[33] *Id.*

[34] *Id.*

Techniques employed by examiners are designed to disclose not only errors in accounting and application of tax law, but also irregularities that indicate the possibility of fraud."[35] As a general rule, for fraud to be considered by the IRS, an IRS employee must show either (i) an additional tax due and owing due to a deliberate intent to evade tax or (ii) the willful and material submission of false statements or false documents in connection with an application and/or return.[36] Notably, the FTA will be consulted in all cases involving potential criminal and civil fraud and will play a vital role in the development of a potential fraud case.[37] When an examiner suspects indicators of fraud (i.e. "Badges of Fraud"), the employee will discuss the case at the earliest possible opportunity with his/her manager.[38] Unsurprisingly, compliance managers will encourage the early involvement of the FTA in all potential fraud cases.[39]

B. CIVIL VS. CRIMINAL FRAUD PENALTIES AND AVOIDANCE VS. EVASION

Tax fraud offenses may result in both civil and/or criminal penalties. However, there are a few differences between criminal and civil fraud cases, most notably, the burden of proof to be satisfied by the Government. In criminal cases, the Government must present sufficient evidence to prove guilt beyond a reasonable doubt.[40] On the other hand, in civil fraud cases, the

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[35] *Id.*

[36] *Id.*

[37] *Id.*

[38] *Id.*

[39] *Id.*

[40] IRM 25.1.1.2.2, Internal Revenue Manual (Jan. 23, 2014). "Reasonable doubt" is defined as "a doubt that would cause a prudent person to hesitate before acting in matters of importance to themselves. Such a doubt will leave a juror's mind uncertain after examination of the evidence." *See* IRM 25.1.1.2.1, Internal Revenue Manual (Jan. 23, 2014).

Government must prove fraud by clear and convincing evidence.[41] Other noteworthy differences between civil and criminal fraud cases are the potential resulting penalties. "Criminal fraud results in a punitive action with penalties consisting of fines and or imprisonment, and criminal penalties:

- Are enforced only by prosecution;
- Are provided to punish the taxpayer for wrongdoings; and
- Serve as a deterrent to other taxpayers."[42]

Meanwhile, "[c]ivil fraud results in a remedial action taken by the Government such as assessing the correct tax and imposing civil penalties as an addition to tax, as well as retrieving transferred assets."[43] Furthermore, civil penalties are assessed and collected administratively as part of the unpaid balance of assessment.[44]

Just as there is a distinction between the burden of proof for civil and criminal penalties, there is also a fine delineation between an individual legally avoiding taxes and an individual running afoul of the law by evading taxes. Taxpayers have the right to reduce, avoid, or minimize their taxes by legitimate means, and a taxpayer that avoids tax does not conceal or misrepresent, but rather shapes and preplans events to reduce or eliminate tax liability within the parameters of the law.[45] On the other hand, evasion involves some affirmative act to evade or

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[41] IRM 25.1.1.2.2. Internal Revenue Manual (Jan. 23, 2014). "Clear and convincing evidence" is defined as "evidence showing that the assertion made is highly probable or reasonably certain. This is a greater burden of proof than preponderance of the evidence but less than beyond a reasonable doubt." *See* IRM 25.1.1.2.1, Internal Revenue Manual (Jan. 23, 2014).

[42] IRM 25.1.1.2.3, Internal Revenue Manual (Jan. 23, 2014).

[43] *Id.*

[44] *Id.*

[45] IRM 25.1.1.2.4, Internal Revenue Manual (Jan. 23, 2014).

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defeat a tax, or payment of tax. Examples of affirmative acts include deceit, subterfuge, camouflage, concealment, attempts to color or obscure events, or any act done to make things seem different than they truly are.[46] Common evasion schemes include:[47]

- Intentional understatement or omission of income;
- Claiming fictitious or improper deductions;
- False allocation of income;
- Improper claims, credits, or exemptions; and/or
- Concealment of assets.

C. INDICATORS ("BADGES") OF FRAUD VS. AFFIRMATIVE ACTS OF FRAUD

Taxpayers who knowingly understate their tax liability often leave evidence in the form of identifying earmarks or indicators (also known as "badges") of fraud that provide a sign or symptom that actions may have been done for the purpose of deceit, concealment or to make things seem other than what they are.[48] IRS examiners undergo intense training to identify these first badges of fraud. "Examples include substantial unexplained increases in net worth, substantial excess of personal expenditures over available resources, bank deposits from unexplained sources substantially exceeding reported income, and documents that appear to be altered or false."[49] Exhibit 1 of this article provides a non-exhaustive list of examples of the badges of fraud contained in the IRM, broken down by category.[50]

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[46] *Id.*

[47] *Id.*

[48] IRM 25.1.1.3, Internal Revenue Manual (Jan. 23, 2014).

[49] *Id.*

[50] IRM 25.1.2.3, Internal Revenue Manual (Apr. 24, 2014).

In contrast to badges of fraud, taxpayers can also engage in affirmative actions that *establish* that a particular action was deliberately done for the purpose of deceit, subterfuge, camouflage, concealment, some attempt to color or obscure events, or make things seem other than what they are.[51] Significantly, fraud cannot be established without proof of affirmative acts of fraud.[52] Examples include omissions of specific items where similar items are included; concealment of bank accounts or other assets; failure to deposit receipts to business accounts; and covering up sources of receipts.[53]

D. FRAUD DEVELOPMENT PROCEDURES, FRAUD PLAN, AND EXAMPLES OF FRAUD INDICATORS

After reviewing the potential fraud indicators and possible barriers to a successful referral, if the examiner, examiner's group manager, and FTA agree the potential for fraud exists, a plan is implemented that outlines the steps required to establish affirmative acts (proof) of fraud, and the case is subsequently placed in fraud development status.[54] This results in the examiner preparing Form 11661: Fraud Development Recommendation—Examination or Form 11661-A: Fraud Development Recommendation—Field Collection.[55]

The examiner then proceeds with the plan until affirmative acts of fraud are established or a determination is made that the potential for fraud no longer exists. If affirmative acts of fraud are established:[56]

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[51] *Id.*

[52] *Id.*

[53] *Id.*

[54] IRM 25.1.2.2, Internal Revenue Manual (Apr. 24, 2014).

[55] *Id.*

[56] *Id.*

1. The examiner must suspend collection or examination activity, and immediately notify the group manager and the FTA.
2. The FTA recommends a referral to Criminal Investigation (CI), if criminal criteria are met (see IRM 25.1.3, Criminal Referrals).
3. If criminal criteria has not been met or the case is returned by CI subsequent to a criminal investigation, the IRS will consider imposition of:
   a. the civil fraud penalty under IRC 6663 and/or
   b. the fraudulent failure to file penalty under IRC 6651(f), and/or
   c. the 10-year earned income tax credit (EITC) ban under IRC 32(k).

Notably, the decision to impose any of these punishments is the shared responsibility of the examiner, the examiner's group manager and the FTA. The final decision rests with the examiner's group manager.[57]

E. INVESTIGATIVE TECHNIQUES AND PENALTIES FOR AIDING AND ABETTING

The minimum plan of action for the examiner must include following up on all leads identified as fraud indicators (signs or symptoms); securing copies of all relevant data relating to indicators of fraud; and noting the individuals or persons who provided the leads and when that information was obtained.[58] Unusual, inconsistent or incongruous items will alert examiners to the possibility of fraud and will be subject to further investigation.[59] As such, examiners will attempt to secure the taxpayer's explanation(s) for any discrepancies.[60] In doing so, the IRS understands that the first contact with the taxpayer offers the most valuable opportunity to obtain

[57] *See* IRM 25.1.6.2, Internal Revenue Manual (Oct. 30, 2009).

[58] IRM 25.1.2.4, Internal Revenue Manual (Apr. 24, 2014).

[59] *Id.*

[60] *Id.*

useful information and records.[61] This first contact is often the most damaging aspect of the examination for a taxpayer who is misunderstood by or, worse, lies to the examiner.

IRS examiners are also directed to document, (verbatim) the questions asked of, and the answers provided from, the taxpayer, and to also record nonresponsive answers.[62] Significantly, examiners are given discretion in deciding what information is relevant to the fraud inquiry, and are given permission to utilize affidavits as a tool in their investigation.[63]

In cases where a return has not been filed and fraud is suspected, the examiner cannot demand a return from the taxpayer.[64] The IRS wants the examiner to avoid soliciting the return. Rather, a Letter 3798, Non-filer Appointment Letter, in place of the regular initial appointment letter, will be used. Nonetheless, books and records pertaining to the unfiled year(s) will still be requested from the taxpayer.[65] While fraud may be present in any type of tax return, and committed by taxpayers with various levels of sophistication, the IRS has noted that most fraud cases involve individual and business taxpayers with poor or nonexistent internal controls, and/or where there is little or no separation of duties.[66]

In regards to workpapers completed during the examination, the examiner is directed to record the tax year, the date of the contact, who was present during the contact, and the author of

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[61] *Id.*

[62] *Id.*

[63] *Id.*

[64] *Id.*

[65] *Id.*

[66] *Id.*

the examination work papers. Furthermore, the examiner must include the following information on examination work papers:[67]

- Who prepared the information used to complete the tax return,
- Who approved and classified expense items,
- Who deposited business receipts, and
- How business gross receipts, per the tax return, were determined.

Additionally, the examiner must prepare a Memorandum of Interview, summarizing information obtained and statements made. This becomes part of the Collection case file or Examination work papers, and aids in the fraud development.[68] The IRS also directs examiners to probe beneath the surface to validate and determine the consistency of information provided and to formulate statements to evaluate the credibility of evidence and testimony provided by the taxpayer. Amazingly, the IRM emphasizes that fraud is not ordinarily discovered when the examiner readily accepts the completeness and accuracy of records presented and explanations offered by the taxpayer.[69]

Taxpayers and their tax advisors must also be aware of penalties that can be imposed for aiding and abetting the understatement of tax liability. For an individual that aids and abets an understatement of tax liability, civil penalties apply under I.R.C. § 6701.[70] An individual who willfully aids and assists with the understatement of a tax liability can also be criminally charged

[67] *Id.*

[68] *Id.*

[69] *Id.*

[70] IRM 25.1.2.5, Internal Revenue Manual (Apr. 24, 2014).

under I.R.C. § 7206(2).[71] To be charged, an individual must be directly involved in the preparation or presentation of the false or fraudulent document. These individuals can include independent parties such as lawyers, accountants, return preparers, and appraisers who counsel on a course of action.[72] Thus, it is possible for criminal referrals and/or civil penalties to apply to both the taxpayer and the person assisting the taxpayer.[73]

V. WHAT CAN WE DO?

A. PRE-EGGSHELL AUDIT INTERNAL INVESTIGATIONS

Counsel for taxpayers can provide valuable advice to clients before the need for an eggshell audit arises. This can be done by keeping a pulse on clients' activities. For example, periodic discussions and questions with clients can foster proactive discovery of non-compliant issues that can be addressed before IRS involvement. For example, counsel can conduct internal investigations of the individual taxpayer and small businesses, medium-sized businesses, large entities (such as corporations, partnerships, and LLCs), and family offices in search of traditional red flags that may trigger an IRS examination. Subsequent to the internal investigation, counsel can then produce internal investigation findings to the taxpayer. Significantly, it is imperative that taxpayer counsel ensure that the internal investigation and drafted internal investigation report is appropriately documented to preserve all applicable privileges, especially the attorney-client privilege. Notably, the internal investigation may look much different if the attorney represents the corporation/entity as opposed to an employee/individual. Thereafter, counsel can

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[71] *Id.*

[72] *Id.*

[73] *Id. See also* IRM 4.32.2.1, Internal Revenue Manual (June 8, 2012).

approach the Government through a formal or informal disclosure program, such as the OVDP and DVOP, and offer to timely file a voluntary disclosure.[74]

B. ACTION AFTER IRS CONTACT AND RELATED ISSUES

If the client has already been contacted by an examining agent of the IRS, there are important first steps to take before any formal action is taken in responding to IRS inquiries. An obvious, but extremely important step is to determine what type of IRS individual is performing the investigation. An examiner's title can provide valuable indications of the type of examination or investigation that will ensue. As such, it is imperative to determine whether a taxpayer is dealing with a Revenue Officer, Revenue Agent, a Revenue Agent from the SEP, a FTA, or a Special Agent. Furthermore, ask for, and maintain, a copy of the IRS agent's card in your records.

It is also important to be aware of potential traps and issues. As noted in Part V.A. above, protect all privileges, including the attorney-client privilege, the accountant-client privilege under I.R.C. § 7525, constitutionally provided Fifth Amendment privilege, any joint defense agreement privilege, and any spousal privilege. Caution must be exercised when providing written or oral information to the IRS, and one must take care to ensure that an inadvertent waiver of one or all of the above privileges does not result. Specifically, there is a high probability that if the taxpayer talks to the IRS, the taxpayer will not only waive their privilege, but may also be misunderstood, make inadvertent misstatements, or may outright lie to IRS agents. As a result, it is important that the tax advisor avoid any entre nous, i.e. "just between us" conversations with the IRS agent.

It should be the expectation of the client and the tax advisor that every conversation with any IRS employee will subsequently be memorialized by the examiner in the exam contact sheet

[74] See discussion infra Part I. Recent IRS Focus: Why are We Here?

and/or a memorandum of interview. Because there is a high likelihood that the taxpayer will be approached by an IRS agent without the taxpayer's representative present, it is important that the taxpayer know that there are multiple alternatives. First, the taxpayer can politely refuse to speak with the IRS agent by simply telling the agent they are not going to talk without counsel present. At a later date, the tax advisor can also agree to a limited scope interview at another time or an interview with written questions and answers.

Issues regarding current and past-due returns are also present in an examination, such as an IRS agent's solicitation that previously unfiled returns be filed. Other practical issues arise, such as ensuring that all tax returns filed after the beginning of the examination are correct. It is wise for the taxpayer to exercise any extensions for their tax returns at that time as well. Moreover, there are also some Fifth Amendment protections that may be available with the tax return for specific line items.

Finally, in some cases, it is necessary to "waive the white flag." In cases where no meaningful substantive or factual arguments will aid in a favorable resolution to the client's tax matter, the taxpayer may consider whether to concede and accept their wrongdoings. While this path may result in a myriad of substantive tax issues and penalties, even the 75% civil fraud penalty, it may ultimately bring closure to a bad scenario.

V. CONCLUSION

A close look at the IRM Sections on fraud and fraud development are sobering. The IRS is doing its homework in these cases, and tax advisors must do the same. Often, the returns in issue were prepared many years ago, and the background facts need to be developed. The exercise of extreme due diligence cane make the difference between a fraud case and an ordinary exam.

EXHIBIT 1: INDICATORS ("BADGES") OF FRAUD

1. **Indicators of Fraud—Income**
   A. Omitting specific items where similar items are included.
   B. Omitting entire sources of income.
   C. Failing to report or explain substantial amounts of income identified as received.
   D. Inability to explain substantial increases in net worth, especially over a period of years.
   E. Substantial personal expenditures exceeding reported resources.
   F. Inability to explain sources of bank deposits substantially exceeding reported income.
   G. Concealing bank accounts, brokerage accounts, and other property.
   H. Inadequately explaining dealings in large sums of currency, or the unexplained expenditure of currency.
   I. Consistent concealment of unexplained currency, especially in a business not routinely requiring large cash transactions.
   J. Failing to deposit receipts in a business account, contrary to established practices.
   K. Failing to file a tax return, especially for a period of several years, despite evidence of receipt of substantial amounts of taxable income.
   L. Cashing checks, representing income, at check cashing services and at banks where the taxpayer does not maintain an account.
   M. Concealing sources of receipts by false description of the source(s) of disclosed income, and/or nontaxable receipts.
2. **Indicators of Fraud—Expenses or Deductions**
   A. Claiming fictitious or substantially overstated deductions.
   B. Claiming substantial business expense deductions for personal expenditures.
   C. Claiming dependency exemptions for nonexistent, deceased, or self-supporting persons. Providing false or altered documents, such as birth certificates, lease documents, school/medical records, for the purpose of claiming the education credit, additional child tax credit, earned income tax credit (EITC), or other refundable credits.
   D. Disguising trust fund loans as expenses or deductions.
3. **Indicators of Fraud—Books and Records**
   A. Multiple sets of books or no records.
   B. Failure to keep adequate records, concealment of records, or refusal to make records available.
   C. False entries, or alterations made on the books and records; back-dated or post-dated documents; false invoices, false applications, false statements, or other false documents or applications.
   D. Invoices are irregularly numbered, unnumbered or altered.
   E. Checks made payable to third parties that are endorsed back to the taxpayer. Checks made payable to vendors and other business payees that are cashed by the taxpayer.
   F. Variances between treatment of questionable items as reflected on the tax return, and representations within the books.
   G. Intentional under- or over-footing of columns in journal or ledger.
   H. Amounts on tax return not in agreement with amounts in books.
   I. Amounts posted to ledger accounts not in agreement with source books or records.
   J. Journalizing questionable items out of correct account.
   K. Recording income items in suspense or asset accounts.
   L. False receipts to donors by exempt organizations.
4. **Indicators of Fraud—Allocations of Income**
   A. Distribution of profits to fictitious partners.
   B. Inclusion of income or deductions in the tax return of a related taxpayer, when tax rate differences are a factor.
5. **Indicators of Fraud—Conduct of Taxpayer**
   A. False statement about a material fact pertaining to the examination.
   B. Attempt to hinder or obstruct the examination. For example, failure to answer questions; repeated cancelled or rescheduled appointments; refusal to provide records; threatening potential witnesses, including the examiner; or assaulting the examiner.
   C. Failure to follow the advice of accountant, attorney or return preparer.
   D. Failure to make full disclosure of relevant facts to the accountant, attorney or return preparer.
   E. The taxpayer's knowledge of taxes and business practices where numerous

questionable items appear on the tax returns.

F. Testimony of employees concerning irregular business practices by the taxpayer.

G. Destruction of books and records, especially if just after examination was started.

H. Transfer of assets for purposes of concealment, or diversion of funds and/or assets by officials or trustees.

I. Pattern of consistent failure over several years to report income fully.

J. Proof that the tax return was incorrect to such an extent and in respect to items of such magnitude and character as to compel the conclusion that the falsity was known and deliberate.

K. Payment of improper expenses by or for officials or trustees.

L. Willful and intentional failure to execute pension plan amendments

M. Backdated applications and related documents.

N. False statements on Tax Exempt/Government Entity (TE/GE) determination letter applications.

O. Use of false social security numbers.

P. Submission of false Form W–4.

Q. Submission of a false affidavit.

R. Attempt to bribe the examiner.

S. Submission of tax returns with false claims of withholding (Form 1099-OID, Form W-2) or refundable credits (Form 4136, Form 2439) resulting in a substantial refund.

T. Intentional submission of a bad check resulting in erroneous refunds and releases of liens.

U. Submission of false Form W-7 information to secure Individual Taxpayer Identification Number (ITIN) for self and dependants.

6. **Indicators of Fraud—Methods of Concealment**

A. Inadequacy of consideration.

B. Insolvency of transferor.

C. Asset ownership placed in other names.

D. Transfer of all or nearly all of debtor's property.

E. Close relationship between parties to the transfer.

F. Transfer made in anticipation of a tax assessment or while the investigation of a deficiency is pending.

G. Reservation of any interest in the property transferred.

H. Transaction not in the usual course of business.

I. Retention of possession or continued use of asset.

J. Transactions surrounded by secrecy.

K. False entries in books of transferor or transferee.

L. Unusual disposition of the consideration received for the property.

M. Use of secret bank accounts for income.

N. Deposits into bank accounts under nominee names.

O. Conduct of business transactions in false names.

TAX COLLECTIONS AND THE TEXAS HOMESTEAD

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December 3 – 5 , 2014

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TAX COLLECTIONS AND THE TEXAS HOMESTEAD

I. INTRODUCTION. When the question of whether the IRS can seize a homestead in Texas for a federal tax debt is asked, most tax practitioners would say, "Yes, the IRS can levy, foreclose, seize all of the delinquent taxpayer's assets." A non-tax practitioner would likely say no, the taxpayer's homestead is sacred in Texas and cannot be lost to satisfy a federal tax liability. Neither answer, of course, is entirely accurate. The correct answer in typical tax non-answer jargon is, "It depends."

II. THE TYPICAL FACT PATTERNS. There are four distinct fact patterns that control the outcome of an attempt by the IRS to levy upon and seize a residence[1] for unpaid federal taxes. Obviously, there are variations that can occur within the basic fact patterns but, such variations normally have only minor impact to the result. The following ownership patterns produce different, and in at least one case, quite surprising results:

(i) The residence is Texas community property and both spouses are liable for the tax;

(ii) The residence is Texas community property and only one of the spouses is liable for the tax;

(iii) Only one spouse is liable for the tax and the residence is the separate property of the liable spouse; and

(iv) Only one spouse is liable for the tax and the residence is the separate property of the non-liable spouse.

III. THE APPLICABLE STATUTORY LAW. The following outlines the basic law from which controls the case law applying to homestead seizure for tax.

A. <u>U.S. Constitution</u>.

Article VI [2] This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

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[1] The tax term "residence" is used throughout this outline and each time it is used in an example it is assumed that the residence qualifies as a homestead under Texas law.

B. Texas Constitution.

Article 16

Section 50(a). The homestead of a family, or of a single adult person shall be, and is hereby protected from a forced sale, for the payment of all debts except for: *** (2) The taxes due thereon;...

Section 52. DESCENT AND DISTRIBUTION OF HOMESTEAD; RESTRICTIONS ON PARTITION. On the death of the husband or wife, or both, the homestead shall descend and vest in like manner as other real property of the deceased, and shall be governed by the same laws of descent and distribution, but it shall not be partitioned among the heirs of the deceased during the lifetime of the surviving husband or wife, or so long as the survivor may elect to use or occupy the same as a homestead, or so long as the guardian of the minor children of the deceased may be permitted, under the order of the proper court having the jurisdiction, to use and occupy the same.

C. Texas Law Applicable to Property Exposure for Debts.

1. Texas Family Code §3.202 RULES OF MARITAL PROPERTY LIABILITY

(a) A spouse's separate property is not subject to liabilities of the other spouse unless both spouses are liable by other rules of law.

(b) Unless both spouses are personally liable as provided by this subchapter, the community property subject to a spouse's sole management, control, and disposition is not subject to:

(1) any liabilities that the other spouse incurred before marriage; or
(2) any nontortious liabilities that the other spouse incurs during marriage.

(c) The community property subject to a spouse's sole or joint management, control, and disposition is subject to the liabilities incurred by the spouse before or during marriage.

(d) All community property is subject to tortious liability of either spouse incurred during marriage.

2. Texas Property Code §41.001. INTERESTS IN LAND EXEMPT FROM SEIZURE

(a) A homestead and one or more lots used for a place of burial of the dead are exempt from seizure for the claims of creditors except for encumbrances properly fixed on homestead property.

(b) Encumbrances may be properly fixed on homestead property for:

(1) purchase money;
(2) taxes on property….

D. Internal Revenue Code.

1. SECTION 6321. LIEN FOR TAXES. If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States *upon all property and rights to property*, whether real or personal, belonging to such person.

2. SECTION 6331. LEVY AND DISTRAINT. (a) AUTHORITY OF SECRETARY. – If any person liable to pay any tax neglects or refuses to pay the same within 10 days after notice and demand, it shall be lawful for the Secretary to collect such tax (and such further sum as shall be sufficient to cover the expenses of the levy) by levy *upon all property and rights to property*….

3. SECTION 7403. ACTION TO ENFORCE LIEN OR TO SUBJECT PROPERTY TO PAYMENT OF TAX (a) FILING. – In any case where there has been a refusal or neglect to pay any tax, or to discharge any liability in respect thereof, whether or not levy has been made, the Attorney General or his delegate, at the request of the Secretary, may direct a civil action to be filed in a district court of the United States to enforce the lien of the United States under this title with respect to such tax or liability or to subject any property, of whatever nature, of the delinquent, or in which he has any right, title, or interest, to the payment of such tax or liability. For the purposes of the preceding sentence, any acceleration of payment under section 6166(g) shall be treated as a neglect to pay tax.

4. SECTION 7520(a). GENERAL RULE. 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 2/10ths 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.

IV. THE FACT PATTERNS AND THE EVOLVEMENT OF THE LAW.

A. <u>Community Property; Both Spouses Liable</u>. The initial fact pattern is simple: The residence is community property and both spouses are liable for the tax because they filed a joint return. While the Texas Constitution and Texas Property Code prohibit the collection of tax that is not *tax on the property* by foreclosure of a homestead, the federal law (IRC Sections 6321 and 7403) override the Texas Constitution and Texas Property Code pursuant to the U.S. Constitution Supremacy Clause. Because this fact pattern is the most frequently encountered fact pattern, it causes most people to believe the IRS can always foreclose on the homestead but, as will be seen, variations of the facts produces a different result.

B. <u>Community Property; One Spouse Liable</u>. The second most frequently encountered fact pattern is the same as presented in IV.A, but with a significant variation. The residence is community property but only one spouse is liable for the tax. The liable spouse may have filed a separate return or, as shows up with remarkable frequency in the case law, the liable spouse has been assessed a payroll tax liability, either a direct liability for the tax or an assessed Section 6672 penalty. The 5th Circuit Court of Appeals decision in *Harris*, hereafter discussed, is the guidance presently followed by the IRS but before one can understand *Harris*, the U.S. Supreme Court decision in *Rodgers v. United States*, 461 U.S. 677 (1983) must be considered.

1. *Rodgers v. United States.* While homestead survivorship rights may have been a target of IRS collection activity prior to *Rodgers*[2], it was the *Rodgers* decision that caused the IRS to focus on homestead survivorship rights as a property right.

(a) Lucille Boscoe Rodgers lived in Texas in a home that was the community property of Phillip Boscoe and Lucille during their marriage. Phillip died in 1974 at a time when he owed assessed taxes to the IRS. Lucille was not liable for any part of the tax. The IRS filed liens on the residence prior to Phillip's death and, subsequent to his death, the IRS attempted to foreclose the lien. Lucille's position was that under the Texas Constitution she had a right to live in the residence until her death because it was a homestead and the IRS has to wait until she died to foreclose. The IRS position was that not only could the IRS foreclose immediately, Lucille's survivorship right of occupancy could be ignored.

(b) The U. S. Supreme Court disagreed with both parties and held that the IRS could foreclose on the residence, and a sale of the residence could be ordered by the district court, but Lucille had to be compensated for her lifetime right to occupy the residence as provided by the Texas Constitution. The Court held that the government's lien under Section 6321 could not extend beyond the property interests held by the delinquent taxpayer and that the government could not collect more than the value of the taxpayer's property interests subject to Lucille's survivorship right to occupy the homestead for her life.

[2] *See e.g.*, United States v. St. Clair, 45 AFTR 2d 80-1528 (N.D. Tex. 1980) a pre *Rodgers* decision. There the court allowed the foreclosure of a community property homestead for husband's separate tax liability and the wife received none of the proceeds representing her survivorship right.

Apparently, the IRS believes that the Supreme Court determined the privilege of lifetime occupancy pursuant to the Texas Constitution to be a right to property and not merely a statutory entitlement or inchoate personal privilege. But, is it?

(c) The question then became how would the value of such a right be calculated. The Court laid down a practical solution which was to simply apply a life estate calculation to determine the value of Lucille's survivorship right. The Court did not mandate the form of the life estate calculation, indeed, as an illustration of how a life estate would be calculated the Court discussed the use of a "standard statutory or commercial" table.

(d) In reaching its decision, the IRS also held that under certain facts and circumstances, the IRS could not sell the residency immediately but would have to wait on the death of the surviving spouse. See V.A hereafter.

2. *Harris v. United States,* 764 F. 2d 1126 (5th Cir. 1985). Two years after the *Rodgers* decision, the Fifth Circuit Court of Appeals was faced with a fact pattern similar to *Rodgers* but with one major distinction: both spouses were still alive.

(a) Sarah Harris (the appellant) and John Harris were married in 1973. In 1977 they purchased a home. In 1978, John incurred a payroll tax liability. On May 17, 1979, the IRS and John Harris stipulated to the amount of debt in bankruptcy proceedings. On June 22, 1979, the IRS filed a lien and on July 13, 1979 Sarah was awarded the home by a judgment in a divorce proceeding. Sarah sold her home (which had been community property) and by agreement with the IRS a portion of the sales proceeds were escrowed. The fight was over the split of the proceeds. Sarah argued that she should be entitled to a life estate equivalent based on the single life tables and alternatively one-half of the proceeds of her one-half community property.

(b) The court rejected Sarah's arguments and determined that under Texas law debts incurred during marriage are presumed to be debts of the community and all the community property is eligible to satisfy the debts of *either* husband or wife; therefore, the only interest she was entitled to retain was her homestead survivorship interest determined on the two life table, not the single life table as in *Rodgers* where only one party to the marriage was alive at the time of the foreclosure.

(c) In reaching its conclusion, the Court in *Harris* made a statement that has proven to be somewhat misleading to the IRS and thus, problematic for taxpayers. The Court was trying to show that Sarah's one life table position had to be erroneous because at the time of the lien John also had a survivor's homestead right and, if they were both valued on a one life table, the two combined values would exceed 100%. In making its point, the Court made the following simple observation:

> "In this case, the following interests existed in the Harrises' residence. First, at the time of assessment notice and attachment of the lien, Sarah and John owned a joint homestead interest in the residence, which is the economic equivalent of a joint life estate. Second, Sarah and John each owned a contingent homestead interest or life estate, which would become a possessory interest in favor of the surviving spouse. Finally, Sarah and John jointly owned the remainder interest in the property."
>
> 764 F.2d 1126, 1131.

(d) The Fifth Circuit Court of Appeals mandated very specific tables for the calculation of the life estate there in issue. The government asserted in *Harris* that the appropriate tables to apply in determining the life estate was found in Treasury Publication 723A, Actuarial Values II: *Factors at 6 Percent Involving One and Two Lives* (1971). The taxpayer in *Harris* argued that a question of fact existed as to which actuarial table measured her life expectancy. The Court adopted the use of the treasury tables for the purpose of determining the life estate and, while acknowledging that the regulatory tables had not attained the force of law by applying them, the Court in essence bestowed the force of law on the tables.

(e) Subsequent to *Harris*, pursuant to the short statement in *Harris* quoted above, the IRS developed the following formula (hereafter the "*Harris* Formula").

REQUIRED FACTORS FROM PUBLICATION 1457
A. Taxpayer Remainder Factor
B. Taxpayer Life Estate Factor
C. Spouse Remainder Factor
D. Spouse Life Estate Factor
E. Two Life Remainder Interest
COMPUTATION OF FIRST TO DIE
F. First to Die Remainder Factor (A + C – E)
G. First to Die Income Factor (1.0 – F)

TAXPAYERS SHARE
H. One Half of Joint Life Estate (G ÷ 2)
I. Deferred Contingent Life Estate (B – G)
J. Remainder (E)
K. Total (H + I + J)
SPOUSES SHARE
L. One-Half of Joint Income Interest (G ÷ 2)
M. Deferred Contingent Life Estate (D – G)
N. Total (L + M)
CHECK
Total of Taxpayer and Spouse's Interests (K + N)

(f) Applying the *Harris* Formula calculation for the respective interests in the community property residence where the liable spouse (H) is 56 and the non-liable spouse (W) is 55 and the Section 7520 rate at the particular time of sale is 2.4%.

REQUIRED FACTORS FROM PUBLICATION 1457	
A. Taxpayer (Liable Spouse) Remainder Factor	.57383
B. Taxpayer Life Estate Factor	.42617
C. Non-Liable Spouse Remainder Factor	.56322
D. Non Liable Spouse Life Estate Factor	.43678
E. Two Life Remainder Interest	.48605
COMPUTATION OF FIRST TO DIE	
F. First to Die Remainder Factor (A + C – E)	.65100
G. First to Die Income Factor (1.0 – F)	.34900
TAXPAYERS SHARE	
H. One Half of Joint Life Estate (G ÷ 2)	.17450
I. Deferred Contingent Life Estate (B – G)	.07717
J. Two Life Remainder (E)	.48605
K. Total (H + I + J)	.73772
SPOUSES SHARE	
L. One-Half of Joint Income Interest (G ÷ 2)	.17450
M. Deferred Contingent Life Estate (D – G)	.08778
N. Total (L + M)	.26288
CHECK	
Total of Taxpayer and Spouse's Interests (K + N)	.10000

C. <u>Separate Property Owned by the Liable Spouse</u>. In the event the liable spouse owns the home but is married at the time of the seizure, the non-liable spouse must be compensated for his or her Texas homestead survivorship right pursuant to the *Rodgers* decision. Unlike the *Harris* decision where the home was community property, the non-liable spouse has no potential for a remainder interest, just a life possessory right if the non-liable spouse survives the liable spouse. The computation therefore is a different formula then that in *Harris*, and not exactly like that in *Rodgers* (where the liable spouse was dead) because the only value the non-liable spouse has is a lifetime possessory right *if* the non-liable spouse survives the liable spouse. Accordingly, a two life formula without the remainder interest factors must be used.

Accordingly, applying the same facts as set out in the example at IV.B.2(f) except the residence is the separate property of the liable spouse, then the non-liable spouse's only interest is a contingent life estate calculated as if both the non-liable spouse and the liable spouse live lives according to the assumptions in the tables, the non-liable spouse's interest is tiny (.08778).

D. Separate Property Owned by the Non-Liable Spouse. In this ownership pattern when applying a typical IRS collection process, the result is not only surprising but patently inequitable.

1. The Fact Pattern. Consider the following example: As in the prior example, husband (H) is 56 and wife (W) is 55 and they live in Texas. The home they live in is W's separate property that she acquired prior to their marriage by inheritance. Unknown to both W and H at the time of their marriage, H had potential exposure for penalties for failure to pay payroll taxes. H and W signed a premarital agreement, which among other things, acknowledged that the home was W's separate property but the agreement did not provide for a waiver or abandonment of H's survivorship rights. After the IRS assessed a Section 6672 penalty against H, the IRS filed a nominee lien on the home that, in essence, says W is holding title to property rights (the survivorship right) owned by H. Unless W pays the IRS for a release of the lien, the IRS will attempt to foreclose, sell the home and extract from the proceeds an amount equal to H's survivorship rights and apply it to his liability with the balance going to W. Does the IRS have the authority to force a sale of W's home under the existing case law? If so, what value may the IRS take from the sale proceeds? The answers, if favorable to the IRS, present significantly negative results to the uninformed non-liable spouse. Unfortunately, the IRS has not published guidance to the public and perhaps not even to the various local revenue officers who are filing nominee liens in such circumstances and pursuing levies.

2. The IRS' Position. It was not difficult to predict the IRS' reaction to *Rodgers*. If a homestead survivorship right is a right that must be respected and immune from IRS collection of tax debt when owned by a non-liable owner, then it is a *property right* that can be seized when it is owned by a taxpayer who owes delinquent taxes. Apparently, the IRS views *Rodgers* as direct authority for the right to seize a survivorship right no matter what surrounding facts exist. Stated differently, if the Supreme Court determined that a homestead survivorship right is a property right that has to be protected for the non-liable spouse, then it is a property right that may be extracted when it is owned by the liable spouse. But, it must be recognized that in doing so, the IRS will be evicting the non-liable owner from the home in order to satisfy

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or partially satisfy the tax delinquency with the non owner's survivorship right — *a property right created by the marriage rather than an asset bought and paid for with the taxpayer's money*.

3. The Calculation. The *Harris* formula cannot be applied where H (the liable spouse) has only a contingent survivor's life estate and no other rights. The correct calculation should be item I. (.07717) set out in IV.B.2(f), less than 8% of the value of the house. This result occurs because of 3 factors:

(i) the liable spouse owns no present interest in the residence;

(ii) the liable spouse owns no remainder interest; and

(iii) the 7520 rate is very low working against the value of the life estate.

The result would be dramatically different in favor of the IRS if H and W were half their age and the 7520 rate was doubled. Is it conceivable that the IRS should be allowed to dislodge the non-liable spouse for an 8% interest in the value? See V.A hereafter.

4. Valuation Confusion. In *Rodgers*, the valuation of the survivorship right was made easy by the court. The taxpayer was deceased and Lucille Rodgers' survivorship rights had vested, that is, she was married to Phillip Boscoe and was living in the home at the time of his death. Other fact patterns present much more complicated issues. Indeed, the Court in *Rodgers* seemed to be aware that it may have been setting up a rule of law that could be unintentionally extended beyond the facts of *Rodgers* when the Court stated:

> "Thus, *although analogy is somewhat hazardous in this area*, it may be said that the homestead laws [referring to the survivorship rights] have the effect of reducing the underlying ownership rights in a property to something akin to remainder interests and vesting in each spouse an interest akin to an undivided life estate in the property." [emphasis added].
>
> 461 U.S. 677, 685, 686.

This statement and the interpretation and application of it in *Harris* appears to create a rule that, standing by itself, could apply to facts beyond those that existed in *Rodgers*.

5. The Challenge. As indicated in IV.D.3 above, the IRS believes it has the authority (presumably from *Rodgers*) to proceed to file liens on and seize a residence owned by a non-liable spouse in a situation where the liable spouse has not waived the homestead rights. The IRS believes it can force a sale of the residence and extract the liable spouse's share of the residence. In

Rodgers, the Supreme Court protected Mrs. Rodger's survivorship right but it did not directly hold that it was a property or property right which is required under Section 6331 for the IRS to seize. The position of the IRS is based solely on the assumption that if a non-liable spouse's survivorship right must be extracted from the liable spouse bundle of property rights held by the liable spouse in the home, it (the bare survivorship right) must also be a property right. A bare spousal survivorship right, however, is not clothed with any of the rights normally associated with property: (i) it cannot be transferred; (ii) the possessory right is contingent in the sense that it can be lost by divorce or death; and (iii) it can be lost if the survivor moves out of the home. These are very realistic contingencies that not only call into question whether a bare survivor's life right is a property right but they also point to the impossibility of valuation of a bare survivorship right.

6. The *Kim* Decision. In *Kim v. Dome Entertainment Center, Inc.*, 748 F.3d 647 (5th Cir. 2014), the Fifth Circuit Court of Appeals cast a big shadow on the IRS position. *Kim* is an appeal from a District Court's affirmation of a Bankruptcy Court decision when the non-debtor spouse had to be compensated for her Texas rights although they were limited to the value of the homestead survivor's rights based on the dollar amount of the homestead exemption set out in 11 U.S.C. §522(p), not based on fair market value of the residence. In coming to its decision, the 5th Circuit made notable observations about Texas law:

> The Kims rely upon the United States Supreme Court's hypothetical calculations of the value of Texas homestead rights in the *Rodgers* decision. But the Court *assumed "only for the sake of illustration*, that a homestead estate is the exact economic equivalent of a life estate." The Kims have provided no authority that Texas law would value homestead rights as "the exact economic equivalent of a life estate," and the Supreme Court of Texas has said that "the homestead estate is not identical to a life estate because one's homestead rights can be lost through abandonment." *Laster v. First Huntsville Properties, Co.*, 826 S.W.2d 125 (Tex. 1992).
>
> From our examination of Texas law, it is not entirely clear that Texas courts would place exactly the same economic value on homestead rights as it would on a life estate. One significant difference between the economic value of a life estate and homestead rights is that the former can be alienated while the latter cannot. When a spouse no longer possesses the real property that was impressed with homestead rights, the homestead rights in that property cease to exist. A spouse cannot transfer her homestead rights and receive value in exchange. This is not true of a life estate. The assumptions used only for illustrative purposes in

Rodgers would seem to overvalue homestead rights under Texas law.

7. The Closing Argument. If a survivor's right to remain in the residence is simply a legal right of possession which has value to the owner but is not a vested economic right, can it be characterized as a property right allowing the IRS to extract a value from the true owner of the real property? It would seem that it is not a property right. When the IRS forecloses on a liable spouse's bare homestead survivor's right, it is not foreclosing on an asset that it can sell. Indeed, it is foreclosing on a property (the residence) that is not owned by the taxpayer but in which the taxpayer, the liable spouse, has a personal, non assignable right. It does not follow that a mere flipping *Rodgers* on its head is enough to make the bare survivor's personal right of possession a property right under Sections 6321 and 6331 of the Code. [3]

V. PROTECTION FOR THE NON – LIABLE SPOUSE.

A. *Rodgers* Court's Exceptions To A Forced Sale. The Supreme Court made the following statement:

> "[W]e are convinced that recognizing that district courts may exercise a degree of equitable discretion in §7403 proceedings is consistent with the policies of the statute: unlike an absolute exception … the exercise of limited equitable discretion in individual cases can take into account both the Government's interest in prompt and certain collection of delinquent taxes and the possibility that innocent third parties will be unduly harmed by that effort."

The following are the circumstances the Supreme Court stated that a court should consider when applying equity.

1. A Factor Favoring the Government. A court should consider the extent to which the Government's interests are prejudiced if it were relegated to a forced sale of the partial interest actually liable for the delinquent taxes

[3] Since the *Rodgers* decision, there have been many federal district court decisions determining whether the *Rodgers* equity factors applied to the specific facts in each case to produce a denial of the government's proposed foreclosure. Each case is a facts and circumstance decision and for the most part the federal district courts have been rather stingy with equitable relief to the taxpayers. Not many of the district court opinions result in Court of Appeal reviews, but the Sixth Circuit (applying the *Craft* decision, not *Rodgers*) has been particularly active. *See e.g.*, United States v. Winsper, 680 F.3d 482 (6th Cir. 2012) (remanding the taxpayer favorable decision back to the district court based on the lower courts mischaracterization of the *Rodgers* four factor test); United States v. Barczyk, 434 Fed.Appx. 488 (108 AFTR 2d 2011-5862 (6th Cir. 2011) (following United States v. Barr holding non-liable spouse was entitled to 50% of the house proceeds not a greater share based on her longer life expectancy); United States v. Barr, 617 F.3d 370 (6th Cir. 2010). Although *Barczyk* and *Barr* were Michigan cases applying the state law legal principles arising under Michigan's tenancies by the entireties the results cannot be reconciled with the more complex formula adopted by the Fifth Circuit in *Harris*.

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meaning could the government sell a home subject to the non-liable party's homestead rights and receive as much as government would get if it sold the entire property interests and reimbursed the non-liable spouse for his or her interests. It would be rare that anyone would buy under those circumstances.

2. Non-Liable Spouse's Expectation. A court should consider whether the third party with a non-liable separate interest in the property would, in the normal course of events (leaving aside Section 7403 and eminent domain proceedings, of course), have a legally recognized expectation that that separate property would not be subject to forced sale by the delinquent taxpayer or his or her creditors. If there is no expectation (meaning a creditor other than the government could foreclose), there is no reason to preclude the sale. In most situations there would be an expectation that the homestead could not be taken.

3. Equitable Factors Relating to the Non-Liable Spouse. A court should consider the likely prejudice to the non-liable spouse, both in personal dislocation costs and in the sort of practical undercompensation that most likely occur here. The court made no point of it but if there were minor children living in the home, it should be a critical factor.

4. Relative Valuations. A court should consider the relative character and value of the non-liable and liable interests held in the property. If the innocent spouse has no present possessory interest or fee interest in the property, there may be little reason not to allow the sale. If, on the other hand, the third party not only has a possessory interest or fee interest, but that interest is worth 99% of the value of the property, for example, then there might well be virtually no reason to allow the sale to proceed.

B. Waivers. Note the facts in IV.D.1. H and W signed a premarital agreement but H did not waive his Texas homestead rights. If he had, there would be no right that would set up the issue of whether his bare survival right can be a property right under Section 6321 and Section 6331. Even if a party is coming into the marriage with a known tax liability or potential tax liability, a premarital agreement including a waiver will be respected. Whether post-marital agreements will be respected falls into the gray zone and the facts and circumstances that exist have to be examined. On one extreme, if H and W execute a post marital agreement with a waiver of Texas Homestead right before they have knowledge of the tax liability, there is no reason for the IRS to reject the agreement. At the other extreme, if the post marital agreement is executed upon the threat of a tax lien but before the filing of the lien, maybe not[4].

[4] *See* Calmes v. United States, 926 F. Supp. 582 (N.D. Tex. 1996) where the IRS challenged the efficacy of a premarital agreement (earned income was separate property in a community property state) on the basis of the agreement being a fraudulent conveyance (inadequate consideration). The Court held that the non-liable spouse was not a related party at the time of the agreement and even if she was she paid adequate consideration to the liable taxpayer by giving up equal claims to his future earned income.

VI. COMPARABLE TREATMENT IN NON-COMMUNITY PROPERTY STATES.

A. *United States V. Craft,* 535 U.S. 274 (2002). In *United States v. Craft*, the Supreme Court dealt with the question of whether a tenancy by the entirety created under Michigan law was a property right to which an IRS lien could attach, followed by a forced sale then a division of the proceeds from a sale of the underlying property between the IRS and the non-liable spouse. The taxpayer (husband of the respondent in the Supreme Court proceedings) failed to pay federal income tax liabilities assessed against him, and pursuant to Section 6321 a federal tax lien attached to "all [of his] property and rights to property." After the notice of the lien was filed, respondent and her husband jointly executed a quitclaim deed purporting to transfer to her his interest in a piece of real property in Michigan that they owned as tenants by the entirety and, subsequently, the IRS agreed to release the lien and allow respondent to sell the property with half the net proceeds to be held in escrow pending determination of the IRS' interest in the property. Respondent brought the action to quiet title to the escrowed proceeds. The IRS claimed, among other things, that its lien had attached to the husband's interest in the tenancy by the entirety. The district court had no problem finding that the quitclaim deed would be a fraudulent conveyance if the IRS could seize that which was conveyed, the husband's interest in the tenancy by the entireties property. The district court granted the government motion for summary judgment, but the Sixth Circuit held that no lien attached because the husband had no separate interest in the entireties property under Michigan law, and remanded the case for consideration of an alternative claim not at issue at the Supreme Court. The Supreme Court held that the husband's interests in the entireties property constituted property or rights to property to which a federal tax lien could attach.

B. Whether A Property Right? In *Craft*, the Court noted that it looks initially to state law to determine what rights the taxpayer has in the property the government seeks to reach and then to federal law to determine whether such state-delineated rights qualify as property or rights to property under Section 6321. At the time *Rodgers* was decided, the rule of property or property right determination was primarily a state court function. *United States v. Bess*, 357 U.S. 51 (1958). The Court observed: "…section 3670 [1939 Internal Revenue Code] creates no property rights but merely attaches consequences, federally defined, to rights created under state law…." But post *Rodgers*, the concept was narrowed somewhat by *United States v. National Bank of Commerce,* 472 U.S. 713 (1985). The Court said "…state law defines nature of the taxpayer's interest in the property, but the state law consequences of that definition are of no concern to the operation of the federal tax law." It was then further narrowed in *Drye v. United States,* 528 U.S. 49 (1999). In *Drye,* the Supreme Court further extended the federal law control by explaining that state law is only initially examined to find the rights the taxpayer has in the subject property then federal law determines whether the taxpayer's rights constitute property or property rights.

C. The Three Legal Structures For Concurrent Ownership Property. In *Craft*, the Court further noted that "English common law provided three legal structures for the concurrent ownership of property that have survived into modern times: tenancy in common, joint tenancy, and tenancy by the entirety." Citing 7 R. Powell & P. Rohan, Real Property §51.01[3] (M. Wolf ed. 2001), the Court described tenants in common as each owning a separate fractional share in undivided property and each tenant may unilaterally alienate their shares through sale or gift or place encumbrances upon these shares and transfer such shares at death. They also have many other rights in the property, including the right to use the property, to exclude third parties from it, and to receive a portion of any income produced from it. *Id* at §§50.03 – 50.06.

D. <u>The Survivorship Component</u>. Joint tenancies, the *Craft* Court noted, also have a survivorship component, meaning that upon the first to die of the joint tenants, the survivor owns all of the underlying property. Tenancy by the entirety is yet distinguishable from both tenancies in common and joint tenancies in that tenancy by the entirety is available only to married couples and, like joint tenancies, there is a right of survivorship. The Court noted that a unilateral disposition of one spouse's interest in a tenancy by the entireties is typically not possible without severance and severance requires the consent of both spouses. Under Michigan law, a spouse could not unilaterally convey an interest in a property held as tenancy by the entireties, and each spouse had a survivorship right. In coming to its conclusion that one spouse's "bundle of sticks" in a tenancy by the entireties was enough to call it a "property right", the court relied heavily on *Rodgers* and rejected the respondent's argument that a property right that could not be alienated could not be seized by the IRS. Note the similarity of this analysis to the Fifth Circuit's analysis in *Harris.* The *Craft* Court said:

> "Excluding property from a federal tax lien simply because the taxpayer does not have the power to unilaterally alienate it would, moreover, exempt a rather large amount of what is commonly thought of as property. It would exempt not only the type of property discussed in *Rodgers*, but also some community property. Community property states often provide that real community property cannot be alienated without the consent of both spouses. See, *e.g.,* Ariz. Rev. Stat. Ann. §25-214(C) (2000); Ca. Fam. Code. Ann. §1102 (West 1994); Idaho Code §32-912 (1996); La. Civ. Code Ann/. Art. 2347 (West Supp. 2002); Nev. Rev. Stat. Ann. §123.230(3) (Supp. 2001); N.M. Stat. Ann. §40-3-13 (1999); Wash. Rev. Code §26.16.030(3) (1994). Accordingly, the fact that respondent's husband could not unilaterally alienate the property does not preclude him from possessing 'property and rights to property' for the purposes of §6321."
>
> 535 U.S. 274, 285.

E. <u>Strong Dissents</u>. The *Craft* Court's majority opinion was delivered by Justice O'Connor. Justices Thomas, Scalia and Stevens dissented strongly taking issue primarily with the notion that a property right that cannot be alienated and may be lost on termination of the marriage should not be a property right eligible to be lost to the

IRS (535 U.S. 274, 292-301 (2002)). The dissenting opinion makes an analogy of a marriage to that of a partnership or a corporation, that is, a fiction of law with the point being that if the IRS files a lien that attaches to a partnership interest the IRS does not have the ability to dissolve the partnership and take its share. It is possible that in future litigation dealing with the question posed here, that is, whether a nonowner's contingent homestead survivor's right is a property right subject to levy, the *Craft* decision will play a larger role than the *Rodgers* decision. In *Rodgers*, the court acknowledged the age old rule that state law determined when property rights existed and federal law controlled with respect to the government's right to take it. Even though the issue was whether a single element of the homestead bundle of rights (the right to remain in the home after the death of the first spouse to die) was a property right that the government could not take from Mrs. Rodgers, the Court did not break it down and analyze that single piece of the bundle as the Court did in *Craft*. In *Craft*, significant debate over the elements of a property ensued between the majority opinion and the dissenting opinion, principally over the absence of a unilateral right to convey the economic benefit of a tenancy by the entireties. The focus here is on the right of survivorship as a separate property right and whether the government can force the sale of a non-liable spouse's home to extract solely the value of that right. The right of survivorship under homestead law does not include all those elements of a property right that were debated in *Craft*. It is non assignable and the owner of it can do nothing with it except possess it. More importantly, it is contingent and may never be of any value since it can be lost by divorce.

F. <u>Speculation Regarding Today's Court</u>. Similarly, a property right that is created by a marriage and subject to being lost by dissolution of the marriage should not be eligible for foreclosure even if the other spouse, the non taxpayer, is compensated. Query whether the Supreme Court today would reach the same conclusion since the Court now has four different Justices. Would this decision be the same if reviewed today or would the forceful voice of the dissent get additional votes? It is interesting that in *United States v. Parcel of Real Property Known as 1500 Linda Avenue*, 949 F.2d 73 (3rd Cir. 1991), Justice Alito (who was not on the Supreme Court at the time of the *Craft* decision) writing for the three judge panel in a Third Circuit Court of Appeals in a civil forfeiture case involving real property used in the illegal diversion of pharmaceutical drugs, refused to allow a forced sale of the property but required the government to wait until the death of the innocent co-owner. The property was owned by the convicted party and the innocent party as a tenancy by the entireties. The result of this decision was exactly the result requested by the non-liable spouse in *Rodgers*, but rejected by the Supreme Court and subsequently rejected by *Craft*, where a forced sale and proceeds splitting was ordered.

G. <u>The Bundle Of Sticks</u>. The Court in *Craft* broke down the bundle of sticks and analyzed the individual elements of ownership by the entireties, that is, the separate rights that comprise the bundle of rights. In contrast, *Rodgers* applied the then simplistic rule that state law defines property and federal law determines what the IRS can do with it. *Rodgers* did not dissect homestead rights and it must be remembered that the single right at issue in *Rodgers* was the right of survivorship and not any of the

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other homestead rights such as the right of creditor protection and the right precluding unilateral alienation by a single spouse during the marriage. And, to add further complexity, that single right of survivorship must be applied to different sets of fact patterns since the survivorship at issue in *Rodgers* was the unconditional right to possess the homestead for life, but such right in other cases are distinguishable because the right is conditional. What "sticks" then exist for owners of a bare survivorship right? In *Rodgers* it was simply one, the right of possession, no right of sale or even transfer by gift. If, however, the two spouses still occupy the homestead at the time of an attempted seizure and sale by the IRS, there is no vested right of occupancy since that right is subject to staying married and subject to one spouse surviving the other spouse and there is no right of assignment. That is not a large bundle of sticks and one can only speculate what the *Craft* court in 2003 and, more importantly, the Supreme Court today, would do with the question presented here. A tenancy by the entireties is a consensual contractual arrangement that two spouses enter into presumably with full knowledge of their respective rights. A homestead survivorship right is a property right created by marriage with the couple usually having very little knowledge of the risks the non-liable spouse is taking.

H. IRS Notice 2003-60. Subsequent to *Craft*, the IRS published guidance in Notice 2003-60, 2003-39 I.R.B. 643, on collection from property held in a tenancy by the entirety, where only one spouse is liable for the tax deficiency. Though the IRS' position is that *Craft* is not new law, the IRS has offered some comfort to non-liable spouses. As a matter of policy, the IRS will not apply *Craft* for certain interests created before *Craft* to the detriment of third parties who may have reasonably relied on the belief that state law prevents the attachment of the federal tax lien. The sale of entireties property subject to the federal tax lien presents practical problems and, because of the potential adverse consequences to the non-liable spouse, the IRS will use lien foreclosure for entireties property on a case by case basis. Notice 2003-60 further provides that the value of the taxpayer's interest in entireties property generally is deemed to be one-half and whether there has been a sale or other transfer of entireties property subject to the lien that does not provide for the lien's discharge, the lien thereafter encumbers a one-half interest in the property held by the non-liable spouse or third party transferee.

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The Perfect Storm Has the Tide Turned Against Offshore Tax Evasion?

By Jason B. Freeman, JD, CPA

The government is building momentum in its effort to turn the tide against offshore tax evasion. With the fall of Swiss bank secrecy, the rise of the Foreign Account Tax Compliance Act of 2009 (FATCA), and an increasingly global push for cross-border transparency, we are truly entering a new era: an era marked by international cooperation. The government, with its net now cast wider than ever, is poised to haul in a big catch.

The past five years have seen an unprecedented movement towards transparency and international cooperation. A growing number of countries have signed on to information-exchange agreements, such as FATCA. Super-national organizations—such as the Organization for Economic Cooperation and Development (OECD), G20 and the European Union—have pushed, with much success, for more effective disclosure agreements. Government prosecution efforts have led to the collapse of Swiss bank secrecy. The capstone on the effort has been the Internal Revenue Service's (IRS's) voluntary disclosure program—a program that has, by most accounts, been wildly successful, bringing forward as many as 50,000 Americans and infusing over $6.5 billion in taxes, penalties and interest back into federal coffers over the past five years.

The government, however, is anything but complacent with this success. Congress has put the political spotlight back on hidden offshore accounts. Last year, the Senate Permanent Subcommittee on Investigations, in a lengthy and extensive report, took the Department of Justice (DOJ) to task for its "lax" past enforcement efforts and failure to prosecute enough U.S. citizens with undisclosed accounts. It called on the DOJ "to obtain the names of U.S. taxpayers with undeclared accounts at tax haven banks" and to "take legal action against U.S. taxpayers to collect unpaid taxes on billions of dollars in offshore assets."1 Such pointed criticism and calls to action, coming on the heels of truly unprecedented success, underscores the political will behind the effort to prosecute those who have not yet come forward.

Importantly, that political will is guided by more than high-minded ideals of fairness and tax compliance. There is a much more fundamental driver: the need for tax revenues.2 The IRS estimates that the annual U.S. tax gap is around $450 billion,3 and unreported offshore funds account for almost one third of this gap, an estimated $150 billion.4 Those are big dollars in the face of an annual deficit that exceeds $500 billion.

A Little History

The U.S. government has long been concerned about offshore tax abuses and the role that tax haven banks have played in facilitating tax evasion. Over 30 years ago, the Senate Permanent Subcommittee on Investigations first began conducting investigations into how U.S. taxpayers were using offshore secrecy jurisdictions to hide assets and evade taxes.5 Attempts to gauge the magnitude of the problem have varied over time, but current estimates indicate that trillions upon trillions of U.S. dollars are held offshore.

Throughout the years, the government has undertaken a number of initiatives to combat offshore tax abuses. One major prong of the attack has been its ongoing effort to establish tax

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treaties and tax information-exchange agreements with foreign countries. For many years, however, offshore tax havens staunchly resisted entering into such agreements. Bank secrecy jurisdictions, the most prominent of which was Switzerland, successfully created barriers to information exchange. Partly in response to such barriers, the United States also established another key initiative, its Qualified Intermediary Program. In addition to these measures, the government undertook a number of multilateral initiatives, such as the establishment of the Joint International Shelter Information Centre.

These efforts met with relatively modest success in terms of curbing offshore tax evasion. However, they paved the way for new-and-improved intergovernmental approaches like FATCA that will surely usher in a new era in the battle against offshore abuses.

The Rise of FATCA and Intergovernmental Cooperation

At the forefront of the government's attack is FATCA, which was part of the 2010 Hiring Incentives to Restore Employment (HIRE) Act, though its provisions were set for delayed and phased-in implementation. A significant wave of disclosure obligations and withholding tax went into effect on July 1, 2014, and the effects will soon be seen.

FATCA requires foreign financial institutions to either report foreign accounts held by U.S. citizens to the U.S. government or incur a 30 percent withholding tax on certain payments related to U.S.-source income. As a result, foreign financial intermediaries will soon be reporting many, many more accounts to the IRS.

Because FATCA and its regulations are extremely complex, many countries have opted to enter into streamlined Intergovernmental Agreements (IGAs) with the United States, which offer procedures that simplify compliance and streamline the exchange of information. The IRS now has at least 54 IGAs in place, and has reached agreements in substance with at least another 58 countries.6

In addition, the United States has a network of tax treaties, tax information exchange agreements (TIEAs), Mutual Legal Assistance Treaties (MLATs) and Agreements (MLAAs). These instruments serve an increasingly important role in tax enforcement. As of 2011, the United States had more than 140 tax treaties, protocols, TIEAs, MLATs or similar tax information exchange agreements with 90 foreign jurisdictions.7

International Efforts to Combat Cross-Border Tax Evasion

There is also growing international support to stop tax haven banks from facilitating tax evasion.8 Two key multilateral organizations, the G8 and G20, have strengthened efforts to combat cross-border tax evasion and have become increasingly vocal in support of their efforts. For 2009, the G20 heads of state issued a joint and unequivocal communique declaring that "the era of bank secrecy is over."

Following UBS and other highly publicized scandals, the G20 intensified its focus on tax haven abuses, including supporting the OECD's efforts to promote the exchange of tax information across borders, the issuance of a list of uncooperative tax havens, and the imposition of sanctions on jurisdictions that impeded tax enforcement.9 After the enactment of FATCA, G20 and G8 world leaders advocated for automated tax information exchanges as the new international standard, and have called on countries to make automated exchanges effective by the end of 2015.10

The OECD has increased the pressure on countries to move towards transparency and to adopt broader information exchange provisions. It has issued influential reports criticizing tax havens that have failed to provide key information, criticizing bank secrecy laws in tax haven jurisdictions, and identifying “uncooperative tax havens.”11 These efforts have directly led a number of previously uncooperative jurisdictions to get on board and commit to exchange information in international tax matters.12

In addition, the OECD has developed model information-exchange agreements to support reporting regimes like FATCA13 and has sought to enable countries to exchange information on an automatic basis.14 Like the G20 and G8, it has established a goal of enabling automated reporting by 2015.

The Voluntary Disclosure Programs and Key Prosecutions

Another key initiative has been the IRS’s Offshore Voluntary Disclosure Program (OVDP). The OVDP allows qualifying taxpayers to disclose unreported foreign accounts in exchange for reduced penalties and an agreement not to refer them for criminal prosecution.

Although the IRS has had a general voluntary disclosure practice for decades, in recent years there has been an explosion in the number of voluntary disclosures of offshore accounts. This has largely been the product of a targeted disclosure program and its promotion through well-publicized prosecutions and settlements that have given taxpayers an extra nudge to enter into the program.

In roughly the past decade, the IRS has implemented four programs specifically targeted at offshore voluntary disclosures—the 2003, 2009, 2011 and 2012 programs.15 These programs have, by most estimates, been very successful, though they may have only scratched the surface. While the voluntary disclosure programs resulted in as many as 50,000 Americans coming forward and over $6.5 billion in back taxes, penalties and interest, prior government estimates indicated that there were some 500,000-plus U.S. citizens utilizing abusive offshore schemes to start with.16

The 2003 Offshore Voluntary Compliance Initiative was the first voluntary disclosure program specifically targeted at foreign disclosures. In 2003, the IRS estimated that over 500,000 U.S. taxpayers were engaged in abusive offshore schemes.17 Following an investigation into the identity of offshore credit and debit card holders believed to be hiding taxable income, the Service offered eligible taxpayers an opportunity to come back into compliance, and mitigate their civil penalties and exposure to criminal prosecution. Though the initiative was only open for three months, it resulted in just over 1,300 disclosures and raised approximately $200 million.

For about five years, however, there was not much action on the offshore voluntary disclosure front. But in 2009, the world changed. In February of that year, the U.S. DOJ entered into a deferred prosecution agreement with UBS AG, Switzerland’s largest bank. UBS agreed, as part of the deferred prosecution agreement, to a fine of $780 million. As a result of this scandal, UBS ultimately agreed to turn over 4,700 undisclosed accounts owned by U.S. clients.

Shortly after UBS entered into a deferred prosecution agreement, the IRS, leveraging its position of strength, rolled out the 2009 OVDP. The threat that UBS was disclosing names and account information that would link U.S. citizens to undisclosed accounts led many to come forward under the OVDP and greatly increased its success.

The 2009 OVDP was only open for a limited time and provided taxpayers with relief from criminal prosecution, as well as limited civil penalty exposure. To enter into the program, a taxpayer was required to fully disclose their offshore accounts and pay 20 percent of the highest account balance during an eight-year look-back period plus some minor additions. The program, which closed in October 2009, led to about 18,000 taxpayer disclosures and raised $3.4 billion.18

In 2011, the IRS offered taxpayers another chance to come forward. However, the 2011 program came with a higher cost, providing a standard penalty equal to 25 percent of the taxpayer's highest account balance. The higher cost was designed to strike a balance between incentivizing those who had not yet come forward to do so, but also sending a message that the deal would not get sweeter if the account holder waited longer. The 2011 offshore voluntary disclosure initiative offered the same basic benefits as the 2009 program, but it also introduced the possibility of reduced penalties for qualifying taxpayers. The program, which closed in September of 2011, resulted in about 15,000 disclosures and raised just over $1.6 billion.

In 2012, DOJ indicted Wegelin & Co., Switzerland's oldest bank. Months later, Wegelin & Co. pled guilty to conspiracy to defraud the United States and forfeited $32 million in frozen U.S. accounts, paying fines and restitution of another $42 million. The indictment and guilty plea crippled Wegelin beyond repair and it soon folded. The fall of Switzerland's oldest bank was symbolic of the decline and eventual fall of Swiss banking secrecy.

Also in January of 2012, the IRS introduced yet another voluntary disclosure program. Like the 2011 program, the 2012 initiative once again raised the standard penalty, this time to 27.5 percent; however, it also introduced a new "opt-out" procedure, allowing taxpayers to opt-out of the one-size-fits-all penalty structure and make their case for a lower penalty. It also maintained a reduced penalty structure for qualifying taxpayers and introduced, for the first time, a "streamlined" procedure for "low risk" nonresidents.19 Rather than set a deadline, the IRS left the 2012 program open-ended, reminding taxpayers that it may end the program at any time. And as of July 1, 2014, a date that coincides with phased-in FATCA reporting obligations, the IRS implemented its latest changes to the program and expanded the streamlined procedure—a welcomed development for many U.S. citizens with undisclosed accounts, as it may greatly decrease the applicable penalties under some circumstances.

While the government's efforts against UBS and Wegelin had been successful, in May 2014, the government notched its biggest settlement yet. Credit Suisse entered a plea of guilty to charges of conspiracy to aid and assist in the preparation of filing of false tax returns. As part of that guilty plea, Credit Suisse agreed to pay a total of $2.6 billion to the DOJ, along with $100 million to the Federal Reserve and $715 million to the New York State Department of Financial Services.

All told, in the span of five years, Switzerland saw its oldest, longest-running private bank prosecuted and destroyed, and its two largest banks, UBS and Credit Suisse, agree to massive financial penalties and systemic changes that ended decades, if not centuries, of business practices.

The United States government, aware that it has the upper hand, has not let up. There are currently 13 other Swiss banks under active DOJ investigation. These banks include, among others, Julius Baer, Basler Kantonalbank, Zuercher Kantonalbank, and Swiss arms of

Lichtenstein's LLB and the UK's HSBC.20 The banks on this so-called DOJ "hit-list," having witnessed the fates of UBS, Credit Suisse and Wegelin & Co., are braced for the fallout.

Swiss Non-Prosecution Program

In the midst of all this, the DOJ, in August of 2013, announced a program to enable almost 300 Swiss banks to receive non-prosecution agreements or non-target letters. The DOJ made the program available to all Swiss banks except those under active DOJ investigation,21 and the Swiss Finance Department urged Swiss banks to participate.

Over 100 Swiss banks have apparently entered into the program. In essence, these banks are agreeing to fully disclose their practices with U.S. customers and pay severe penalties in exchange for the United States government's agreement not to prosecute them. The United States government will be able to utilize the information that it receives to request the identity of U.S. taxpayers under the U.S.-Swiss tax treaty. The fruits of that information will likely set off the next wave and write the next chapter in this saga.

The Impact of the Fall of Swiss Bank Secrecy

These developments set the stage for major changes in the foreign account reporting landscape and led to the fall of Swiss bank secrecy. Switzerland's strategic importance in the battle against offshore evasion cannot be overstated. Switzerland had long been a stronghold for bank secrecy and hidden bank accounts. Even as recently as 2013, it was ranked number one out of 82 jurisdictions on the Tax Justice Network's Financial Secrecy Index.22 Swiss banks manage about a quarter of the world's total assets,23 and until recently, the two largest banks—UBS and Credit Suisse—managed about half of those assets.

While the United States has had a tax treaty with Switzerland since 1951, that treaty effectively provided for the exchange of information only in fairly narrow circumstances.24 These limitations, though addressed to some extent in a 1996 protocol, were unique to the Swiss-United States treaty; they did not exist in any other United States tax treaty.25

For years, Switzerland resisted adopting the OECD standards for tax information exchange. However, in March 2009, Switzerland reversed more than a decade of tax policy and announced that it would adopt the OECD standard for tax information exchange.26

By September of that year, Switzerland signed a protocol with the United States amending the countries' tax treaty to incorporate the OECD standard for tax information exchange,27 a standard that conforms with the U.S. Model Income Tax Convention and U.S. law governing IRS inquiries.28 Interestingly, though, the United States Senate has yet to vote on ratifying the revised treaty due to a hold on consideration of the treaty that has been in place for more than three years.29 But that may soon change, as ratification of the revised Swiss tax treaty is one of the top recommendations from the Senate Permanent Subcommittee's 2014 report.30

In the meantime, Switzerland has already demonstrated its commitment to change and has entered into several agreements with the United States that open the door to transparency now. Switzerland has not only signed an IGA with the United States, requiring all Swiss financial institutions to comply with FATCA's new disclosures,31 it also signed the Convention on Mutual Administrative Assistance in Tax Matters, a multilateral agreement that mandates that participating countries cooperate with international tax information exchange requests and tax enforcement efforts.32

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These developments are a trend. The past several years have seen countries that include well-known tax havens, such as Liechtenstein, Austria, Belgium, Luxembourg and Monaco, pledge that they will cooperate with international tax enforcement efforts and share tax information. More countries will follow.

And with the success in Switzerland, the government has expanded its efforts to target other key countries. For instance, in November 2013—as part of what the IRS described as the "next phase" of its offshore compliance crackdown—the IRS announced that it would soon be deploying agents from SB/SE's special enforcement program to examine U.S. taxpayers suspected of holding undeclared accounts in Indian banks. Initiatives like this will be interesting to follow and will undoubtedly lead to some high-profile prosecutions.

Other Forces at Work

In addition to the international forces at work, a number of domestic developments have bolstered the government's attack. For instance, the revamped whistleblower program has seen a burgeoning and unprecedented cottage industry of whistleblowers in the offshore account context. Prosecutions for undisclosed offshore accounts are higher than ever. John Doe summonses, which allow the government to obtain information about a class of taxpayers even when it does not know their identities, have increased the information flow and sidestepped traditional legal barriers to gathering information. The development of the so-called required records doctrine has seen an emasculated, if non-existent, Fifth Amendment privilege in the context of undisclosed accounts. These developments bode poorly for those still hesitant to come forward and disclose their offshore accounts.

Unprecedented

We are truly witnessing an unprecedented movement towards global transparency and international cooperation. Those with undisclosed accounts are increasingly at risk, and the stakes are only getting higher. The fall of Swiss banking secrecy, the rise of FATCA, and the growing international coalition calling for cross-border tax transparency is creating a proverbial perfect storm that is lending credence to the claim that the tide is turning against offshore tax evasion.

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Code Section 457A Revisited: Permitted Offshore Deferrals for Investment Fund Managers

Chris M. Kang

Although formal guidance under Section 457A of the Internal Revenue Code of 1986, as amended (the "***Code***") has been limited since its enactment, the Internal Revenue Service (the "***IRS***") recently issued guidance that may open the pathway for permitting investment fund managers to defer the compensation paid from certain investment funds and to better align their interests with the investors in their funds.

Elimination of Deferrals; Misalignment of Interests Between the Fund Manager and Investor

Section 457A of the Code ("***Section 457A***") was enacted by Congress in 2008 as a part of the Emergency Economic Stabilization Act of 2008 (commonly referred to as the "bailout" bill).[1] At the time, there was a perception that U.S. hedge fund managers were deferring substantial amounts of income offshore without subjecting such income to U.S. taxation. Section 457A was enacted as a measure to curb such "abuse" by hedge fund managers.[2]

As a general matter, when compensation is paid by U.S. service recipients, at the time such compensation is taken into income by the service provider, the service recipient is entitled to a corresponding tax deduction.[3] When the service provider defers receipt of such compensation, the service recipient loses the immediate ability to take a tax deduction and must wait until the compensation is paid. However, when the service recipient is not subject to a comprehensive tax system or is otherwise "tax-indifferent" (such is often the case with offshore hedge funds or funds predominately held by tax-exempt organizations), the service recipient has no inherent interest in taking a tax deduction (as there is no or little tax to pay) and paying the compensation. To create the incentive of paying such compensation, Congress passed Section 457A. Although the actual statute that was passed into law was much broader in its application, the law effectively accomplished its purpose of limiting deferrals of compensation payable to U.S. hedge fund managers by such offshore investment fund and other "tax-indifferent" service recipients.

Section 457A effectively accomplishes its purpose by including amounts in the service provider's income when such amounts are no longer subject to a substantial risk of forfeiture (i.e., when the right to the compensation "vests").[4] Under Section 457A, any compensation deferred under a "nonqualified deferred compensation plan" of a "nonqualified entity" is includable in gross income and taxable when there is no substantial risk of forfeiture to the rights to the compensation.[5] A "nonqualified entity" includes (i) a foreign corporation where substantially all of its income is not effectively connected with the conduct of a trade or business in the U.S. or where it is not subject to a comprehensive foreign income tax, and (ii) any partnership where substantially all of its income is allocated to foreign persons who are not subject to a comprehensive foreign income tax or to organizations that are exempt from U.S. income tax.[6] In short, the compensation payable by entities in tax-haven jurisdictions and partnerships with foreign or tax-

[1] Pub. L. No. 110-343 (Oct. 3, 2008).

[2] For purposes of this article, the term "fund manager" is used to refer to the person providing investment management services to the investment fund, and interchangeably to mean the party establishing the investment fund as well.

[3] *See* Code § 162.

[4] Code § 457A(a). In cases where the compensation is not determinable, the amounts can be paid later than the date such amounts are no longer subject to a substantial risk of forfeiture, but such amounts will be subject to substantial penalty taxes. *Id.* at § 457A(c).

[5] Code § 457A(a). Under Section 457A, an amount is subject to a "substantial risk of forfeiture" only if the service provider's right to such amount is conditioned on the performance of future services by such service provider. *Id.* at § 457A(d)(1)(A).

[6] *Id.* at § 457A(b).

exempt partners will be taxed upon vesting, even if it has not been paid to the service provider, unless those entities (or partners of those entities) are otherwise subject to tax. Unlike Section 409A of the Code ("***Section 409A***"), which permits the deferral of compensation so long as it complies with the requirements of Section 409A, compensation that is subject to Section 457A simply may not be deferred at all.

Historically, U.S. hedge fund managers have charged the investments funds under their management a management fee based on assets under management and an incentive fee based on gains and returns on investments. Prior to Section 457A, fund managers routinely deferred the receipt of the incentive fee compensation payable from offshore hedge funds for a variety of reasons and often reinvested such amounts in the investment funds they managed. For the fund manager, this deferral had the advantage of tax-free growth and delayed taxes. From the investor's perspective, the fund manager was truly in a "partnership" with the investor by investing in the same investment fund as the investors – i.e., the fund managers had "skin in the game." By having such amounts invested along with the investors, the interests of the fund managers and the investors were aligned, and if the fund didn't perform well going forward, there was an intrinsic "clawback" of the performance compensation.

A consequential effect of curtailing the deferral of compensation was that the investors in such offshore investment funds lost such advantages. Because fund managers are effectively paid on an annual basis under a post-Section 457A regime with limited ability to structure multi-year incentive compensation arrangements, in highly profitable years, the fund manager could receive the full incentive compensation, with lesser risk of a clawback of such compensation in any subsequent poorly performing years. This misalignment of interests can be illustrated with the following basic example:

> Tax-Exempt Investor acquires 1,000 equity units of Offshore Fund at a net asset value (NAV) price of $1,000 per unit. The fund manager receives a 20% incentive fee that is payable on an annual basis. After year 1, the NAV per unit rises up to $2,000 per unit, but then after year 2, it drops to $1,800 per unit, and then after year 3, drops further to $1,500 per unit. Following year 1, an incentive fee of $200,000 would be paid [20% of the appreciation of $1,000,000]. Assuming the fee is subject to a high-water mark, no incentive compensation would be paid after year 2 or 3. After year 3, the Tax-Exempt Investor's units have a value of $1,300,000, with a net investment gain of $300,000. This equates to the Tax-Exempt Investor deriving 60% of the gain and the fund manager earning 40% of the gain. Based on this arrangement, when viewed as a multi-year arrangement, the fund manager has gained far more than the "20% incentive fee" payable to the fund manager. Because of Section 457A, there has been misalignment of the interests of the Tax-Exempt Investor and the fund manager and, unless the investor specifically negotiated a clawback of the compensation, is arguably in a worse position than under a multi-year arrangement prior to Section 457A.

Stock Options and Stock-Settled Stock Appreciation Rights Under Section 457A

Section 457A generally covers the same "nonqualified deferred compensation plans" as those covered under Section 409A.[7] Under Section 409A, a "nonqualified deferred compensation plan" is a plan that provides for (or may provide for) the payment of compensation to a service provider in a year later than the year in which the service provider has a legally binding right to such compensation.[8] Section 409A generally excludes from the definition of "nonqualified deferred compensation plan," stock options and stock appreciation rights ("***SARs***") that are granted with an exercise price that is no less than the fair

[7] Code § 457A(d)(3).
[8] Code § 409A(d), Treas. Reg. § 1.409A-1(b)(1).

market value of the underlying service recipient stock issued at the time of grant.[9] Unlike Section 409A, however, Section 457A specifically includes "any plan that provides a right to compensation based on the appreciation in value of a specified number of equity units of the service recipient."[10] This statutory language, when read broadly, appears to cover SARs as a form of deferred compensation under Section 457A.

Following the enactment of Section 457A, the IRS issued guidance under IRS Notice 2009-8, 2009-4 I.R.B. 347 ("***Notice 2009-8***"), which attempted to clarify that stock options and "stock-settled" SARs (effectively, net or cashless exercise stock options) that otherwise meet the exemption from nonqualified deferred compensation under Section 409A should not be treated as deferred compensation under Section 457A.[11] The IRS specifically made the distinction that SARs that are settled in stock, as opposed to cash, are excluded from coverage under Section 457A.[12] Further, the IRS attempted to address the application of the foregoing rules in the context of non-corporate service recipients, stating that, "for purposes of applying the exception from coverage under § 1.409A–1(b)(5)(i)(A) to an equity interest in a non-corporate entity (meaning a right to purchase actual equity in such entity, and not a mere right to an amount equal to the appreciation in such equity), the rules of § 1.409A–1(b)(5)(i)(A) are applied by analogy."[13] Accordingly, for non-corporate service recipients, options and equity-settled appreciation rights of the non-corporate would similarly be excluded from Section 457A.

Notwithstanding the guidance issued by the IRS, many hedge fund managers were wary that the "stock-settled" SAR exception would not apply in the context of deferrals paid by offshore investment funds. With potentially significant deferrals at stake, and without clear authority and guidance the IRS, many fund managers were simply unwilling to embrace the exemption as a valid means of fee deferral. In response to Section 457A, fund managers embraced other arrangements to address Section 457A concerns. Notably, many incentive fee arrangements were structured as performance allocations payable on partnership interests or as profits interests, which generally are not subject to Section 457A.[14]

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[9] Treas. Reg. § 1.409A-1(b)(5).

[10] Code § 457A(d)(3).

[11] Notice 2009-8, Q&A 2(b).

[12] *Id.* ("the exception from coverage under § 1.409A–1(b)(5)(i)(B) may be applied so that a stock appreciation right which by its terms at all times must be settled in service recipient stock, and is settled in service recipient stock (and otherwise meets the requirements of that section), will be excluded from coverage under § 457A").

[13] Notice 2009-8, Q&A 2(b).

[14] Notice 2009-8, Q&A 2(a) ("[w]ith respect to an arrangement between a partner and a partnership, taxpayers may rely upon the applicable guidance under § 409A, which as of January 9, 2008, included Notice 2005–1, Q&A–7, 2005–1 C.B. 274, § II.E of the preamble to the proposed § 409A regulations published on October 4, 2005 (REG–158080–04, 2005–2 C.B. 786 [70 Fed. Reg. 57930]) and § III.G of the preamble to the final § 409A regulations published on April 17, 2007 (T.D. 9321, 2007–1 C.B. 1123 [72 Fed. Reg. 19234])."). IRS Notice 2005–1, Q&A–7 provides that, "until additional guidance is issued, for purposes of § 409A taxpayers may treat the issuance of a partnership interest (including a profits interest), or an option to purchase a partnership interest, granted in connection with the performance of services under the same principles that govern the issuance of stock (see Q&A 4). Specifically, until additional guidance is issued, for purposes of § 409A, taxpayers may treat an issuance of a profits interest in connection with the performance of services that is properly treated under applicable guidance as not resulting in inclusion of income by the service provider at the time of issuance, as also not resulting in the deferral of compensation. Similarly, until additional guidance is issued, for purposes of § 409A, taxpayers may treat an issuance of a capital interest in connection with the performance of services in the same manner as an issuance of stock. The § 409A rules governing other stock-based compensation may be applied by analogy to grants of equity-based compensation where the compensation is determined by reference to partnership equity. In addition, until further guidance is issued, taxpayers may treat arrangements providing for payments subject to § 736 as not being subject to § 409A, except that an arrangement providing for payments which qualify as payments to a partner under § 1402(a)(10) are subject to § 409A." For investment funds with "side-pocket" arrangements, the use of partnership interests with performance allocations became the norm to address Section 457A concern for such arrangements.

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IRS Ruling – Revenue Ruling 2014-18

In response to requests for additional clarity on the matter, the IRS issued Revenue Ruling 2014-18, I.R.B. 2014-26 (June 23, 2014) (the "***Ruling***"). The Ruling amplified the guidance in Notice 2009-8 in the form of a formal ruling by the IRS, and confirmed that stock options and stock-settled SARs, when properly structured, are exempt from Section 457A. As drafted, the Ruling indicates that the exception would apply to many common hedge fund structures, as the parties described in the Ruling closely resemble common offshore investment fund and fund manager relationships. The service recipient in the Ruling was an entity that was organized and taxed as a foreign corporation and the service provider was a limited liability company that was taxed as a partnership, with allocations to U.S. taxpayers. The Ruling provides that the compensation arrangement between the service provider and the service recipient is a stock option or stock-settled SAR that otherwise meets the requirements to be exempt from Section 409A.[15] Both the stock option and the stock-settled SAR must be settled in service recipient stock.[16] The service provider (i.e., the fund manager) has the same redemption rights with respect to any shares received upon exercise as any other shareholder of the service recipient (i.e., the investors). Because the stock option and stock-settled SAR are not deferred compensation arrangements under Section 457A, any inherent gains are realized and included in income by the fund manager only upon the exercise of the stock option / stock-settled SAR.

In the context of an investment fund, which may be structured as a corporation or a partnership, the Ruling illustrates the ability to provide equity-settled appreciation rights (referred to herein as, "***ESARs***"), to the fund manager. Thus, the Ruling opens the door to potentially structuring a compensation arrangement that could realign the interests of the fund manager and the investors, and for fund managers that were reluctant to adopt such arrangements, the Ruling may provide some comfort that the arrangement will be respected by the IRS. On a basic level, continuing with the example above, an ESAR arrangement can be illustrated as follows:

> Tax-Exempt Investor acquires 1,000 units of Offshore Fund at a net asset value (NAV) price of $1,000 per unit. Offshore Fund issues ESARs to the fund manager purchase 200 units at an exercise price of $1,000 per unit (i.e., at NAV at issuance). The vesting of the ESARs and the timing of the exercise may be negotiated by the fund manager and Tax-Exempt Investor (e.g., after a fixed number of years or upon the occurrence of certain events such as the exiting of the investor). For purposes of this example, the ESAR is exercisable on the third anniversary of the date of grant. After year 1, the NAV per unit rises up to $2,000 per unit, but then after year 2, it drops to $1,800 per unit, and then after year 3, drops further to $1,500 per unit. If the ESARs are fully exercised after year 3 and the fund manager's units are redeemed thereafter in accordance with the terms of

[15] Under Section 409A, stock options and stock-settled SARs generally meet the requirements for exemption from Section 409A if the awards are for a fixed number of shares of the service recipient, the exercise price is not less than the fair market value of the shares on the date of grant, and there no other features for the deferral of compensation. *See generally* Treas. Reg. § 1.409A-1(b)(5).

[16] Ruling ("Although stock appreciation rights are generally subject to section 457A, a stock appreciation right that at all times by its terms must be settled, and is settled, in service recipient stock is functionally identical in all material respects to a nonstatutory stock option to purchase service recipient stock with a net exercise feature, and the stock transfer under such an arrangement, like the stock transfer pursuant to the exercise of a nonstatutory stock option, is taxable under section 83. Accordingly, a nonstatutory stock option exempt from section 409A is exempt from section 457A. In addition, a stock appreciation right exempt from section 409A that at all times by its terms must be settled, and is settled, in service recipient stock is exempt from section 457A. A stock appreciation right that may be or is settled other than in service recipient stock is not exempt from section 457A, regardless of whether the stock appreciation right is a nonqualified deferred compensation plan for purposes of section 409A.")

Offshore Fund's governing documents, the value of the exercise to the fund manager is \$100,000 [(\$1,500-\$1,000) x 200 = \$100,000]. The remaining Tax-Exempt Investor's units have a value of \$1,400,000, with a net investment gain of \$400,000. This equates to the Tax-Exempt Investor deriving 80% of the gain and the fund manager earning 20% of the gain. For compensation based on multi-year performance, this provides a true "20% incentive fee" to the fund manager at the end of the performance period. The ESARs in this example provide an intrinsic "clawback" of the incentive compensation in the poorer performing years. As compared to the annual fee example, the Tax-Exempt Investor is a far better position using ESARs than if the compensation been arranged as an annual fee, and arguably the appropriate result for both the fund manager and the Tax-Exempt Investor has been achieved.

ESARs can be drafted to fit a wide variety of arrangements, with flexibility to negotiate when they will vest and when they may be exercised, to fit the business arrangement between the investor and the fund manager. While the possible compensation arrangements are promising, there still remain a number of issues that are uncertain following the Ruling, and ESARs may not be appropriate in all situations. As noted in the Ruling, the ESAR arrangement only works if the service provider is granted ESARs for "service recipient stock."[17] For more complex investment fund structures and the provision of services across multiple funds, it may be more difficult to determine if the EARs have been granted for service recipient stock. And, as with stock options and SARs under Section 409A, subsequent modifications to the ESARs following their date of grant, must be limited to avoid extensions or other changes that could result in the impermissible deferral of income. Careful analysis would be necessary to confirm that the arrangements (or changes to the arrangements) satisfy the exemption requirements under Section 409A (and in turn, the requirements under Section 457A). There are also questions as to how soon following the exercise of an ESAR, the equity units may be redeemed. While the Ruling stated that the service provider has the same redemption rights with respect to any shares received upon exercise as any other shareholder of the service recipient, it is not entirely clear if an arrangement would be respected as "stock-settled" in all situations, including those in which a redemption may occur immediately following the settlement. Further, there are also some other cross-border international issues that may need to be addressed as well, including, issues arising under the "passive foreign investment company" (PFIC) rules.

<u>Conclusion</u>

Section 457A significantly altered the landscape for offshore fee deferrals and in the process, created a misalignment of interests between certain investors and the fund managers. The Ruling provides some clarity on the use of ESAR arrangements and may allow fund managers who were previously unwilling to consider the use of such arrangements to reconsider their use as a possible solution that avoids the restrictions of Section 457A. Although ESARs may not be appropriate for all investment funds for business reasons or tax reasons, there may be certain investments funds and investors in which this solution may be appropriate. For many tax-exempt and other institutional investors, the ESAR may be an attractive compensation arrangement that provides a means of deferring compensation for the fund manager, as well as a realignment of the interests of the investors and the fund managers in a post-Section 457A environment.

[17] *See supra* fn. 14. This may present some challenges, for example in a master-feeder structure, if the ESARs are granted at the feeder level as opposed to the master fund level. If the feeder is a pass-through entity (e.g., a "plan asset" feeder structured as a directed investment into the master fund to reduce concerns under the Employee Retirement Income Act of 1974, as amended), it is not clear if the feeder would be respected as the service recipient for purposes granting EARs.

IRS Alphabet Soup: Practical and Precedential Value of AODs, I.R.B.s, TAMs, & Other Guidance

By Tina R. Green and Nikki L. Laing

I. INTRODUCTION[1]

Have you ever come across an unfamiliar citation or abbreviation while reading an article in a tax law journal? Or, while working on a project for a client, have you ever wondered about the authority of a particular source that you encountered in your tax research? This article is the product of the authors having confronted similar queries in practice. It is the authors' hope that this article will help the practitioner to identify certain guidance that may be encountered during tax research, as well as determine the origin, reliability, and precedential value of that guidance.

II. SCOPE

This article is intended to serve as a resource to explain some of the more common sources encountered during tax research. The sources covered in this article include statutes passed by the legislative branch of the government and administrative interpretations of the law issued by the executive branch of the government.

An extremely important component of tax law is the role of the judicial branch of the government in interpreting and applying statutes and administrative guidance. This article does not address the application of case law in tax research. In addition, this article does not address in any detail the legal force or level of judicial deference assigned by the various courts to IRS guidance.

III. INTERNAL REVENUE CODE

The starting point for researching Federal tax law is the Internal Revenue Code (sometimes referred to in this article as "IRC" or the "Code"). It is a set of statutes passed by Congress and signed into law by the President, and it is the primary source of Federal tax law.[1] It imposes income, estate, gift, employment miscellaneous excise taxes, and provisions controlling the administration of Federal taxation. The Code is located in Title 26 of the United States Code (U.S.C.) which is made up of a total of 50 titles. Practitioners typically cite to the separate Internal Revenue Code as opposed to Title 26 of the U.S.C.

A. Definition

The IRC is the domestic portion of federal statutory tax law in the United States. These tax laws are implemented by the Internal Revenue Service (sometimes referred to in this article as "the Service" or "IRS") through Treasury regulations and other interpretive guidance.

The Code is organized topically into subtitles, chapters, parts, subparts, sections, subsection, paragraphs, subparagraphs, and clauses. There are eleven subtitles to the Code. (See Appendix A for a listing of the subtitles.) The Code divides subtitles into chapters. The Code contains 100 chapters numbered consecutively without starting anew within each subtitle. Subchapters partition chapters. For

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[1] An earlier version of this article appeared in the June-July 2013 issue of the JOURNAL OF TAX PRACTICE & PROCEDURE, a bimonthly publication by Wolters Kluwer.

example, a couple of the better-known subchapters in Chapter 1 include Subchapter C (dealing with corporations) and Subchapter K (covering partnerships). Parts and subparts further divide many subchapters. Because of extensive revisions made in the Tax Reform Act of 1986, Title 26 is known as the Internal Revenue Code of 1986.[2] See Appendix B for a listing of the contents of portions of Subtitles A and B of Title 26.

The Code is ever-changing as new laws are added and existing laws are amended or revoked. Therefore, it is important that practitioners determine the law applicable to the year the transaction that is being researched occurred.[3]

B. Precedential Value

1. <u>In General</u>

The Code is the primary source of all tax laws in the United States.[4] However, not every tax matter can be resolved solely by the language in the Code.[5] In cases where the literal language of the Code is ambiguous (which is more often than one might expect), the courts will consider the history of a particular Code section, including committee reports and other legislative history, Treasury regulations and other published guidance by the Service interpreting the Code section, and the relationship of the particular Code section to other Code sections.[6]

2. <u>Penalty for Negligence or Disregard of "Rules or Regulations"</u>

The Code provides for an accuracy-related penalty of 20 percent of any portion of an underpayment of tax required to be shown on a return that is attributable to negligence or disregard of "rules or regulations."[7] For the purpose of the penalty, the definition of "negligence" includes any failure to make a reasonable attempt to comply with the provisions of the internal revenue laws.[8] The Internal Revenue Code constitutes a "rule or regulation" that must not be disregarded.[9]

3. <u>"Substantial Authority" Shelter from Understatement Penalty</u>

The Code imposes an accuracy-related penalty of 20 percent of any portion of an underpayment of tax required to be shown on a return that is attributable to a substantial understatement of income tax.[10] A taxpayer who may otherwise have been subject to the 20 percent underpayment penalty for a certain transaction may be sheltered if he can show that there was "substantial authority" for his tax position with respect to the transaction.[11] If there was "substantial authority" for the tax treatment of an item, the item is treated as if it were shown properly on the return for the taxable year in computing the amount of the tax shown on the return.[12] The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists. Clearly, the Internal Revenue Code serves as "authority" for purposes of determining whether there is substantial authority for the tax treatment of an item.[13]

IV. TREASURY REGULATIONS

While Code sections become law only after being passed by both the House and the Senate and then presented to and signed by the President, Treasury regulations are issued by the executive branch of the government. The Secretary of the Treasury is given authority by Congress to prescribe all necessary rules and regulations for the enforcement of the Internal Revenue Code.[14] Through the Commission of Internal Revenue, the Treasury Department issues regulations that expound upon the Code.[15]

A. Definition

The Federal Tax Regulations ("Regs") are the Service's official interpretation of the Code.[16]

1. Classifications of Regulations

There are three classes of regulations: proposed, temporary, and final.

a. Proposed Regulations

Generally, regulations are first issued to the public in proposed form.[17] Proposed regulations provide guidance concerning Treasury's interpretation of a Code section.[18] The public is given an opportunity to comment on a proposed regulation, and a public hearing may be held if a sufficient number of requests to speak at a hearing are received.[19] Proposed Regulations are published in the *Federal Register* and posted on the IRS website. They are not in effect until adopted as final. Consequently, they carry no more weight than the arguments of the Service in a court brief.[20]

b. Temporary Regulations

Temporary regulations are published in the *Federal Register* and posted on the IRS website. Upon issuance, Temporary regulations are authoritative and have the same weight as final regulations.[21] However, they expire after 3 years or when replaced by final regulations.[22]

c. Final Regulations

The Treasury Department drafts final regulations after the public has had an opportunity to comment on proposed regulations. Final regulations supersede both temporary and proposed regulations. A final regulation is effective, unless stated otherwise, the day that it is published as a Treasury Decision in the *Federal Register*.[23] Final regulations are also known as Treasury Decisions and are codified in 26 Code of Federal Regulations.

B. Precedential Value

1. In General

Treasury regulations are the most authoritative source for determining the meaning of the Code, and they are binding upon the Service.[24] Final or temporary regulations may be relied on by taxpayers in planning transactions in the same manner in which taxpayers may rely upon a provision of the Internal Revenue Code. However, taxpayers generally may not rely on proposed regulations for planning purposes, except if there are no applicable final or temporary regulations in force and there is an express statement in the proposed regulations that taxpayers may rely on them currently. If there are applicable final or temporary regulations in force, taxpayers may only rely on proposed regulations for planning purposes in the limited circumstances that the proposed regulations contain an express statement permitting taxpayers to rely on them currently.

2. Judicial Deference

As a general rule, Treasury regulations carry the force and effect of law. However, in rare instances, certain Treasury regulations have been denied the rank customarily recognized by the courts.[25] An analysis of the standards applied by the courts in determining the level of judicial deference to afford a given treasury regulation is beyond the scope of this article. A number of cases have endeavored to articulate these standards.[26] However, scholars remain frustrated over the continued vagueness of such standards.[27]

3. Penalty for Negligence or Disregard of "Rules or Regulations"

The term "rules or regulations" of the § 6662(b)(1) penalty discussed in Section III.B.2, *supra*, includes temporary or final treasury regulations.[28]

4. "Substantial Authority" Shelter from Understatement Penalty

With respect to the § 6662(b)(2) understatement penalty discussed in Section III.B.3, *supra*, proposed, temporary and final regulations are all included in the definition of "authority" for purposes of determining whether there is substantial authority for the tax treatment of an item.[29]

V. INTERNAL REVENUE BULLETIN

While Code sections and Treasury regulations both undergo comprehensive and formal processes before taking effect, many interpretations of law found in the Internal Revenue Bulletin ("IRB" or "Bulletin") are informal guidance provided by the Service to taxpayers.

A. Definition

The Treasury regulations define the Internal Revenue Bulletin as "the authoritative instrument of the Commissioner for the announcement of official rulings, decisions, opinions, and procedures, and for the publication of Treasury decisions, Executive orders, tax conventions, legislation, court decisions, and other items pertaining to internal revenue matters."[30] The policy of the Service is to publish in the IRB "all substantive and procedural rulings of importance or general interest, the publication of which is considered necessary to promote a uniform application of the laws administered by the Service," as well as "all rulings which revoke, modify, amend, or affect any published ruling."[31] Published weekly, the Bulletin addresses issues and provides answers necessary to promote a uniform application of the substantive tax laws, including all rulings and statements of procedure that supersede, revoke, modify, amend, or affect any of those that have previously been published in the Bulletin.[32] The Service also utilizes the Bulletin to announce the Commissioner's acquiescence or nonacquiescence in decisions of the United States Tax Court (other than decisions in memorandum opinions). While a variety of information is provided by the Bulletin, the most common guidance found in the Bulletin are revenue rulings, revenue procedures, and notices.

Some categories that the Service does not address in the Bulletin include (i) issues answered by statutes, treaties, or regulations; (ii) issues of little importance or interest, or that have been answered in a prior Bulletin; and (iii) determinations of fact rather than interpretations of law.[33] The Service also avoids disclosing private or confidential information, such as secret business practices and the identity of informers, when describing fact patterns in the Bulletin.

The contents of the weekly Internal Revenue Bulletins are consolidated into the Cumulative Bulletin to provide a permanent reference source.[34] The Cumulative Bulletin is issued on a semiannual basis. The Cumulative Bulletin is divided into four parts. Part I contains information pertaining to the Internal Revenue Code. Part II relates to treaties and tax legislation. Part III contains administrative and procedural guidance. Part IV posts notices of proposed regulations and rules, as well as a list of persons who have been disbarred or suspended from practicing before the Service. The Service recently announced that it will no longer create the Cumulative Bulletin.[35]

B. Precedential Value

Although informal, the guidance published in the Bulletin is official and it carries precedential value. It is important to note that all rulings published in the Bulletin apply retroactively unless specified otherwise.[36] The guidance issued in the Internal Revenue Bulletin is generally understood to carry practical binding effect. However, it is not always clear the degree of binding effect that can be assigned to this non-legislative guidance. In addition, the degree of precedential value may vary among different types of guidance printed in the Bulletin. "The relative weight and significance of such informal guidance varies tremendously, although prudent regulated parties take seriously agency guidance in virtually any form."[37]

C. Citing to Items Published in the Internal Revenue Bulletin

Each Bulletin is identified by the week and year it is issued. For example, the IRB published in the third week of 2012 would be indicated by the following cite: "2012–3 I.R.B."

Items appearing in a Bulletin that have not yet appeared in the Cumulative Bulletin would be cited by referring to the weekly Internal Revenue Bulletin. As an example, a revenue ruling would be cited as follows: "Rev. Rul. 96–55, 1996–49 I.R.B. 4." In this example, the Internal Revenue Bulletin was issued in week 49 of the year 1996, and the particular guidance being cited, Revenue Ruling 96–55, can be found on page 4.

Items that have been published in a Cumulative Bulletin should be cited to the Cumulative Bulletin rather than to the Internal Revenue Bulletin in which they first appeared. Each Cumulative Bulletin published after December 31, 1936 is identified by the particular year covered, as well as whether it covers the first or second half of the year. For example, the citation "1963–1 C.B." identifies the Cumulative Bulletin that covers the period from January 1, 1963 to June 30, 1963.

VI. REVENUE RULINGS AND REVENUE PROCEDURES

Revenue rulings and revenue procedures are published in the Internal Revenue Bulletin. The purpose of publishing revenue rulings and revenue procedures is to promote correct and uniform application of the tax laws by informing Service personnel and the public of National Office interpretations of the internal revenue laws, related statutes, treaties, regulations, and statements of Service procedures affecting the rights and duties of taxpayers.[38] Internal Revenue Service employees must follow revenue rulings and revenue procedures, and taxpayers may rely on them or appeal their position to the Tax Court or other Federal court.[39] While revenue rulings and revenue procedures do not have the force and effect of statutes or regulations, they do reflect the current policies and positions of the Service.[40]

As discussed below, the traditional view is that revenue rulings provide interpretations of substantive tax law and revenue procedures communicate procedural information and instructions relative to forms, deadlines, and measurements. In fact, according to the Internal Revenue Manual, whether an item is published as a revenue ruling or revenue procedure depends on its content, and there should generally be a clear distinction between the content of a revenue ruling and a revenue procedure.[41] Furthermore, the Internal Revenue Manual states that a revenue ruling typically would not include a statement of Service practice or procedure and a revenue procedure would not ordinarily include a statement of Service position on a substantive tax issue, and when a matter does involve both a statement of Service position on a substantive tax issue and a statement of practice or procedure, it normally requires the issuance of both a revenue ruling and a revenue procedure.[42] However, a review of the content of many revenue rulings and revenue procedures reveals that the line between substantive and procedural is often blurred.[43]

Often, Rulings and Procedures expand upon or override prior Rulings and Procedures. When the practitioner finds a revenue ruling or revenue procedure upon which he or she plans to rely, it is important

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for the practitioner to investigate whether the guidance supported by the Ruling or Procedure has been modified by a subsequent publication. Revenue rulings and revenue procedures that have an effect on earlier published guidance use the following terms to describe the effect:

- *Amplified* describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the original fact situation.

- *Clarified* is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, confusion. It is not used where a position in a prior ruling is being changed.

- *Distinguished* describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

- *Modified* is used where the substance of a previously published position is being changed.

- *Obsoleted* describes a previously published ruling that is not considered determinative with respect to future transactions. The term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

- *Revoked* describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

- *Superseded* describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desirable to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, "modified and superseded" describes a situation where the substance of previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self-contained. In this case the previously published ruling is first modified and then, as modified, is superseded.

- *Supplemented* is used in situations in which a list, such as a list of the name of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

- *Suspended* is used in rare situations to show that the previously published ruling will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.[44]

A. Revenue Rulings

1. Definition

A revenue ruling is an official interpretation by or communication from the Service which has been published in the Internal Revenue Bulletin.[45] Revenue rulings are issued only by the National Office and are published for the information and guidance of taxpayers, Internal Revenue Service officials, and others concerned.[46] Topics addressed by revenue rulings arise from various sources, including prior private rulings to taxpayers, technical advice to district offices, court decisions, and suggestions from tax practitioner groups.

A revenue ruling is often presented as the Service's response to a hypothetical situation.[47] When presented in such a format, the conclusions expressed in a revenue ruling will be directly responsive to and limited in scope by the pivotal facts stated in the revenue ruling.

Sometimes, hypothetical fact patterns modeled in revenue rulings are based on actual situations encountered by taxpayers or the Service. In those cases, the Service publishes as much as is necessary for readers to understand the position stated, but identifying details and confidential information (such as names and addresses of persons involved) are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.[48] It bears repeating that such a ruling represents the conclusions of the Service on the application of the law only to the specific set of facts stated in the revenue ruling.[49]

While many revenue rulings follow the traditional pattern of presenting a hypothetical, analyzing the relevant laws, and providing the Service's interpretation of the law with respect to a certain set of facts, some provide information in other formats.[50] For example, revenue rulings are regularly used to provide taxpayers with updated lists and tables of variable interest rates and adjustable percentages.[51]

2. Precedential Value of Revenue Rulings

a. In General

According to the Treasury regulations, revenue rulings are published to provide precedents to be used in the disposition of other cases, and may be cited and relied upon for that purpose.[52] Although revenue rulings do not have the force and effect of statutes, Treasury regulations, or Treasury Decisions, they may be used as precedents.[53]

Revenue rulings may be used as precedents in the disposition of cases with analogous fact patterns.[54] As with any other precedent, when applying published rulings, the effects of subsequent legislation, regulations, court decisions, procedures, and other rulings must be considered.

Taxpayers generally may rely upon revenue rulings published in the Bulletin in determining the tax treatment of their own transactions and need not request specific rulings applying the principles of a published revenue ruling to the facts of their particular cases.[55] However, since each revenue ruling represents the conclusion of the Service as to the application of the law to the precise set of facts involved, caution is urged against reaching the same conclusion in other cases unless the facts and circumstances are substantially the same.[56]

b. Retroactivity

By default, revenue rulings (except for those relating to the qualification of pension annuity, profit-sharing, stock bonus, and bond purchase plans) apply retroactively unless the revenue ruling includes a specific statement indicating otherwise.[57]

A revenue ruling may be revoked retroactively if it is contrary to law. However, to avoid penalizing taxpayers' reliance on revenue rulings when carrying out a transaction, revocation or modification of a previous revenue ruling is usually made nonretroactive to the extent that the new revenue ruling has adverse tax consequences to taxpayers.[58] In fact, with respect to litigation, Chief Counsel attorneys may not take a position that is less favorable to a taxpayer than the position set forth in a revenue ruling in existence at the time of the matter being litigated.[59]

c. Judicial Deference

Although revenue rulings do not carry the weight of law, they are generally entitled to some level of judicial deference if they have not been affected by subsequent legislation, regulations, other revenue rulings, or cases. Case law indicates that revenue rulings should be given weight because they are official interpretations of law by the Service, but they do not deserve the same level of judicial deference as Treasury regulations.[60] The exact level of deference that should be afforded to IRB publications remains a matter under substantial debate.[61]

d. Penalty for Negligence or Disregard of "Rules or Regulations"

Revenue rulings are included in the term "rules or regulations" for purposes of the § 6662(b)(1) penalty discussed in Section III.B.2, *supra*.[62]

e. "Substantial Authority" Shelter from Understatement Penalty

Revenue rulings are included in the definition of "authority" for purposes of the "substantial authority" exception to the § 6662(b)(2) underpayment penalty discussed in Section III.B.3, *supra*.[63]

3. <u>Citation</u>

Elements of a revenue ruling citation include: (1) the year the ruling was issued; (2) the chronological number assigned to the ruling from a series of consecutive numbers that start over at the beginning of each year; (3) the volume number of the Internal Revenue Bulletin or Cumulative Bulletin in which the ruling was published; and (4) the page number on which the text of the ruling begins in the Internal Revenue Bulletin or Cumulative Bulletin.

The first revenue ruling was published in 1953, and revenue rulings published during that year were numbered simply as "Rev. Rul. 1," "Rev. Rul. 2," and so on, followed by the applicable cite for the Cumulative Bulletin in which they were published. For example, the cite for the thirty-eighth revenue ruling published on page 16 of the Cumulative Bulletin released during the first half of 1953 is "Rev. Rul. 38, 1953-1 C.B. 16."

In 1954, the Service added the last two digits of the year of publication to its revenue ruling titles, so the second revenue ruling published in the year 1954 would be labeled as "Rev. Rul. 54-2" followed by reference to the Cumulative Bulletin in which it was published.

For revenue rulings published on or after January 1, 2000, the title includes the full year. For example, the first revenue ruling published in the year 2000 would be cited as "Rev. Rul. 2000-1" followed by the applicable Cumulative Bulletin cite.

B. Revenue Procedures

1. <u>Definition</u>

A revenue procedure is defined as a statement of procedure that affects the rights or duties of taxpayers or other members of the public under the Code and related statutes or information that, although not necessarily affecting the rights and duties of the public, should be a matter of public knowledge.[64] Some revenue procedures are issued to assist taxpayers in complying with procedural issues that deal with tax return preparation and compliance and to announce practices and procedures for guidance of the public.[65] Other revenue procedures provide lists and tables for information that fluctuates frequently, such as interest rates and inflation rates. One important function that revenue procedures serve is keeping taxpayers and practitioners informed of certain transactions that are likely to be closely scrutinized by the Service.[66]

2. Precedential Value of Revenue Procedures

a. In General

According to the Regulations, the purpose of revenue procedures is to promote correct and uniform application of the tax laws by Internal Revenue Service employees and to assist taxpayers in attaining maximum voluntary compliance.[67] Revenue procedures are published in order to inform Service personnel and the public of the Service's official interpretations of tax laws, related statutes, treaties, regulations, and statements of Service procedures affecting the rights and duties of taxpayers.[68]

The Service is generally bound to follow the legal position of an unrevoked, unmodified revenue procedure, and Service attorneys may not take a position that is less favorable to a taxpayer than the legal position contained in a revenue procedure.[69] Therefore, a taxpayer should be able to rely on a revenue procedure if the facts of the taxpayer's case are substantially similar to the facts set forth in the revenue procedure.

Before placing reliance in a revenue procedure, a taxpayer should confirm that the taxpayer's situation is analogous to the facts outlined in the revenue procedure. Furthermore, the taxpayer must investigate whether the position supported by the revenue procedure has been modified by a subsequent statute, regulation, or IRB publication. Finally, if the federal tax law conclusion of a revenue procedure is predicated upon a certain provision or interpretation of law other than federal tax law, a taxpayer who plans to rely on the revenue procedure should determine whether such relevant nontax law has changed materially from that used in the revenue procedure.[70]

As with revenue rulings, the Service has the power to revoke or modify revenue procedures.[71] As a result, a taxpayer can reasonably rely on the continued vitality of statements made in a published revenue procedure that has not been revoked or modified by the Service.

b. Judicial Deference

Although revenue procedures do not carry legal force, they are generally entitled to judicial deference. As discussed in Section VI.A.2.c, *supra*, the precise level of deference that should be given to IRB publications in general remains unclear.

c. Penalty for Negligence or Disregard of "Rules or Regulations"

With respect to the § 6662(b)(1) penalty discussed in Section III.B.2, *supra*, revenue procedures are not automatically considered to be included in the term "rules or regulations" because revenue procedures are not generally substantive in nature. However, considering all facts and circumstances, a revenue procedure may be treated as a "rule or regulation" for purposes of the penalty if it contains substantive interpretations of tax law.[72]

d. "Substantial Authority" Shelter from Understatement Penalty

For purposes of the § 6662(b)(2) underpayment penalty referenced in Section III.B.3, *supra*, revenue procedures are included in the definition of "authority" for purposes of determining whether there is "substantial authority" for the tax treatment of an item.[73]

3. Citation

The citation of a revenue procedure follows the same format as a revenue ruling: (1) the year the Procedure was issued; (2) the number assigned to the Procedure from that year's chronological numerical series; (3) the volume number of the Internal Revenue Bulletin or Cumulative Bulletin in which the Procedure was published; and (4) the page number on which the text of the Procedure begins in the Internal Revenue Bulletin or Cumulative Bulletin.

The first revenue procedure was published in 1955. Revenue procedures published from 1955 through 1999 are identified by the last two digits of the year of publication, followed by the number showing its chronological sequence for that year and then its location in the Internal Revenue Bulletin or Cumulative Bulletin. For example, the second revenue procedure published in the year 1957 is titled "Rev. Proc. 57-2." Its complete citation of "Rev. Proc. 57-2; 1957-1 C.B. 723" indicates that it is located on page 723 of the Cumulative Bulletin published for the first half of the year 1957. Revenue procedures published on or after January 1, 2000, are identified by the four digits of the year of publication (e.g., Rev. Proc. 2000-1), followed by its applicable Internal Revenue Bulletin or Cumulative Bulletin citation.

VII. NOTICES

A. Definition

A notice is a public announcement issued by the Internal Revenue Service that is published in the Internal Revenue Bulletin.[74] Notices are compiled in the Cumulative Bulletin. They can serve as "informal statements of IRS policy regarding enforcement [or] other issues."[75] They have also been described as "press releases" that state the position of the Service on certain issues.[76] Notices may be used in circumstances where a revenue ruling or revenue procedure would not be appropriate.[77] The Service "often resorts to notice . . . when there is need for guidance on an expedited basis."[78]

A notice can serve one of several functions. For example, it may contain guidance that involves substantive interpretations of the Internal Revenue Code or other provisions of the law.[79] Another function that a notice may serve is to solicit public comments on issues under consideration in connection with non-regulatory guidance, such as a proposed revenue procedure. A notice can also be used to relate to taxpayers and practitioners what regulations will say in situations where the regulations may not be published in the immediate future. One particularly important use a notice may have is disseminating information regarding "reportable transactions" under I.R.C. § 6011.[80]

B. Precedential Value

According to the Internal Revenue Manual, Chief Counsel attorneys must follow legal positions established by notices in papers filed in Tax Court or in defense letters or suit letters sent to the Department of Justice. In addition, Chief Counsel attorneys may not rely on case law to take a position that is less favorable to a taxpayer in a particular case than the position set forth in a notice.[81]

1. <u>Penalty for Negligence or Disregard of "Rules or Regulations"</u>

Notices which contain substantive interpretations of federal tax law fall within the definition of "rules or regulations" for purposes of the § 6662(b)(1) accuracy-related penalty discussed in Section III.B.2, *supra*.[82]

2. <u>"Substantial Authority" Shelter from Understatement Penalty</u>

With respect to the underpayment penalty imposed by § 6662(b)(2), discussed in Section III.B.3, *supra*, notices are treated as "authority" for purposes of determining whether there is substantial authority for the tax treatment of an item.[83]

VIII. ANNOUNCEMENTS

In addition to revenue rulings, revenue procedures, and notices, a number of miscellaneous documents having application to tax law interpretation and administration are published in the Internal Revenue Bulletin. One such document is an announcement.

A. Definition

An announcement is a public pronouncement that is used to summarize the law or regulations without making any substantive interpretation. An announcement is issued when guidance of a substantive or procedural nature is needed quickly.[84] It can also be used to notify taxpayers of matters of general interest, such as the existence of an election, effective dates of temporary regulations, an approaching deadline for making an election, or clarification of rulings and form instructions.[85]

One characteristic that sets announcements apart from other guidance found in the Bulletin is that an announcement generally has only immediate or short-term value.[86] Commentators note that announcements are distinguishable from other guidance found in the Bulletin because they often merely highlight information that taxpayers could obtain from other sources.[87]

B. Precedential Value

According to the Internal Revenue Manual, announcements can be relied on to the same extent as revenue rulings and revenue procedures.[88] In addition, Chief Counsel attorneys must follow legal positions established by IRB publications in papers filed in Tax Court or in defense letters or suit letters sent to the Department of Justice, and they may not rely on case law to take a position that is less favorable to a taxpayer in a particular case than the position set forth in an IRB publication.[89]

1. <u>Penalty for Negligence or Disregard of “Rules or Regulations”</u>

Announcements are not included in the definition of "rules or regulations" for purposes of the 20 percent accuracy-related penalty imposed by § 6662(b)(1), referenced in Section III.B.2, *supra*.[90]

2. <u>“Substantial Authority” Shelter from Understatement Penalty</u>

For purposes of the understatement penalty imposed by § 6662(b)(2) (discussed in Section III.B.3, *supra*), announcements published in the Internal Revenue Bulletin are considered “authority” when determining whether there is substantial authority for the tax treatment of an item.[91]

C. Citing to Announcements

Announcements are identified by a two or four digit number (representing the year) and a sequence number separated by a hyphen, followed by its location in the Internal Revenue Bulletin or Cumulative Bulletin. For example, the citation “I.R.S. Ann. 96-124, 1996-49 I.R.B. 22” indicates that the announcement was the 124th announcement published in the year 1996, and it could be found on page 22 of Internal Revenue Bulletin No. 1996-49, which was issued in the forty-ninth week of the year 1996 (December 2, 1996).

IX. PUBLICATIONS

A. Definition

Service publications explain the law in plain language for taxpayers and their advisors. They typically highlight changes in the law, provide examples illustrating Service positions, and include worksheets. Publications are written from the point of view of the government and issued primarily to assist taxpayers in preparing their tax returns. An example of a publication is *Publication 15, (Circular E), Employer's Tax Guide*, which explains an employer's tax responsibilities and provides current tax withholding tables.

B. Precedential Value

Publications are nonbinding on the Service and do not necessarily cover all positions for a given issue. While a good source of general information, publications should not be cited to sustain a position.[92]

X. PRIVATE LETTER RULINGS

When published guidance provides insufficient direction for a taxpayer involved in a complex financial transaction, the taxpayer may wish to seek a private letter ruling.

A. Definition

A private letter ruling (PLR) is a written determination issued by the Service to a taxpayer in response to the taxpayer's written inquiry, submitted prior to the filing of returns or reports that are required by the tax laws, about its status for tax purposes or the tax effects of its acts or transactions.[93] A PLR interprets federal tax laws and applies them to the taxpayer's specific set of facts.[94]

Private letter rulings can provide assurance to a taxpayer involved in a complex transaction, and they have been described as "a policy of insurance that is a practical prerequisite to a merger of corporate giants."[95] In addition to the comfort of having a ruling that the taxpayer can rely on, another advantage to requesting a PLR is that the Service will often consider how the taxpayer might alter the transaction to comply with federal tax laws.[96] If a less than favorable letter ruling is indicated, the branch representative may tell the taxpayer whether minor changes in the transactions or adherence to certain published positions would bring about a favorable ruling.[97]

PLRs are made public once all information that could identify the taxpayer has been removed.[98] Released PLRs can be accessed through the Electronic Reading Room found on the IRS website, located at the following link: <u>http://www.irs.gov/uac/Electronic-Reading-Room</u>.

1. <u>How to Obtain a PLR</u>

The procedures and user fees for applying for a PLR are published annually in the first revenue procedure of each calendar year. The third annual revenue procedure updates the list of those areas of the Code in which the Service will not issue advanced guidance. The third revenue procedure establishes three general no ruling areas: 1) areas in which the Service will not issue rulings; 2) areas in which the Service will not ordinarily issue a ruling; and 3) areas that are under extensive study. Therefore, a taxpayer interested in obtaining a PLR should not only review the first revenue procedure published each year but also the third to make sure that the issue the taxpayer is wanting an advance ruling on is not one that the Service has determined it will not issue. Even if the taxpayer's issue is not one that the Service has published it will not rule on, the Service may decline to issue a PLR when appropriate in the interest of sound tax administration or on other grounds whenever warranted.

The Service does not rule on an oral request. The taxpayer must prepare a letter to the Service and comply with numerous requirements set forth in the first revenue procedure of the calendar year (*e.g.*, Rev. Proc. 2015-1). Requests for PLRs must not be submitted by fax.

The Service will examine the incoming documents for completeness, process the user fee, and forward the file to the appropriate assistant chief counsel which will then assign the letter ruling to one of its applicable branches.

The Service is supposed to communicate with the taxpayer or the authorized representative within 21 calendar days after a PLR request has been received. If the request lacks the central information required for the processing of the PLR, the taxpayer will have 21 days to supply the information requested. If it is not received within the 21 calendar day time period, then the Service will close the transaction. However, an extension of time may be granted if justified in writing and approved by the Service.

Generally, before the PLR is issued, the branch representative will inform the taxpayer of its conclusions. If the Service is going to rule adversely to the taxpayer, the taxpayer should be offered the opportunity to withdraw the letter ruling request. The user fee will not be refunded for a letter ruling request that is withdrawn.

2. <u>What To Include in a PLR Request</u>

There are a number of necessary items which must be included in the PLR request, specifically the following:

- Complete statement of facts and other information;
- Identity of the district office that has or will have examination jurisdiction over the return;
- True copies of all contracts, wills, deeds, agreements and other documents pertinent to the transaction must be submitted with the request;
- Statement regarding whether the same or similar issue previously ruled on or requested is currently pending;
- Statement of supporting authority;
- Statement identifying pending legislation;
- Statement indicating the desired deletions before the PLR is made public;
- Signature of the taxpayer or authorized representative;
- A penalties of perjury statement;
- A request for a conference (it is highly recommended that the conference be requested in writing at the time of filing); and
- Checklist which must be completed, signed, and placed on top of the ruling request.

B. Precedential Value

1. <u>In General</u>

A PLR represents the conclusion of the Service for an individual taxpayer. The application of a PLR is confined to the specific case for which it was issued, unless the issue involved was specifically covered by statute, regulations, ruling, opinion, or decision published in the Internal Revenue Bulletin.[99] A PLR serves to establish with certainty the federal tax consequences of the fact situation before the taxpayer has entered into the transaction or before the federal tax return has been filed.

The PLR is binding on the Service for the taxpayer that requested the PLR so long as the taxpayer fully and adequately discloses the transaction and carries it out as described in the ruling request. However, a PLR may not be relied on as precedent by any other taxpayer or Service personnel.

A PLR, which by definition relates only to a sole taxpayer's particular case, should not be applied or relied upon as a precedent in the disposition of other cases.[100] However, a PLR can provide insight with regard to the Service's position on the law and serve as a guide.[101] When the facts in a PLR are substantially similar to a particular taxpayer's circumstances and it is the only available source of guidance, it may reasonable, from a practical perspective, for the taxpayer to rely upon the conclusions in the PLR. For legal purposes, however, it is more effective for the taxpayer to rely upon an independent analysis of the underlying authorities cited in the PLR. An analysis of the authorities cited in the PLR could prove of great assistance to taxpayers considering a particular transaction. This assists the taxpayer in reducing the risk of entering into a transaction substantially similar transaction to those over which a PLR has previously been issued.

2. Judicial Deference

According to the Code, PLRs may not be used or cited as precedent.[102] "Most courts therefore, do not find private letter rulings, issued to other taxpayers, to be of precedential value in deciding the tax claims before them."[103] However, some courts have found that PLRs may provide persuasive authority for taxpayers other than to whom the PLR was issued.[104]

3. Penalty for Negligence or Disregard of "Rules or Regulations"

Private letter rulings are not included in the definition of "rules or regulations" for purposes of the 20 percent accuracy-related penalty imposed by § 6662(b)(1), referenced in Section III.B.2, *supra*.[105]

4. "Substantial Authority" Shelter from Understatement Penalty

Private letter rulings issued after October 31, 1976, are included in the definition of "authority" for purposes of the "substantial authority" exception to the § 6662(b)(2) underpayment penalty discussed in Section III.B.3, *supra*.[106]

XI. TECHNICAL ADVICE MEMORANDUMS

A. Definition

A technical advice memorandum (TAM) is a written memorandum furnished by the Office of Associate Chief Counsel of the Service upon request of specified Service personnel.[107]

A TAM is advice furnished by an Associate office in a memorandum that responds to a request for assistance on any technical or procedural question that develops during any proceeding before the Service.[108] Proceedings before the Service include: (1) the examination of a taxpayer's return; (2) the consideration of a taxpayer's claim for credit or refund; (3) any matter under examination or in Appeals pertaining to tax-exempt bonds, tax credit bonds, or mortgage credit certificates; and (4) any other matter involving a specific taxpayer under the jurisdiction of a Director.[109]

Personnel in any examination or Appeals office may request a TAM when the application of the law to the facts involved is unclear. The question must be on the interpretation and proper application of tax laws, tax treaties, regulations, revenue rulings, notices, or other precedents to a specific set of facts that concerns the treatment of an item in a period under examination or appeal.[110] However, a TAM may not be requested for prospective or hypothetical transactions.

B. Precedential Value

1. In General

While technical advice memorandums are binding on the Service in relation to the taxpayer who is the subject of the ruling, they cannot be used or cited as precedent.[111] However, they may be useful to other taxpayers in providing an indication of the Service's position in a particular area.[112]

2. Penalty for Negligence or Disregard of "Rules or Regulations"

For purposes of the § 6662(b)(1) accuracy-related penalty referenced in Section III.B.2, *supra*, the term "rules or regulations" does not include technical advice memorandums.[113]

3. "Substantial Authority" Shelter from Understatement Penalty

Technical advice memoranda issued after October 31, 1976, are treated as "authority" for purposes of determining whether there is substantial authority for the tax treatment of an item under the § 6662(b)(2) underpayment penalty discussed in Section III.B.3, *supra*.[114]

XII. GENERAL COUNSEL MEMORANDUMS

A. Definition

A general counsel memorandum (GCM) is a legal memorandum from the Office of Chief Counsel prepared in connection with the review of certain proposed rulings.[115] They are formal legal opinions on substantive and procedural matters issued by the Office of Chief Counsel. They provide legal analyses of substantive and procedural issues which can be helpful in understanding the reasoning behind a particular ruling and the Service's response to similar issues in the future.[116] General counsel memorandums are no longer issued, except to revoke earlier GCMs.[117]

B. Precedential Value

1. In General

General counsel memorandums cannot be used or cited as precedent, and they do not provide legal advice.[118]

2. Penalty for Negligence or Disregard of "Rules or Regulations"

With respect to the § 6662(b)(1) accuracy-related penalty referenced in Section III.B.2, *supra*, the term "rules or regulations" does not include general counsel memorandums.[119]

3. "Substantial Authority" Shelter from Understatement Penalty

General counsel memoranda issued after March 12, 1981, (as well as GCMs published in pre-1955 volumes of the Cumulative Bulletin) are included in the definition of "authority" for purposes of determining whether there is substantial authority for the tax treatment of an item under the § 6662(b)(2) underpayment penalty discussed in Section III.B.3, *supra*.[120]

XIII. ACTION ON DECISION

It is the policy of the Internal Revenue Service to announce at an early date whether it will follow the holdings of lower courts in certain cases that involve significant issues decided adversely to the government.[121] The Service makes such an announcement using a two-pronged method. First, the Office of Chief Counsel prepares a memorandum containing its recommendation and the substantive reasoning behind its position. Second, the Service publishes a succinct statement in the Internal Revenue Bulletin declaring its position to taxpayers.

A. Definition

1. Action on Decision—the Document

An Action on Decision (AOD) is a document prepared by the Office of Chief Counsel to alert Service personnel and the public to its current litigating position.[122] The purpose of this document is to convey the Office's recommendation as to whether the Service will follow a significant adverse opinion.[123] This document is not published in the Internal Revenue Bulletin. Instead, it is released to the public via the Electronic Reading Room found on the IRS website. The Electronic Reading Room can be accessed at the following link: http://www.irs.gov/uac/Electronic-Reading-Room.

Generally, an Action on Decision is prepared when a court decides one or more significant issues adversely to the Government. An issue is decided adversely to the Government when the Service's legal position is adversely affected by the court's opinion.[124]

There are only three possible recommendations that can be stated in an Action on Decision: acquiescence, acquiescence in result only, or nonacquiescence.[125]

a. Acquiescence

"Acquiescence" means that the Service accepts the holding of the court in a case and that the Service will follow it in disposing of cases with the same controlling facts. Acquiescence indicates neither approval nor disapproval of the reasons assigned by the court for its conclusions.

b. Acquiescence in Result Only

"Acquiescence in result only" means that the Service accepts the holding of the court in a case and that the Service will follow it in disposing of cases with the same controlling facts. In contrast to a position of mere "acquiescence," it indicates disagreement or concern with some or all of the court's reasons behind its decision.

c. Nonacquiescence

A recommendation of "nonacquiescence" signifies that the Service does not agree with the holding of the court and generally will not follow the decision in disposing of cases involving other taxpayers. In reference to an opinion of a circuit court of appeals, a statement of "nonacquiescence" indicates that the Service will not follow the holding on a nationwide basis. However, the Service will recognize the precedential impact of the opinion on cases arising within the venue of the deciding circuit.

2. Action on Decision—Printed in the Internal Revenue Bulletin

Every week, the Internal Revenue Bulletin contains a list of the Actions on Decision that have been issued.[126] The list simply states the name of the case and whether the Commissioner does or does not acquiesce in the court's decision—it does not contain any substantive content.

B. Precedential Value

There is a significant difference between the reliance that can be placed in an Action on Decision by the Service and by taxpayers.

1. Reliance on AOD by the Service

Generally, an Action on Decision is issued where guidance would be helpful to Service personnel working with the same or similar issues. An Action on Decision may be relied upon within the Service only as the conclusion, applying the law to the facts in the particular case at the time the Action on Decision was issued.[127] Counsel attorneys are required to follow the litigating positions announced in AODs in future litigation or dispute resolution.[128]

2. Reliance on AOD by Taxpayers

Unlike a Treasury regulation or a revenue ruling, an Action on Decision is not an affirmative statement of Service position. It is not intended to serve as guidance to taxpayers and may not be cited as precedent.[129] In fact, each Action on Decision contains a disclaimer stating that "THIS DOCUMENT IS NOT TO BE RELIED UPON OR OTHERWISE CITED AS PRECEDENT BY TAXPAYERS."

a. Penalty for Negligence or Disregard of "Rules or Regulations"

The term "rules or regulations" contained in § 6662(b)(1), discussed in Section III.B.2, *supra*, does not include Actions on Decision.[130]

b. "Substantial Authority" Shelter from Understatement Penalty

Actions on Decisions issued after March 12, 1981, are included in the long list of items that are accepted as "authority" for purposes of the § 6662(b)(2) underpayment penalty discussed in Section III.B.3, *supra*.[131]

XIV. CONCLUSION

As with most subjects, the more you research, study, and learn about IRS guidance, the more the pieces of the puzzle start to come together. The authors hope that you have found this article enlightening, and the next time that you have to research a tax-related topic, you will be more familiar with the guidance encountered as well as the origin, reliability, and precedential value of the guidance.

APPENDIX A

ELEVEN SUBTITLES TO THE CODE

Subtitle	**Topic**	**Sections**
A	Income Taxes	1–1564
B	Estate and Gift Taxes	2001–2801
C	Employment Taxes	3101–3510
D	Miscellaneous Excise Taxes	4001–5000C
E	Alcohol, Tobacco, and Certain Other Excise Taxes	5001–5891
F	Procedure and Administration	6001–7874
G	The Joint Committee on Taxation	8001–8023
H	Financing of Presidential Election Campaigns	9001–9042
I	Trust Fund Code	9500–9602
J	Coal Industry Health Benefits	9701–9722
K	Group Health Plan Requirements	9801–9834

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APPENDIX B

TABLE OF CONTENTS FOR SELECTED PORTIONS OF SUBTITLES A AND B

SUBTITLE A - INCOME TAXES

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[CHAPTER 5—REPEALED] (§§ 1491, 1492–1494)

CHAPTER 6—CONSOLIDATED RETURNS (§§ 1501–1564)
- Subchapter A—Returns and Payment of Tax (§§ 1501–1505)
- Subchapter B—Related Rules (§§ 1551–1564)

SUBTITLE B - ESTATE AND GIFT TAXES

CHAPTER 11—ESTATE TAX (§§ 2001–2210)
- Subchapter A—Estates of Citizens or Residents (§§ 2001–2058)
- Subchapter B—Estates of Nonresidents Not Citizens (§§ 2101–2108)
- Subchapter C—Miscellaneous (§§ 2201–2210)

CHAPTER 12—GIFT TAX (§§ 2501–2524)
- Subchapter A—Determination of Tax Liability (§§ 2501–2505)
- Subchapter B—Transfers (§§ 2511–2519)
- Subchapter C—Deductions (§§ 2521–2524)

CHAPTER 13—TAX ON GENERATION-SKIPPING TRANSFERS (§§ 2601–2664)
- Subchapter A—Tax Imposed (§§ 2601–2604)
- Subchapter B—Generation-Skipping Transfers (§§ 2611–2614)
- Subchapter C—Taxable Amount (§§ 2621–2624)
- Subchapter D—GST Exemption (§§ 2631–2632)
- Subchapter E—Applicable Rate; Inclusion Ratio (§§ 2641–2642)
- Subchapter F—Other Definitions and Special Rules (§§ 2651–2654)
- Subchapter G—Administration (§§ 2661–2664)

CHAPTER 14—SPECIAL VALUATION RULES (§§ 2701–2704)
- § 2701. Special valuation rules in case of transfers of certain interests in corporations or partnerships
- § 2702. Special valuation rules in case of transfers of interests in trusts
- § 2703. Certain rights and restrictions disregarded
- § 2704. Treatment of certain lapsing rights and restrictions

CHAPTER 15—GIFTS AND BEQUESTS FROM EXPATRIATES (§ 2801)
- § 2801. Imposition of tax

APPENDIX C

INTERNAL REVENUE CODE

Citation Format	The Code is found at Title 26 of the United States Code (U.S.C.) which has a total of 50 titles. An example: 26 U.S.C. § 170(b)(1)(A)(i). Practitioners usually cite to the Internal Revenue Code, rather than to the United States Code. The Internal Revenue Code is abbreviated "I.R.C." followed by a space, the symbols § or §§ followed by a space, and the section number. The date is enclosed in parentheses. Practitioners sometimes do not include the year if citing to the current version of the I.R.C. An example: I.R.C. § 170(b)(1)(A)(i). When citing to a Code section, usually no reference is made to the title, subtitle, chapter, subchapter, or part. Code sections are divided into subsections, paragraphs, subparagraphs, and clauses. For example, IRC § 170(b)(1)(A)(i) is subdivided as follows: I.R.C. § 170 → Code section, Arabic numbers Subsection (b) → lower case letter in parentheses Paragraph (1) → Arabic number in parentheses Subparagraph (A) → capital letter in parentheses Clause (i) → lower case Roman numeral in parentheses
What is it?	The Internal Revenue Code is enacted by Congress. It is the primary source of Federal tax law. It imposes income, estate, gift, employment, miscellaneous excise taxes, and provisions controlling the administration of Federal taxation.
Precedential Value	The Code is the definitive source of all tax laws in the United States and has the force of law in and of itself. All Code provisions are included in the definition of "rules or regulations" for purposes of the negligence/disregard prong of the § 6662(b)(1) accuracy-related penalty. The Code is considered "authority" for purposes of the "substantial authority" exception to the § 6662(b)(2) understatement penalty.

APPENDIX D

TREASURY REGULATION

Citation Format	Treasury regulations are located in Title 26 of the Code of Federal Regulations (26 C.F.R.). An example: 26 C.F.R. § 1.61-9(a)(1957). Practitioners usually cite to separate Treasury regulations, rather than to the Code of Federal Regulations. The citation includes the source abbreviation, section symbol followed by one space, and a section number; enclose the year of promulgation in parentheses. An example: Treas. Reg. § 1.61-9(a)(1957). If the regulation is unamended, cite to the year of promulgation. If amended, cite to the year of last amendment. Practitioners often do not include the year if citing to the current version of the Treasury regulations. Cite temporary regulations as “Temp.” and proposed regulations as “Prop.”
What is it?	A Treasury regulation is an official Treasury Department interpretation of one or more provisions of the Internal Revenue Code.
Precedential Value	The Service is bound by Treasury regulations; however, courts are not. Treasury regulations are included in the definition of “rules or regulations” for purposes of the negligence/disregard prong of the § 6662(b)(1) accuracy-related penalty. They are also considered “authority” for purposes of the “substantial authority” exception to the § 6662(b)(2) understatement penalty.

APPENDIX E

REVENUE RULING

Citation Format	To cite to a revenue ruling, write the abbreviation "Rev. Rul." and then list the year the ruling was issued and its sequential number, separated by a hyphen. Follow with the citation for the revenue ruling's location in the Internal Revenue Bulletin or Cumulative Bulletin, as applicable. Rev. Rul. 2012-1, 2012-1 C.B. 255.
What is it?	A revenue ruling is an official interpretation by the Service of the Internal Revenue Code, related statutes, tax treaties and regulations. It is the conclusion of the Service on how the law is applied to a specific set of facts. Revenue rulings are published in the Internal Revenue Bulletin to provide information and guidance to taxpayers, Service personnel, and tax professionals.
Precedential Value	Revenue rulings are published to provide precedents to be used in the disposition of other cases, and may be cited and relied upon for that purpose in the disposition of cases with analogous fact patterns. Taxpayers generally may rely upon revenue rulings published in the Bulletin. However, as with any other precedent, when applying published rulings, the effects of subsequent legislation, regulations, court decisions, procedures, and other rulings must be considered. Revenue rulings are included in the definition of "rules or regulations" for purposes of the negligence/disregard prong of the § 6662(b)(1) accuracy-related penalty. Revenue rulings are also considered "authority" for purposes of the "substantial authority" exception to the § 6662(b)(2) understatement penalty.

APPENDIX F

REVENUE PROCEDURE

Citation Format	To cite to a revenue procedure, write the abbreviation "Rev. Proc." and then list the year the Procedure was issued and its sequential number, separated by a hyphen. Follow with the citation for the Procedure's location in the Internal Revenue Bulletin or Cumulative Bulletin, as applicable. Rev. Proc. 2011-1, 2011-1 C.B. 1.
What is it?	A revenue procedure is an official statement of a procedure that affects the rights or duties of taxpayers or other members of the public under the Internal Revenue Code, related statutes, tax treaties and regulations and that should be a matter of public knowledge. It is published in the Internal Revenue Bulletin. While a revenue ruling generally states a Service position, a revenue procedure typically provides return filing or other instructions concerning a Service position.
Precedential Value	The Service is generally bound to follow the legal position of an unrevoked, unmodified revenue procedure, and IRS attorneys may not take a position that is less favorable to a taxpayer than the legal position contained in a revenue procedure. Therefore, a taxpayer should be able to rely on a revenue procedure if the facts of the taxpayer's case are substantially similar to the facts set forth in the revenue procedure. Revenue procedures are not automatically included in § 6662(b)(1)'s definition of "rules or regulations." However, a revenue procedure that contains substantive interpretations of tax law may be treated as a "rule or regulation." Revenue procedures are considered "authority" for purposes of the "substantial authority" exception to the § 6662(b)(2) understatement penalty.

APPENDIX G

NOTICE

Citation Format	Cite by listing the two or four digit number representing the year of publication and a sequence number, followed by its location in the Internal Revenue Bulletin or Cumulative Bulletin. I.R.S. Notice 95-67, 1995-2 C.B. 343. I.R.S. Notice 2009-2, 2009-1 C.B. 344. *Weighted Average Interest Rate Update*, I.R.S. Notice 99-7, 1999-1 C.B. 351.
What is it?	A notice is a public pronouncement by the Service that may contain guidance that involves substantive interpretations of the Internal Revenue Code or other provisions of the law. Alternatively, notices may be used to solicit public comments on issues under consideration. Notices are published in the Internal Revenue Bulletin.
Precedential Value	Chief Counsel attorneys must follow legal positions established by notices in papers filed in Tax Court or in defense letters or suit letters sent to the Department of Justice. A notice that contains substantive interpretation of tax law is considered a “rule or regulation” for purposes of the negligence/disregard prong of the § 6662(b)(1) accuracy-related penalty. Notices are included in the definition of “authority” for purposes of the “substantial authority” shelter from the § 6662(b)(2) understatement penalty.

APPENDIX H

ANNOUNCEMENT

Citation Format	Cite to the year of publication and the unique sequence number, followed by its location in the Internal Revenue Bulletin or Cumulative Bulletin. Some examples: I.R.S. Announcement 2011-1, 2011-2 I.R.B. 304. I.R.S. Ann. 2011-1, 2011-2 I.R.B. 304. *Foundations Status of Certain Organizations*, I.R.S. Ann. 2001-57, 2001-20 I.R.B. 1187.
What is it?	An announcement is a public pronouncement that has only immediate or short-term value. For example, announcements can be used to summarize the law or regulations without making any substantive interpretation, to state what regulations will say when they are certain to be published in the immediate future, or to notify taxpayers of the existence of an approaching deadline.
Precedential Value	Announcements can generally be relied on to the same extent as revenue rulings and revenue procedures. However, most announcements have only short-term value. An announcement is not a "rule or regulation" for purposes of the negligence/disregard prong of the § 6662(b)(1) accuracy-related penalty. Announcements are included in the definition of "authority" for purposes of the "substantial authority" shelter from the § 6662(b)(2) understatement penalty.

APPENDIX I

PUBLICATION

Citation Format	Cite the title of the publication in italics, the publication number, the page (if applicable), and the year. An example: *Tax Guide for Individuals*, I.R.S. Pub. No. 17, at 31 (1998).
What is it?	Publications explain the law in plain language for taxpayers and their advisors, primarily for the purposes of assisting taxpayers in preparing tax returns. They typically provide instructions, examples, and worksheets.
Precedential Value	Publications are nonbinding on the Service cannot be cited as precedent. A publication is not a "rule or regulation" for purposes of the negligence/disregard prong of the § 6662(b)(1) accuracy-related penalty. Publications are not included in the definition of "authority" for purposes of the "substantial authority" shelter from the § 6662(b)(2) understatement penalty.

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APPENDIX J

PRIVATE LETTER RULING

Citation Format	Cite to the year followed by a hyphen, the week of release followed by a hyphen, and the three-digit sequential item number for the week; enclose the date of issue in parentheses. I.R.S. Priv. Ltr. Rul. 90-31-022 (May 7, 1990). I.R.S. P.L.R. 1991-08-030 (Nov. 27, 1990).
What is it?	A private letter ruling is a written statement issued by the Service upon receiving a written request from the taxpayer. The PLR interprets federal tax law and applies it to the specific fact situation submitted by the taxpayer. It establishes with certainty the federal tax consequences of the fact situation before the taxpayer has entered into the transaction or before the federal tax return has been filed. PLRs are made public once all information that could identify the taxpayer has been removed. They are posted on the electronic reading room on the IRS website.
How do you request a PLR?	The procedures and user fees for applying for a PLR are published annually in the first revenue procedure of each calendar year. The current procedure is detailed in Rev. Proc. 2015-1.
Filing Fee	Filing fees are listed in the appendix to the first revenue procedure published in a calendar year.
Precedential Value	A PLR is binding on the Service if the taxpayer fully and adequately discloses the transaction and carries it out as described to the Service. However, a PLR may not be relied on as precedent by any other taxpayer or Service personnel. A PLR is not a "rule or regulation" for purposes of the negligence/disregard prong of the § 6662(b)(1) accuracy-related penalty. A PLR is included in the definition of "authority" for purposes of the "substantial authority" shelter from the § 6662(b)(2) understatement penalty.

APPENDIX K

TECHNICAL ADVICE MEMORANDUM

Citation Format	Cite the year followed by a hyphen, the week of release followed by a hyphen, and the three-digit sequential item number; enclose the date of issue in parentheses. I.R.S. Tech. Adv. Mem. 87-14-008 (Dec. 17, 1986). T.A.M. 2001-02-051 (Jan. 12, 2001).
What is it?	A technical advice memorandum (TAM) is a memorandum furnished by an Associate office of the Service that responds to a request for assistance on any technical or procedural question that develops during any proceeding before the Service. The field office may request a TAM when the application of the law to the facts involved is unclear.
Precedential Value	Technical advice memorandums cannot be used or cited as precedent. However, they may be useful to other taxpayers by providing an indication of the Service's position. A technical advice memorandum is not a "rule or regulation" for purposes of the negligence/disregard prong of the § 6662(b)(1) accuracy-related penalty. Technical advice memoranda issued after October 31, 1976, are included in the definition of "authority" for purposes of the "substantial authority" shelter from the § 6662(b)(2) understatement penalty.

APPENDIX L

GENERAL COUNSEL MEMORANDUM

Citation Format	Section 318 Constructive Ownership of Stock, GCM 37162, I-526-76 (June 14, 1977). I.R.S. G.C.M. 39,417 (Sept. 30, 1985).
What is it?	General counsel memorandums are legal memorandums from the Office of Chief Counsel prepared in connection with the review of certain proposed rulings (revenue rulings, TAM, PLRs, etc.). They contain legal analyses of substantive issues and can be helpful in understanding the reasoning behind a particular ruling and the Service's response to similar issues in the future. General counsel memorandums are no longer issued, except to revoke earlier GCMs.
Precedential Value	General counsel memorandums cannot be used or cited as precedent, and they do not provide legal advice. A general counsel memorandum is not a "rule or regulation" for purposes of the negligence/disregard prong of the § 6662(b)(1) accuracy-related penalty. General counsel memoranda issued after March 12, 1981 (as well as general counsel memoranda published in pre-1955 volumes of the Cumulative Bulletin) are included in the definition of "authority" for purposes of the "substantial authority" shelter from the § 6662(b)(2) understatement penalty.

ACTION ON DECISION

Citation Format	To cite to the memorandum, list the initials "A.O.D.," followed by the year the memorandum was issued and the memorandum's sequential number for that year. A.O.D. 2011-2 To cite to the brief statement of position published in the Internal Revenue Bulletin, write the name of the case in italics, followed by the memorandum's citation, the I.R.B.'s citation, and the date of publication. *Norris v. Comm'r*, A.O.D. 2011-52, 2011-52 I.R.B. (Dec. 27, 2011). To indicate the Service's acquiescence or nonacquiescence, cite to the case as follows: *Lemmen v. Comm'r.*, 77 T.C. 1326 (1981), *acq.*, 1983-1 C.B. 1. *Dean v. Comm'r.*, 35 T.C. 1083 (1961), *nonacq.*, 1973-2 C.B. 4.
What is it?	An Action on Decision is a legal memorandum issued by the Service Chief Counsel's office when a court makes a significant ruling against the government in a case. The memorandum recommends the action the Service should take in response to the decision.
Precedential Value	An Action on Decision is not an affirmative statement of Service position. It is not intended to serve as public guidance and may not be cited as precedent. An Action on Decision is not a "rule or regulation" for purposes of the negligence/disregard prong of the § 6662(b)(1) accuracy-related penalty. Actions on Decision are considered "authority" for purposes of the "substantial authority" shelter from the § 6662(b)(2) understatement penalty.

[1] INTERNAL REVENUE MANUAL § 4.10.7.2.1.1 (Jan. 1, 2006).
[2] Pub. L. No. 99-514, § 2, 100 Stat. 2095 (Oct. 22, 1986).
[3] INTERNAL REVENUE MANUAL § 4.10.7.2.1.3 (Jan. 1, 2006).
[4] *See, e.g., United States v. Quality Stores, Inc.*, 134 S. Ct. 1395, 1399 (2014) ("The beginning point is the relevant statutory text.")
[5] INTERNAL REVENUE MANUAL § 4.10.7.2.1.1 (Jan. 1, 2006).
[6] *Id.*
[7] I.R.C. § 6662(b)(1).
[8] I.R.C. § 6662(c).

[9] Treas. Reg. § 1.6662-3(b)(2).
[10] I.R.C. § 6662(b)(2).
[11] I.R.C. § 6662(d)(2)(B).
[12] Treas. Reg. § 1.6662-4(d)(1).
[13] Treas. Reg. § 1.6662-4(d)(3)(iii).
[14] I.R.C. § 7805(a).
[15] Treas. Reg. § 301.7805–1.
[16] INTERNAL REVENUE MANUAL § 4.10.7.2.3.1 (Jan. 1, 2006).
[17] *See* 1 West's Legal Forms, Business Organizations Div. I § 2:2 (3d ed.).
[18] *See* 1 West's Legal Forms, Business Organizations Div. I § 3:14 (3d ed.).
[19] *See* 1 West's Legal Forms, Business Organizations Div. I § 2:2 (3d ed.).
[20] 1 Mertens Law of Fed. Income Tax'n § 3:38.
[21] *Id.*
[22] *See* I.R.C. § 7805(e)(2).
[23] I.R.C. § 7805(b)(1).
[24] *See* Treas. Reg. § 601.601(a)(1) ("The most important rules are issued as regulations and Treasury decisions prescribed by the Commissioner and approved by the Secretary or his delegate."); INTERNAL REVENUE MANUAL § 4.10.7.2.3.4 (Jan. 1, 2006) ("The Service is bound by the regulations").
[25] *See, e.g., United States v. Home Concrete & Supply, LLC*, 132 S. Ct. 1836 (2012).
[26] *See, e.g., United States v. Mead Corp*., 533 U.S. 218 (2001); *Mayo Found. for Med. Educ. & Research v. United States*, 131 S. Ct. 704 (U.S. 2011).
[27] *See* Kristin E. Hickman, *IRB Guidance: The No Man's Land of Tax Code Interpretation*, 2009 MICH. ST. L. REV. 239; Leandra Lederman, *The Fight Over "Fighting Regs" and Judicial Deference in Tax Litigation,* 92 B.U. L. REV. 643 (2012).
[28] Treas. Reg. § 1.6662-3(b)(2).
[29] Treas. Reg. § 1.6662-4(d)(3)(iii).
[30] Treas. Reg. § 601.601(d)(1).
[31] *Id*.
[32] *See* Rev. Proc. 89-14, 1989-1 C.B. 814; INTERNAL REVENUE MANUAL § 4.10.7.2.4 (Jan. 1, 2006).
[33] Rev. Proc. 89-14, 1989-1 C.B. 814.
[34] *Id.*
[35] *See* I.R.S. Announcement 2013-12, 2013-11 I.R.B. 651.
[36] INTERNAL REVENUE MANUAL § 4.10.7.2.4 (Jan. 1, 2006).
[37] Kristin E. Hickman, *IRB Guidance: The No Man's Land of Tax Code Interpretation*, 2009 MICH. ST. L. REV. 239, 240.
[38] Treas. Reg. § 601.601(d)(2)(iii).
[39] INTERNAL REVENUE MANUAL § 4.10.7.2.6 (Jan. 1, 2006).
[40] *See* 1 West's Legal Forms, Business Organizations Div. I § 2:2 (3d ed.).
[41] INTERNAL REVENUE MANUAL § 32.2.2.4 (Aug. 11, 2004).
[42] *Id*.
[43] *See* Kristin E. Hickman, *IRB Guidance: The No Man's Land of Tax Code Interpretation*, 2009 MICH. ST. L. REV. 239, 244–45.
[44] INTERNAL REVENUE MANUAL § 32.2.2.8.1 (Aug. 11, 2004).
[45] Rev. Proc. 89-14; 1989-1 C.B. 814.
[46] Treas. Reg. § 601.601(d)(2)(i)(a).
[47] *See Limited, Inc. v. Comm'r*, 286 F.3d 324, 337 (6th Cir. 2002).
[48] Rev. Proc. 89-14; 1989-1 C.B. 814; INTERNAL REVENUE MANUAL § 4.10.7.2.6 (Jan. 1, 2006).
[49] INTERNAL REVENUE MANUAL § 4.10.7.2.6.1 (Jan. 1, 2006).
[50] *See* Kristin E. Hickman, *IRB Guidance: The No Man's Land of Tax Code Interpretation*, 2009 MICH. ST. L. REV. 239, 244–45.
[51] *Id*.
[52] Treas. Reg. § 601.601(d)(2)(v)(d).
[53] *See id*.; INTERNAL REVENUE MANUAL § 4.10.7.2.6.1 (Jan. 1, 2006).
[54] *See* Rev. Proc. 89-14, 1989-1 C.B. 814; INTERNAL REVENUE MANUAL § 32.2.2.10 (Aug. 11, 2004).
[55] Treas. Reg. § 601.601(d)(2)(v)(e).
[56] INTERNAL REVENUE MANUAL § 4.10.7.2.6.1 (Jan. 1, 2006).
[57] Treas. Reg. § 601.601(d)(2)(v)(c).
[58] INTERNAL REVENUE MANUAL § 32.2.3.5.1.2.7(3) (Aug. 11, 2004).
[59] *See* Donald L. Korb, *The Four R's Revisited: Regulations, Rulings, Reliance, and Retroactivity in the 21st Century: A View From Within*, 46 DUQ. L. REV. 323, 335–36 (2008).
[60] *See United States v. Mead Corp*., 533 U.S. 218 (2001); *Mayo Found. for Med. Educ. & Research v. United States*, 131 S. Ct. 704 (U.S. 2011). *See also* 47A C.J.S. Internal Revenue § 10 (explaining that revenue rulings are "persuasive, and entitled to weight in the interpretative process as expressing the views of the agency which is intrusted with administration of the Internal Revenue Code, but do not have the force or effect of regulations or Treasury decisions, much less that of law.").

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[61] *See generally,* Kristin E. Hickman, *IRB Guidance: The No Man's Land of Tax Code Interpretation*, 2009 MICH. ST. L. REV. 239; Ryan C. Morris, Comment, *Substantially Deferring to Revenue rulings After Mead*, 2005 B.Y.U. L. REV. 999.

[62] *See* Treas. Reg. § 1.6662-3(b)(2); T.D. 8381, 1992-1 C.B. 374.

[63] *See* Treas. Reg. § 1.6662-4(d)(3)(iii).

[64] Treas. Reg. § 601.601(d)(2)(i)(b); Rev. Proc. 89-14; 1989-1 C.B. 814.

[65] INTERNAL REVENUE MANUAL § 4.10.7.2.6 (Jan. 1, 2006); Treas. Reg. § 601.601(d)(2)(vi).

[66] *See* Donald L. Korb, *The Four R's Revisited: Regulations, Rulings, Reliance, and Retroactivity in the 21st Century: A View From Within*, 46 DUQ. L. REV. 323, 337 (2008).

[67] Treas. Reg. § 601.601(d)(2)(iii).

[68] *Id*.

[69] *See* INTERNAL REVENUE MANUAL § 32.2.2.10 (Aug. 11, 2004).

[70] *See* Rev. Proc. 89-14; 1989-1 C.B. 814.

[71] Treas. Reg. § 601.601(d)(1).

[72] *See* T.D. 8381, 1992-1 C.B. 374.

[73] Treas. Reg. § 1.6662-4(d)(3)(iii).

[74] INTERNAL REVENUE MANUAL § 4.10.7.2.4.1 (Jan. 1, 2006).

[75] Kristin E. Hickman, *IRB Guidance: The No Man's Land of Tax Code Interpretation*, 2009 MICH. ST. L. REV. 239, 242.

[76] *Id*. at 242 n.12.

[77] INTERNAL REVENUE MANUAL § 32.2.2.3.3 (Aug. 11, 2004).

[78] Donald L. Korb, *The Four R's Revisited: Regulations, Rulings, Reliance, and Retroactivity in the 21st Century: A View From Within*, 46 DUQ. L. REV. 323, 339 (2008).

[79] INTERNAL REVENUE MANUAL § 32.2.2.3.3 (Aug. 11, 2004).

[80] *See* Donald L. Korb, *The Four R's Revisited: Regulations, Rulings, Reliance, and Retroactivity in the 21st Century: A View From Within*, 46 DUQ. L. REV. 323, 339–40 (2008).

[81] INTERNAL REVENUE MANUAL § 32.2.2.10.4 (Aug. 11, 2004).

[82] *See* Treas. Reg. § 1.6662-3(b)(2); T.D. 8381, 1992-1 C.B. 374.

[83] *See* Treas. Reg. § 1.6662-4(d)(3)(iii); Rev. Rul. 90-91, 1990-2 C.B. 262.

[84] *See* 1 Mertens Law of Fed. Income Tax'n § 3:42.

[85] *See* INTERNAL REVENUE MANUAL § 32.2.2.3.4 (Aug. 11, 2004); INTERNAL REVENUE MANUAL § 4.10.7.2.4.1 (Jan. 1, 2006).

[86] *See* INTERNAL REVENUE MANUAL § 32.2.2.3.4 (Aug. 11, 2004).

[87] *See* Kristin E. Hickman, *IRB Guidance: The No Man's Land of Tax Code Interpretation*, 2009 MICH. ST. L. REV. 239, 240 n.5.

[88] INTERNAL REVENUE MANUAL § 4.10.7.2.4.1 (Jan. 1, 2006).

[89] INTERNAL REVENUE MANUAL § 32.2.2.10 (Aug. 11, 2004).

[90] Treas. Reg. § 1.6662-3(b)(2).

[91] *See* Treas. Reg. § 1.6662-4(d)(3)(iii); Rev. Rul. 90-91; 1990-2 C.B. 262.

[92] INTERNAL REVENUE MANUAL § 4.10.7.2.8 (Jan. 1, 2006).

[93] Rev. Proc. 2015-1, 2015-1 I.R.B. 1.

[94] *See id.*; Treas. Reg. § 601.201(a)(2).

[95] Donald L. Korb, *The Four R's Revisited: Regulations, Rulings, Reliance, and Retroactivity in the 21st Century: A View From Within*, 46 DUQ. L. REV. 323, 343 (2008).

[96] Rev. Proc. 2015-1 at § 8.03, 2015-1 I.R.B. 1.

[97] *Id.*

[98] *See* 1 West's Legal Forms, Business Organizations Div. I § 2:2 (3d ed.).

[99] INTERNAL REVENUE MANUAL § 4.10.7.2.10.1 (Jan. 1, 2006).

[100] *See* I.R.C. § 6110(k)(3).

[101] INTERNAL REVENUE MANUAL § 4.10.7.2.10.3 (Jan. 1, 2006).

[102] *See* I.R.C. § 6110(k)(3).

[103] *AmerGen Energy Co. v. United States*, 94 Fed. Cl. 413, 418 (Fed. Cl. 2010).

[104] *See, e.g.*, *Glass v. Comm'r*, 471 F.3d 698, 709 (6th Cir. 2006); *Thom v. United States*, 283 F.3d 939, 943 n.6 (8th Cir. 2002); *ABC Rentals of San Antonio, Inc. v. Comm'r*, 142 F.3d 1200, 1207 n.5 (10th Cir. 1998).

[105] Treas. Reg. § 1.6662-3(b)(2).

[106] Treas. Reg. § 1.6662-4(d)(3)(iii).

[107] *See* INTERNAL REVENUE MANUAL § 33.2.1.2 (Aug. 11, 2004).

[108] Rev. Proc. 2015-2, 2015-1 I.R.B. 105.

[109] *See* INTERNAL REVENUE MANUAL § 33.2.1.2(1) (Aug. 11, 2004).

[110] Rev. Proc. 2015-2, 2015-1 I.R.B. 105.

[111] *See* INTERNAL REVENUE MANUAL § 4.10.7.2.10 (Jan. 1, 2006); I.R.C. § 6110(k)(3).

[112] *See* INTERNAL REVENUE MANUAL § 4.10.7.2.10 (Jan. 1, 2006).

[113] Treas. Reg. § 1.6662-3(b)(2).

[114] Treas. Reg. § 1.6662-4(d)(3)(iii).

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[115] *See* INTERNAL REVENUE MANUAL § 4.10.7.2.11 (Jan. 1, 2006).

[116] *See* INTERNAL REVENUE MANUAL § 4.10.7.2.11 (Jan. 1, 2006).

[117] *See* Donald L. Korb, *The Four R's Revisited: Regulations, Rulings, Reliance, and Retroactivity in the 21st Century: A View From Within*, 46 DUQ. L. REV. 323, 362 n.185 (2008).

[118] *See* I.R.C. § 6110(k)(3).

[119] Treas. Reg. § 1.6662-3(b)(2).

[120] Treas. Reg. § 1.6662-4(d)(3)(iii).

[121] INTERNAL REVENUE MANUAL § 4.10.7.2.9.8.1 (Jan. 1, 2006).

[122] INTERNAL REVENUE MANUAL § 36.3.1.1 (Mar. 14, 2013).

[123] *Id.*

[124] INTERNAL REVENUE MANUAL § 36.3.1.2.1 (Mar. 14, 2013).

[125] INTERNAL REVENUE MANUAL § 4.10.7.2.9.8.1.4 (Jan. 1, 2006).

[126] INTERNAL REVENUE MANUAL § 4.10.7.2.9.8.2 (Jan. 1, 2006).

[127] *Id*.

[128] INTERNAL REVENUE MANUAL § 36.3.1.1 (Mar. 14, 2013).

[129] INTERNAL REVENUE MANUAL § 4.10.7.2.9.8.1 (Jan. 1, 2006).

[130] Treas. Reg. § 1.6662-3(b)(2).

[131] Treas. Reg. § 1.6662-4(d)(3)(iii).

Vinson&Elkins

The Unified Loss Rules: An Overview

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Introduction

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Set forth herein is a summary of the "unified loss rules," and in particular the "attribute reduction rules" contained in Treas. Reg. § 1.1502-36(d), which are designed to prevent taxpayers from recognizing more than one tax loss with respect to a single economic loss. The attribute reduction rules can lead to surprising results and should be carefully analyzed to determine their potential application in connection with the purchase and sale of a corporation out of a consolidated group. Given the current natural resource commodity price environment, these rules will likely become increasingly relevant for certain M&A transactions within the energy space.

Introduction

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- Background:
  - The unified loss rules are contained in Treas. Reg. § 1.1502-36.
  - Proposed in January of 2007 and finalized September 17, 2008.
  - They are the culmination of 20 years of notices, proposed, temporary and final regulations, court cases, and legislation, including:
    - Notice 87-14, 1987 C.B. 445.
    - Numerous proposed, temporary, and final regulations.
    - *Rite Aid Corp v. U.S.*, 255 F.3d 1357 (Fed. Cir. 2001).
    - Section 646 of American Jobs Creation Act of 2004.

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Definitions

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- For simplicity, assume the following unless otherwise indicated:
  - "Seller" is the common parent of an affiliated group of corporations that have elected to file consolidated federal income tax returns (the "Seller Group").
  - "Target" is a member of the Seller Group and is 100% directly owned by Seller.
  - "Buyer" is a corporation that is not affiliated with the Seller Group.

Purposes

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The Unified Loss Rules have two primary purposes:

- Preventing the consolidated return provisions from reducing Seller Group's consolidated taxable income through the creation and recognition of noneconomic loss on Target's stock (Treas. Reg. 1.1502-36(a)(2)); and
- Preventing members (including former members) of a Seller Group from collectively obtaining more than one tax benefit from a single economic loss (*Id.)*.

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Overview

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- The Unified Loss Rules Contain Three Principal Rules:
  1. Basis redetermination rule to reduce disparity in bases of subsidiary stock. Treas. Reg. § 1.1502-36(b).
  2. Basis reduction rule to prevent noneconomic loss. Treas. Reg. § 1.1502-36(c).
  3. Attribute reduction rule to prevent loss duplication. Treas. Reg. § 1.1502-36(d).
- Each of the three rules, to the extent applicable, apply in the order set forth above.

1. The Basis Redetermination Rule: Treas. Reg. § 1.1502-36(b)

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The Basis Redetermination Rule is designed to prevent prior adjustments made under Treas. Reg. § 1.1502-32 from creating non-economic or duplicated losses where Seller (or other Seller Group members) hold Target shares with disparate bases.

- The rule reallocates previously applied investment adjustments to reduce basis disparity among different classes or blocks of Target stock.
  - Doesn't apply if there is no disparity among bases in Target's common shares and no member of the Seller Group owns preferred shares with an unrecognized gain or loss.
  - Doesn't apply where all of Target's shares are sold to a non-member in a fully taxable transaction.

2. The Stock Basis Reduction Rule: Treas. Reg. § 1.1502-36(c)

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The Stock Basis Reduction Rule is primarily designed to prevent the "son of mirrors" and similar transactions that the IRS thinks result in noneconomic losses.

- Son of Mirror Example: Seller purchases Target for $400 and files a consolidated return. Target has two assets (X and Y), each of which has a $200 value and $100 basis. Seller only wants Asset X. Target distributes Asset X to Seller and then Seller sells Target's stock for $200. The distribution of Asset X results in $100 deferred intercompany gain (a "DIG") to Target and a $200 reduction Seller's basis in its Target stock. The DIG is triggered in connection with the stock sale, resulting in a $100 increase in Seller's stock basis under the investment adjustment rules. As a result, Seller recognizes a $100 loss on the stock sale, which offsets the gain recognized on the distribution of Asset X.
- The stock basis reduction rule prevents this result by reducing Seller's basis in the Target stock by the $100 positive investment adjustment.

3. The Attribute Reduction Rule: Treas. Reg. § 1.1502-36(d)

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The Attributed Reduction Rule is primarily intended to prevent recognition of more than one loss with respect to a single economic loss.

- Unlike the prior temporary regulations, the final regulations do not trace losses.
- Basic Example of Problem: Seller buys Target's stock for $200, at which time Target's assets have a $200 basis and value. A year later, Target's assets have declined in value to $100. Before Target recognizes a loss on the assets for tax purposes, Seller sells Target's stock for $100.
  - Absent the attribute reduction rule, Seller would recognize a $100 loss on its Target stock and Target would continue to have a $100 built-in loss that it could later recognize. Thus, there could be $200 of losses recognized even though the economic loss was only $100.

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Default Attribution Reduction Mechanics

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- If any transferred share remains a loss share after the application of the stock basis redetermination and reduction rules, Target's tax attributes are reduced by the "attribution reduction amount." Treas. Reg. § 1.1502-36(d)(2)(i).
- Attribute Reduction Amount = the lesser of (i) the net stock loss and (ii) the aggregate inside loss. § 1.1502-36(d)(3).
  - Net stock loss = the excess, if any, of the aggregate basis of all Target shares transferred over the aggregate value of those shares.
  - Aggregate Inside Loss = the excess, if any, of Target's net inside attribute amount (loss carryovers, plus deferred deductions, plus money, plus basis in assets other than money, minus liabilities) over the value of all outstanding Target shares. Complicated further if Target owns subsidiaries – See Treas. Reg. 1.1502-36(d)(5).
- Exception if the attribution reduction amount < 5% of the value of the shares transferred (unless Seller elects otherwise). Treas. Reg. § 1.1502-36(d)(2)(ii).

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Default Attribution Reduction Mechanics, Continued

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- Default Application of Attribution Reduction.
  1. Category A: Capital loss carryovers (oldest to newest);
  2. Category B: NOL carryovers (oldest to newest);
  3. Category C: Deferred deductions (proportionately); and
  4. Category D: Asset basis (other than cash and general deposit accounts). Treas. Reg. § 1.1502-36(d)(4).
  - Seller can specify the allocation of the attribution reduction amount among attributes in Categories A, B, and C. *Id*.
  - Asset basis cannot be reduced until all of the attributes in Categories A, B, and C are reduced in full. *Id*.

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Default Attribution Reduction Mechanics, Continued

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- Reduction of Target's Asset Basis.
  - After reducing the attributes in Categories A, B, and C, any excess attribution reduction amount is applied to reduce the basis of Target's Category D assets.
    - The basis reduction is allocated between any stock of Target's subsidiaries, if any, and Target's other assets based on relative basis. Special rules apply to determine the "deemed basis" of Target's subsidiary stock. *See* Treas. Reg. § 1.1502-36(d)(5).
    - The attribution reduction amount allocated to non-stock Category D assets are allocated to Target's Class VII, VI, V, IV, III, and II assets in reverse sequential order. Treas. Reg. § 1.1502-36(4)(ii)(B)(2). Basis of assets within a class are reduced proportionately.

Default Attribution Reduction Mechanics, Continued

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- Reduction of Target's Asset Basis Cont.
  - If the attribution reduction amount exceeds Target's attributes and Target has contingent liabilities, the excess is suspended and applied to any future attributes attributable to those liabilities. Otherwise, the excess attribution reduction amount has no further effect. Treas. Reg. § 1.1502-36(d)(4)(iii).
  - Attribute reductions are effective immediately before the transfer of Target's stock. *Id*.
  - Any reduction of attributes are NOT noncapital, nondeductible expenses described in Treas. Reg. § 1.1502-32(b)(2)(iii). The point here is to prevent duplicative stock basis reductions under the investment adjustment rules.

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Seller Elections Under Treas. Reg. § 1.1502-36(d)(6)

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- In lieu of the default attribute reduction rules described above, Seller can elect to:
    1. Reduce all or any portion of its basis in Target's shares (i.e., reduce its capital loss on the sale of Target);
    2. Reattribute all or any portion of Target's Category A, B, and C attributes to the extent they would otherwise be reduced; or
    3. Any combination of the above.
- Seller may specify the amount of attributes in Category A, B, and C (up to the extent such attributes would otherwise be subject to reduction).
- Seller can make a protective election to reduce stock basis or reattribute attributes.

Seller Elections Under Treas. Reg. § 1.1502-36(d)(6), Continued

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- Seller is treated as succeeding to any attributes that are reattributed to it as though such attributes were acquired in a Section 381 transaction. Treas. Reg. § 1.1502-36(d)(6)(iv)(A).
- The reattribution of Target's assets IS a noncapital, nondeductible expense of Target described in Treas. Reg. § 1.1502-32(b)(2)(iii).
- In general, any stock basis reduction and reattribution of attributes is deemed to occur immediately before the application of the default loss attribution reduction rules (which in turn is deemed to occur immediately before the stock sale).
- Stock basis reduction is deemed elected if the stock loss would be permanently disallowed (e.g., under Section 311(a)). Treas. Reg. § 1.1502-36(d)(6)(iv)(C).
- An election is made by Seller in a statement titled "Section 1.1502-36 Statement," which must be attached to the Seller Group's return for the taxable year of the transaction. See Treas. Reg. § 1.1502-36(e)(5) for election filing details.

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Attribute Reduction Rules Examples

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- Facts:
  - Seller owns all 100 outstanding shares of Target with a basis of $2.10/share ($210).
  - Seller sells all of its Target shares to X for $1/share ($100).
  - At the time of the sale, Target has no liabilities, a $10 capital loss carryover (Category A), $90 NOL carryover (Category B), and $40 deferred deduction (Category C), and land with a basis of $70 (Category D) (total attributes = $210).

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Attribute Reduction Rules Examples, Continued

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- Computation of Attribute Reduction Amount
  - Attribution reduction amount = lesser of the $110 net stock loss ($210 basis over $100 purchase price) and Target's $110 aggregate inside loss ($210 total attributes over the $100 purchase price).
- Allocation of Attribute Reduction Amount of $110
  - Absent a specific allocation, Target's $10 capital loss carryover and $90 NOL carryover would be reduced to $0, and its $40 deferred deduction would be reduced by $10 to $30.
  - Alternatively, Seller could specifically state how it wants to apply the $110 attribute reduction amount among the capital loss carryover, NOL carryover, and deferred deduction.
  - Seller recognizes a $110 capital loss on the stock sale.

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Attribute Reduction Rules Examples, Continued

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- Election to Reduce Stock Basis.
  - Instead of the attribution reduction described above, Seller Group could elect pursuant to Treas. Reg. § 1.1502-36(d)(6) to reduce Seller's basis in the Target shares by the full attribute reduction amount of $110. It could also elect to reduce its basis by only part of the attribute reduction amount.
  - After giving effect to the election, the Target shares are not loss shares and therefore Target's attributes are not subject to reduction.

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Attribute Reduction Rules Examples, Continued

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- Election to Reattribute Losses.
  - Instead of the attribution reduction described above, Seller Group could elect pursuant to Treas. Reg. § 1.1502-36(d)(6) to reattribute Target's attributes up to the attribute reduction amount.
  - For example, Seller Group could elect to reattribute the $10 capital loss carryover, $90 NOL, and $10 of the deferred deduction to the Seller Group.
    - As a result, Target's remaining attributes would be a $30 deferred deduction and land with a basis of $70.
    - The reattribution is treated as a noncapital, nondeductible expense of Target that is deemed to occur immediately before the application of Treas. Reg. § 1.1502-36(d) (and therefore before the stock sale), which reduces Seller's basis in its Target shares by $110 under the investment adjustment rules.
    - Seller Group succeeds to the reattributed attributes.

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A Few Strategic Considerations

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- Buyers need to be careful anytime the purchase price is less than the basis in Target's shares and the net attributes of Target.
- Buyer should consider requiring Seller to make a protective Treas. Reg. § 1.1502-36(d)(6) election to reduce stock basis at the time of sale.
  - The existence or amount of the attribution reduction amount may not be known at closing (e.g., there may be a purchase price adjustment or audit that affects the calculation post-closing).
  - If Seller is unwilling to make the election (e.g., because it is expecting to have capital gain income from another source), Buyer could ask for a representation regarding the attributes that Target will take with it.
- In certain circumstances, it may make sense for Seller to reattribute Target net operating losses ("NOLs") and other attributes because the NOLs will not be subject to a 382 limitation resulting from the sale of Target to Buyer.

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IRS CIRCULAR 230 STATEMENT

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- These presentation materials and discussion are not intended or written to be used, and cannot be used, by any person (i) as a basis for avoiding federal tax penalties that may be imposed on that person or (ii) to promote, market or recommend any transaction or matter addressed herein.

A ROSE BY ANY OTHER NAME: UTILIZING AND DRAFTING POWERS FOR TRUSTEES, TRUSTEE ADVISORS, AND TRUST PROTECTORS[1]

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I. INTRODUCTION

When designing trusts these days, practitioners often use such titles as "Trustee Advisor," "Trust Consultant," "Trust Committee," and "Trust Protector," and the terms are becoming more familiar to clients. Many clients request – or their situations warrant – a division of authority between fiduciaries.[4] At other times, an unusual power is sought to be given to the sole fiduciary. Whatever the reason, the trend is to share and divide the trust administration and corresponding duties in various ways among co-trustees, directed trustees, special trustees, and protectors.[5]

So what's in a name? Not much, by way of statutory authority. The Internal Revenue Code (the "Code") does not offer a definition of an "independent trustee." Similarly, Texas law does not provide specific duties or liabilities as they relate to any specialized trustees. One exception is that the Texas Trust Code defines the phrase "discretionary power holder" as a person who has the sole power or power shared with another person to make discretionary decisions on behalf of a trustee with respect to distributions from a trust.[6]

Other exceptions, of sort, include the Texas Trust Code provision sanctioning ancillary trustees[7] and addressing co-trustees.[8] Though specifically described in the Trust Code, a client may assume a different meaning for the term "co-trustee." For example, it could mean someone the settlor wants to watch over the trustee on behalf of a minor beneficiary or someone he or she wants to advise the trustee. Likewise, non-statutory terms can have many different connotations even among attorneys.

Thus, the trust agreement specifies not only the name of the power holder but also determines the powers and duties granted. One common theme among drafters appears to be that many use the Code's definition of "related or subordinate party"[9] as a negative requirement to describe an independent trustee.

The bottom line is that any specialized power holder can be given any name; the key is in the powers given. Some powers are taxable, so it matters to whom they are given. Other powers are not taxable but, rather, provide desired controls and oversight infrastructure. Because most every power granted in a trust agreement is indeed

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[1] This article represents the views of the authors and not necessarily those of Sprouse Shrader Smith PLLC or Richards Rodriguez & Skeith LLP. While every effort has been made to check citations and statements made herein, the authors expressly disclaim all express and implied warranties as to the accuracy of the citations, statements, and all other contents. Readers should independently review all material in this article before using this article to craft their planning advice or draft documents.

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[4] There is some disagreement among practitioners as to whether a protector is a fiduciary. For that discussion, *see* IV.A below.

[5] Ronald D. Aucutt, *When is a Trust a Trust?*, made part of Ronald D. Aucutt, et al., *It Slices; It Dices; It Makes Julienne Fries: Cutting-Edge Trust Tools,* State Bar of Texas 20th Annual Advanced Estate Planning Strategies Course, Ch. 4, p. 16 (Apr. 24-25, 2014).

[6] Tex. Trust Code § 113.029(e).

[7] *See* discussion at II.D.4 relating to ancillary trustees.

[8] Co-trustees may act by majority decision. Tex. Trust Code § 113.085(a). If a vacancy occurs in a co-trusteeship, the remaining co-trustees may act for the trust. Tex. Trust Code § 113.085(b). A co-trustee shall participate in the performance of a trustee's function unless the co-trustee: (1) is unavailable to perform the function because of absence, illness, suspension under this code or other law, disqualification, if any, under this code, disqualification under other law, or other temporary incapacity; or (2) has delegated the performance of the function to another trustee in accordance with the terms of the trust or applicable law, has communicated the delegation to all other co-trustees, and has filed the delegation in the records of the trust. Tex. Trust Code § 113.085(c). If a co-trustee is unavailable to participate in the performance of a trustee's function for a reason described by Subsection (c)(1) and prompt action is necessary to achieve the efficient administration or purposes of the trust or to avoid injury to the trust property or a beneficiary, the remaining co-trustee or a majority of the remaining co-trustees may act for the trust. Tex. Trust Code § 113.085(d). A trustee may delegate to a co-trustee the performance of a trustee's function unless the settlor specifically directs that the function be performed jointly. Unless a co-trustee's delegation under this subsection is irrevocable, the co-trustee making the delegation may revoke the delegation. Tex. Trust Code § 113.085(e).

[9] A person related or subordinate to the settlor includes the settlor's spouse if living with the settlor, and the settlor's parents, issue, or sibling. I.R.C. § 672(c).

"powerful," structuring who can exercise them, relinquish them, or reacquire them provides for the best assurance of carrying out the settlor's intent and providing checks and balances to avoid the misuse of the powers.

The focus of this article is to explore the various powers granted to an appointee in special circumstances and examine the applications of several such powers.[10] This article is not intended to encompass drafting for flexibility *per se*,[11] nor is it intended to cover the various ways to draft trust distribution standards, although the topics are related and overlap.[12]

II. SITUATIONS WARRANTING MORE THAN A BOILERPLATE TRUSTEE

Certain situations warrant naming an additional power holder or giving the regular trustee atypical powers. The powers themselves and who should and should not possess them are addressed in Section III below.

A. Longevity

Clients who create trusts for their family also opt more frequently for longer lasting trusts over the once conventional trust that ended when the primary beneficiary reached a certain age. Whether dynastic (within Texas' rule against perpetuities), perpetual (under another state's laws), or simply longer-term, the odds of facing unanticipated circumstances increase with the longevity of the trust. An additional trustee or power holder can provide flexibility and even cost savings.

One example is where the settlor wants to grant someone the power to remove a non-responsive corporate trustee without going to court and without otherwise establishing a "for cause" standard. Without estate tax inclusion, even the settlor can have the removal power as long as he or she is prohibited from naming someone related or subordinate to himself.[13]

Giving someone the power to terminate a trust early under more liberal provisions than a judicial termination or that of the non-economic termination statute under the Texas Trust Code[14] can be very desirable in a multi-generational trust.

A settlor also may desire to give someone the power to address and modify a trust in reaction to future legislative changes dealing with tax laws, a beneficiary's change of circumstances, and perhaps items such as same sex marital relationships, paternity and reproductive issues.

B. Division of Responsibilities and Powers

Instead of generically naming co-trustees where each has the same power as the other, clients may want or need to customize who holds each power over a trust. A client may, for example, want to divide the powers between those that are administrative and those that more directly affect distributions. The impetus to do this may be driven by the client's desire to utilize one trusted person's investment talents to be the "investment trustee" and another trusted person's interpersonal skills to be the "distribution trustee." The division of powers should be based on the appointees' personal attributes, expertise, and ability to act impartially, particularly where beneficiaries have conflicting interests or where family tensions are high. By way of example, assume the surviving spouse (who is the second wife and not the mother of the settlor's children) is the trustee. She may face great pressure when responding to requests or demands from her stepchildren for distributions from the trust that may damage an already tenuous relationship.

Other ways to divide responsibilities can be through a trust committee that is in charge of certain trust administration aspects, whether investment decisions, trustee appointments and removals, distribution decisions, early trust terminations, and/or conflict resolutions between trustees and beneficiaries.

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[10] Other resources to consult are Marjorie J. Stephens, *The Malleable Trust…*, State Bar of Texas 21st Annual Estate Planning & Probate Drafting Course (2010); Steve R. Akers, *Structuring Trustee Powers to Avoid a Tax Catastrophe,* Denver Estate Planning Council (September 18, 2008); Philip M. Lindquist, *Drafting Fiduciary Powers for Trust Protectors and Independent Trustees*, State Bar of Texas 24th Annual Estate Planning & Probate Drafting Course (2013); and Michael W. Johnson, *Drafting for Beneficiaries Acting as Trustees*, State Bar of Texas 24th Annual Estate Planning & Probate Drafting Course (2013).

[11] *See* Jeff Chadwick, *Drafting the Beneficiary Flexible Trust,* State Bar of Texas 25th Annual Estate Planning & Probate Drafting Course (2014).

[12] *See* Leslie Kiefer Amann, *Drafting Distribution Provisions: Mean What You Say and Say What You Mean*, State Bar of Texas 25th Annual Estate Planning & Probate Drafting Course (2014).

[13] As defined in I.R.C. § 672(c). *See* Rev. Rul. 95-58, 1995-2 C.B. 191 (ruling that even if the settlor possessed the power to remove the trustee and appoint an individual or corporate successor trustee that was not related or subordinate to the settlor within the meaning of Code section 672(c), the settlor would not have retained a trustee's discretionary control over the trust).

[14] Tex. Trust Code § 112.059 permits the termination of a trust with a value of less than $50,000 to be terminated because of its uneconomic feasibility. *See* discussion at Section III.Q. below.

The combinations are practically endless, and who should be named depends on the powers given. In any event, and especially if no fiduciary duty is attributable to the separate role, the nominee should be someone implicitly trusted by the settlor.

What is most essential is to draft the respective roles clearly in the document. Nominating someone by simply using terms such as "investment trustee," "distribution trustee," or "trustee advisor" may have certain connotations, but without more explanation, fails to provide a clear legal definition of the division of responsibilities or powers granted.

C. Avoiding Unfavorable Tax Consequences

While a client might be motivated to divide powers among different trustees in order to best use their respective talents, practitioners should address whether a division of powers is needed (or even effective) in order to avoid an unintended tax result to the power holder.

As discussed in this article, many powers may cause inadvertent tax consequences when granted to certain parties. To avoid any unintentional adverse tax consequences, these authors advise including a savings clause in the trust agreement, such as the following:

> *"All powers given to the trustee herein are exercisable by the trustee only in a fiduciary capacity. An individual trustee of any trust created by this trust agreement shall not have any power whatsoever in the determination of accumulation of income, or of distribution (including but not limited to distributions to such individual and distributions in discharge of any legal obligation of such individual) of income or principal, or in the apportionment of receipts and expenses between principal and income, or in the establishment and maintenance of reserves in the trust or any power in any other determination or distribution that would cause undistributed trust principal to be includible in such individual's estate for tax purposes, that would cause such individual to make a gift for tax purposes (whether by reason of a prior disclaimer by such individual, by reason of the making of such determination or distribution, or otherwise), or that would cause trust income to be taxed to such individual (except to the extent such individual receives or is deemed to receive distributable net income as a result of an actual or deemed trust distribution), but such determinations and distributions shall be made in the sole discretion of the other trustee then serving. If there is no other trustee then serving, such power shall not be exercised."*[15]

1. <u>Settlor as Trustee</u>

a. Estate Tax Considerations

The trust, or a portion of the trust, is includible in a settlor's gross estate if: (a) the trust agreement provides the trustee with discretion over either income or corpus; and (b) the settlor is a trustee or co-trustee who can:

- name or change beneficiaries;
- change beneficiaries' shares of income or principal;
- decide whether income should be distributed immediately or accumulated and added to trust principal;
- apply a "sprinkling power" to determine which beneficiaries are to receive income;
- directly invade principal other than by following fixed and ascertainable standards;
- vote shares of stock in a controlled corporation; or
- retain incidents of ownership over life insurance on settlor's life, whether exercisable alone or in conjunction with any other person.[16]

The same holds true if the settlor retains the power to direct the trustee as to how such powers should be exercised or if the settlor has the power to appoint himself or herself as trustee.[17]

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[15] Excerpted, with permission, from Michael W. Johnson, *Drafting for Beneficiaries Acting as Trustees,* State Bar of Texas 24th Annual Estate Planning & Probate Drafting Course (2013).

[16] I.R.C. §§ 2036(a)(2), 2036(b), 2038, and 2042. If the settlor is not a trustee and does not retain the power to change trustees, then the trustee's power to change beneficial interests in the manner described above does not cause inclusion of the trust property in the settlor's gross estate, even if the trustee does not have an interest adverse to the settlor or is in fact subservient to the settlor. Conceivably, a settlor could control who would enjoy the beneficial interest of the irrevocable trust he creates by appointing an individual or corporate trustee who he is confident will adhere to his wishes and direction. This control, however, cannot be written into the trust agreement.

[17] Treas. Regs. §§ 20.2036-1(b)(3) and 20.2038-1(a)(3).

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If the settlor is merely a co-trustee, it is irrelevant under Code sections 2036(a)(2) and 2038 whether the other trustee has a substantial adverse interest.[18] Even if the joint power holder can veto the settlor's decision (*e.g.*, where majority vote controls), Code sections 2036(a)(2) and 2038 still may apply.[19]

b. Gift Tax Considerations

For a settlor to make a completed gift to a trust for gift tax purposes, the most simple and conservative approach is for the settlor to serve as trustee only if the trustee's lone discretion is to accelerate or delay distributions to a single beneficiary with no ability to shift benefits to any other person.[20] Alternatively, the settlor may serve jointly with a trustee who has a substantial adverse interest. Although the Treasury Regulations do not define "substantial adverse interest," most practitioners presume that the principles related to adverse parties for income tax purposes[21] and powers of appointment[22] apply.

2. <u>Beneficiary as Trustee</u>

a. Estate Tax Considerations

It is often a settlor's express desire that the primary beneficiary be the trustee. However, if a person is both a beneficiary and the trustee of the same trust, there is a risk that the trust assets will be included in the beneficiary's estate[23] or that the exercise or non-exercise of a power held as trustee will be treated as a gift by the beneficiary.[24] These results are avoided if none of the powers granted to the beneficiary who is a trustee qualify as a general power of appointment. For a beneficiary who is also a trustee, the following are some of the powers that cause estate tax inclusion:

- distribution power to oneself that is not limited to an ascertainable standard;
- distribution power that can satisfy the beneficiary/trustee's legal obligations or that allows his or her creditors to reach as much as he could distribute to himself or herself;
- ability to terminate the trust;
- power to allocate gains to trust income (*i.e.*, power to shift more in distributions to a mandatory income beneficiary);[25] and
- any administrative powers that can be indirectly used to modify or shift beneficial interests in the trust.

b. Gift Tax Considerations

Gift tax consequences can arise for the beneficiary acting as trustee who has a general power of appointment over the trust assets, meaning an unfettered distribution power in favor of himself, his estate, his creditors, or creditors of his estate.[26] So if the beneficiary exercises or releases the general power, he or she makes a taxable gift.[27]

The beneficiary's exercise of an inter vivos limited power of appointment over trust property may result in a gift if it reduces the pool of assets that might eventually be distributed to the beneficiary, particularly if the power holder also has a mandatory income interest in the trust.[28] If the power holder does not have a mandatory income interest and is only a discretionary beneficiary, it is not clear that a gift would result from an inter vivos exercise of a limited power of appointment. An example in the Regulations concludes that there is no taxable gift under Code section

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[18] This is not the case when analyzing the gift tax treatment of powers held by a settlor (*i.e.*, when determining whether a gift is complete or incomplete), as pointed out below in Section II.C.1.b.

[19] Treas. Reg. § 20.2036-1(b)(3).

[20] For more information on drafting a self-trusteed irrevocable non-grantor trust (aka "STINT"), see Santo "Sandy" Bisignano, Jr., *When the Only One You Trust is Yourself…,* State Bar of Texas 32nd Annual Advanced Estate Planning & Probate Course (2008).

[21] For income tax purposes, an adverse party is defined as a person who has a substantial beneficial interest in the trust that would be adversely affected by the exercise or non-exercise of the power in question. I.R.C. § 672(a). By way of example, a current trust beneficiary is an adverse party.

[22] With relation to powers of appointment, an adverse party is defined as a person who, after the death of the possessor, may be possessed of a power of appointment (with respect to the property subject to the possessor's power) which he or she may exercise in his or her own favor. I.R.C. § 2514; *see also* I.R.C. § 2041.

[23] I.R.C. § 2041.

[24] I.R.C. § 2514.

[25] Note, however, Texas' Uniform Principal and Income Act does not permit a beneficiary who is serving as trustee to allocate gains to income under the statute. Tex. Trust Code § 116.005(c)(6).

[26] I.R.C. § 2514(c).

[27] I.R.C. § 2514(b).

[28] Treas. Reg. § 25.2514–1(b)(2).

2514 if the power holder is entitled to receive distributions under an ascertainable standard and exercises a limited power of appointment in favor of his children.[29] However the Regulations do not address whether the power holder has made a gift under the general gift principles of Code section 2511. Note that the issue of exercising a limited power of appointment may not directly impact the selection of trustees, for the holder of the limited power of appointment has the same potential gift tax consequences whether or not he or she is the trustee.

In contrast, the Regulations indicate that a trustee with a beneficial interest in the trust does not make a gift if he distributes trust property to another beneficiary under a fiduciary power limited by a "reasonably fixed or ascertainable standard."[30] The implication is that if a beneficiary acting as trustee makes a distribution that is not subject to an ascertainable standard to another beneficiary, a gift results. Additionally, if a beneficiary has an ascertainable interest under the trust and fails to enforce those rights, a taxable gift may result.[31]

D. Other Warranted Situations

The following outlines several situations that may warrant a special trustee, be it an entity or an individual. The examples presented are non-exhaustive and focus mostly on ensuring the purposes of the trust are fulfilled.

1. Self-Dealing

In situations that call for a trustee to act in more than one capacity,[32] practical and legal self-dealing issues arise. The Texas Trust Code prohibits a loan of trust funds to the trustee or an affiliate;[33] a director, officer, or employee of the trustee or an affiliate; a relative of the trustee;[34] or the trustee's employer, employee, partner, or other business associate.[35] Similarly, it prohibits a purchase or sale of property by or to this same class, with a few specified exceptions,[36] and prohibits a sale of property from one trust to another having the same trustee unless the property is sold for its current market price and fully guaranteed,[37] as well as the purchase of the trustee's securities.[38] While these restrictions can be waived in the trust agreement,[39] a settlor may find it more palatable to give another person the authority to approve an otherwise prohibited self-dealing transaction.

2. Creditor Concerns and Forced Distributions

Separate and apart from being includable in a beneficiary's estate when creditors can be satisfied from trust assets (*e.g.*, under a general power of appointment), a settlor may be concerned that a beneficiary who is a trustee could become insolvent (or near that point) and distribute to himself over and above what the settlor had intended. In such a situation, a settlor may want to appoint another to be able either to turn off a beneficiary/trustee's ability to distribute to himself (even under otherwise ascertainable standards) or to change beneficiaries.

Similarly, a settlor may want an independent trustee to be able to make distributions with absolute discretion to avoid giving a beneficiary (or his or her creditors) the ability to compel distributions. This power is more protective if there is more than one beneficiary.

3. Provide Permanence and Availability of Trustees

Often, the settlor is most comfortable naming his or her trusted friends and advisors who belong to the same generation as trustee and successor trustees. In order to provide for the continuity of trustees without the need for court action,[40] one approach is to designate a "trustee appointer" or give an outgoing trustee the power to name his or

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[29] Treas. Reg. § 25.2514–3(e) Ex. 2.
[30] Treas. Reg. § 25.2511–1(g)(2).
[31] For further discussion, *see* III.A of Steve R. Akers, *Structuring Trustee Powers to Avoid a Tax Catastrophe,* Denver Estate Planning Council (September 18, 2008).
[32] An example would be a trustee who is purchasing assets from related or affiliated parties.
[33] An "affiliate" is: (a) a person who directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with another person; or (b) any officer, director, partner, employee, or relative of a person, and any corporation or partnership of which a person is an officer, director, or partner. Tex. Trust Code § 111.004(1).
[34] "Relative" includes a spouse or, by blood or adoption, an ancestor, descendant, brother or sister, or spouse of any of them. Tex. Trust Code § 111.004(13).
[35] Tex. Trust Code § 113.052.
[36] Tex. Trust Code § 113.053.
[37] Tex. Trust Code § 113.054.
[38] Tex. Trust Code § 113.055.
[39] Tex. Trust Code § 113.035.
[40] Under the Texas Trust Code, the court may appoint a successor trustee as a result, and the court shall appoint a successor trustee on the petition of an interested party. Tex. Trust Code § 113.083(a).

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her own successor or successors. The planner can use these provisions in lieu of another specified succession method, but if it is in addition to another succession provision, the hierarchy of appointments should be clearly specified.

The settlor can be the trustee appointer (and remover) without estate tax inclusion.[41] Of course, to fully achieve continuity of trusteeship without a vacancy, someone should be given the appointment power after settlor's death or incapacity.

4. Out-of-State Trustee

If the client wants a dynastic asset protection trust that is not subject to the rule against perpetuities and is generally protected from creditor claims, it may be necessary to require that there always are sufficient trustees residing in the state whose law is being utilized. The various states allowing for such trusts have differing laws regarding trustee selection in order to take advantage of its laws.[42]

Texas law permits a Texas trustee to name in writing an individual or corporation qualified to act in a foreign jurisdiction in which trust property is situated to serve as "ancillary trustee."[43] The Texas trustee has the power (within the limits given to the Texas trustee in the trust agreement) to delegate to the ancillary trustee those rights, powers, discretions, and duties as specified in the instrument appointing the ancillary trustee.[44] If, however, the law of the foreign jurisdiction requires a certain procedure or a judicial order for the appointment of an ancillary trustee or to authorize an ancillary trustee to act, the Texas trustee and the ancillary trustee must satisfy those requirements.[45]

5. Foreign Trust Treatment

A trust is a foreign trust unless a U.S. court is able to exercise primary supervision over the trust administration and one or more U.S. persons have the authority to control all substantial decisions of the trust.[46] Accordingly, the selection of a non-U.S. trustee can cause foreign tax treatment. Unless the client purposefully wants the trust to be a foreign trust, no foreign person (anyone other than a U.S. citizen or resident or a U.S. domestic corporation) should be appointed as the trustee with the power to control any substantial decisions. Likewise, any non-U.S. persons should comprise less than half of the trustees, and no decisions should be left specifically in their control.

6. Qualified Domestic Trust ("QDOT")

The estate tax marital deduction generally is not available to a decedent if his or her surviving spouse is not a U.S. citizen unless property passes to the non-U.S. spouse in a QDOT.[47] To qualify as a QDOT, the trust agreement must provide that at least one trustee be an individual citizen of the U.S. or a domestic corporation.[48] That trustee must also have the right to withhold from principal distributions the tax imposed on the trust under the Code.[49]

Additionally, QDOTs with assets in excess of $2 million must (1) have a bank as the U.S. trustee, (2) furnish a bond to the IRS in an amount equal to 65% of the fair market value of the trust assets, or (3) furnish an irrevocable letter of credit in an amount equal to 65% of the fair market value of the trust assets.[50] QDOTs with assets of $2 million or less must either meet the requirements that apply to QDOTs with assets in excess of $2 million, or provide that no more than 35% of the fair market value of the trust assets may consist of real property located outside the U.S.[51]

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[41] Even if a settlor possesses the power to remove a trustee and appoint an individual or corporate successor trustee (other than himself) who is not related to or subordinate to him within the meaning of Code section 672(c), the settlor has not retained discretionary control over trust income so as to cause estate tax inclusion. Rev. Rul. 95-58, 1995-2 C.B. 191.

[42] For example, Rhode Island requires all trustees to be a resident or authorized to do business in the state, while Delaware and Alaska require only one trustee to be a resident.

[43] Tex. Trust Code § 113.023(a). The Texas trustee may remove an ancillary trustee and appoint a successor at any time as to all or part of the trust assets. *Id*. at § 113.023(c). Additionally, the Texas trustee may require security of the ancillary trustee. *Id*. at § 113.023(d).

[44] Tex. Trust Code § 113.023(b).

[45] Tex. Trust Code § 113.023(e).

[46] I.R.C. §§ 7701(a)(30)(E), (31)(B).

[47] I.R.C. § 2056A.

[48] Unless waived by the IRS under its regulatory authority granted for estates of decedents dying after August 5, 1997. Taxpayer Relief Act of 1997.

[49] I.R.C. § 2056A(b)(6).

[50] Treas. Reg. § 20.2056A-2(d)(1)(i). The QDOT may alternate among any of those three arrangements provided that, at any given time, one of the arrangements must be operative. *Id*.

[51] Treas. Reg. § 20.2056A-2(d)(1)(ii).

7. Grantor Trust Rules

A trust is a grantor trust for income tax purposes if the settlor or a nonadverse party[52] holds a power of disposition over trust assets.[53] While various statutory exceptions can negate grantor trust treatment, the general rule will not apply if no more than half of the trustees are related or subordinate parties who are subservient to the settlor's wishes and who have the power to distribute or accumulate income or corpus for a class of beneficiaries.

A client may desire grantor trust status for income tax purposes, but not want retained powers that could also risk estate tax inclusion. Although there is guidance as to avoiding the inclusion of the trust assets for estate tax purposes when allowing the settlor to retain powers in trusts holding life insurance on the settlor's life,[54] giving a third party the power to substitute property of equivalent value in a non-fiduciary capacity may be desirable when the trust owns stock in a controlled corporation.[55]

A trust that is initially a grantor trust but can be "toggled off" may be desirable when the grantor initially wants grantor trust status but is concerned about being indefinitely liable for the trust's income and capital gain taxes. In that situation, giving the settlor the authority to relinquish the power that causes grantor trust status can be coupled with a third party's authority to reinstate the power.[56]

III. A CLOSER LOOK AT THOSE SPECIAL POWERS (AND JUST WHAT'S SO SPECIAL ABOUT THEM?)

Some powers that may be granted supplement those automatically granted by the Texas Trust Code or by common law (unless the trust agreement specifically states otherwise). Other powers are merely a division of power between the "main" trustee or trustees and a "special" power holder or committee. This Section III discusses several such supplemental and bifurcated powers.

When granting any power, the drafter should consider: (a) what the power is; (b) why the power is being granted; and (c) who should and should not be given the power for tax and non-tax reasons.

A. Power to Demand Trust Accountings and Records

1. What is the Power?

Though the Texas statute giving rights to beneficiaries to demand accountings is fairly extensive,[57] it still has its limits, particularly for mere interested persons who are not trustees or beneficiaries and for those beneficiaries who may need additional assistance with their affairs.

A "beneficiary" can make a written demand to the trustee to deliver to each trust beneficiary within 90 days a written statement of accounts covering all transactions since the last accounting or since the creation of the trust, whichever is later.[58] The Trust Code further provides than an "interested person" may file suit to compel the trustee to account to the interested person…"on finding that the nature of the interest in the trust of, the claim against the trust by, or the effect of the administration of the trust on the interested person is sufficient to require an accounting by the trustee."[59]

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[52] A "nonadverse party" is any person who is not an "adverse party." I.R.C. § 672(b); Treas. Reg. § 1.672(b)-1. For purposes of the grantor trust rules, an "adverse party" is a person having a substantial beneficial interest in the trust that would be adversely affected by the exercise or non-exercise of a power he possesses respecting the trust. I.R.C. § 672(a).

[53] I.R.C. § 674(a).

[54] *See e.g.*. Rev. Rul. 2008-22, 2008-16 I.R.B. 796 (ruling that the settlor's power to substitute assets, held in a non-fiduciary capacity, would not result in estate tax inclusion under either Code section 2036 or Code section 2038 of the trust assets in the settlor's estate); Rev. Rul. 2011-28, 2011-49 I.R.B. 830 (ruling that the settlor's power to substitute assets in a life insurance trust, held in a non-fiduciary capacity, is not an incident of ownership that could cause estate tax inclusion of the policy proceeds in the settlor's estate). *See also* discussion at Section III.H. below.

[55] *See* discussion at Section III.L. below.

[56] *See* discussion at Section III.E. below.

[57] Tex. Trust Code § 113.151.

[58] Tex. Trust Code § 113.151(a). "Beneficiary" means a person for whose benefit property is held in trust, regardless of the nature of the interest. *Id*. § 111.004(2).

[59] Tex. Trust Code § 113.151(b). "Interested person" means a trustee, beneficiary, or any other person having an interest in or a claim against the trust or any person who is affected by the administration of the trust. Whether a person, excluding a trustee or named beneficiary, is an interested person may vary from time to time and must be determined according to the particular purposes of and matter involved in any proceeding. *Id*. § 111.004(7).

A trust agreement cannot limit a trustee's duty to respond to an accounting demand if it is from a beneficiary of an irrevocable trust who is entitled or permitted to receive distributions from the trust or would receive a distribution from the trust if the trust terminated at the time of the demand.[60]

2. Why Grant the Power?

Giving a third person the power to demand accountings and information from a trustee is helpful in many cases, but primarily adds clarity for everyone involved so that no one needs to be concerned whether the person is "interested" enough to make the demand. One common instance may be to name someone to make accounting demands on behalf of a beneficiary who cannot oversee a trustee on his or her own, such as an incapacitated adult trust beneficiary who may not have a legal guardian or an attorney-in-fact.[61] Anyone holding a removal power,[62] especially if it can only be exercised for cause, should also have this power. Further, a settlor may only be comfortable making an inter vivos gift to a trust if he or she can demand an accounting, or a settlor may want this power to judge whether the trustee should be appointed as a fiduciary for future trusts or executor of his or her estate. The power to demand accountings could also be granted among co-trustees who are handling different aspects of the trust administration (*e.g.*, a trustee who is managing an active business may be keeping separate accounts).[63]

Whether the trust agreement grants the power to a beneficiary or a third party, the trust agreement should also clarify:

- what information the demanding party is entitled to receive (*i.e.*, not just a listing of transactions and account balances,[64] but the underlying documents, such as leases, banking records, contracts to purchase or sell, 1099s, K-1's, and tax returns);
- whether a demand can be made more often than annually and whether the accounting must be provided sooner than the statutory 90 days;
- how the demand can be made (*e.g.*, by email);
- whether the trust pays for any costs related to complying with the demand or whether the demanding party is required to pay;
- whether the demanding party can delegate his or her demand power to another and/or appoint his or her successor;
- when and whether a failure to timely respond to the demand is tantamount to a breach of trust and a removal for cause of the trustee;
- whether a failure forfeits the trustee's fee and for what period of time and/or whether a late response results in the trustee personally paying a fee for each late day to the trust;
- whether the acceptance (or a deemed acceptance) of an accounting is binding and conclusive on all persons who may currently or thereafter have an interest in the trust such that they cannot later contest a disclosed transaction; and
- whether responding in good faith to a request for information and records fulfills the trustee's duty of full disclosure.[65]

3. Who Can Hold the Power?

The settlor, any adult person, or any corporate fiduciary could have the power to demand an accounting and trust records. If the instrument allows the power holder to delegate and/or appoint his or her successor, the settlor may want to specify those persons to whom the power cannot be delegated or in what instances such delegation becomes void (*e.g.*, a power delegated to a now ex-spouse).

[60] Tex. Trust Code § 113.151.
[61] *See* discussion at Section III.R below.
[62] *See* discussion at Section III.C below.
[63] As permitted by section 116.153 of the Texas Trust Code.
[64] As permitted by section 113.152 of the Texas Trust Code.
[65] *See e.g.,* Jeffrey T. Knebel and Jason S. Scott, *The Fiduciary Duty of Full Disclosure: Knowing When and What to Disclose*, State Bar of Texas 36th Annual Advanced Estate Planning & Probate Course (2012); and Frank N. Ikard, Jr., *Trustee's Duties to Disclose Information to Beneficiaries*, State Bar of Texas 32nd Annual Advanced Estate Planning & Probate Course (2008).

4. Who Should Not Hold the Power?

The power to obtain trust information does not cause estate tax inclusion in the power holder's estate because it is not a direct or indirect way to control beneficial enjoyment.[66] Conceivably, therefore, anyone the settlor wishes, including himself, could hold this power.

B. Power to Appoint a Successor Trustee

1. What is the Power?

The Texas Trust Code has its limits with regard to the appointment of successor trustees. The statute requires a petition to the court by an interested person to appoint a successor trustee in the event of the death, resignation, incapacity, or removal of a sole or surviving trustee where no method is prescribed in the trust agreement.[67] If for any reason a successor is not selected under the terms of the trust agreement, a court may, and on petition of any interested person shall, appoint a successor trustee.[68] If a vacancy occurs in the number of trustees originally appointed under a valid charitable trust agreement which does not provide for the filling of a vacancy, the remaining trustees may fill the vacancy by majority vote.[69]

2. Why Grant the Power?

In order to avoid any prolonged vacancy, the trust agreement should provide at least some method to perpetuate the appointment of a trustee. Such provisions become particularly useful with the prevalence of long-term trusts and the popularity of having a removal power.[70] Furthermore, trusts deemed "problematic" by one trustee who decides to resign could likely have the other listed trustees follow suit and decline to serve, leaving no one named in the trust agreement. Similarly, if only corporate trustees are named, and the trust becomes too small to justify their fees, the ability to name an individual trustee without court action becomes vital.

If someone is allowed (or required) to select a corporate trustee, it is common to include language in the trust that qualifies the corporate fiduciary. For example, the settlor may require that the capital and surplus of the corporate fiduciary be of a minimum amount. Except for the deliberate offshore trust, most clients additionally prefer a trust be situated in the U.S. so that it is clearly governed by federal law and regulations.

The settlor also should consider whether to waive any bond requirement for successor individual trustees,[71] particularly when they may be appointed by someone other than the settlor and could be a stranger to the settlor.[72] Requiring a bond may provide a level of comfort to a settlor to ensure that if the trustee does make errors, there is some type of insurance to compensate the beneficiaries.

3. Who Can Hold the Power?

Under state law, there are no major constraints as to who can serve as a trustee and, therefore, who can hold the power to appoint a trustee. A trustee must have the legal capacity to take, hold, and transfer the trust property, and, if the trustee is a corporation, it must have the power to act as a trustee in Texas. Further, except when legal and equitable titles are held by the same person,[73] the fact that the person named as trustee is also a beneficiary does not disqualify the person from acting as trustee if he or she is otherwise qualified. The settlor of a trust may also be the trustee of the trust.[74]

As a general rule, then, a settlor, resigning trustee, a beneficiary, third person, or a committee could have the power to appoint one or more successor trustees, including himself or herself. Nevertheless, the settlor needs to consider who will best utilize the power to give effect to the intent of the trust and maintain its integrity. The drafter, in conjunction with the settlor, should next consider whether any particular persons should be specifically excluded as possible appointees (*e.g.*, the settlor himself or his spouse, a beneficiary, a beneficiary's parent who is not a descendant of settlor, or a beneficiary's spouse or significant other) and whether the trustee appointer may name

[66] I.R.C. §§ 2036, 2038, 2041, 2042.
[67] Tex. Trust Code § 113.083(a).
[68] *Id*.
[69] Tex. Trust Code § 113.083(b).
[70] *See* discussion at Section III.C. below.
[71] Unless the trust agreement provides otherwise, a non-corporate trustee must give bond, but a corporate trustee is not required to provide a bond. Tex. Trust Code § 113.058(a).
[72] Tex. Trust Code § 113.058(b).
[73] Tex. Trust Code § 112.034.
[74] Tex. Trust Code § 112.008.

successor trustees before the need arises. Unless otherwise provided in the trust agreement, the successor trustee has the rights, powers, authority, discretion, and title to trust property conferred on the original trustee.[75]

4. Who Should Not Hold the Power?

a. Estate Tax Considerations for the Settlor

Despite being permissible, great care should be exercised to avoid creating an adverse tax effect when giving the settlor or certain beneficiaries the power to appoint a trustee.

The settlor will be treated as possessing the same dispositive and management powers held by the trustee if the settlor can appoint himself as the trustee at any time.[76] Even if the settlor has a contingent power to appoint himself as trustee upon the occurrence of an event that is out of his or her control, such power will cause the inclusion of the trust assets for estate tax purposes in the settlor's estate.[77] For instance, if the original trustee has the right to designate persons who can possess trust property and income and the settlor can designate himself as a successor trustee, the right of the trustee to designate beneficiaries would be attributed to the settlor. Furthermore, the ability of the settlor to add oneself as a co-trustee would be just as damaging as being able to become sole trustee, unless the trust agreement properly reserves the problematic power to the non-settlor co-trustee.[78] On the other hand, if the settlor merely has the power to add other persons as co-trustees, he or she generally should not be treated as holding the powers of the trustee. Additionally, since 1995, there is a clear safe harbor which provides that trust assets will not be includible in a settlor's estate if the settlor can remove a trustee, so long as he or she cannot appoint a successor trustee who is related or subordinate to him.[79]

If the settlor decides to keep a more expansive ability to appoint others as successor trustees who would not come within the safe harbor rule (*e.g.*, relatives), the drafter likely would include the following language: "A trustee would violate its fiduciary duty if it acquiesced in the wishes of the settlor by taking action that the trustee would not otherwise take."[80]

When the trust is a self-trusteed irrevocable non-grantor trust (also known as a "STINT"), it is carefully crafted to permit the settlor to serve as the trustee without causing estate tax inclusion. As a general rule then, the settlor of a STINT can retain a broad power to remove and appoint a trustee. However, just as the settlor of a STINT should not be given certain tax sensitive powers, the otherwise unlimited power of the settlor to hire and fire a trustee should not be exercisable over a special purpose trustee who holds sensitive powers, such as powers over life insurance, the power to vote stock of a closely held corporation, or the power to terminate a trust.[81]

b. Income Tax Considerations for the Settlor

The settlor's power to remove, substitute, or add trustees (other than a power exercisable only upon limited conditions which do not exist during the taxable year, such as the death or resignation of, or breach of fiduciary duty by, an existing trustee) may cause the trust to be a grantor trust for income tax purposes.[82] For example, if a settlor has an unrestricted power to remove an independent trustee and substitute any person including himself as trustee, the trust will not qualify as a non-grantor trust.[83]

On the other hand, the planner could draft the trust agreement so that the settlor is prohibited from exercising the power to remove, substitute, or add trustees in a manner that would disqualify the trust from being a grantor trust under the grantor trust exceptions.[84] For example, a power in the grantor to remove or discharge an independent

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[75] Tex. Trust Code § 113.084.

[76] Treas. Regs. §§ 20.2036-1(b)(3) and 20.2038-1(a)(3).

[77] I.R.C. § 2036(a).

[78] I.R.C. §§ 2036 and 2038 apply to powers held jointly with someone else.

[79] Rev. Rul. 95-58, 1995-2 C.B. 191; *see also* I.R.C. §§ 2036, 2038. A related or subordinate party is any nonadverse party who is either: the grantor's spouse, if living with the grantor; the grantor's father, mother, brother, or sister; issue of the grantor; 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; or a subordinate employee of a corporation in which the grantor is an executive. I.R.C. § 672(c).

[80] *See Estate of Wall v. Comm'r*, 101 T.C. 300, 312 (1993); *see also Estate of Vak v. Comm'r*, 973 F.2d 1409 (8th Cir. 1992) (where the court rejected IRS' argument that donor had the power to replace trustees with those who would do his bidding).

[81] *See* Santo "Sandy" Bisignano, Jr., *When the Only One You Trust is Yourself…*, State Bar of Texas 32nd Annual Advanced Estate Planning & Probate Course.

[82] Treas. Reg. § 1.674(d)-2.

[83] *See* I.R.C. §§ 674(c), (d).

[84] I.R.C. §§ 674(c), (d).

trustee on the condition that he or she substitute another independent trustee will not prevent a trust from qualifying as a grantor trust under Code section 674(c).[85]

c. Estate Tax Considerations for the Beneficiary

Commonly, the power to remove and replace the trustee is granted to the trust beneficiaries (at some point in the trustee appointer succession). For a beneficiary to have the power to appoint a successor trustee, however, care must be given where the trustee's powers are akin to a general power of appointment if held by the beneficiary. When a beneficiary has the power at any time to appoint himself as trustee or co-trustee (unless the other co-trustee has a substantial adverse interest[86] in the trust), the beneficiary will be treated as holding the powers of the trustee. Therefore, if the power of the trustee to make distributions to beneficiaries is limited to an ascertainable standard, and if the trustee is precluded from making distributions in satisfaction of his or her own obligation to support a beneficiary, there is no estate inclusion problem for the beneficiary, regardless of who serves as trustee.[87] On the other hand, if the trustee's distribution authority is not limited to an ascertainable standard, the ability of a beneficiary to remove and replace trustees can give the beneficiary a general power of appointment. However, the beneficiary is not deemed to hold a power of appointment if he or she only has the power to appoint a successor, including himself or herself, under limited conditions which did not exist at the time of his or her death, without an accompanying unrestricted power of removal.[88] It is of note that section 113.029 of the Texas Trust Code offers a savings provision by restricting a discretionary distribution power held by a beneficiary who is a trustee (other than the settlor) to an ascertainable standard.[89]

C. Power to Remove a Trustee

1. What is the Power?

Unless the terms of the trust agreement provide for a trustee's removal, court action is needed. An exception, mentioned above, is that a Texas trustee automatically has the authority to remove an ancillary trustee and appoint a successor at any time as to all or part of the trust assets.[90]

Removal by the court, on the petition of an interested person and after hearing, requires a finding that: (1) the trustee materially violated or attempted to violate the terms of the trust and the violation or attempted violation results in a material financial loss to the trust; (2) the trustee became incapacitated or insolvent; (3) the trustee failed to make an accounting that is required by law or by the terms of the trust; or (4) the court finds other cause for removal.[91]

2. Why Grant the Power?

The terms of a trust cannot limit the court's power to remove a trustee.[92] However, the terms of a trust can set forth removal procedures and ultimately grant someone the power to remove a trustee at any time, thereby avoiding the need for an expensive and prolonged court proceeding and the need to prove (or even allege) a trustee's incapacity, insolvency, or breach. Avoiding a court proceeding also may temper the animosity created by a proceeding.

Most often, the power to remove is granted in trust agreements where corporate trustees are appointed (or required). Clients realize that corporate trustees often undergo changes over the lifetime of a trust and, therefore, want to give someone the flexibility to remove one and appoint another. A settlor may also need the ability to protect an offshore trust against geopolitical events.[93]

Removal of a trustee by an individual should not be tied to a termination "for cause." This creates a level of difficulty that the power is designed to avoid in the first place. "Cause" is difficult to define and more difficult to

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[85] Treas. Reg. § 1.674(d)-2(a).

[86] An "adverse party" is defined as "any person having a substantial beneficial interest in a trust that would be adversely affected by the exercise or nonexercise of a power he possesses respecting the trust." I.R.C. § 672(a).

[87] The drafter should be mindful of restrictions that need to be in place to avoid estate tax inclusion in the insured's estate if the trust owns an insurance policy on the beneficiary's life. *See e.g.,* I.R.C. § 2042.

[88] Treas. Reg. § 20.2041–1(b)(1).

[89] Tex. Trust Code § 113.029(b).

[90] Tex. Trust Code § 113.023(c).

[91] Tex. Trust Code § 113.082(a).

[92] Tex. Trust Code § 111.0035(b)(5).

[93] *See* discussion at Section III.D below. If a power to remove is used in such a situation, it is important to dovetail this power with the power to change the trust situs and governing law.

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enforce. Frankly, the power holder may not have cause for the removal, but may simply not like the trustee for one reason or another. That said, it is commonplace for a settlor to want to name a special trustee or trust committee to have the ability to remove an individual trustee upon that person's or committee's own finding of incapacity or at least a simpler, well-defined procedure to determine that the trustee is no longer fit to serve. When the power to remove is unfettered, the settlor may want to consider limiting its exercise to once a year or some other specified time period.

3. Who Can Hold the Power?

Generally, a settlor, a beneficiary, a third person, or a committee can hold the power to remove a trustee. The settlor needs to consider who will best utilize the power to give effect to the intent of the trust and maintain its integrity.

4. Who Should Not Hold The Power?

Refer to the discussion above in Section III.B regarding removal powers when coupled with the power to appoint oneself. Though there is no definite authority where the settlor or beneficiary holds only a power of removal (other than a smattering of private letter rulings bereft of factual information or containing peculiar facts), there should be no estate tax inclusion if:

- the power to remove is only exercisable for cause;
- the trustee does not hold powers that would cause estate inclusion if the settlor (or beneficiary) held the powers directly; or
- the successor trustee (or the person with the power to choose the successor trustee) falls within the safe harbor of Revenue Ruling 95-58.

D. Power to Change Situs and Governing Law

1. What is the Power?

When including the power to change the situs and the governing law, the planner must understand that simply moving the situs from one state (or country, in the case of offshore trusts) does not automatically result in a change in the governing law. For example, trust agreements typically provide that the validity, construction, and administration of the trust will be governed by the law of a specific state. If the trust so provides, moving the situs will not change the governing law. Therefore, if one includes the ability to change the trust situs, the corresponding power to change the governing law also should be included in the trust agreement. An alternative drafting choice is to include a provision that the trust will be governed by the law of the jurisdiction where the trust is administered or has its situs. To ensure that the trust agreement provides the most flexibility, it may be best to include the power to change the situs and governing law, as well as include the provision that the trust will be governed by the laws of the jurisdiction in which it is sitused.

2. Why Grant the Power?

The ability to change the governing law and trust situs provides flexibility to address unanticipated changes in the law of the trust's jurisdiction, dissatisfaction with the current trustee (*i.e.*, an expensive, non-responsive, or maleficent trustee), or economic or political unrest in the trust's jurisdiction. The latter issue generally is seen as more of a concern with offshore trusts, but given the recent economic troubles of many states in the United States, a trust could become subject to a higher state income tax, which could prompt the desire to move the trust to a jurisdiction with a lower income tax rate. Additionally, some states impose a state income tax on trusts based on the residency of the trustee or where the trust administration occurs. Although a planner may advise on the initial administration of the trust, over time, an individual trustee may move to an unfavorable jurisdiction or a successor trustee may take office in an unfavorable jurisdiction. Changing the governing law also may permit the trustee to take advantage of more favorable statutes in the new jurisdiction, such as providing decanting ability, reformation ability, better creditor or spendthrift protection, shortening (*i.e.*, terminating) or extending the trust's duration,[94] or avoiding the appointment of a guardian ad litem by choosing a jurisdiction that provides for virtual representation.[95] Changing

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[94] If this is a goal of changing the situs and governing law, the planner should be aware of the Delaware tax trap (discussed below at III.N).

[95] Texas permits virtual representation of a minor by his or her parent, if there is no conflict of interest and no guardian of the estate or guardian ad litem has been appointed. Tex. Trust Code § 115.013(c)(3). Additionally, an unborn or unascertained person who is not otherwise represented can be represented by another party having a substantially identical interest in the proceeding. *Id.* § 115.013(c)(4). While the Texas statute requires a parent to act on behalf of his or her children or another party

the situs may allow the consolidation of multiple trusts in a single jurisdiction, or allow a trust to qualify for diversity jurisdiction so that a matter may be litigated in federal district court.

In short, moving a trust under provisions included in the trust agreement precludes the necessity of a court action to move the trust and correspondingly remove and replace the trustee. In many cases, not only is a petition required in the original jurisdiction, but the new jurisdiction also may require a petition seeking the court's approval of the transfer of situs and acceptance of the trust.

3. Who Should or Should Not Hold the Power?

The transfer of the trust's situs and governing law often results in the need for a different trustee located in the new jurisdiction. Thus, if a planner includes such powers in the trust agreement, it is wise to ensure that someone or some entity has the ability to remove and replace the trustee.

In many instances, a protector is given the power to change the situs and governing law, as well as given the power to remove and replace the trustee. The planner will recall that the power to remove and replace a trustee related or subordinate to himself or herself should not be given to the settlor or a beneficiary to avoid unfavorable tax consequences.[96]

E. Power to Re-grant Powers Held by Settlor

1. What is the Power?

Another tool that a planner may want to employ is granting a special trustee or protector the ability to re-grant a power the settlor has relinquished. By way of example, if a trust agreement is drafted as a grantor trust, provisions allowing the grantor trust provisions to be "toggled off" in the future permits further flexibility if the grantor later decides that the income tax burden of the trust has become or will be too great. In this instance, the grantor could relinquish all powers that would otherwise trigger grantor trust status, such as any power held in a non-fiduciary capacity. However, because most trusts are not drafted so that the powers, once toggled off, can be toggled back on, the decision to toggle off grantor trust status should not be taken lightly and instead should be made only after a careful analysis of the facts and circumstances.

2. Why Grant the Power?

To provide flexibility to trust agreements that allow certain powers to be toggled off and provide a solution when a party makes a misinformed decision to toggle off or inadvertently toggles off a power, some planners include in provisions in their agreements giving a third party the power to re-grant (or toggle on again) the power. That said, these authors advise exercising extreme caution when including such a provision given the Service's unfavorable view of the toggling on and off of grantor trust powers.[97]

3. Who Should or Should Not Hold The Power?

If a drafter decides to include such a provision, then the settlor should not be given the power because if the settlor has both the ability to relinquish the power and turn it back on, then the relinquishment is not given effect.[98] Furthermore, the settlor's retention of the ability to toggle on and off grantor trust status might result in an incomplete gift or cause inclusion of the trust assets in the settlor's estate.

Although a nonadverse party may hold the power to re-grant a power in certain instances, the drafter should carefully analyze the grantor trust rules to determine in which instances using a nonadverse power holder is advisable. The most conservative approach, however, is to not grant the power to a nonadverse party.

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with a substantially identical interest to act on behalf of an unborn or unascertained person, Texas case law is broader. *See e.g.*, *Mason v. Mason*, 366 S.W.2d 552 (Tex. 1963) (holding that a trustee properly virtually represented three minor unnamed beneficiaries because the beneficiaries' interest was not in conflict with the trustee's interest). The *Mason* case thus applies the doctrine of virtual representation outside the context of beneficiaries representing other beneficiaries. The court ruled that the trustee virtually represented the beneficiaries in a suit challenging the validity of the trust. *Id*.

[96] *See* I.R.C. § 672(c) for definition. *See* III.B and III.C above for discussion.

[97] *See* Notice 2007-73, 2007-34 I.R.B. 435; Notice 2009-55, 2009-31 I.R.B. 1. The 2007 Notice identifies a type of transaction involving the toggling on and off of grantor trust status, and substantially similar transactions, as transactions of interest. Specifically, it describes three situations that allow the trust grantor to claim a tax loss greater than his or her actual economic loss, or to avoid the recognition of capital gain. The 2009 Notice includes a warning that the toggling on and off of grantor trust status continues to be considered a transaction of interest subject to penalties for non-compliance.

[98] Treas. Reg. § 1.675-1(a).

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F. Power Relating to Dispute Resolution

1. What is the Power?

A dispute resolution power entails giving a third person or a committee the authority to resolve disputes between trustees and beneficiaries[99] and/or to resolve differences of opinion between co-trustees.

The trust agreement might define "dispute" openly. It could be a difference in opinion relating to whether to make a distribution or how much, whether to allocate a receipt or disbursement to income or principal (when the statute or trust agreement allows for such discretion), investment decisions, lease, purchase, or sale terms, or setting the amount of the trustee's fee.

2. Why Grant the Power?

Granting powers to resolve disputes between trustees and beneficiaries can prove beneficial in avoiding the alternatives of court action (assuming the dispute is justiciable) or putting the trustee in an unenviable position where his or her own judgment will create discord regardless of his or her decision. The power holder could serve as a tie breaker between two co-trustees who differ in opinion and could act when the trustee has a conflict of interest. Both scenarios commonly arise in a marital trust for a second spouse when the spouse and her stepchild are serving as co-trustees or when either of them is serving as sole trustee.

Consideration should be given to whether the power holder will be compensated, whether an exoneration clause will apply, or whether he or she is to be considered a fiduciary. The provisions also should state how the issue is to be brought to the power holder's attention and whether he or she can decline to act on a case-by-case basis.

3. Who Can Hold the Power?

The better question here is who *should* hold the power. There is no restriction or limit as to whom and how many the settlor can grant this power. The initial appointment and provisions for successors should be clear. Ultimately, the settlor needs to be comfortable with the role he or she is creating, and the power holders need to be comfortable with the role they are accepting. The settlor should consider candidates who, among other traits, have or can gain knowledge of the settlor's family affairs (both the economics and personal dynamics), show a history of being able to analyze the issues at hand and make informed decisions with good results, and have a good personal investment history and sound business background.

4. Who Should Not Hold the Power?

It is impractical to name the settlor or a person who is (or could be) a beneficiary when the role naturally calls for independent, unbiased judgment. Further, the power could cause estate tax inclusion for a settlor or a beneficiary if it is deemed broad enough to change beneficial interests or qualify as a general power of appointment.

G. Power to Value Unmarketable Assets[100]

1. What is the Power?

Granting the power to value unmarketable assets may include the power to appoint a third person or a committee to assign a value to assets or to retain an independent, professional appraiser at the expense of the trust estate to value certain trust assets.

2. Why Grant the Power?

In situations where values may not be readily available, giving a third person or a committee powers to value trust property saves the parties time and expense and protects the trustee from liability. The power benefits a trustee whenever the trustee's right to determine the value of property may be self-serving, produce a conflict of interest, or cause adverse tax issues.

The need most often arises where the trust owns an interest in a closely held business, but could be utilized for real property interests and other assets if the settlor desires to provide for an informal evaluation by an unbiased person. For example, some clients and their families may desire a special trustee when the assets are sentimental, but not technically "unmarketable."

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[99] *See Rachal v. Reitz*, 403 S.W.3d 840 (Tex. May 3, 2013) (arbitration provision under the Texas Arbitration Act in an inter vivos trust was enforceable against a trust beneficiary).

[100] Unmarketable assets are assets that are not cash, cash equivalents, or other assets that can be readily sold or exchanged for cash or cash equivalents. For example, unmarketable assets include real property, closely-held stock, and an unregistered security for which there is no available exemption permitting public sale. *See* Treas. Reg. § 1.664-1(a)(7)(ii).

The power also can be utilized when the trustee has the power to divide the assets on a non-fractional basis among beneficiaries at the trust's termination. A different, weightier instance may be where an annual unitrust payment is to be calculated. Most notably, a charitable remainder trust ("CRT") needs to contain provisions for the valuation of unmarketable assets to obtain a charitable contribution deduction for income, gift, and estate tax purposes.[101] If unmarketable assets are transferred to or held by a CRT, the trust neither will be treated as a trust with respect to which a charitable contribution deduction is available for income, gift, and estate tax purposes, nor will it be treated as functioning exclusively as a CRT unless, whenever the trust is required to value these kind of assets, the valuation either is: (1) performed exclusively by an independent trustee; or (2) determined by a current qualified appraisal from a qualified appraiser.[102] Thus, if the settlor, a noncharitable beneficiary, or someone related or subordinate to the settlor, the settlor's spouse, or any noncharitable beneficiary is the sole trustee, he or she must value the unmarketable assets using a current qualified appraisal from a qualified appraiser. To avoid the expense, it may be worth appointing an independent trustee with valuation powers. The draftsman should then consider giving the power holder the discretion to hire a professional appraiser and charge the expense to the trust.

3. Who Should or Should Not Hold the Power?

If the power is one where the settlor desires to protect the trustee, the power holder should be someone who is neither a beneficiary nor has a conflict of interest with or bias towards a beneficiary. A committee could be suitable as well.

If there are transfer tax concerns, particularly for a CRT, an independent person (or committee) should be appointed to hold the power to value unmarketable assets. To be independent, the person cannot be the trust settlor, a noncharitable beneficiary, or a party related or subordinate party to the settlor, the settlor's spouse, or a noncharitable beneficiary.[103]

H. Powers Relating to Life Insurance

1. What are the Powers?

The powers at issue when dealing with life insurance are referred to as "incidents of ownership." Broadly speaking, "incidents of ownership" include any economic interest in or benefit from the insurance policy. For example, the regulations state that it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy or revoke an assignment, to pledge the policy for a loan, or to borrow against the cash surrender value of the policy.[104]

2. Why Grant the Powers?

An insured possessing any incidents of ownership over life insurance, whether exercisable alone or in conjunction with any other person, will cause the insurance proceeds to be included in his or her gross estate.[105] Furthermore, the value of a life insurance policy is included in the insured's estate if the insured transferred incidents of ownership in the policy within three years of the insured's death.[106]

A decedent is considered to have an "incident of ownership" in an insurance policy on his or her life held in trust if the decedent, either alone or in conjunction with another person or persons, has the power, *as trustee or otherwise,* to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust.[107] Moreover, such a power may result in the inclusion in the decedent's gross estate under Code section 2036 or 2038 of other property transferred by the decedent to the trust if, for example, the decedent created the trust, has the power to surrender the insurance policy, and the income otherwise used to pay premiums on the policy would become currently payable to a beneficiary of the trust in the event that the policy were surrendered.[108]

If a trust may acquire insurance on the trustee's life, the trust agreement should include provisions for a special life insurance trustee. The insured trustee can serve as trustee as to the rest of the trust and have powers over the

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[101] *See* Rev. Procs. 2005-52 through 2005-59, providing safe harbor language for qualified charitable remainder unitrusts.
[102] Treas. Reg. § 1.664-1(a)(7); *see also* Treas. Reg. § 1.170A-13(c)(3) (definition of qualified appraisal); Treas. Reg. § 1.170A-13(c)(5) (definition of qualified appraiser).
[103] Treas. Reg. § 1.664-1(a)(7)(iii).
[104] Treas. Reg. § 20.2042-1(c).
[105] I.R.C. § 2042.
[106] I.R.C. § 2035.
[107] Treas. Reg. § 20.2042-1(c)(4)(emphasis added).
[108] Treas. Reg. § 20.2042-1(c)(4).

non-insurance assets. The insured trustee also could have the right to remove and replace the special insurance trustee, provided the replacement power is limited to persons not related or subordinate under Code section 672(c).

3. Who Should or Should Not Hold the Powers?

No insured, whether the settlor, a beneficiary, or a trustee, should hold a power that includes any incidents of ownership over the life insurance policy insuring his or her life owned by the trust. Further, if one of the foregoing individuals has the power to remove a special insurance trustee and appoint a successor, the safe harbor approach of limiting appointees to someone who is not related or subordinate is advisable. Moreover, the special insurance trustee should not be someone who plays a role in another trust such that the reciprocal trust doctrine could be applied if the two trusts were "uncrossed."

I. Power to Control Beneficial Enjoyment

1. What is the Power?

The power to control beneficial enjoyment of the trust income or principal is addressed in the Code under the grantor trust rules.[109] In short, the rules provide that the settlor is treated as the income tax owner of any portion of a trust if the beneficial enjoyment of the corpus or the income is subject to a power of disposition exercisable by the settlor, a nonadverse party, or both, without the approval or consent of any adverse party.[110] Because the grantor trust rules are particularly complex in this context, granting any of the various powers that control beneficial enjoyment to a special or independent trustee reduces the risk of the drafter inadvertently misapplying the rules.

Powers that qualify as controlling the beneficial enjoyment of the trust property include the power to add or remove beneficiaries to the trust or to allocate and distribute trust income and principal among a class of beneficiaries, thereby effectively shifting the trust benefits among beneficiaries (*i.e.*, a sprinkle power).[111]

2. Why Grant the Power?

The power to control beneficial enjoyment is commonly used to provide flexibility for unforeseen circumstances. Assume the settlor creates a trust for his three minor children, one of whom later acquires a substance habit. A flexible trust agreement might provide that someone has the ability to remove the substance abuser child as a beneficiary or to allocate and distribute the trust income and principal among the settlor's children, thereby shifting a greater benefit to the non-substance abusing children.

Another manner of achieving a similar result is to grant to the independent trustee or trust protector a lifetime limited power of appointment. It is unlikely, however, that the power holder would exercise the power in a manner that benefits anyone other than the existing beneficiaries for fear of breaching his or her fiduciary duty.

The ability to allocate and distribute trust income also provides a way to adjust the trust's income tax rate. For example, to combat the trust accumulating income on which it will pay income tax, a special trustee may be given the power to make distributions, which allows the trust to reduce the taxes paid on its income.

3. Who Should or Should Not Hold the Power?

a. Income Tax Considerations

The main consideration in determining who should serve as special trustee with the power to control beneficial enjoyment is income tax related. If the purpose of the trust agreement is to create a non-grantor trust (*i.e.*, the settlor does not want the trust income to be reportable on his or her individual income tax return), then the most simplistic drafting technique is to not to grant the settlor or anyone related or subordinate[112] to the settlor the power to control

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[109] I.R.C. § 674(a). The cautious drafter should realize that relying on Code section 674(a) as a method of ensuring grantor trust status requires careful consideration and drafting around the various exceptions that negate grantor trust status and are enumerated in Code section 674, with particular attention to whether the power applies to and affects income or principal or both. *See, e.g.*, I.R.C. §§ 674(b), (c), (d); Treas. Reg. § 1.674-(b)-1.

[110] An adverse party is defined as a person who has a substantial beneficial interest in the trust that would be adversely affected by the exercise or non-exercise of the power in question. I.R.C. § 672(a). By way of example, a current trust beneficiary is an adverse party.

[111] Treas. Regs. § 20.2041-1; *see also* Priv. Ltr. Rul. 9543050 (Aug. 3, 1995).

[112] A person related or subordinate to the settlor includes the settlor's spouse if living with the settlor, and the settlor's parents, issue, or sibling. I.R.C. § 672(c).

the beneficial enjoyment of the trust. Such power instead should be granted to a special trustee or committee no more of half of whom are related or subordinate to the settlor.[113]

In contrast, if the goal is to create a grantor trust for income tax purposes, then a trustee who is related or subordinate to the settlor may be granted full discretion over distributions. The effect is that the settlor is deemed to have the power to allocate among beneficiaries.

The careful drafter will note, however, that certain powers may be held by anyone as a trustee or not as a trustee without creating a grantor trust under Code section 674.[114] The planner also should note the Treasury Regulations providing certain cutbacks to the general rule under Code section 674 that creates a grantor trust.[115] Moreover, a trust is not a grantor trust for income tax purposes simply by way of another person, the trustee, or the settlor acting as a trustee or co-trustee having the power to apply or distribute income for the support of a beneficiary (other than the settlor's spouse) whom the settlor has the legal obligation to support or maintain unless the income is actually applied or distributed for that purpose.[116] When this rule applies, then Code section 674 is not applicable, and the trust is not a grantor trust for income tax purposes.[117]

In the beneficiary context, if the trust is a non-grantor trust as to the settlor for income tax purposes, the beneficiary should not serve as a special trustee with the discretion to make distributions (whether subject to an ascertainable standard or not) to himself or herself to avoid the trust income being taxed to the beneficiary.[118]

b. Gift Tax Considerations

The settlor should not hold the power to add beneficiaries unless the drafter desires that gifts to the trust by the settlor be incomplete gifts.[119] Additionally, a settlor acting as trustee with the power to make distributions (even if limited by an ascertainable distribution standard) may be deemed to have made a completed gift.

An income beneficiary of the trust should not be given the power to accumulate income because such a power might cause the power holder to be treated as making a gift of the accumulated income. Similarly, a beneficiary with a power to add beneficiaries could be deemed to hold a general power of appointment, thereby causing a completed gift by the beneficiary power holder if the power is exercised.

To preclude a completed gift by the individual holding the power to add beneficiaries, he or she should not be given the power to add himself or herself as a trust beneficiary.

Finally, any person who has any obligation to support any trust beneficiary should not be named as special trustee or protector to preclude a deemed gift of the trust property. The power might be construed as a general power of appointment, and therefore, taxable for gift tax purposes.[120]

c. Generation-Skipping Transfer ("GST") Tax Considerations

When granting a party the power to add beneficiaries or otherwise control the beneficial enjoyment of a trust, the planner also must ensure that the exercise of the power does not cause an unintended and unfavorable GST tax consequence.[121]

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[113] Even if the special trustee or committee is not related or subordinate to the settlor, the trust cannot qualify as a foreign trust under Code section 679 (*see* discussion at Section II.D.5. above) and the trustee cannot have one of the proscribed administrative powers in Code section 675.

[114] I.R.C. § 674(b)(1)-(8).

[115] For example, the power to apply income to support a dependent exception set forth in Code section 674(b)(1) is available only to the settlor (and the settlor's spouse) under Code section 672(e) when the power is held as a trustee.

[116] I.R.C. § 677(b)(1).

[117] I.R.C. §§ 674(b)(1), 677(b)(1).

[118] *See e.g.*, I.R.C. § 678(a)(1), providing that a person other than the grantor shall be treated as the owner of any portion of the trust with respect to which such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself. An important exception to Code section 678(a)(1) is that if a grantor holds a power under Code sections 671 through 679 and the beneficiary holds a Code section 678 power, the beneficiary's power is disregarded, and the grantor is taxed as the owner of the trust *income*. It is of note that there is a disconnect under a strict reading of the rule in that the beneficiary is still deemed the owner for income tax purposes of the trust *principal*.

[119] *See* Treas. Regs. § 25.2511-2(c), (f); *see also Estate of Sanford v. Comm'r*, 308 U.S. 39 (1939).

[120] *See* I.R.C. § 2514.

[121] The planner should keep in mind the GST tax exempt status of the trust and whether it arises by way of qualifying as a grandfathered trust. A grandfathered trust is one of the following:

(1) any generation-skipping transfer under a trust that was irrevocable on September 25, 1985 (the day before the House Ways and Means Committee began consideration of the Bill containing the GST statutes), but only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985 or out of income attributable to such corpus;

d. Estate Tax Considerations

Generally, because most powers that would permit the settlor to control the beneficial enjoyment of the trust property also subject the trust assets to inclusion in the settlor's estate, it is best to give such a power to a special trustee or protector who is not the settlor.[122] Specifically, Code section 2038(a) requires inclusion of trust assets in a decedent's estate when the decedent has the power, alone or in conjunction with any other person, "to alter, amend, revoke, or terminate" the enjoyment of the trust property.[123] Therefore, the settlor should not serve as a special trustee or protector holding the power to make distributions if such power is not limited to an ascertainable standard.[124]

Another example where the power to control the beneficial enjoyment of a trust may be problematic is where a special trustee has the power to accumulate income, consequently resulting in a greater benefit to the remainder beneficiaries. An alternative manner of drafting is to grant such a power to a protector or give the trustee the ability to exercise full discretion over distributions to the beneficiaries.[125]

Additionally, the planner should consider granting the power to control the beneficial enjoyment of a trust to a special trustee when a beneficiary/trustee is serving to prevent the possibility that the spendthrift provisions of the trust could be thwarted by the beneficiary/trustee's creditors.[126]

The settlor's spouse, however, may hold the power to make discretionary distributions of income and principal without the estate tax inclusion issue, as long as he or she did not make any contributions to the trust, the spouse cannot distribute to himself or herself, and the spouse cannot distribute in satisfaction of his or her legal obligations.[127]

Similar to the gift tax implications discussed above, a beneficiary with a power to add beneficiaries could be deemed to hold a general power of appointment, thereby causing estate tax inclusion of the trust property by the beneficiary power holder. Additionally, to preclude estate tax inclusion of the trust property by the special trustee or protector holding the power to add beneficiaries, he or she should not be given the power to add himself or herself as a trust beneficiary.

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(2) any generation-skipping trust under a will or revocable trust executed before October 22, 1986 (the date the Tax Reform Act of 1986 was enacted) if the decedent died before January 1, 1987; or
(3) any trust made by a person who on October 22, 1986, and continuously thereafter was under a mental disability to change the disposition of his or her property and the trust was included in the gross estate of the incompetent person.
Treas. Reg. § 26.2601-1(b)(1)(i).

[122] Another tripwire that can cause estate tax inclusion under Code section 2038 is if the settlor and power holder have any agreement that the power holder will distribute the trust property in accordance with the settlor's desires, so it is best to avoid any such arrangement.

[123] I.R.C. § 2038(a).

[124] *See* Rev. Rul. 77-73, 1977-1 C.B. 175. Even if trust distributions are limited to an ascertainable standard, the trust may be includible in the settlor's estate if trust distributions are mandatory and have the purpose of paying the settlor's support obligations. Specifically, Code section 2036(a) requires the inclusion of property transferred by a decedent in the decedent's gross estate when the decedent retained "(1) the possession or enjoyment of, or the "right to the income from, the property, or the right either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom." I.R.C. § 2036(a). A trustee with the discretion to pay support obligations is less clear unless under state law, but if the trustee could be required to make payments to someone because of an ascertainable standard, then Code section 2036 will apply. *See Estate of Gokey v. Comm'r*, 72 T.C. 721 (1979) (holding irrevocable inter vivos trusts for children were support trusts and included in decedent's gross estate).

[125] If the latter is chosen, the planner must beware of the tax implications involved. *See* discussions at III.B, C, and J.

[126] Texas law provides that a beneficiary is treated as a settlor of a trust in various instances, but specifically excludes those instances where a beneficiary merely holds or exercises: (1) a presently exercisable power to consume, invade, appropriate, or distribute property to or for the power of the beneficiary if the power is: (a) exercisable only with the consent of an adverse party or limited by an ascertainable standard, including a HEMS standard; (b) a limited power of appointment; (2) a testamentary power of appointment; or (3) a presently exercisable withdrawal right that does not exceed the greater of the 5 and 5 rule under Code section 2041(b)(2) and Code section 2514(e), or the gift tax annual exclusion amount under Code section 2503(b). Tex. Trust Code § 112.035.

[127] *See* I.R.C. §§ 2036(a)(2), 2038(a).

Any person who has any obligation to support any trust beneficiary should not be named as special trustee or protector to preclude estate inclusion of the trust property.[128] The power might be construed as a general power of appointment and, therefore, be estate taxable.[129]

e. Non-tax Considerations

Let us look at the power to add beneficiaries. The trustee's fiduciary duties could be construed to limit the trustee's exercise of the power because a trustee has a fiduciary duty to act in the best interests of the trust's beneficiaries and adding beneficiaries would dilute the current beneficiaries' interests in the trust. Thus, granting the power to a special trustee or protector may resolve the issue. However, the question then becomes whether a special trustee or protector is held to the same fiduciary duty, thereby negating his or her ability to add beneficiaries. A protector likely can exercise the power, but another option is to provide a special trustee or protector with the power to grant the power to add beneficiaries to a person who is not the settlor, trustee, special trustee, or protector.

J. Power to Direct or Veto Distributions (Also Known as a Distribution Trustee)[130]

1. What is the Power?

Separate and apart from the power to control beneficial enjoyment addressed in Section III.I above, a third party may be granted the extraordinary power to direct a distribution without the need to satisfy a standard and/or to veto a distribution.

2. Why Grant the Power?

When the trustee is required to make distributions based upon an ascertainable standard, either by deliberate design or by default,[131] it can be desirable to grant a third party or a committee an unlimited power to direct the trustee to make a distribution to one or more beneficiaries. A distribution trustee often appeals to a settlor who anticipates difficult beneficiaries and who would like more distribution flexibility in the hands of a trusted confidant.

Likewise, a settlor may want that same confidant to be able to prohibit a distribution, even one the trustee believes is within the distribution standard expressed in the trust agreement. This veto power provides the settlor with additional oversight to satisfy any of his or her apprehensions. It also provides an extra layer of protection for the trustee who, in a sense, receives implicit approval of his or her distribution decision if no veto is made.

In another instance, the main trustee may hold no distribution powers whatsoever, with such distribution power completely isolated and held only by the distribution trustee. A similar option is to make the power to direct distributions springing so that the trustee can renounce his or her distribution powers, thereby triggering provisions that call for a distribution trustee to commence serving.[132]

A hybrid of this distribution/veto power can arise when the settlor wants a "moral" trustee to make unpopular decisions that may burden the main trustee or cause conflict between the main trustee and the beneficiary. For example, the settlor may want someone to monitor acts he or she believes should disqualify a beneficiary from receiving distributions, such as the beneficiary's living arrangements, school grades, employment situation, or drug use.

3. Who Should or Should Not Hold the Power?

When the power is one of flexibility or decreases the main trustee's burden (*i.e.*, non-taxable), any trusted confidant, whether related or not, or a committee could hold the power.

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[128] *See* I.R.C. §§ 2036(a)(2), 2038(a).

[129] *See* I.R.C. § 2041.

[130] A variation of this concept includes a special trustee to make tax-sensitive distributions and tax elections.

[131] *E.g.*, where the Texas Trust Code limits distributions for health, education, maintenance, or support. Tex. Trust Code § 113.029(b)(1).

[132] For an example of such language, *see* Philip M. Lindquist, "Drafting Fiduciary Powers for Trust Protectors and Independent Trustees," State Bar of Texas 24th Annual Estate Planning & Probate Drafting Course, Appendix D (Oct. 24-25, 2013). In 2014, the I.R.S. issued several related private letter rulings in which it concluded that membership on an "approval committee" was not tantamount to a general power of appointment under section 2041 or section 2514 when the committee has more than one member whose interests are adverse to one another. Priv. Ltr. Rul. 201438010 (Sept. 19, 2014); Priv. Ltr. Rul. 201438011 (Sept. 19, 2014); Priv. Ltr. Rul. 201438012 (Sept. 19, 2014); Priv. Ltr. Rul. 201438013 (Sept. 19, 2014).

When the power to distribute conferred upon the special trustee is without an ascertainable standard, the same care must be taken as when granting the power to remove a trustee and appoint a successor.[133] To avoid any possible estate tax inclusion issues, the distribution trustee should be independent (*i.e.*, not subordinate or related).

K. Power to Control and Direct Trust Investments (also known as the Investment Trustee)

1. What is the Power?

The power to control and direct the trust investments or particular investments to the exclusion of the other trustee or trustees may be given to an investment trustee. For example, a settlor may want to name a particular trusted family friend as trustee, but want to provide for a situation where an investment trustee with specialized expertise in certain investments or classes of investments assists the trustee on the investment side.

2. Why Grant the Power?

Compare the situation where a trustee merely delegates its investment responsibilities to an advisor. An investment trustee has a fiduciary duty to invest the trust assets for the best interest of the beneficiaries, whereas it is less clear whether the investment manager to whom investment decisions have been delegated is liable to anyone other than the trustee. Therefore, the claim against the investment manager, if any, would appear to arise as a breach of contract, rather than as a breach of fiduciary duty. Therefore, if the planner and settlor would like to ensure a higher standard for the individual or entity tasked with making investment decisions, the planner should consider bifurcating the responsibilities between a trustee and an investment trustee.

3. Who Should or Should Not Hold the Power?

One potential downside to naming a specific investment trustee is that an individual investment trustee may die or a corporate investment trustee may terminate. Thus, drafting for the two types of trustees requires a bit of duplication in the successor and removal provisions. Additionally, an individual or corporation who accepts the appointment as an investment trustee may charge more for his, her, or its services given the higher standard of responsibility assumed.

Additionally, there are certain considerations relating to tax consequences. Specifically, if the goal is to create a non-grantor trust, then neither the settlor nor any related or subordinate party should be named as investment trustee because the settlor would, as a result of the power to determine the trust investments, have the power to control the beneficial enjoyment of the trust assets (by controlling the income and principal of the trust), thereby causing the settlor to be the grantor for income tax purposes.[134]

L. Powers Relating to Business Control

1. What are the Powers?

The power to vote corporate stock warrants discussion when a trust will own business interests. Voting rights include all decision-making authority which shareholders possess under state law or the corporate bylaws. In 1972, the Supreme Court rejected the Service's argument that retaining voting powers over stock transferred to a trust constituted a power causing estate tax inclusion under Code section 2036(a)(2).[135] In response, Congress passed the "anti-Byrum" amendment, enacting the predecessor to Code section 2036(b).[136]

2. Why Grant the Powers?

A settlor who retains the power, as trustee or otherwise, to vote the stock of a controlled corporation[137] must include such stock in his or her estate for estate tax purposes.[138] Indirect retention of the right to vote stock also can

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[133] *See* discussion at Sections III.B and III.C above.

[134] *See* discussion at III.I. above.

[135] *U.S. v. Byrum*, 408 U.S. 125 (1972) (holding that a decedent who transferred stock into an irrevocable trust for the benefit of others could retain the powers to vote the stock and veto its transfer by the trustee without having the value of the stock included in the decedent's estate under Code section 2036).

[136] The original amendment in 1976 simply added the following language at the end of Code section 2036(a): "For purposes of paragraph (1), the retention of voting rights in retained stock shall be considered to be a retention of the enjoyment of such stock." Pub. L. No. 94-455, § 2009(a), 90 Stat. 1520, 1893 (1976).

[137] A controlled corporation is defined as one in which the decedent (at any time after the transfer and during the three-year period before the decedent's death) owned or had the right, alone or in conjunction with any person to vote, stock comprising at least 20% of the total combined voting power of all classes of stock. I.R.C. § 2036(b)(2); Prop. Treas. Reg. § 20.2036-2(d),

trigger estate tax inclusion of the stock.[139] Indirect retention includes the right to vote in a fiduciary capacity as a trustee, co-trustee, or officer of a corporation.[140]

3. Who Should or Should Not Hold the Powers?

Given the discussion above, it generally is not advisable for a settlor to serve as the trustee or co-trustee of a trust that owns stock in a controlled corporation if the settlor wants to avoid inclusion of the trust's assets in his or her estate.[141] Likewise, the settlor (or anyone related or subordinate to the settlor) should not be granted the authority to vote controlled stock held by the trust. Further consideration should be given to extend the prohibition to the donor's spouse if the controlled stock was community property when given to the trust. Instead, a special trustee should be appointed to vote the stock.

Moreover, voting power is deemed retained if there is any express or implied agreement with the settlor that the trust as shareholder (or other holder of the power to vote stock) either will vote the stock in a specified manner or will not vote the stock.[142] Therefore, the appearance of an agreement should be avoided at all costs.

M. Power to Convert a Power of Appointment

1. What is the Power?

In order to provide additional flexibility to the beneficiary with regard to his or her planning, a special trustee or protector may be given the power to convert a beneficiary's limited power of appointment to a general power of appointment.

2. Why Grant the Power?

Powers of appointment can provide tremendous flexibility to a multi-generational trust agreement by allowing the power holders to exercise the judgment that the settlor would have exercised if he or she had known the future facts, circumstances, and law applicable to the trust.[143]

The two types of powers of appointment are the general power of appointment[144] and the limited (or special) power of appointment. When a general power of appointment is given to a beneficiary, the trust settlor has effectively relinquished all dominion and control over the trust assets.[145] Therefore, the settlor has made a completed gift to the beneficiary granted the general power of appointment.[146] Consequently, any assets subject to the general power of appointment are includible in the beneficiary's estate for estate tax purposes unless the power falls under one of the exceptions to the general power.[147]

1983-2 C.B. 626. It is important to note that the attribution rules of Code section 318 apply to the determination of the 20% test. *Id*.

[138] Such power is deemed a transfer with a retained life estate. I.R.C. § 2036(b)(1).

[139] *See* Rev. Rul. 80-346, 1980-50 I.R.B. 14 (even informal strings on voting stock held in trust can bring it into the settlor's estate); *see cf.* Rev. Rul. 81-15, 1981-2 I.R.B. 26 and Prop. Treas. Reg. § 20.2036-2, 1983-2 C.B. 626 (the settlor's retention of voting stock outside of a trust will not cause the Code section 2036(b) inclusion of nonvoting stock transferred in trust).

[140] Prop. Treas. Reg. § 20.2036-2(c), 1983-2 C.B. 626.

[141] Beware of the situation where the settlor insists on retaining management control via management of a family limited partnership or other entity where interests in such entity are contributed to the trust. *See e.g.*, TAM 199938005 (in which decedent transferred a portion of both his voting and nonvoting stock to a family limited partnership of which he was a general partner; the Service pulled the voting stock back into decedent's estate under section 2036(b)). Instead, the planner might consider recapitalizing the company and transferring non-voting stock to the entity (which cannot have elected S corporation treatment), followed by gifts of non-managing entity interests.

[142] Prop. Treas. Reg. § 20.2036-2(c), 1983-2 C.B. 626.

[143] Steinkamp, Josh G., *Estate and Gift Taxation of Powers of Appointment Limited by Ascertainable Standards*, Marquette Law Review, Vol. 79, Issue 1, pp. 195-294, at 196 (Fall 1995); *see also* W. Barton Leach, *Powers of Appointment*, 24 A.B.A.J. 807 (1938) (in which the author, a property professor at Harvard School of Law, proclaimed the common law power of appointment to be "the most efficient dispositive device that the ingenuity of Anglo-American lawyers has ever worked out).

[144] A general power of appointment means a power exercisable in favor of the power holder, his or her estate, his or her creditors, or the creditors of his or her estate, subject to certain exceptions. I.R.C. § 2041(b)(1). Pursuant to the Treasury Regulations, a general power of appointment includes: a power exercisable to meet the estate tax, or any other taxes, debts or charges that are enforceable against the possessor or his or her estate and a power exercisable for the purpose of discharging a legal obligation of the possessor or for his pecuniary benefit. Treas. Regs. §§ 25.2514-1(c), 20.2041-1(c).

[145] Unless, of course, the settlor retains a concurrent general power over the trust assets.

[146] I.R.C. § 2514(a).

[147] I.R.C. §§ 2041(a), (b).

In contrast, granting a limited power of appointment does not by itself result in a completed gift by the settlor. Therefore, when drafting a trust agreement, planners often include a limited power of appointment to achieve three goals. First, a limited power of appointment can be granted to a trust beneficiary while preserving the creditor protection of the trust assets from the beneficiary's creditors. Second, planners grant a limited power of appointment to beneficiaries to provide estate tax and GST tax benefits to the beneficiaries. Specifically, if a beneficiary holds only a limited power of appointment, the property subject to the power (*e.g.*, the trust assets) will not be includible in the beneficiary's estate for estate tax purposes. Additionally, an exercise or release of such a power does not constitute a taxable gift by the beneficiary. The result is that the trust property (assuming the remainder of the trust agreement is drafted properly) will be passed to successive generations free of transfer tax while at the same time providing flexibility as to the ultimate disposition of the trust property.

Converting a limited power to a general power may be desirable for several reasons, most of which are tax driven. By way of example, suppose the planner represents a beneficiary of a GST tax non-exempt trust[148] created by her grandparents that owns assets that have significantly appreciated in value since they were contributed to the trust. Because the trust is non-exempt for GST tax purposes, any distributions made to the beneficiary are subject to GST tax at the time of distribution.[149] Moreover, the rule of perpetuities will require the trust's termination during the lifetime of the beneficiary's children, meaning that the trust assets will be forced out of trust and into the estates of the beneficiary's children. Suppose also that the beneficiary and her spouse do not anticipate that their joint estates will exceed the estate tax exemption amount (after considering portability). In this instance, it would be helpful if a third party had the ability to convert the beneficiary's limited power of appointment to a general power of appointment in order to force the inclusion of the trust assets in the beneficiary's estate. Doing so would permit the beneficiary to allocate some or all of her (and her spouse's, should he choose to split gifts with her,) GST tax exemption amount to the trust assets and provide a step-up in basis of all of the trust assets for income tax purposes at the beneficiary's death. The results are two-fold. First, the beneficiary, at her death, could appoint the assets in trust for the benefit of her children by appointing the trust assets to another trust for which she is the transferor for GST tax purposes, thereby deferring the GST tax for several more generations.[150] Second, the inclusion in the beneficiary's estate thereby would effectuate a step-up in basis for the trust assets at her death, providing the trust with an income tax benefit.

3. Who Should or Should Not Hold the Power?

To preclude estate tax inclusion of the trust assets in the settlor's estate, the settlor never should be given the ability to convert a limited power of appointment to a general power of appointment.

A beneficiary also should not be given the power so as to preserve the asset protection of the trust as to the beneficiary and to preclude estate tax inclusion of the trust assets in the beneficiary's estate (at least not until the power is deliberately exercised).

Consequently, the power to grant a beneficiary of a trust a general power of appointment or to expand an existing limited power to a general power of appointment should be held by a third party not related or subordinate to the settlor or the beneficiary.

N. More on Powers of Appointment and the Delaware Tax Trap

1. What is the Power?

The power to grant a beneficiary of a trust a general power of appointment or to expand an existing limited power to a general power of appointment can be beneficial not only to provide general flexibility as discussed above,[151] but as an alternative when springing the Delaware tax trap is desired but cannot be achieved. Code sections 2041(a)(3) and 2514(d) were enacted to prevent the tax free passing of property from generation to generation by the use of successive powers of appointment where applicable state law allows a power of appointment to be exercised without regard to the common law rule against perpetuities ("RAP"). Referred to as "the Delaware tax trap," the Code sections provide that the exercise of a limited power of appointment results in the imposition of estate or gift taxes if the power is exercised in a manner that starts a new perpetuities period. In other words, a limited power of appointment will be taxed as a general power of appointment if the holder exercises it to create another power of

[148] Planners recently have become more concerned about the fact that the assets in dynastic trusts such as the one described do not receive a step-up in basis at the death of the settlor (as they would if the settlor held the assets individually outside of trust). Instead, because the assets were gifted to the trust, the assets retain a carryover basis.
[149] I.R.C. §§ 2601, 2621.
[150] *See* discussion of the Delaware tax trap below at III.N.
[151] *See* discussion at Section III.M above.

appointment which, under applicable local law (*e.g.*, Delaware), can be used in a manner that extends the RAP period.

In contrast, the Texas Trust Code codified the common law RAP.[152] In Texas, where one limited power of appointment is exercised to create another limited power of appointment, the date of creation of the second power is deemed to be the date of creation of the first power. Therefore, property subject to both limited powers of appointment will have the same perpetuities period, and there is no trap for the unwary.

One way to spring the trap is to exercise a limited power of appointment creating a presently exercisable (*i.e.*, inter vivos) general power of appointment. The second is to exercise a limited power of appointment creating a second limited power of appointment where the date of creation of the second power re-starts the applicable perpetuities period. In Texas, the first method of springing the trap is possible,[153] but exposes the assets to the power holder's creditors and may raise concerns within the family that the power holder will exercise it in an undesirable manner. It is not currently possible to spring the trap by the second method in Texas. Therefore, the planner may find other possibilities that would accomplish the same results as springing the Delaware tax trap.

As discussed in Section III.M above, another method with the same result is to give a power to a third party to grant a trust beneficiary a general power of appointment or to expand an existing limited power of appointment into a general one over all or part of the trust assets. If the power is implemented, it causes those assets to be included in the beneficiary's gross estate, and therefore, the assets receive a stepped up basis equal to their value on the date of the beneficiary's death.

2. Why Grant the Power?

In this new era of increased federal estate tax exemption amounts, one may see a trap where another may see an opportunity. Opportunities caused by springing the Delaware tax trap can include:

- achieving a step-up in basis (when values have appreciated) for income tax purposes;
- avoiding GST tax by making assets subject to an estate tax;[154]
- changing the transferor for GST purposes to use the new transferor's available GST tax exemption.

The power would be used by the third party only if he or she believes that the beneficiary's estate is sufficiently smaller than his or her remaining exemption amount and that including these additional assets in the beneficiary's gross estate would not generate (additional) estate taxes.

3. Who Should or Should Not Hold the Power?

The power to bestow a general power of appointment should be held only by an independent trustee. There are two somewhat contrary reasons why. First, if a trustee who is also a beneficiary may have an interest adverse to the exercise of this power, it would arguably render the power a limited power of appointment for estate tax purposes.[155] Second, the Service may argue that a trustee who is a close relative of the beneficiary has indirect control over the grant of the general power, causing the entire trust to be included in the beneficiary's estate even without a specific grant of the general power of appointment.

O. Broader Decanting Power

1. What is the Power?

As with most of the powers discussed in this article, the power to decant the trust into another trust or trusts generally is included to provide flexibility to the trust agreement over time as circumstances and laws change.[156] Effective September 1, 2013, Texas permits decanting under statutory law.[157] The statute distinguishes between "full discretion trusts" and "limited discretion trusts."[158] To qualify as a full discretion trust, the trustee's distribution

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[152] The rule against perpetuities applies to trusts other than charitable trusts. Accordingly, an interest is not good unless it must vest, if at all, not later than 21 years after some life in being at the time of the creation of the interest, plus a period of gestation. Any interest in a trust may, however, be reformed or construed to the extent and as provided by section 5.043. Tex. Trust Code §112.036.

[153] *See* Tex. Prop. Code §181.083.

[154] *See* discussion at Section III.M.

[155] *See* I.R.C. § 2041(b)(1)(C)(ii).

[156] For example, a trust may be decanted to separate the beneficial interests of different beneficiaries and to modify certain provisions of the original trust.

[157] Tex. Trust Code §§ 112.071-112.087.

[158] The discussion in this Section may change in the next year, given that the Real Property, Probate & Trust Section of the State Bar of Texas has proposed legislation for the 2015 session that would revise the definitions of full discretion and limited

power must not be limited in any way. If the trust is a full discretion trust, the trustee may distribute principal from a full discretion trust to another trust for the benefit of one or more of the current beneficiaries of the first trust and give a wholly discretionary beneficiary a power of appointment (*i.e.*, the trustee may decant the original trust). For tax and non-tax reasons, few trust agreements are drafted as full discretion trusts. To address this commonality, the Texas statute also provides that a limited discretion trust may be decanted. A limited discretion trust is one in which the trustee's power to distribute is limited. For example, the common language permitting distributions for a beneficiary's health, education, support, and maintenance qualifies a trust as a limited discretion trust under Texas law. To decant a limited discretion trust under the Texas decanting statute, the current beneficiaries, the successor beneficiaries, and the remainder beneficiaries of both the original and the new trust must be the same, and the distribution standard in both trusts must be the same. In essence, the decanting statute as applied to a limited discretion trust has limited applicability and is most useful when strictly administrative changes are desired.

2. Why Grant the Power?

Given the limitations of the Texas decanting statute, including a power to decant in the trust agreement can be helpful if a change later needs to be made and one wants to avoid the requirement of going to court or obtaining consent from all of the trust beneficiaries. When including such a provision, however, one must analyze the tax implications of granting such a power.[159]

An alternative to achieve decanting via another power is to permit a change of governing law and situs.[160]

3. Who Should or Should Not Hold the Power?

If the trust is fully discretionary (*i.e.*, the trustee has the power to decant the trust under Texas law), the Texas decanting statute contains a tax savings provision[161] to preclude an unintended or undesirable tax consequence to the trustee. Rather than relying on the statute, these authors believe it more effective to grant in the trust agreement an independent third-party trustee who is not related or subordinate to the settlor the power to decant the trust. First, doing so removes the requirement that the trustee must have full discretion over distributions, a power with which many settlors are uncomfortable. Second, it ensures that the settlor will not be deemed to hold a general power of appointment over the trust assets (which would make the assets includible in the settlor's estate for estate tax purposes). The beneficiary should not hold the power for the same reason. Similarly, if the trust is a limited discretion trust, then someone other than the trustee should be given the power to decant the trust assets into another trust.

Some drafters instead include provisions in their trust agreements that permit all of the current and remainder beneficiaries (only if they are not related or subordinate to the settlor) the ability to appoint an independent trustee to decant the trust.

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discretion under Texas Trust Code section 112.071. Under the proposed legislation, limited discretion means a power to distribute principal that is limited by an ascertainable standard, and parallels the language in the existing Texas Trust Code section 112.035(f)(1)(A)(ii), which relates to spendthrift trusts. Full discretion under the legislation means a power to distribute principal that is not limited by an ascertainable standard (the language requiring that the trust terms not limit or modify the discretion have been deleted).

159 For an in-depth discussion of the tax implications inherent in decanting, *see* Gordon, et al., *The Tax Consequences of Decanting: An Overview of the Gift, Estate, Income, and Generation-Skipping Transfer Tax Issues to Consider When Contemplating a Trust Decanting*, presented by Robert M. Weylandt at the State Bar of Texas 19th Annual Advanced Estate Planning Strategies Course (April 4-5, 2013).

160 *See* discussion at Section III.D. above.

161 The Texas decanting statute provides the following tax savings clause:

Subject to Subsection (d), and unless the terms of the trust expressly indicate that a requirement provided by this subsection does not apply:

(1) a person, other than a settlor, who is a beneficiary and trustee, trustee affiliate, or discretionary power holder of a trust that confers on the trustee a power to make discretionary distributions to or for the trustee's, the trustee affiliate's, or the discretionary power holder's personal benefit may exercise the power only in accordance with an ascertainable standard relating to the trustee's, the trustee affiliate's, or the discretionary power holder's individual health, education, support, or maintenance within the meaning of Section 2041(b)(1)(A) or 2514(c)(1), Internal Revenue Code of 1986; and

(2) a trustee may not exercise a power to make discretionary distributions to satisfy a legal obligation of support that the trustee personally owes another person.

Tex. Trust Code § 113.029(b).

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Finally, the planner must be cautious when decanting a trust that is grandfathered for GST tax purposes so as not to jeopardize the exempt status of the trust.[162] A distribution of trust principal from a grandfathered trust to a new trust will not cause a loss of exempt status if the following two requirements are satisfied: (1) the distribution is pursuant to the trust agreement or pre-effective date state law[163] and (2) the new trust cannot violate the perpetuities period measured by the original trust.[164] If the trust cannot be decanted because the trust cannot meet the above requirements, there is the possibility it might be "decant-able" under one of the safe harbors set forth in the Treasury Regulations.[165]

P. Reformation Power for S Corporation Purposes

1. What is the Power?

The shareholders of a corporation may elect to have net profits and losses taxed directly to them without a separate federal income tax on the corporation. These corporations are known as S corporations. However, only certain specified trusts qualify to hold stock in an S corporation. Grantor and beneficiary-controlled trusts,[166] voting trusts,[167] qualified Subchapter S trusts ("QSSTs"),[168] and electing small business trusts ("ESBTs"),[169] along with a few other trusts, may be shareholders.[170]

2. Why Grant the Power?

Practitioners typically include language authorizing the trustee or special power holder to reform a trust to ensure it qualifies as a QSST or an ESBT (when it is not or is no longer a grantor trust or voting trust or is past the two-year grace period) in anticipation of the trust owning S corporation stock.

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[162] There are no Code sections or Treasury Regulations that deal directly with the decanting or modification of non-grandfathered trusts. However, several private letter rulings (which cannot be used as precedent or relied upon) suggest that the Treasury Regulations for grandfathered trusts should apply to non-grandfathered trusts. *See* Priv. Ltr. Rul. 200822008 (May 30, 2008); Priv. Ltr. Rul. 200743028 (May 29, 2007); Priv. Ltr. Rul. 200714016 (April 6, 2007).

[163] The first prong of the test requires that either (1) the terms of the governing instrument of the grandfathered trust authorize distributions to other trusts, without the consent or approval of any beneficiary or court or (2) at the time the grandfathered trust became irrevocable, state law authorized distributions to other trusts, without the consent or approval of any beneficiary or court. Treas. Reg. § 26.2601-1(b)(4)(i)(A)(1). Because Texas did not enact a decanting statute prior to 1985 (when the GST tax was enacted), it is not possible to satisfy the factor that requires the state law to authorize distributions. As a result, the terms of the governing instrument must permit distributions to other trusts without the consent or approval of any beneficiary of court.

[164] The second prong of the test requires that the terms of the governing instrument of the receiving trust cannot extend the time for vesting of any beneficial interest in a manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property beyond a period measured by 21 years after the death of any life in being at the time the original trust became irrevocable. Treas. Reg. § 26.2601-1(b)(4)(i)(A)(2).

[165] *See* Treas. Regs. § 26.2601-1(b)(4)(i)(A), (D).

[166] The regulations refer to such trusts as "qualified Subpart E trusts" because the grantor or other person owns the trust under subpart E of Subchapter J of Chapter 1 of the Code. It does not matter under which section of the grantor trust rules the trust is deemed owned by the grantor or another person, as long as that person owns all of the trust while the trust holds S corporation shares. Treas. Reg. § 1.1361-1(h)(1). A beneficiary owns a trust if he has a power to withdraw the income and principal from the trust and the settlor has not retained any grantor trust powers. I.R.C. § 678(a). Therefore, a trust that can be terminated by the beneficiary at any time, with the trust funds distributed immediately to the terminating beneficiary, is an eligible S corporation shareholder under Code section 1361(a)(1). Furthermore, a beneficiary may own a trust by reason of a combination of a temporary withdrawal power and certain continuing interests in the trust. I.R.C. § 678(b).

[167] A trust is an eligible S corporation shareholder if it is "created primarily to exercise the voting power of stock transferred to it." I.R.C. § 1361(c)(2)(A)(iv). The beneficiaries of a voting trust are treated as S corporation shareholders, so each beneficiary must be a U.S. individual or eligible trust. I.R.C. § 1361(c)(2)(B)(iv).

[168] A QSST is a special type of trust allowed to own S corporation stock, provided that the benefits of its S corporation stock are almost entirely dedicated to one individual beneficiary who agrees to be treated as the deemed owner of the trust. I.R.C. § 1361(d)(3). A separate share of a trust that meets the requirements of Code section 663(c) will constitute a separate trust for purposes of the QSST rules. Treas. Regs. § 1.1361-1(j)(3). Therefore, a trust may include a power to create subtrusts to hold the S corporation stock.

[169] Generally, a trust may elect to be treated as an ESBT if: (1) the trust has as beneficiaries only individuals, estates, charitable organizations described in paragraphs two through five of Section 170(c)(1), and governmental organizations if they hold only contingent interests in the trust and are not potential current beneficiaries, and (2) no interest in the trust was acquired by purchase. I.R.C. § 1361(e)(1).

[170] I.R.C. § 1361(c)(2).

3. Who Should or Should Not Hold the Power?

There is concern among practitioners that some modification and election powers are often too broad, creating other tax concerns if the trustee is not independent. Cautious drafting could include language that limits who can exercise the modification power (typically to an independent trustee or protector).

Q. Power to Terminate the Trust

1. What is the Power?

Although Texas statutory law permits the termination of an "uneconomic trust" (*i.e.*, a trust with a value of less than $50,000),[171] most drafters would contend that the administration of a trust becomes uneconomic at some dollar value well above $50,000. Texas statutory law also permits the termination of a trust for several other reasons, including when the purpose of the trust has been fulfilled or when circumstances not known at the time of drafting warrant termination of the trust.[172]

2. Why Grant the Power?

To avoid the cost and time commitment associated with initiating a statutory court action to terminate the trust, many drafters instead prefer to include a provision permitting the termination of the trust by either the trustee or a special power holder.

3. Who Should or Should Not Hold the Power?

A settlor acting as trustee should never be given the power to terminate the trust. Such a power likely would be deemed a retained power to affect the beneficial enjoyment of the trust that is not limited by an ascertainable standard, thereby causing estate tax inclusion of the trust property in the settlor's estate.[173] Several drafting options will preclude this result, however.[174] First, the trustee could be barred from receiving a distribution for his or her benefit or to discharge his or her legal obligation or could be deemed to be predeceased in this event. Second, the trustee could resign prior to the termination. Third, the power could be held jointly held with or held by an adverse party. Finally, the trust agreement can set a value (*e.g.*, $25,000) to limit the value included in the beneficiary's estate for estate tax purposes to that amount.

Additionally, the power to terminate the trust should only be given to an independent trustee or special power holder if the trustee is related or subordinate to the settlor (*e.g.*, the settlor's spouse is named trustee of a nonmarital testamentary trust).

If the trustee is given the power to terminate the trust at any time and distribute the trust property to the beneficiaries then entitled to receive the net income of the trust, then the trustee also should not be a or the only trust beneficiary. The power of a beneficiary who is trustee to make distributions to himself or herself must be limited to an ascertainable standard to preclude the beneficiary who is trustee having a general power of appointment.[175] A beneficiary who holds a general power of appointment must include all of the trust assets in his or her estate for

[171] Tex. Trust Code § 112.059(a).

[172] Under Texas statute, a court may order the termination of a trust upon a petition by a trustee or a beneficiary if: (1) the purposes of the trust have been fulfilled or have become illegal or impossible to fulfill; (2) the order will further the purposes of trust because of circumstances not known to or anticipated by the settlor; (3) modification of administrative, nondispositive terms of the trust is necessary or appropriate to prevent waste or avoid impairment of the trust's administration; (4) the order is necessary or appropriate to achieve the settlor's tax objectives and is not contrary to the settlor's intent; or (5) (subject to section 112.054(d)), (a) continuance of the trust is not necessary to achieve any material purpose of the trust; or (b) the order is not inconsistent with a material purpose of the trust. Tex. Trust Code § 112.054(a).

[173] *See e.g.*, *Commissioner v. Holmes' Estate*, 326 U.S. 480 (1946); *Lober v. U.S.*, 346 U.S. 335 (1953).

[174] *See* Glenn Karisch, *Modifying and Terminating Irrevocable Trusts*, available at http://www.texasprobate.net/artciles/modifyingorterminatingtrusts.pdf (last visited August 9, 2014).

[175] I.R.C. § 2041. Code section 2041 applies if the beneficiary is a co-trustee unless the other party is an adverse party. Section 2041 also includes an exception for a power limited by an ascertainable standard relating to the health, education, maintenance, or support ("HEMS") of the decedent. Therefore, the drafter must exercise caution when including the ability of the beneficiary who is trustee to make distributions to himself or herself. If the trust agreement deviates from the HEMS standard or the standards set forth in Treasury Regulations section 20.2041-1(c)(2), the beneficiary is trustee will be deemed to hold a general power of appointment. The courts, however, have ruled differently over time on the same standard. *See e.g., Whelan v. United States*, 81-1 U.S. Tax Cas. (CCH) ¶ 13,393 (S.D. Cal. 1981) (holding that a distribution power "for the reasonable support, care, and comfort" of a beneficiary was an ascertainable standard); *Tucker v. United States*, 74-2 U.S. Tax Cas. (CCH) ¶ 13,026 (S.D. Cal. 1974) (holding that a distribution power "for the reasonable support, care, and comfort" of a beneficiary was *not* ascertainable standard).

estate tax purposes. Furthermore, if a beneficiary who is trustee makes a distribution to another beneficiary under a non-ascertainable standard, the beneficiary who is trustee is treated as making a gift.[176] In short, the beneficiary who is trustee will be deemed to have either made a gift or have the trust assets included in his or her estate for estate tax purposes. Thus, careful planners draft around this issue.

R. Considerations When Drafting Special Needs Trusts

1. Why Grant Special Powers?

One particular difficulty with drafting a special needs trust is that the drafter wants the document to change and flex with the special needs beneficiary, and the situation of the special needs beneficiary may change incrementally or drastically over time. Because many special needs trust beneficiaries are incapable of monitoring the actions of the trustee, a protector or other power holder may be given this role. Some drafters include a requirement in the trust agreement that the trustee engage a professional to conduct an annual evaluation and make recommendations regarding the special needs beneficiary's care.[177] This professional might be called a special trustee, case manager, or trust protector (to avoid confusion with the concept of a trust protector,[178] special trustee will be used in this context).

The special trustee might be given the ability to: (1) toggle distributions on or off or otherwise exercise discretion so as not to prevent benefits for which the beneficiary might otherwise be eligible; (2) amend the trust in the event of beneficiary's changed circumstances or to maximize government benefits; (3) move the trust to a different jurisdiction to obtain greater benefits for the beneficiary; (4) monitor the trustee's investment decisions. The drafter can provide additional flexibility by including provisions allowing the trustee to: (1) purchase life insurance on a parent or caregiver's life to provide additional funds in the event of parent/caregiver's untimely death; (2) pay funeral and attendant expenses after reimbursing the State for Medicaid expenditures; and (3) transfer trust assets to pooled trust (if the assets are too complex for an individual trustee to manage or too small for corporate trustee to cost-efficiently manage).

One cautionary note to planners is to consider the potential effect that naming a protector or special trustee can have in the special needs context. For example, public benefits agencies reviewing the trust agreement may be unfamiliar with the protector or special trustee role, and, therefore, they may view the trust agreement with a skeptical eye. As a precaution, the planner may consider including a provision prohibiting any violation of agency trust requirements by the protector or special trustee.

2. Who Should or Should Not Act as Trustee or Special Trustee?

The Texas Estates Code prohibits an individual from serving as trustee of a court-created management trust unless: (1) the trust corpus is less than $150,000; or (2) the trust corpus was greater than $150,000 and no corporate trustee in the geographic area will accept trusteeship.[179] The Texas Estates Code also addresses the potential requirement of a bond for an individual trustee.[180] Even if an individual qualifies, he or she may not have sufficient experience or time to devote to the fiduciary role requiring attention to distributions, investing, accounting, and tax returns.

Trusts that are settled by third-parties (such as a family member) are not subject to the same statutory prohibitions on who can serve as trustee. If using an individual trustee, however, it may be best to name an unrelated trustee. A related party may not have time to handle ongoing distributions or may not have the necessary skills to manage the large investments held by a special needs trust.

Even if the family member does not have the time or experience to serve as trustee, a family member can act as the special trustee to monitor the trustee's activities and amend the trust[181] or approve specific distributions. This system of checks and balances can be particularly helpful when a corporate trustee is acting.

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[176] A release of a general power of appointment is deemed a taxable gift by the beneficiary who is trustee under Code section 2514(b). I.R.C. § 2514(b).

[177] *See* Patricia F. Sitchler and Kathy Lynch, *And How Are the Children? Planning for Children with Special Needs Trusts*, State Bar of Texas, Advanced Guardianship Law Course, p. 46 (Apr. 8, 2011).

[178] *See* discussion at IV.A below.

[179] Tex. Est. Code § 1301.057. For trusts created by the court to hold property recovered in a suit by a next friend or guardian ad litem that will be settled with assets greater than $50,000, an individual may serve as trustee only if no financial institution is willing to act as trustee. Tex. Trust Code § 142.005(m), (n).

[180] Tex. Est. Code §§ 1301.058 and 1301.101.

[181] Caution should be exercised when naming a family member, especially in a third-party-settled special needs trust, to avoid any unintended tax consequences.

IV. PRACTICAL CONSIDERATIONS

A. Comparing Trustees and Protectors

1. What is a Protector?

Following the discussion of the various types of powers that can be carved out and allocated to a special-purpose trustee or other trusted individual, we turn now to the concept of a protector. The role of a protector, although not used often in the United States until the 1990s, is not novel. One commentator attributes the protector to three origins: (1) non-trustee fiduciaries in England and other Commonwealth countries; (2) similar individuals and financial institutions acting with respect to offshore and domestic asset protection trusts; and (3) trust advisors[182] in American trusts.[183]

The first use of the specific term "protector," however, was made in a 1989 amendment to the Cook Islands International Trusts Act 1984.[184] The term was defined as "the holder of a power which when invoked is capable of directing the trustee in matters relating to the trust in respect of which matters the trustee has discretion and includes a person who is the holder of a power of appointment or dismissal of trustees."[185] Today, the Cook Islands International Trusts Act of 1984 (as amended, most recently in 1999) provides that a protector is one who: (1) has the power to appoint or remove a trustee; (2) directly or indirectly controls, whether by power of veto or otherwise, the trustees' exercise of one or more of their powers, functions or discretions under the trust; or (3) holds the office of protector in accordance with the Act.[186]

In essence, a protector is the holder of one or more powers capable of affecting what the trustee is to do with the trust property.[187] A protector is not a trustee and should have no beneficial interest in the trust.[188] Instead, the role of a protector provides flexibility within the trust document to allow it to grow or change over time. Because there is no statutory provision made for a protector as such under Texas law, a protector of a Texas trust derives its powers, rights, and authority solely from the trust agreement.[189]

2. What Powers Should the Protector Hold?

The powers granted to a protector by the drafter should be carefully considered and based on the specific facts and circumstances of the client's situation and intent. For instance, the protector might be given one or more powers to remove and replace a trustee, add new beneficiaries or remove existing beneficiaries, amend the trust for tax or other reasons, terminate the trust, convert a limited power of appointment to a testamentary general power of appointment, change the situs and governing law of the trust, or resolve disputes between trustees or between beneficiaries and the trustee.[190] Some commentators mention the inclusion of the power to veto or direct trust distributions or monitor the trustee's investment decisions,[191] but the drafter granting such powers should be aware that these powers put the protector into a fiduciary realm.[192]

In any event, Texas law provides that the terms of a trust prevail over the Texas Trust Code except that the terms of a trust may not limit: (1) requirements that the trust cannot require a trustee to commit an act that is criminal,

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182 "A trust adviser is a person who has power to control a trustee in the exercise of some or all of his powers." Note, *Trust Advisers*, 78 HARV. L. REV. 1230, 1230 (Apr. 1965).

183 Richard C. Ausness, *When is a Trust Protector a Fiduciary?*, 27 QUINN. PROB. LAW JOUR. 277 No. 3 (2014).

184 Cook Islands International Trust Amendment Act 1989, § 3(2) (1989), available at http://www.paclii.org/ck/legis/num_act/itaa1989351/index.html.

185 Cook Islands International Trust Amendment Act 1989, § 3(2) (1989), available at http://www.paclii.org/ck/legis/num_act/itaa1989351/index.html.

186 Cook Islands International Trusts Act 1984 (as amended 1985, 1989, 1991, 1995-1996, and 1999), § 20.

187 Donovan W.M. Waters, *The Protector: New Wine in Old Bottles?*, 63 TRENDS IN CONTEMPORARY TRUST LAW 64 (A.J. Oakely ed., Clarendon Press, 1996).

188 Robert C. Lawrence III, *The Role of the Trust Protector or Protective Committee*, Practicing Law Institute, Nov. 2001, § 7:2.4

189 Several states, excluding Texas (which has used several Uniform Trust Code provisions, but adopted its own comprehensive Trust Code), have adopted the Uniform Trust Code. Section 808(c) of the Uniform Trust Code permits a trust agreement to "confer upon a trustee or other person a power to direct the modification or termination of the trust." Unif. Trust Code § 808(c) (2000) (amended 2010). *Cf.* discussion at Section III.O relating to proposed legislation by the Real Property, Probate & Trust Section of the State Bar of Texas that would impact the decanting powers exercisable by a trustee.

190 *See also* discussion above at Section III.D relating to the listed powers.

191 *See e.g.,* Alexander A. Bove, Jr., *The Trust Protector: Trust(y) Watchdog or Expensive Exotic Pet?*" 30 ESTATE PLANNING 390 (Aug. 2003).

192 *See* discussion above at III.J.

tortious, or contrary to public policy;[193] (2) the duties and liabilities of and restrictions placed on a corporate trustee;[194] (3) the statute addressing exculpation of a trustee;[195] (4) the period of limitations for commencing a judicial proceeding;[196] (5) certain trustee duties;[197] and (6) the power of a court to take action or exercise jurisdiction.[198]

3. What Powers Should the Protector Not Hold?

There are certain powers that should not be given to a protector to preclude an unfavorable tax situation for the protector. The drafter should not give the protector a general power of appointment because such a power could cause the inclusion of the trust assets in his or her estate. For example, the protector should not be given a power to appoint as trustee himself or anyone related or subordinate to him, should not be permitted to exercise the powers in favor of himself or herself, his or her creditors, his or her estate, or the creditors of his or her estate or discharge his or her legal obligation of support, or be allowed to determine his compensation (this last issue should be given to the trustee).

4. Who Should Act as Protector?

The ideal candidate is someone who would act exactly as the trust settlor would to protect the purpose of the trust and trust property. Whatever the powers given to the protector, neither the settlor nor anyone related or subordinate to the settlor or the beneficiaries should be named as the protector. Otherwise, the asset protection and the tax purposes of the trust may be compromised.

5. Is a Protector a Fiduciary?

Another issue is whether a protector is a fiduciary (*i.e.*, does a protector owe a duty, and if so, to whom?),[199] which is a topic of much debate among the American estate planning bar. While an exhaustive discussion of the issue is not appropriate here given the broad topic and the space limitations, it bears some mention.[200] Few American cases address the question of whether a protector is a fiduciary.

A 2002 federal bankruptcy case makes the statement (without further analysis) that "Plaintiff correctly points out that a fiduciary position such as Protector of the Trust…."[201] Subsequently, the Missouri Court of Appeals decided a case in 2009 that addressed the issue (in dicta)[202] in a case where the trust agreement explicitly provided that the "[p]rotector's authority … is conferred in a fiduciary capacity and shall be so exercised," then in a later provision provided that the "[p]rotector shall not be liable for any action taken in good faith."[203] The case was remanded to the trial court[204] in 2011, and in 2013, the case again was before the Missouri Court of Appeals for decision.[205] The

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[193] TEX. TRUST CODE §§ 111.035(b)(1), 112.031.
[194] TEX. TRUST CODE §§ 111.035(b)(2), 113.052, 113.053.
[195] TEX. TRUST CODE §§ 111.035(b)(3), 114.007.
[196] TEX. TRUST CODE § 111.035(b)(4).
[197] TEX. TRUST CODE § 111.035(b)(5).
[198] TEX. TRUST CODE § 111.035(b)(6).
[199] The discussion in this Section may change in the next year, given that the Real Property, Probate & Trust Section of the State Bar of Texas has proposed legislation for the 2015 session that would amend Texas Trust Code section 114.003 to clarify that a directed trustee is a fiduciary. The proposed legislation provides that an individual given the power to require the trustee to follow investment direction is a fiduciary and has the same fiduciary duty as a trustee with respect to the power such individual is given. Additionally, the proposed legislation would allow a settlor to limit the liability of a trustee who is required to follow directions.
[200] Several articles have addressed the topic (some at length), including: Alexander A. Bove, Jr., *The Trust Protector: Trust(y) Watchdog or Expensive Exotic Pet?*" 30 ESTATE PLANNING 390 (Aug. 2003); Alexander A. Bove, Jr., *The Case Against the Trust Protector*, ACTEC LAW JOURN. (Summer 2011); John T. Brooks and Gregory F. Monday, *Do We Need Protection from Trust Protectors?*, TRUSTS & ESTATES (MAR. 28, 2012); Richard C. Ausness, *When is a Trust Protector a Fiduciary?*, 27 QUINN. PROB. LAW JOUR. 277 No. 3 (2014); Ronald D. Aucutt, *When is a Trust a Trust?*, made part of Ronald D. Aucutt, et al., *It Slices; It Dices; It Makes Julienne Fries: Cutting-Edge Trust Tools,* State Bar of Texas 20th Annual Advanced Estate Planning Strategies Course, Ch. 4, p. 16 (Apr. 24-25, 2014).
[201] *Walker v. Weese*, 286 B.R. 294 (D. Md. 2002).
[202] The issue disputed at the appellate level was whether the trial court erred in granting the protector's motion.
[203] *Robert T. McLean Irrevocable Trust v. Patrick Davis, P.C.*, 283 S.W.3d 786, 789-790 (Mo. Ct. App. 2009). A special needs trust was created for Mr. Robert McLean from the settlement proceeds of a personal injury case and the trust agreement named a protector who was given the power to remove the trustee and appoint a successor trustee. *Id*.
[204] *Robert T. McLean Irrevocable Trust v. Ponder*, No. 36V010500665-01 (Mo. Cir. Ct. 2011).
[205] *Robert T. McLean Irrevocable Trust v. Ponder*, 418 S.W.3d 482 (Mo. Ct. App. 2013). For an in-depth discussion of the court cases, *see* Richard C. Ausness, *When is a Trust Protector a Fiduciary?*, 27 QUINN. PROB. LAW JOUR. 277 No. 3 (2014).

Court, however, did not rule whether the protector was a fiduciary, and if there was a fiduciary duty, whether it arose as a matter of law or simply under the trust agreement.[206]

In contrast, however, dicta in a 2013 federal case[207] states that "[c]ommentators agree, however, that the trust protector is, at [his] core, an agent."[208]

If the planner takes the position that a duty exists, the next question becomes whether it can it be drafted away. When drafting, the planner should consider the possible consequences of doing so and what recourse, if any, the settlor[209] and the beneficiaries will have against the protector if the protector decides to become a bad actor. One option is to grant a combination of fiduciary and non-fiduciary (*i.e.*, personal) powers to the protector, with the likely result being that the protector would be held to a fiduciary standard in those actions which are non-personal, but not with regard to the exercise of any personal powers. Another option is to include language stating that the protector is not liable for any action or inaction unless recklessness, fraud, or willful misconduct is found.

B. Comparing a Single Appointee to a Committee

After determining that the settlor needs or simply wants to appoint a special-purpose power holder in the trust agreement, the next step is to decide whether the powers granted will be implemented by a single appointee or a committee.

Decision making by committee precludes any one person from being solely responsible for the decision and may avoid emotional aspects that can be evoked when one individual is making the decision. Generally, provisions for a committee initially appoint specified individuals who then can select their own successors. Provisions also may require that the group consist of persons with specific qualifications or, if the powers are not sensitive ones from a tax or personal standpoint, the group can include family members.

Some items to consider when comparing the two options with the client are:

- the settlor's desire to include family in the decisions without bestowing total control or responsibility. Oftentimes, one member of the trust committee is required to be the settlor's spouse or issue, giving them a formal platform for input which can be overruled by the majority;
- the settlor's desire to have a certain type of professional serve on the committee (e.g., attorney, accountant, or financial advisor);
- the availability and willingness of multiple persons to serve;
- whether the majority will rule or some actions will require unanimity;
- the settlor must understand that appointment of a committee can lead to delays in action to be taken on behalf of the trust, as well as slower responses to a beneficiary's or trustee's questions or concerns;
- increased complexity and cost concerns, especially when the committee members are entitled to fees, in addition to out-of-pocket costs, perhaps for meeting and travel expenses;
- the settlor's need for a greater system of checks and balances; and
- whether having a committee would better manage or curtail the litigation risks of all the appointed fiduciaries.

V. CONCLUSION

Although the name given to a special purpose power holder may have a certain meaning to practitioners and another meaning to clients, what remains critical is providing clarity within the trust agreement as to the powers, duties, and liabilities for those appointed. Equally essential is understanding the tax and non-tax advantages and pitfalls when sharing or dividing the trust's administration roles among the parties.

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[206] *Robert T. McLean Irrevocable Trust v. Ponder*, 418 S.W.3d 482, 490-500 (Mo. Ct. App. 2013).

[207] *PHL Variable Ins. Co. v. 2008 Irrevocable Trust*, 970 F. Supp. 2d 932 (2013) (the issue before the court was whether the actions of the protector, in his role as such, were attributable to the settlor or the trust).

[208] *Id*. at 943.

[209] The settlor likely will have no or little recourse, as a settlor generally does not have standing to bring suit with regard to an irrevocable trust.

CASHING IN WITHOUT CASHING OUT

Taking Advantage of Section 1031 Like-Kind Exchanges

November 5, 2014

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CASHING IN WITHOUT CASHING OUT

I. Scope of Article.

The purpose of this article is to acquaint you with some of the more common tax concepts, opportunities and pitfalls that arise in like-kind exchanges. This article will generally be "practice" oriented to help you understand the general principles relevant in like-kind exchanges and to help you spot opportunities where your clients can take advantage of the tax deferrals available via like-kind exchanges.

II. Elements of Section 1031 Like-Kind Exchanges.

Pursuant to Code[1] Section 1001, a taxpayer generally must realize gain or loss from "the sale or other disposition of property." The gain or loss generally must be recognized in the year of the sale, and the character of that gain or loss will depend on the type of property sold. Certain types of exchanges are specifically excluded from current recognition of gain and loss under the Code. Among these excluded transactions are certain "like-kind" exchanges meeting the requirements in Section 1031. In a like-kind exchange, the gain inherent in the transferred or relinquished property (the "Relinquished Property") is deferred until the property acquired in the trade (the "Replacement Property") is sold. This is generally accomplished by simply allowing the taxpayer to use his basis in the Relinquished Property as the basis in the Replacement Property (i.e., carryover basis). Note that losses are also not recognized in a Section 1031 exchange.

Section 1031 was born from a perceived inequality in the Code where a taxpayer sells real estate at a gain and immediately reinvests the proceeds in "like-kind" property. If the taxpayer disposed of the property at a gain, the taxpayer will then owe tax on that gain, which lessens the taxpayer's ability to re-invest in replacement real estate. Congress reasoned that, where a taxpayer does not "cash out" or "cash in" on an investment, they should be allowed to defer paying tax on the built-in gain. As discussed below, all of the like-kind exchange requirements must be satisfied in order to defer gain recognition. Some of these requirements are more difficult to meet than others. However, there are tools and services that may aid the taxpayer and their advisors in completing a like-kind exchange.

A. General Rule.

Under Code § 1031(a), no gain or loss is recognized on the exchange of *property held for productive use in a trade or business or for investment*, if the Relinquished Property is exchanged solely for Replacement Property which is of a like-kind and is to be held either for

[1] All references to the "Code" are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated thereunder.

productive use in a trade or business or for investment. Thus, the following are the four requirements to effect a tax-free like-kind exchange:

1. Property, whether real or personal, is required;
2. Property must be *held* for a qualified purpose (i.e. held for productive use in a trade or business or for investment);
3. Property relinquished must be like-kind with replacement property; and
4. An Exchange is required.

B. Property Requirement.

Generally, if an item is considered property for federal income tax purposes, it will also be property for the purposes of Section 1031. The word "property" in the Code is a federal question and federal courts are "in no way bound by state courts' answers to similar questions involving state law."[2] All property must be like-kind and held in a trade or business or for investment. Some property cannot be exchanged because it is considered too much like an assignment of income, like a lessor's interest in a new leasehold, or certain limited mineral interests or water rights. Non-recognition of gain or loss does not apply to any exchange of:

1. Stock in trade or other property held primarily for sale (i.e. "dealer property");
2. Stocks, bonds, or notes;
3. Other securities or evidences of indebtedness or interest;
4. Interests in a partnership;
5. Real property located outside the United States for real property located inside the United States;[3]
6. Certificates of trust or beneficial interests; or
7. Choses in action.[4]

The Treasury Regulations provide that non-recognition treatment does not apply to any exchange of partnership interests, whether the interests are general or limited partnership interests, or are interests in the same or different partnerships.[5] These regulations also apply to limited liability companies that are taxed as partnerships and not as disregarded entities. For purposes of Section 1031(a)(2)(d), "an interest in a partnership which has in effect a valid election under I.R.C. §761(a) to be excluded from the application of all subchapter K shall be treated as an interest in each of the assets of such partnership and not as an interest in a partnership."[6] The Treasury Regulations also state that while intangible personal property or nondepreciable personal property may qualify for non-recognition treatment if the properties are

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[2] *U.S. v. Craft*, 2002-2 C.B. 548, 535 U.S. 274, 275 (2002).
[3] § 1031(h).
[4] § 1031(a)(2).
[5] Treas. Reg. §1.1031(a)-1(a)(1).
[6] Tax Reform Act of 1984, Pub. L. No. 98-369, 98th Cong, 2d Sess., approved July 18, 1984.

of a like kind,[7] goodwill or going concern of a business is never of a like kind to the goodwill or going concern value of another business[8] because the nature of goodwill or going concern value is so inherently unique and inseparable from the business.[9] In PLR 200602034, the IRS concluded that the taxpayer's trademarks and trade names were not separate intangible assets and were instead included in the goodwill or going concern value of the business. Therefore, these assets were per se ineligible for like-kind exchange treatment under the Section 1031 regulations.

C. Qualified Purpose.

Property that is not excluded from the nonrecognition provisions of Section 1031(a)(2) must still be held by the taxpayer for either productive use in a trade or business or for investment in order to qualify.[10] Neither property held primarily for sale to customers in the ordinary course of business (i.e. "dealer property" such as residential lots in a subdivision) nor property held primarily for personal use (e.g. a personal residence or a vacation home) meets this requirement. The taxpayer's purpose for holding the relinquished property and the replacement property is determined when the exchange takes place.[11] This is a question of fact,[12] and the taxpayer has the burden of proof.[13]

i. Holding Period.

Although there is no specific duration required to meet the holding requirement, the IRS generally takes the view that property acquired immediately before a like-kind exchange or property only held for a short time after a like-kind exchange was not *held* by a taxpayer for use in a trade or business or as an investment, but rather for a re-sale intention. In Rev. Rul. 75-292, 1975-2 C.B. 333, the IRS held that a like-kind exchange followed by the contribution of the taxpayer's property into a corporation did not qualify for nonrecognition. The IRS reasoned that the taxpayer failed to hold the property for investment purposes since he immediately contributed the property into a wholly-owned corporation following the like-kind exchange. The holding requirement is generally thought to be akin to a continuity of ownership concept. It is uncertain how long real estate received in a like-kind exchange must be held by the taxpayer to prove that real estate has been held for trade or business, or for investment, but Section 1031(f) contains a two-year holding period for related party exchanges. Based on the purpose of the related party rules, many practitioners believe that the holding period should be at least 18 months, or in unusual cases in which a shorter period can be justified, at least 12 months.

1. Swap and Drop.

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[7] Treas. Reg. § 1.1031(a)-2(c)(1).
[8] Treas. Reg. § 1.1031-2(c)(3).
[9] Preamble to Treas. Reg. § 1.1031(a)-2; T.D. 8342, 1991-1 C.B. 165, 56 Fed. Reg. 14, 851 (April 12, 1991).
[10] § 1031(a)(1).
[11] Rev. Rul. 57-244, 1957-1 C.B. 247.
[12] *Gulfstream Land and Development Corp. v. Comm'r*, 71 T.C. 587 (1979).
[13] *Land Dynamics v. Comm'r*, T.C. Memo 1978-259.

In a "Swap and Drop" type of transaction, the taxpayer exchanges assets and then soon after contributes those assets into an existing or newly formed partnership or corporation. The issues are whether the "held for" requirement is met after the exchange or whether the exchange was really for the corporate stock or partnership interest the taxpayer receives after dropping the real property into the entity, both of which are not considered "like-kind" property. In Rev. Rul. 75-292, the IRS held that the transfer of property acquired in a Section 1031 like-kind exchange to a wholly owned corporation violated the "held for" requirement. Even though the transaction was tax-free under Section 351, the IRS refused to continue the "held for" period as an investment in the newly formed corporation. The Tax Court disagreed and the Ninth Circuit in *Magneson v. Commissioner* affirmed the Tax Court holding that the transfer of replacement property immediately into a partnership did not violate Section 1031.[14] The Ninth Circuit wrote that "…for tax purposes, joint ownership of the property and partnership ownership of the property are merely formal differences and not substantial differences." However, it is unsettled what the courts would do if the IRS would have argued that, under the "step-transaction" doctrine, the transaction was not for like-kind property and instead for a partnership interest. Because there is no clear guidance on the issues, taxpayers should be aware that such transactions will be subject to a greater level of scrutiny by the IRS, and taxpayers should realize that the IRS is likely to challenge a Swap and Drop transaction due to the fact that the IRS can challenge both the "holding" and "like-kind" requirements. Note that swapping or dropping to an LLC or other disregarded entity for federal tax purposes will not affect the holding period of the exchange assets. When exchange property is held in a disregarded entity, the entity is ignored for purposes of Section 1031.[15]

2. Drop and Swap.

In this transaction, the taxpayer drops down assets from an existing partnership or corporation and then immediately exchanges the property. The issue is whether the "holding" requirement is met prior to the exchange. The IRS has held that a taxpayer who drops property down does not meet the "holding" requirement.[16] In Rev. Rul. 77-337, the IRS held that where a taxpayer liquidated a wholly-owned corporation and then exchanged some of the assets immediately after the liquidation, the exchange violated the "held for" requirement before the exchange.[17] However, in *Bolker v. Commissioner*, the Ninth Circuit, affirming the Tax Court, held that if a taxpayer owns property which he does not intend to liquidate or use for personal pursuits, he is holding the property "for productive use in trade or business or for investment" within the meaning of Section 1031(a).[18] Under this formulation, the intent to exchange property for like-kind property satisfies the holding requirement because it is not an intent to liquidate the

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[14] 753 F.2d 1490 (9th Cir. 1985).
[15] Rev. Proc. 2000-37, 2000-2 C.B. 308.
[16] *See* Rev. Rul. 75-291, 1975-2 CB 332; Rev. Rul. 77-297, 1972-2 CB 304.
[17] 1977-2, CB 305.
[18] 753 F.2d 1490 (9th Cir. 1985).

investment or to use it for personal pursuits. Accordingly, the taxpayer was allowed like-kind exchange treatment after having liquidated a wholly-owned corporation. Despite the Tax Court's and the Ninth Circuit's rejection of the IRS's position with respect to drop and swap transactions, planners and taxpayers must be aware that any transaction structured in this manner could be subject to additional scrutiny and attack by the IRS, even though the IRS may only be able to argue that the holding requirement was not met, rather than arguing that both the like-kind requirement and the holding requirement were violated. Note that swapping or dropping to an LLC or other disregarded entity for federal tax purposes will not affect the holding period of the exchange assets. When exchange property is held in a disregarded entity, the entity is ignored for purposes of Section 1031.[19]

3. Disregarded Entities and the Holding Requirement.

Fortunately, the IRS has freely permitted the use of disregarded entities in structuring like-exchanges without asserting that such use violates the holding requirement.[20] In PLR 9807013, the taxpayer, a limited partnership, disposed of relinquished property in an exchange. The lender for the replacement properties required that each replacement property be held by a "single asset entity" – a bankruptcy remote entity. The taxpayer formed three separate disregarded entities for which it was the sole owner of each, and the IRS confirmed that the ownership of each entity should be viewed as the ownership of each underlying asset, qualifying for like-kind exchange treatment. In PLR 200118023, the taxpayer wanted to acquire replacement property from an exchange accommodator, but the transfer of property was subject to a real estate transfer fee. Thus, the exchange accommodator placed the real property in a single member LLC and transferred the membership interests to the taxpayer. The IRS ruled that the transfer of membership interest in the single member LLC for relinquished real estate satisfied the requirements under Section 1031.

4. Converting Qualified Purpose Property.

"A taxpayer's intent to hold a property for productive use in a trade or business or for investment is a question of fact that must be determined at the time of the exchange."[21] A subsequent conversion to a personal residence or vacation home should not prevent the taxpayer from satisfying the qualifying use requirement provided the taxpayer did not have the intention to convert the property to personal use at the time of the exchange.[22] In *Reesink*, the Tax Court upheld the validity of a section 1031 like-kind exchange by noting that the taxpayers' efforts to rent the home, including placing flyers in nearby areas and showing the property to potential renters, demonstrated their intent to hold the property for business purposes. The Tax Court came to such a conclusion notwithstanding the fact that the taxpayers moved into the home eight

[19] Rev. Proc. 2000-37, 2000-2 C.B. 308.
[20] *See* PLRs 9751012, 9807013, 200118023, 200732012.
[21] *Reesink v. Comm'r*, T.C. Memo 2012-118; *see also Yates v. Comm'r*, T.C. Memo 2013-28.
[22] *Id*.

months after the exchange. However, in *Yates*, the Tax Court noted that taxpayers' failure to submit any evidence into the record regarding their efforts to transform their property into a business enterprise underscores their lack of business motive in the exchange. Furthermore, the Court wrote that taxpayers' use of the property as their personal residence, beginning a mere four days following the close of the sale, created a clear presumption of nonbusiness intent, exceeding that of the taxpayers in *Reesink*.

Rev. Proc. 2008-16 provides a safe harbor for determining how long a Replacement Property must be held as a rental prior to converting it to a primary residence or vacation home without invalidating the prior exchange. Under the safe harbor, a dwelling unit qualifies as Replacement Property in an exchange if it is owned by the taxpayer for at least twenty-four (24) months immediately after the exchange, and, in each of the two twelve (12) month periods: (i) the taxpayer rents the Replacement Property to another person or persons at a fair rental for fourteen (14) days or more; and (ii) the taxpayer's personal use of the Replacement Property does not exceed the greater of fourteen (14) days or 10% of the number of days during the twelve (12) month period that the dwelling unit is rented at a fare rental.

D. Like-Kind Requirement.

In order to qualify for nonrecognition treatment under Section 1031, the Relinquished Property and Replacement Property must be of "like-kind". The words "like-kind" refer to the nature or character of the property and not its grade or quality.[23] For example, the fact that any real estate involved is improved or unimproved is not material because that relates only to the grade or quality of the property and not to its kind or class.[24] In making a determination of like-kind status, consideration is given to the respective interests in the physical properties, the nature of the title conveyed, the rights of the parties, the duration of the interests, and any other factor bearing on the nature or character of the properties as distinguished from their grade or quality.[25] The Regulations give the following examples of like-kind property:

(1) a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose; or
(2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate; or
(3) a taxpayer exchanges investment property and cash for investment property of a like kind.[26]

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[23] Treas. Reg. § 1.1031(a)-1(b).
[24] *Id*.
[25] *Id*.
[26] Treas. Reg. § 1.1031(a)-1(c).

Real property is not like-kind to personal property.[27] Thus, the definitions of each are critical in determining if an exchange has occurred and are determined by federal law, although federal law generally looks to state law if there is no conflict. For example, the IRS has issued a ruling which held that identical properties located in different states were like-kind for Section 1031 purposes even though the properties were characterized as real property in one state and personal property in the other state.[28] The ruling contained four cases. In the first case, a natural gas pipeline classified as personal property in State A was found to be like-kind to a natural gas pipeline classified as real property in State B. The ruling found that the natural gas pipelines were real property for purposes of Section 1031 because they were inherently permanent structures that were affixed to real property that would ordinarily remain for an indefinite period of time, and they were transferred as part of the land to which they were affixed. The other three cases in the ruling all involved the exchange of a building with a steam turbine attached as a fixture. The steam turbine was characterized as real property by State A, but the ruling found that it was personal property for Section 1031 purposes regardless of the state's characterization. Accordingly, in case 2 the steam turbine fixture was like-kind to an identical steam turbine fixture treated as personal property in State B. In case 3, it was not like-kind to raw land, and in case 4, it was not like-kind to a natural gas pipeline.

> Relying solely on state property classifications can lead to absurd results and would make federal tax law dependent on state laws and state policies. For example, a conclusion that the exchange of identical pipelines (as in Case 1) is not an exchange of like-kind property merely because of a conflict in the classification of property between the states where the pipelines happen to located would be difficult to justify. Factors and considerations used by states to classify property as real or personal, such as revenue considerations or other state law policies, are generally irrelevant to the federal tax law question of what is of like kind. Further, some states classify property as real for some purposes and personal for others. If state laws were determinative, this would raise the question of to which purpose federal tax law should look. Accordingly, state law property classifications are not determinative of whether property is of like kind. Rather, the Service should consider all facts and circumstances, including state law and federal tax law classifications as appropriate.[29]

i. Personal Property.

The like-kind standard has been interpreted more narrowly in the case of exchanges of personal property as opposed to real property. Under the personal property regulations, "depreciable tangible personal property is of a like class to other depreciable tangible personal

[27] Rev. Rul. 59-229, 1959-2 C.B. 180; *Oregon Lumber Co. v. Comm'r*, 20 T.C. 192 (1953).
[28] CCA 201238027.
[29] *Id*.

property if the exchanged properties are either within the same General Asset Class or within the same Product Class."[30] The Regulations identify the asset classes as follows:

a. Office furniture, fixtures, and equipment (asset class 00.11),
b. Information systems (computers and peripheral equipment) (asset class 00.12),
c. Data handling equipment, except computers (asset class 00.13),
d. Airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines) (asset class 00.21),
e. Automobiles, taxis (asset class 00.22),
f. Buses (asset class 00.23),
g. Light general purpose trucks (asset class 00.241),
h. Heavy general purpose trucks (asset class 00.242),
i. Railroad cars and locomotives, except those owned by railroad transportation companies (asset class 00.25),
j. Tractor units for use over-the-road (asset class 00.26),
k. Trailers and trailer-mounted containers (asset class 00.27),
l. Vessels, barges, tugs, and similar water-transportation equipment, except those used in marine construction (asset class 00.28), and
m. Industrial steam and electric generation and/or distribution systems (asset class 00.4).[31]

Example (1). Taxpayer A transfers a personal computer (asset class 00.12) to B in exchange for a printer (asset class 00.12). With respect to A, the properties exchanged are within the same General Asset Class and therefore are of a like class.[32]

Example (2). Taxpayer C transfers an airplane (asset class 00.21) to D in exchange for a heavy general purpose truck (asset class 00.242). The properties exchanged are not of a like class because they are within different General Asset Classes. Because each of the properties is within a General Asset Class, the properties may not be classified within a Product Class. The airplane and heavy general purpose truck are also not of a like kind. Therefore, the exchange does not qualify for nonrecognition of gain or loss under section 1031.[33]

Example (3). Taxpayer E transfers a grader to F in exchange for a scraper. Neither property is within any of the general asset classes. However, both properties are within the same product

[30] Treas. Reg. § 1.1031(a)-2(b)(1).
[31] Treas. Reg. § 1.1031(a)-2(b)(2).
[32] Treas. Reg. § 1.1031(a)-2(b)(7).
[33] *Id*.

class (NAICS code 333120). The grader and scraper are of a like class and deemed to be of a like kind for purposes of section 1031.[34]

An exchange of intangible personal property or non-depreciable personal property qualifies for nonrecognition of gain or loss under Section 1031 only if the exchanged properties are of a like-kind. However, no like classes are provided for these properties. Whether intangible personal property is of a like-kind to other intangible personal property generally depends on the nature or character of the rights involved (e.g., patent or a copyright) and also on the nature or character of the underlying property to which the intangible personal property relates.[35]

Some examples of personal property exchanges permitted by the authorities include:

(1) Exchanges of major league sports contracts;[36]
(2) Mexican gold coins for Australian gold coins;[37] and
(3) Gold bullion for gold Canadian maple leaf coins.[38]

Some examples of personal property exchanges NOT permitted include:

(1) Gold bullion for silver bullion;[39]
(2) Numismatic coins held for investment and bullion coins held for investment;[40] and
(3) The exchange of livestock of one sex for livestock of the other sex. This is not an exchange of property of like-kind for purposes of Section 1031(a) because the different sexes of livestock represent investments of different types, in one case an investment for breeding purposes, in the other an investment in livestock raised for slaughter.

ii. Real Property.

The like-kind standard for real property is extremely broad, and generally all real property is like-kind to all other real property, with some noted exceptions. Under the Regulations, a lease of 30 years or more is real property for purposes of Section 1031 regardless

[34] *Id*.
[35] Treas. Reg. § 1.1031(a)-2(c)(2).
[36] Rev. Rul. 71-123, 1971-1 C.B. 227; *but see* IRS Market Segment Specialization Program, Sports Franchises, Released August 1999, stating that future draft picks and existing player contracts do not constitute like-kind property.
[37] Rev. Rul. 76-214, 1976-1 C.B. 218.
[38] PLR 8202101.
[39] Rev. Rul. 82-166, 1982-2 C.B. 190 ("Silver and gold are intrinsically different metals and primarily are used in different ways").
[40] Rev. Rul. 79-143, 1979-1 C.B. 264. ("[a]lthough the coins appear to be similar because they both contain gold, they actually represent totally different types of underlying investment, and therefore are not of the same nature or character. The bullion-type coins, unlike the numismatic-type coins, represent an investment in gold on world markets rather than in the coins themselves. Therefore, the bullion-type coins and the numismatic-type coins are not property of like kind.")

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of its state law characterization.[41] As described above, in making a determination of like-kind status, consideration is given to the respective interests in the physical properties, the nature of the title conveyed, the rights of the parties, the duration of the interests, and any other factor bearing on the nature or character of the properties as distinguished from their grade or quality.[42]

Examples of real property exchanges held to be like-kind are:

a. Unimproved real property for unimproved real property;[43]
b. Commercial building for lots;[44]
c. City real estate for a ranch or farm;[45]
d. One property for more than one property and vice versa;[46]
e. A tenancy-in-common interest for a fee interest and vice versa;[47]
f. An easement for a fee interest;[48]
g. Perpetual water rights for a fee interest where water rights are real property under state law;[49]
h. A fee for a fee, subject to a 99 year lease;[50]
i. A fee for a leasehold interest with 30 years or more to run[51] (all unexercised option periods are included in meeting the 30 year requirement)[52];
j. A remainder interest in one property for life estate in another property where the life tenant has a life expectancy of at least 30 years;[53]
k. A conservation easement for a fee interest in timberland, farm land or ranch land;[54] and
l. A natural gas pipeline that is real property in one state and personal property in another state.[55]

Examples of real property exchanges held NOT to be like-kind are:

(1) A fee for services;[56]

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[41] Treas. Reg. § 1.1031(a)-1(c).
[42] *Id*.
[43] *Id*.
[44] *Burkhard Inv. Co. v. U.S.*, 100 F.2d 642 (9th Cir. 1938).
[45] Treas. Reg. § 1.1031(a)-1(c).
[46] *Coupe v. Comm'r*, 52 T.C. 394 (1969).
[47] Rev. Rul. 79-44, 1979-1 C.B. 265.
[48] Rev. Rul. 72-549, 1972-2 C.B. 472.
[49] Rev. Rul. 55-749, 1955-2 C.B. 295.
[50] *Koch v. Comm'r*, 71 T.C. 54 (1978).
[51] Treas. Reg. § 1.1031(a)-1(c).
[52] *Peabody Natural Res. Co. v. Comm'r*, 126 T.C. at 275; *Century Elec. Co. v. Comm'r*, 15 T.C. 581, 591–592, 1950 WL 77 (1950), *aff'd*, 192 F.2d 155 (8th Cir.1951); Rev. Rul. 78-72, 1978-1 C.B. 258.
[53] Rev. Rul. 78-4, 1978-1 C.B. 256.
[54] PLR 9621012.
[55] CCA 201238027.
[56] *Badgett v. U.S.*, 175 F. Supp. 120 (W.D. Ky. 1959).

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(2) A fee interest in timberland for cutting rights;[57]
(3) Water or mineral rights of limited duration for a fee interest;[58] and
(4) An attached railroad track for an unattached railroad track.[59]

iii. Oil, Gas and Mineral Interests.

When a mineral lease gives the lessee the right to extract the minerals for a set period of time, or until exhaustion, the lessor retains a royalty interest. The lessee's interest in a mineral lease is a real estate interest for federal income tax purposes.[60] This is true even if the mineral lease is considered personal property for state law purposes.[61] Working interests may also contain equipment and other tangible personal property, in which case an exchange of working interests could be a multi-asset exchange if there is personal property.[62]

A royalty interest, which is a nonworking interest, provides that the holder will receive a designated percentage of all minerals without regard to the operator's cost to extract those minerals. A royalty interest is also considered a real property interest for federal income tax purposes and would be exchangeable.[63] Similarly, an overriding royalty interest has been held to be like-kind to unimproved real estate.[64] Conversely, a production payment is not considered real property for federal income tax purposes and will not qualify for exchange treatment under Section 1031.[65] "Carved out" interests like production payments are treated differently than overriding royalty interests and other interests because of the duration of the interests. An overriding royalty interest exists until the mineral deposit is exhausted whereas a carved out oil payment right terminates when a specified quantity of minerals has been produced or a stated amount of proceeds from the sale of minerals has been received.[66] A profits interest is like a royalty interest and will be considered real estate unless limited like a production payment.[67]

In Rev. Rul. 68-331, the IRS stated that the exchange of a producing oil lease for the fee interest in a ranch constituted a nontaxable exchange of realty to the following extent:

> Accordingly, the exchange by the taxpayer of his leasehold interest in a producing oil lease (not including personal property, stock in trade, or other property held primarily for sale), extending until the exhaustion of the deposit, that is held for

[57] *Oregon Lumber Co. v. Comm'r*, 20 T.C. 192 (1953).
[58] Rev. Rul. 55-749, 1955-2 C.B. 295.
[59] TAM 200424001.
[60] *Palmer v. Bender*, 1933-1 C.B. 235 (1933); Rev. Rul. 68-226, 1968-1 C.B. 362.
[61] Rev. Rul. 68-226, 1968-1 C.B. 362.
[62] *Id*.
[63] Rev. Rul. 73-428, 1973-2 C.B. 303.
[64] Rev. Rul. 72-117, 1972-1 C.B. 226.
[65] §636 ("A production payment carved out of mineral property shall be treated, for purposes of this subtitle, as if it were a mortgage loan on the property, and shall not qualify as an economic interest in the mineral property.").
[66] *See Koch*, at 65.
[67] Rev. Rul. 73-541, 1973-2 C.B. 206.

productive use in trade or business or for investment, for the fee interest in the improved ranch to be held for productive use in trade or business or for investment is an exchange of property for property of a like kind under section 1031(a) of the Code, to the extent of the ranch land and permanent improvements thereon, but not including that part of the ranch property consisting of a personal residence within the meaning of section 1034 of the Code, personal property, stock in trade, or other property held primarily for sale.

In *Crichton v. Commissioner*,[68] a taxpayer and her children owned undivided interests in unimproved country land and also an unimproved city lot. The children transferred to the taxpayer their undivided interest in the city lot in exchange for the taxpayer's transferring to them her undivided interest as to oil, gas, and other minerals, in, on, and under the country land. This exchange qualified for nonrecognition treatment under Section 1031.

E. Exchange Requirement.

In order to complete a like-kind exchange, there must be an actual "exchange" of eligible property. When Section 1031 was enacted, the IRS argued that any "exchange" (i.e., passage of title) must occur simultaneously for the exchange requirement to be satisfied. Any exchange involving an exchange agreement or binding promise to exchange was not considered an exchange of "like-kind" property unless the exchange was simultaneous. However, the Ninth Circuit held in *Starker* that the simultaneous exchange of title was not significant where the taxpayer had signed an agreement binding them to an exchange.[69] After *Starker*, taxpayers had more flexibility to structure exchanges that occurred in a series of "steps" which eventually led to the practice of multi-party and deferred exchanges. A typical multi-party exchange involves (i) a taxpayer who proposes to exchange properties, (ii) the purchaser to whom the taxpayer will sell the Relinquished Property, (iii) the seller of the Replacement Property, and (iv) an intermediary to facilitate a deferred exchange pursuant to the safe harbor rules.

i. Deferred Exchanges.

Like-kind exchanges were initially only thought of in the context of a simultaneous exchange of Relinquished Property for Replacement Property between the respective owners of those properties. However, deferred like-kind exchanges, in which the Relinquished Property is not simultaneously exchanged for the Replacement Property, are also possible. On May 1, 1991, the Department of Treasury published Regulations on deferred exchanges.[70] The most significant provisions in the Regulations are those creating the four safe harbors.[71] These techniques avoid both the actual or constructive receipt of money (resulting in a fully and

[68] 42 BTA 490 (1940).
[69] *Starker v. U.S.*, 602 F2d 1341 (9th Cir. 1979).
[70] T.D. 8346.
[71] Treas. Reg. § 1.1031(k)-1(g).

presently taxable transfer) for purposes of Section 1031. A deferred like-kind exchange that does not satisfy the safe harbor rules may qualify under the like-kind exchange rules established by case law precedent. Treas. Reg. § 1.1031(k)-1 provides guidance on deferred exchanges. According to the safe harbor rules, like-kind can be acquired after the sale of Relinquished Property, provided that the "identification" and "exchange" deadlines are met.

1. Identification Period – 45 Day Rule.

The identification period begins on the date the taxpayer transfers the Relinquished Property and ends at midnight on the 45th day thereafter.[72] The counting of days begins on the date after the transfer, and is illustrated in the Regulations to be a full 45 days following the date of closing.[73]

During the identification period, the taxpayer may identify more than one potential Replacement Property if the identification satisfies either of the following tests:

(1) 3-property test. Under this test, the taxpayer may identify any three (3) properties without regard to their fair market value.[74]

(2) 200% test. Under this test, the taxpayer may identify any number of properties as long as the aggregate fair market values of the identified properties do not exceed 200% of the aggregate fair market values of the Relinquished Property as of the closing date.[75]

2. Exchange Period – 180 Day Rule.

The exchange period begins on the date the taxpayer transfers the Relinquished Property and ends at midnight on the earlier of (i) the 180th day thereafter, or (ii) the due date (including extensions) of the taxpayer's tax return for the year in which the transfer of the Relinquished Property occurs.[76] A taxpayer must file Form 4868 (for individuals) on or before the normal due date of the return to obtain the automatic extension for filing. If the form is not filed properly and timely, the exchange period ends on the normal due date of the return and any Replacement Property acquired after the normal due date will not qualify for the exchange. Form 8824 describes the like-kind exchange and should be attached to the taxpayer's tax return.

The Regulations provide the following example:

[72] Treas. Reg. § 1.1031(k)-1(b)(2)(i).
[73] Treas. Reg. § 1.1031(k)-1(b)(3).
[74] Treas. Reg. § 1.1031(k)-1(c)(4).
[75] Treas. Reg. § 1.1031(k)-1(e)(2)(ii).
[76] Treas. Reg. § 1.1031(k)-1.

Example. (i) M is a corporation that files its Federal income tax return on a calendar year basis. M and C enter into an agreement for an exchange of property that requires M to transfer property X to C. Under the agreement, M is to identify like-kind replacement property which C is required to purchase and to transfer to M. M transfers property X to C on November 16, 1992.

(ii) The identification period ends at midnight on December 31, 1992, the day which is 45 days after the date of transfer of property X. The exchange period ends at midnight on March 15, 1993, the due date for M's Federal income tax return for the taxable year in which M transferred property X. However, if M is allowed the automatic six-month extension for filing its tax return, the exchange period ends at midnight on May 15, 1993, the day which is 180 days after the date of transfer of property X.

Taxpayers may be entitled to an extension of these deadlines in extenuating circumstances, but the IRS must publish a notice or issue some other guidance providing relief with respect to a federally declared disaster, or a terroristic or military action.[77]

3. Multiple Properties.

If the taxpayer transfers multiple properties pursuant to the same deferred exchange and the Relinquished Properties are transferred on different dates, the identification period and the exchange period are determined by reference to the earliest date to which any of the properties are transferred.

4. Receipt of Money or Other Property.

A transfer of relinquished property in a deferred exchange is not within the provisions of Section 1031(a) if, as part of the consideration, the taxpayer receives money or other property.[78] In addition, in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or other property before the taxpayer actually receives like-kind replacement property. If the taxpayer actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before the taxpayer actually receives like-kind replacement property, the transaction will constitute a sale and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property.[79]

Except as provided in the safe harbor provisions of the Regulations, the determination of whether (or the extent to which) the taxpayer is in actual or constructive receipt of money or

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[77] Rev. Proc. 2007-56.
[78] Treas. Reg. § 1.1031(k)-1(f)(1).
[79] *Id*.

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other property before the taxpayer actually receives like-kind Replacement Property is made under the general rules concerning actual and constructive receipt and without regard to the taxpayer's method of accounting.[80] The taxpayer is in actual receipt of money or property at the time the taxpayer (i) actually receives the money or property, or (ii) receives the economic benefit of the money or property. The taxpayer is in constructive receipt of money or property at the time the money or property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to draw is given. Although the taxpayer is not in constructive receipt of money or property if the taxpayer's control of its receipt is subject to substantial limitations or restrictions, the taxpayer is in constructive receipt of the money or property at the time the limitations or restrictions lapse, expire, or are waived. In addition, actual or constructive receipt of money or property by an agent of the taxpayer is actual or constructive receipt by the taxpayer.

5. Safe Harbor Exchanges.

Treas. Reg. § 1.1031(k)-1(g) provides four "safe harbor" techniques to avoid both the actual or constructive receipt of money (resulting in a fully and presently taxable transfer) for purposes of Section 1031. Note that the safe harbors do not apply if the taxpayer has the ability or unrestricted right to receive money or other property before the taxpayer actually receives like-kind Replacement Property.

a. Security or Guaranty Arrangements.

Pursuant to Treas. Reg. § 1.1031(k)-1(g)(2), the obligation of the taxpayer's transferee to transfer the Replacement Property to the taxpayer may be secured or guaranteed by:

(1) a mortgage, deed of trust, or the security interest in property (other than cash or a cash equivalent),
(2) a standby letter of credit which meets certain requirements set forth in Treas. Reg. § 15A.453-1(b)(3) and does not allow the taxpayer to draw on the standby letter of credit except upon default of the transferee's obligation to transfer like-kind replacement property to the taxpayer, or
(3) a guaranty of a third party.

This safe harbor ceases to apply when the taxpayer has an immediate ability or unrestricted right to receive money or other property under the security or guaranty agreement. This method is more restrictive than other options and is not typically used by taxpayers.

[80] Treas. Reg. § 1.1031(k)-1(f)(2).

b. Qualified Escrow Accounts and Qualified Trusts.

The obligation of the taxpayer's transferee to transfer the Replacement Property to the taxpayer may be secured by cash or a cash equivalent if the cash or cash equivalent is held in a qualified escrow account or in a qualified trust.[81] A qualified escrow account is an escrow account where the escrow holder is not the taxpayer or an otherwise disqualified person, and the taxpayer's right to receive, pledge, borrow or otherwise obtain the benefits of the cash or cash equivalent held in the escrow account are limited to certain circumstances. A qualified trust is a trust where the trustee is neither the taxpayer nor an otherwise disqualified person, and the taxpayer's rights to receive, pledge, borrow or otherwise obtain the benefits of the cash or cash equivalent held by the trustee are limited to certain circumstances. The right conferred upon the taxpayer under state law with respect to the termination or dismissal of an escrow holder or trustee are disregarded in determining the taxpayer's immediate ability or right to receive or otherwise obtain the benefits of amounts held in escrow or by the trust. Additionally, the taxpayer may receive money or other property directly from a party to the exchange without voiding the safe harbor provisions. However, the failure to use a qualified escrow account will render the exchange ineligible for non-recognition.[82]

c. Qualified Intermediaries.

In general, pursuant to Treas. Reg. § 1.1031(k)-1(g)(4), a Qualified Intermediary ("QI") is not considered an agent of the taxpayer for purposes of Section 1031. This safe harbor applies only if the exchange agreement between the taxpayer and the QI expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the QI. A QI is generally a person other than the taxpayer or an otherwise disqualified person who, for a fee, acts to facilitate the deferred exchange. The QI enters into a written agreement with the taxpayer where the QI agrees to receive the relinquished property from the taxpayer, acquire the replacement property with the proceeds of the relinquished property, and transfer the replacement property to the taxpayer. A QI will be treated as properly acquiring and transferring property if the QI: (1) transfers legal title to the property; (2) enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property to that person and pursuant to that agreement, the relinquished property is transferred to that person; and (3) enters into an agreement with the owner of the replacement property for the transfer of that property and pursuant to that agreement, the replacement property is transferred to the taxpayer.[83] A taxpayer may enter into an agreement for the transfer of the Relinquished

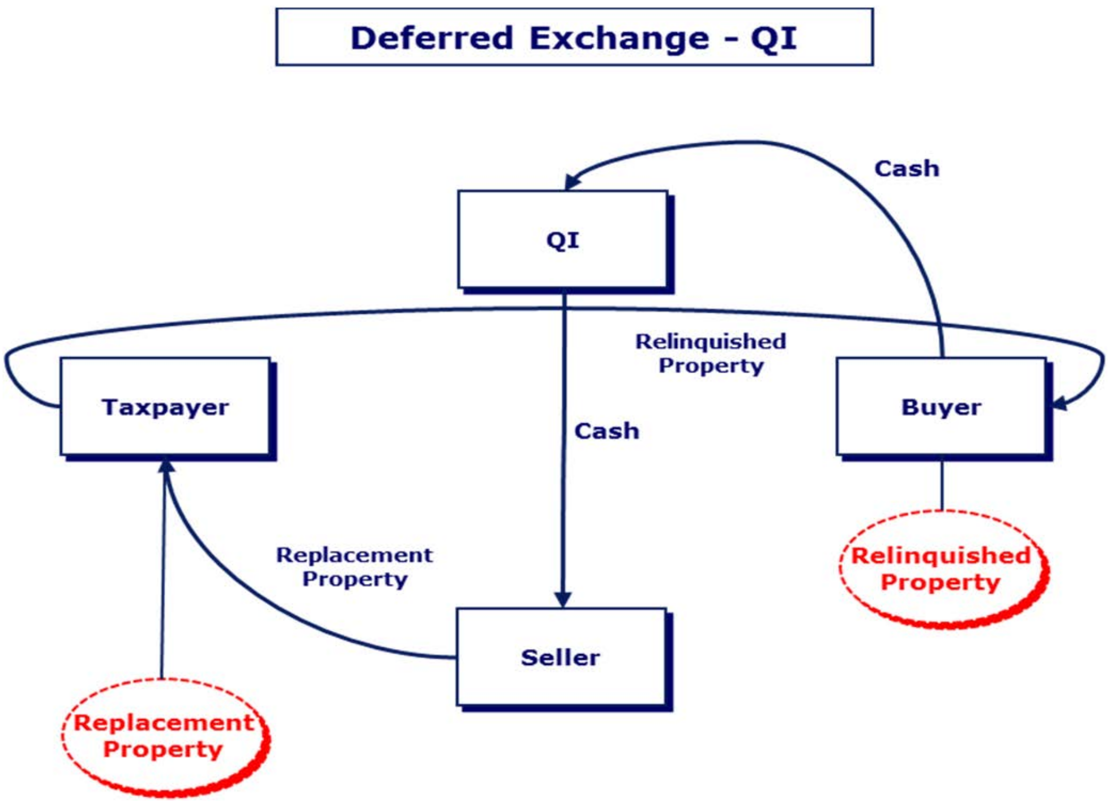
[81] Treas. Reg. § 1.1031(k)-1(g)(3).

[82] *See Ralph E. Crandall, Jr. and Dene E. Dulin*, T.C. Summary Opinion 2011-12, in which the escrow account used by the sellers did not include the limitations of use of funds by the taxpayers as required under Treas. Reg. § 1.1031(k)-1(g)(3)(ii). Even though the funds in the escrow account were used to purchase the Replacement Property, the transaction did not qualify for deferred recognition.

[83] Treas. Reg. § 1.1031(k)-1(g)(4)(iv).

Property and thereafter notify, in writing, all parties of the assignment to the QI.[84] This is the typical structure of a like-kind exchange. If the Relinquished Property is subsequently transferred pursuant to the agreement, the QI is treated as having acquired and transferred the Relinquished Property for purposes of the QI safe harbor rules.

Under Rev. Proc. 2010-14, the IRS has provided a safe harbor method to report gain or loss by taxpayers who are unable to complete a deferred like-kind exchange solely due to a QI who defaults on its obligation to acquire and transfer replacement property. As long as certain specified conditions are met, gain need only be recognized on the disposition of Relinquished Property as required under the guidance.



d. Additional Restrictions on Safe Harbor Methods.

All of the safe harbor exchange techniques described above are available only if the taxpayer has no rights to receive, pledge, borrow or otherwise obtain the benefits of money or other property before the end of the 180-day exchange period unless: (1) the taxpayer has not identified Replacement Property by the end of the 45-day identification period; (2) the taxpayer has received all of the Replacement Property to which the taxpayer is entitled under the

[84] *See* Treas. Reg. § 1.1031(k)-1(g)(4)(v).

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exchange agreement; or (3) the occurrence of a material and substantial contingency after the end of the identification period that (x) relates to the deferred exchange, (y) is provided for in the written exchange agreement, and (z) is beyond the control of the taxpayer and of any disqualified person other than the person obligated to transfer the replacement property to the taxpayer.[85]

6. Reverse Exchanges.

a. Typical Structures.

In a typical like-kind exchange, the taxpayer finds the Replacement Property it wishes to purchase before it sells the Relinquished Property. Suppose the order of events is reversed, however, and the taxpayer sells the Relinquished Property before identifying the Replacement Property. Rev. Proc. 2000-37[86] provides a safe harbor for this "reverse" exchange and allows an exchange accommodation titleholder ("EAT") to acquire either the Relinquished Property or the Replacement Property to hold for up to 180 days while the taxpayer attempts to sell the Relinquished Property. The IRS will treat an EAT as the beneficial owner of such property if the property is held in a qualified exchange accommodation arrangement ("QEAA"). Without the safe harbor established by Rev. Proc. 2000-37, the taxpayer could not be sure whether the EAT was the owner of the parked property for federal income tax purposes or was acting as the taxpayer's agent. Under Rev. Proc. 2000-37, the IRS will not challenge: (i) the qualification of property as either Replacement Property or Relinquished Property in an exchange; or (ii) the treatment of an EAT as the beneficial owner of such property if the property is held pursuant a QEAA. While the IRS recognizes that reverse exchanges can be accomplished outside the safe harbor rules discussed above, there is no certainty that the exchange will be respected. Moreover, in addition to the rules identified in Rev. Proc. 2000-37, the IRS issued Rev. Proc. 2004-51 to provide that the safe harbor will not apply to any Replacement Property held by the taxpayer within the 180 days prior to its transfer to the EAT. The IRS and Treasury Department are continuing to study parking arrangements, including transactions in which a person related to the taxpayer transfers a leasehold interest in land to an EAT, the EAT makes improvements to the land, and the EAT transfers the leasehold with improvements to the taxpayer in exchange for other real estate.

Rev. Proc. 2000-37 provides for two types of QEA arrangements. In the first structure, the exchange occurs up front with the taxpayer acquiring the Replacement Property and conveying the Relinquished Property to the EAT. This is often the case when the lender requires the taxpayer, rather than the EAT, acquire title to the Replacement Property. Most single family residential lenders require that the taxpayer own title to the Replacement Property when the loan is made. It could also be the case that the taxpayer wishes to begin depreciating the Replacement

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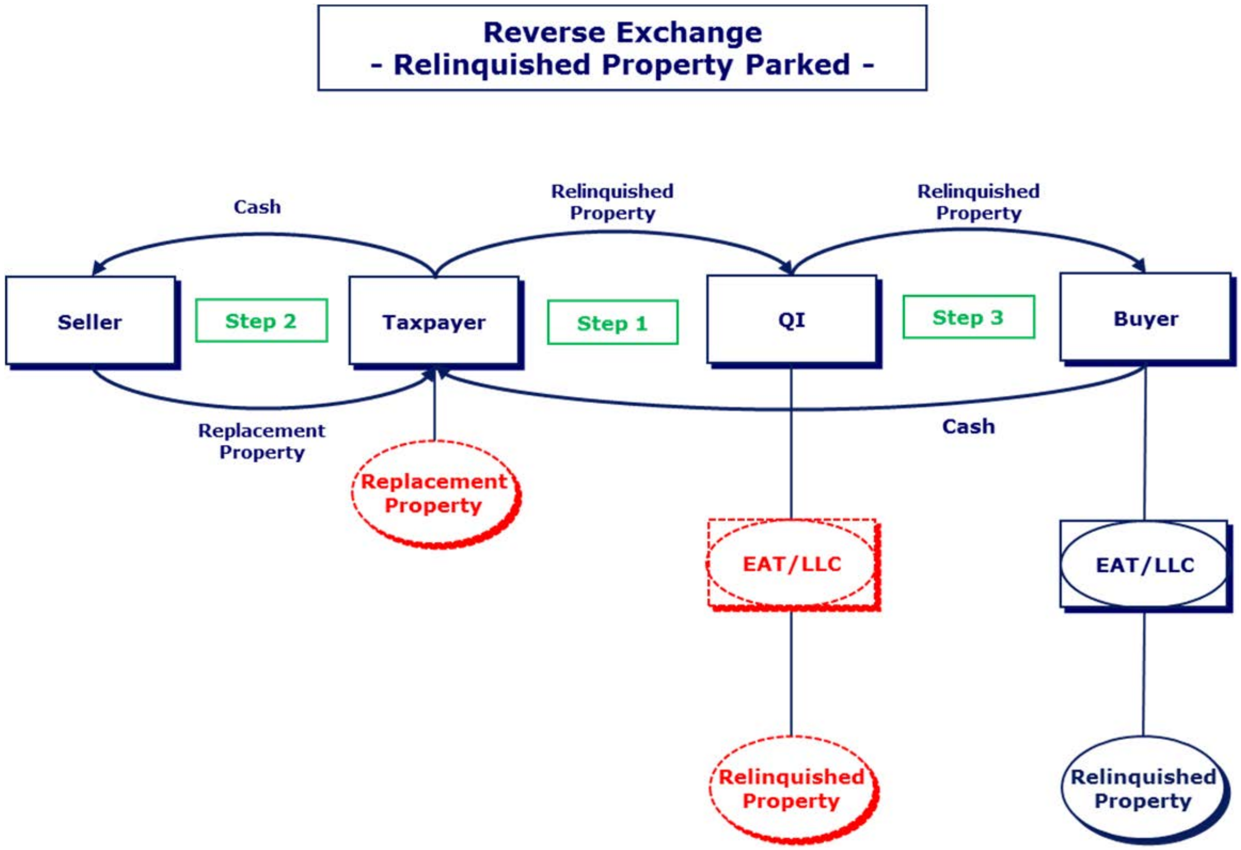
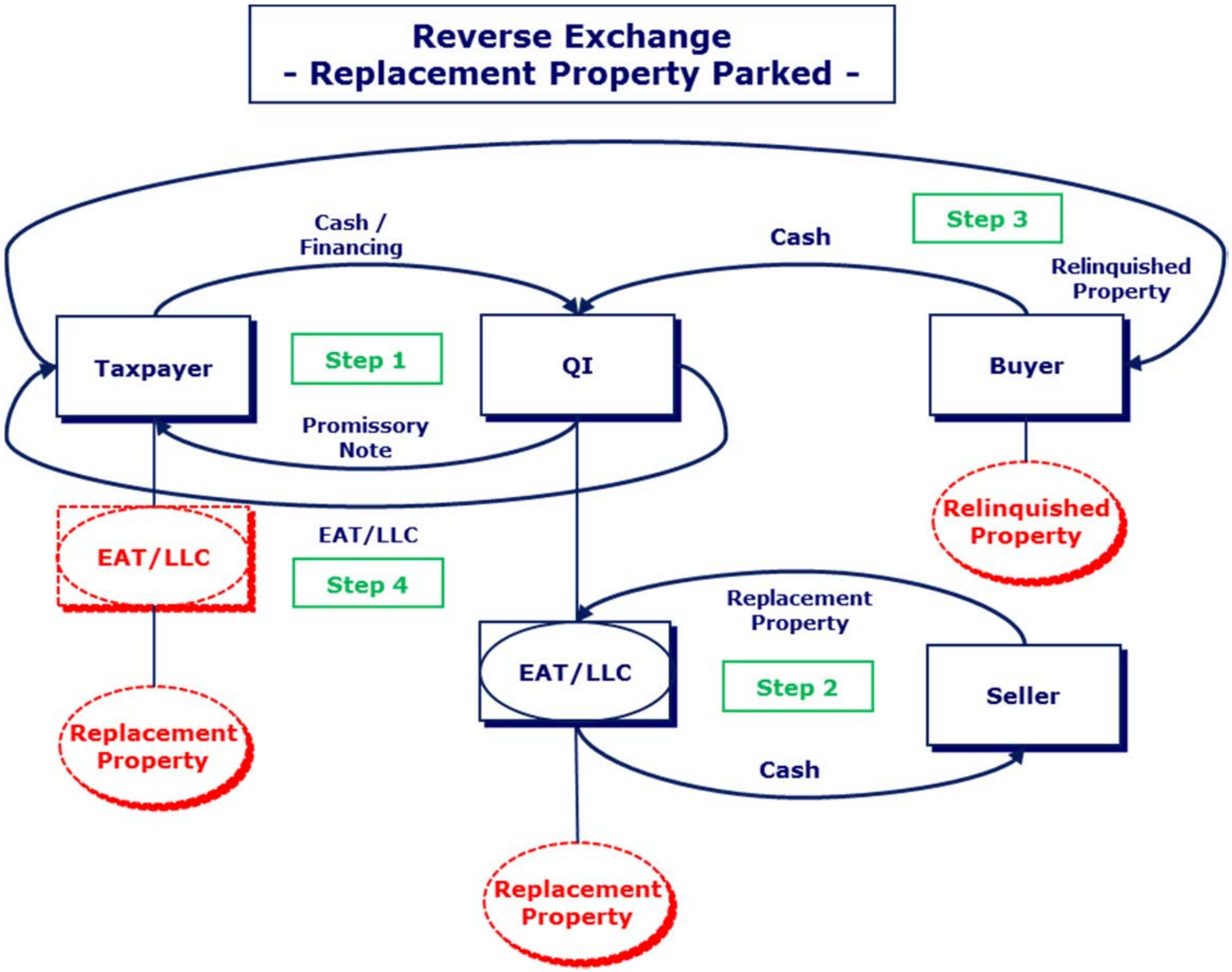
[85] Treas. Reg. § 1.1031(k)-1(g)(6).
[86] 2000-40 I.RB 308.

Property immediately, as opposed to waiting until it is conveyed from the QI or EAT 180 days later. This type of reverse exchange is depicted below:



In the second structure, the EAT acquires the Replacement Property. When the taxpayer's Relinquished Property is ready to close, then the taxpayer will exchange the Relinquished Property for the Replacement Property at the back end of the exchange transaction. This type of exchange is depicted as follows:



The EAT is also permitted to park both the Replacement Property and the Relinquished Property as long as the combined parking period does not exceed 180 days.[87]

b. EAT Requirements.

The EAT, who may also act as the QI, cannot be the taxpayer or a "disqualified person".[88] The services performed as an EAT will not be considered in determining whether someone is a disqualified person.[89] The EAT must be a person subject to federal income tax, and if the EAT is treated as a partnership or S corporation for federal income tax purposes, then more than 90% of its interests or stock must be owned by partners or shareholders who are subject to federal income tax.[90] The EAT must hold "qualified indicia of ownership" at all times from the date of acquisition by the EAT until the parked property is transferred, which includes legal title. Qualified indicia of ownership also includes interests in a disregarded entity. Rev. Proc. 2000-37

[87] Rev. Proc. 2000-37, § 3.02(6).
[88] *See* Treas. Reg. § 1.1031(k)-1(k); Rev. Proc. 2000-37.
[89] Rev. Proc. 2000-37, §3.03, 2000-2 C.B. 308.
[90] Rev. Proc. 2000-37, §4.02(1), 2000-2 C.B. 308.

does not state whether the deed must be recorded in the case of real property, although an unrecorded deed should be allowable if it transfers title under applicable state law. The QEA agreement may specify that the EAT is the taxpayer's agent, which may be helpful in avoiding transfer taxes in some jurisdictions and when the parked property is undergoing construction. The EAT should be a single purpose entity, holding only the taxpayer's property. The taxpayer may also be able to acquire 100% ownership of the EAT (rather than directly acquiring the Replacement Property), and avoid a second real estate transfer tax in some jurisdictions.[91]

c. Qualified Exchange Accommodation Agreement.

No later than five (5) business days after the EAT receives the parked property, the taxpayer and the EAT must enter into a written QEAA, which must state that the EAT is holding the property for the benefit of the taxpayer to facilitate a Section 1031 like-kind exchange. The QEAA must specify that the EAT will be treated as the beneficial owner of the property for all federal income tax purposes. Rev. Proc. 2000-37 specifically does not address whether the EAT should depreciate the property while holding it. At the time the parked property is transferred to the EAT, the taxpayer must have the bona fide intent that the parked property held by the EAT represent either Replacement Property or Relinquished Property in an exchange under Section 1031.[92]

Rev. Proc. 2000-37 provides that the QEAA may contain the following legal or contractual arrangements, regardless of whether such arrangements contain terms that typically would result from arm's length bargaining between unrelated parties.[93] The listed permissible agreements are as follows:

(1) An EAT that satisfies the requirements of the qualified intermediary safe harbor set forth in section 1.1031(k)-1(g)(4) may enter into an exchange agreement with the taxpayer to serve as the qualified intermediary in a simultaneous or deferred exchange of the property under section 1031;

(2) The taxpayer or a disqualified person ***guarantees*** some or all of the obligations of the exchange accommodation titleholder, including secured or unsecured debt incurred to acquire the property, or ***indemnifies*** the exchange accommodation titleholder against costs and expenses;

(3) The taxpayer or a disqualified person ***loans or advances funds*** to the EAT or guarantees a loan or advance to the EAT;

(4) The property is ***leased*** by the EAT to the taxpayer or a disqualified person;

[91] *See* Rev. Rul. 99-6, 1999-1 C.B. 432.
[92] Rev. Proc. 2000-37, §4.02(2), 2000-2 C.B. 308.
[93] Rev. Proc. 2000-37, §4.03, 2000-2 C.B. 308.

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(5) The taxpayer or a disqualified person ***manages*** the property, ***supervises*** improvement of the property, acts as a ***contractor***, or otherwise ***provides services*** to the EAT with respect to the property;

(6) The taxpayer and the EAT enter into agreements or arrangements relating to the purchase or sale of the property, including puts and calls at fixed or formula prices, effective for a period not in excess of 185 days from the date the property is acquired by the EAT; and

(7) The taxpayer and the EAT enter into agreements or arrangements providing that any variation in the value of a Relinquished Property from the estimated value on the date of the EAT's receipt of the property be taken into account upon the exchange accommodation titleholder's disposition of the Relinquished Property through the taxpayer's advance of funds to, or receipt of funds from, the EAT.

ii. Related Party Exchanges.

The Treasury Regulations expressly allow 1031 exchanges of like-kind property between related parties, but because of the potential for abuse, special restrictions are imposed. Subsection (f) of Section 1031 denies nonrecognition treatment to a taxpayer who exchanges property with a related person when the taxpayer would otherwise qualify for nonrecognition treatment, if either the taxpayer or the related person disposes of the property within two years of the date of the last transfer that was part of the exchange. In such a scenario, gain or loss is taken into account as of the date of the disposition of the property by either the taxpayer or the related party.[94] An exchange can also be taxable under Section 1031(f)(4) if the taxpayer transfers Relinquished Property to an unrelated party, but acquires the Replacement Property from a related party. The concept behind these related party rules was to prohibit shifting of tax basis between properties owned by related parties.

A "related party" under Section 1031 is a very broad concept, which includes the relationships described in Sections 267(b) and 707(b)(1) as well as: (i) family members, including brothers, sisters, ancestors and lineal descendants (i.e., children and grandchildren, etc...); (ii) an individual and corporation in which the individual directly or indirectly owns more than 50% of the stock issued by that corporation; (iii) two corporations which are members of the same controlled group; and (iv) a trust and its grantor or trustee.[95] The constructive ownership rules and family attribution rules also apply, so care should be taken when attempting to perform a 1031 exchange between multiple related parties.

[94] § 1031(f)(c).
[95] § 1031(f)(3).

Example. X owns Property 1 with a FMV of $1,000,000 and an adjusted basis of $100,000. Y, a related party to X, owns Property 2 with a FMV of $100,000 but an adjusted basis of $800,000. An unrelated buyer wants to acquire Property 1. X and Y exchange Property 1 for Property 2 in a like-kind exchange. Y sells Property 1 to buyer and pays tax on a $200,000 gain. A $900,000 gain would have been recognized had X sold Property 1 to the buyer instead of exchanging Property 1 for Property 2 with Y.

Exceptions to the two-year holding period which will not cause the gain to be taxable upon disposition include: (a) if the subsequent disposition occurs after the death of the taxpayer or the related party; (b) if the subsequent disposition occurs as a result of a compulsory or involuntary conversion, but only if the original like-kind exchange took place before the threat of conversion; or (c) if the taxpayer can establish that tax avoidance was not the purpose for either the original exchange or the subsequent disposition.[96]

III. Calculating Gain, Loss and Basis.

A. Boot.

If an exchange otherwise would be eligible for tax-free treatment under Section 1031(a) but for the receipt of cash or non-qualifying property ("boot"), any gain inherent in the Relinquished Property is taxable to the extent of the boot received. The amount of any of the taxpayer's liabilities assumed in the exchange or the amount of any liabilities attaching to the Replacement Property is also treated as money received by the taxpayer in the exchange.[97] Treas. Reg. § 1.1031(d)-2 expressly permits a taxpayer to determine whether liabilities have been relieved by using a "netting" concept, i.e., the liabilities encumbering the Relinquished Property or otherwise assumed in respect to the Relinquished Property are netted against the liabilities encumbering the Replacement Property or otherwise assumed in respect to the Replacement Property. If there is a net decrease in the "net" liabilities, then the taxpayer has taxable boot to the extent of the decrease. Cash paid by a taxpayer to compensate the other party in the transaction for a net decrease in the taxpayer's liabilities will offset and reduce the "net decrease in liabilities" boot. Boot given or paid by the taxpayer includes paying additional cash for the Replacement Property, assuming a mortgage on the Replacement Property, or giving the seller of the Replacement Property a note in the exchange.

Example (1). Land with an adjusted basis of $70,000 and a FMV of $100,000 is transferred for land with a FMV of $80,000 plus cash of $20,000. A gain of $30,000 is realized ($100,000 amount realized (the FMV of land plus cash) less $70,000 adjusted basis of the transferred land). Gain is recognized to the extent of

[96] § 1031(f)(2).
[97] Treas. Reg. § 1.1031(b)-1(c).

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the boot received ($20,000 cash received) and the tax on the remaining $10,000 of gain is deferred.

Example (2). Land with an adjusted basis of $90,000 and a FMV of $100,000 is transferred for land with a FMV of $80,000 plus cash of $20,000. The amount recognized is limited to the gain realized of $10,000 ($100,000 amount realized minus $90,000 adjusted basis) which is less than the boot received ($20,000 cash).

Example (3). Taxpayer transfers Relinquished Property with value of $100,000 and mortgage of $30,000 in a deferred exchange. Within 180 days, taxpayer acquires Replacement Property with FMV of $90,000 and mortgage of $20,000 which partially offsets the $30,000 mortgage relief from the Relinquished Property. Taxpayer recognizes a gain of $10,000.

B. Transaction Expenses.

Some of the transactional costs paid by the taxpayer related to the exchange reduce the realized gain and recognized gain of the taxpayer and increase the tax basis of the Replacement Property.[98] Other closing costs are considered exchange expenses and are subtracted from the consideration received in the exchange to reduce realized gain. These include attorney's fees and brokerage fees. These closing costs are referred to as "exchange expenses" on Form 8824. While not specifically listed anywhere, these are costs that should include shipping costs, bidding costs, sales and transfer taxes, legal and accounting fees, title fees, engineering fees, survey costs, inspection costs, appraisal fees, recording fees, application fees, commissions, and compensation for the services of the QI or other exchange facilitator.

C. Depreciation Recapture.

Section 1245 depreciation recapture applies to a like-kind sale or exchange of personal property, and the recapture amount is limited to: (i) the amount of gain recognized, plus (ii) the fair market value of property acquired that is not Code § 1245 property.[99] Section 1250 depreciation recapture applies to a like-kind sale or exchange of real property, and the recapture amount is limited to the greater of either (i) the gain recognized for the exchange, or (ii) the Section 1250 recapture amount less the market value of Section 1250 property acquired in the transaction.[100] If any of the Section 1250 depreciation is not fully recaptured, then the remaining amount is deferred until the new property is sold or exchanged.

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[98] Treas. Reg. § 1.1031(d)-2.
[99] § 1245(b)(4).
[100] § 1250(d)(4).

D. Carryover Basis.

Like-kind exchanges result in tax deferral, not tax elimination. To preserve the inherent deferred gain for later taxation, § 1031(d) provides that the taxpayer's basis in the Replacement Property will equal the taxpayer's basis in the Relinquished Property, less any cash received by the taxpayer, less any loss recognized, plus any "boot" gain taxable to the taxpayer as a result of the exchange, plus any cash paid by the taxpayer for the Replacement Property.

IV. Planning Opportunities.

A. Corporation Built-In-Gain Tax.

A corporate-level tax, at the highest marginal rate applicable to corporations (i.e. 35%), is imposed on an S corporation's net recognized built-in gain (i.e., gain that arose prior to the conversion of the C corporation to an S corporation) and is recognized by the S corporation during the recognition period, which is generally the ten (10) year period beginning with the first day of the first taxable year for which the corporation is an S corporation.[101] The built-in gains tax is designed to prevent corporations that had unrecognized gain on assets during C years from avoiding corporate-level tax on the gain by converting to S status and then distributing the assets.

Following an S corporation election (whether timely filed or not), the corporation should have an appraisal of its assets in order to determine the built-in-gain as of effective date of the S election. The built-in-gain is the difference between the fair market value (which should be determined by independent appraisers) of the corporation's assets (as of the effective date of the S corporation election) and the corporation's tax basis in each of the assets. This built-in-gain as determined by an independent appraiser is subject to challenge by the IRS at a later date.

If any of the corporation's assets are sold within ten (10) years of the effective date of the S Corporation election, then the corporation will be liable for a built-in-gain tax under Section 1374 at the 35% corporate level income rate. However, all appreciation in the corporation's assets after the S corporation election effective date should be subject to one level of tax – a shareholder level tax. The shareholder tax rate will depend on the nature of the assets sold. Generally, depreciation recapture will be subject to ordinary income tax rates, while capital gains will be subject to a 20% to 23.8% capital gain tax rate at the individual level. As noted above, the appraisals are subject to IRS review. An IRS review is more likely if the corporation's assets are sold for a gain substantially in excess of the appraised value shortly after the effective dates. As such, it is important to obtain good appraisals.

In order to avoid recognizing the built-in-gain tax under Section 1374, taxpayers should consider whether the opportunity exists to eliminate that tax via a like-kind exchange. The

[101] § 1374(d)(7)(A).

requirement to recognize a 35% corporate level tax may be avoided if the recognition event is deferred beyond the ten (10) year "recognition period."

B. Basis Step-Up at Death.

Under the stepped-up basis rules, the income tax basis of property acquired from a decedent at death generally is stepped-up (or stepped down) to equal its value as of the date of the decedent's death (or on the date six months after the date of death, if alternate valuation (Code Sec. 2032) is elected on the decedent's estate tax return).[102]

The stepped-up basis rules contained in Section 1014 will not apply, however, with respect to appreciated property acquired by the decedent through gift within one year of the decedent's death (including the gift element of a bargain sale), if such property passes, either directly or indirectly, from the donee-decedent to the original donor or the donor's spouse.[103] The denial of a stepped-up basis is applicable when the donor receives the benefit of the appreciated property regardless of whether the bequest by the decedent is a specific bequest, a general bequest, a pecuniary bequest, or a residuary bequest. However, in the case of a pecuniary bequest, the donor will receive the benefit of the appreciated property only if the inclusion of such property in the estate of the decedent affects the amount that the donor receives under the pecuniary bequest.

> *Example*. Assume that A transfers appreciated property with a basis of $100 and a fair market value of $1,000 to D within one year of D's death. At D's death the property's basis was $200 and the fair market value of the property was $2,000. If A is D's heir and inherits the property, A's basis in the property will be $200, the basis to D at the time of his death. If A then subsequently sells the property for its fair market value of $2,000, he will recognize gain of $1,800 ($2,000 − $200). A similar computation results if, instead, the executor disposes of the property and distributes the proceeds to A. The estate recognizes gain of $1,800.

This rule applies only to the extent that the donor-heir is entitled to receive the value of the appreciated property. If the heir is only entitled to receive a portion of the property, e.g., because the property must be used to satisfy debts or administrative expenses, the rule is applicable on a pro-rata basis.

In order to take advantage of a basis step-up upon the death of a decedent, careful consideration should be given to using a like-kind exchange to avoid current recognition of tax. For example, as opposed to selling Relinquished Property for cash or other currently recognizable consideration, consider using a like-kind exchange to trade into a different like-kind property. As a result, the taxpayer will not have a current income recognition event and the

[102] § 1014.
[103] § 1014(e).

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taxpayer's heirs will inherit an asset with a FMV basis, eliminating what could be a substantial tax liability. Such a scenario will be especially true if the taxpayer has a large built-in gain.

C. Construction Improvements in a Deferred Exchange.

It is not uncommon for a taxpayer to want to make improvements to Replacement Property, and it is possible for those improvements to be included in the exchange value for the Replacement Property in a deferred exchange. Improvements could be repairs, remodeling, or even construction of a new building on existing undeveloped land. Improvements constructed after the taxpayer acquires the Replacement Property will not qualify for nonrecognition treatment.[104] In other words, construction occurring after receipt by the taxpayer of the Replacement Property is the receipt of services and is not like-kind.[105]

Improvements must be identified by the 45th day of the exchange period, and should be completed and transferred to the taxpayer by the 180th day in order for the exchange funds used to qualify for nonrecognition treatment. Thus, if a building is 20% complete at the time of transfer to the taxpayer, 80% of the construction will not be considered like-kind.

The following is a typical structure when improvements are made to Replacement Property:

> Taxpayer enters into an agreement to purchase land from the seller. After the sale of the Relinquished Property, taxpayer then assigns the purchase agreement to QI, who creates a new LLC (i.e., disregarded entity) to hold the property. The QI's sub, or the LLC, acquires land with a portion of the exchange proceeds and enters into a construction contract for the improvements. The QEAA (i.e., the exchange agreement) provides for the LLC to acquire the land and construct specific improvements within the required timeframe of the Section 1031 regulations. Alternatively, the land and improvements can be identified separately, as long as the improvements are identified by the 45th day of the exchange period. Taxpayer should approve all construction payments. Insurance, taxes, fees, and construction draws can be paid from the exchange proceeds. If the proceeds are insufficient to complete the construction, the QI may borrow from a bank or the taxpayer. If borrowing from a bank, the taxpayer can guarantee the loan without violating the permissible agreements outlined by Rev. Proc. 2000-37. Upon the earlier of the end of the exchange period, the completion of the construction, or when the improvements and land have enough value to meet the necessary exchange value, the land and improvements are transferred to the taxpayer via a

[104] Treas. Reg. § 1.1031(k)-1(e)(4).
[105] *Id.*

transfer of the LLC membership interests. Care should be made to avoid constructive receipt of the Replacement Property before the appropriate time.[106]

In certain instances, the taxpayer may want to dispose of Relinquished Property in order to build improvements on land it already owns. It is well established, however, that improvements alone in the form of construction and services are not like-kind to land.[107] "Although the term 'real estate' is often used to describe both land and improvements on the land, land and improvements are by nature not alike merely because one term is used to describe both. Land is not of the same nature or character as a building."[108]

One alternative that may be available to structure around this issue is to convey the land to a third party under the terms of an agreement whereby the taxpayer will buy the land back with the improvement completed as Replacement Property. Rev. Proc. 2004-51, however, specifically provides that the safe harbor guidelines in Rev. Proc. 2000-37 do not apply if the Replacement Property is owned by the taxpayer within the 180-day period pending on the date of the transfer of qualified indicia of ownership of the parked property. Moreover, the Tax Court in *DeCleene v. Commissioner*[109] found that the taxpayer in that case never actually divested itself of beneficial title to the Replacement Property land, and thus, could not acquire it in a like-kind exchange. "An exchange of real estate owned by a taxpayer for improvements on land owned by the same taxpayer does not meet the requirements of Section 1031."[110]

Another alternative technique may be to lease the land to an EAT for a period in excess of 30 years and 180 days. The EAT or a contractor could then construct the improvements on the leasehold and convey the EAT's leasehold interest to the taxpayer as Replacement Property. Caution should be taken in ensuring at least 30 years are on the remaining term of the leasehold interest at the time of conveyance. A very similar structure was employed in PLR 201408019. However, Rev. Proc. 2004-51 continues to warn that "The Service and Treasury Department are continuing to study parking transactions, including transactions in which a person related to the taxpayer transfers a leasehold in land to an accommodation party and the accommodation party makes improvements to the land and transfers the leasehold with the improvements to the taxpayer in exchange for other real estate."

It may also be possible to transfer a fee interest to a related party more than 180 days prior to the commencement of the parking transaction, and then have the EAT ground lease the property from the related party and construct the improvements. The taxpayer would then receive the ground lease and improvements as Replacement Property and the related party would

[106] *See* PLR 9428007.
[107] Rev. Proc. 2004-51, 2004-33 I.R.B. 294; Treas. Reg. § 1.1031(k)-1(e)(4).
[108] Rev. Rul. 76-391, 1976-2 C.B. 243.
[109] 115 T.C. 457 (2000).
[110] Rev. Proc. 2004-51.

continue to own the fee interest subject to the ground lease. Query whether the step-transaction doctrine may apply here, though.

D. Tenant-In-Common Interests.

As described above, non-recognition treatment does not apply to any exchange of partnership interests, whether the interests are general or limited partnership interests, or are interests in the same or different partnerships.[111] However, a tenancy-in-common ("TIC") should not be considered a partnership, and if the conditions set forth in Rev. Proc. 2002-22 are observed, the IRS should rule that an ownership interest in real estate as a TIC is not an interest in a business entity like a partnership.[112] The TIC structure is often utilized so that the owners may exchange in and out of their interest in the real property. TICs may be as simple as two individuals owning a single family rental residence together or as complicated as a syndicated TIC that could include strip malls, commercial real estate, multi-family, etc…. Rev. Proc. 2002-22 applies equally to all TIC scenarios. There are 15 guidelines found in section 6 of the Revenue Procedure, and the guidelines describe the conditions upon which a taxpayer may request a ruling from the IRS that an undivided fractional interest in rental real property (other than a mineral property as defined in Section 614) is not an interest in a business entity. *See* Exhibit A for a copy of Rev. Proc. 2002-22.

E. Delaware Statutory Trusts and Land Trusts.

In Rev. Rul. 92-105,[113] the IRS ruled that an interest in a land trust, like one created under California, Florida, Hawaii, Indiana, North Dakota, Virginia, or Illinois law, will be considered an interest in the real property held by the land trust for purposes of Section 1031 and not as a beneficial interest in the trust. To receive such treatment, (1) the trustee must have title to the real property, (2) the beneficiary (or a designee of the beneficiary) must have exclusive right to direct or control the trustee in dealing with the title to the property, and (3) the beneficiary must have the exclusive control of the management of the property, the exclusive right to the earnings and proceeds from the property, and the obligation to pay any taxes and liabilities relating to the property. This ruling does not apply to Real Estate Investment Trusts ("REITs"). The Revenue Ruling also pointed out that there were no other existing agreements which could have caused the arrangement to be classified as a partnership. If reclassified as a partnership, an exchange would not qualify for nonrecognition treatment under Section 1031. If a land trust has multiple beneficiaries, it is likely that the same guidelines set forth in Rev. Proc. 2002-22 regarding TICs should be observed.

A beneficial interest in a Delaware statutory trust ("DST") may also be considered an interest in the underlying real property held by the DST and eligible for nonrecognition treatment

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[111] Treas. Reg. §1.1031(a)-1(a)(1).
[112] 2002-14 I.R.B. 733.
[113] 1992-2 C.B. 204.

of Section 1031. In Rev. Rul. 2004-86,[114] the DST was not publicly traded and the trustee's duties were limited to the collection and distribution of income to the beneficial owners. The IRS ruled the beneficial interests represented interests in a grantor trust and the beneficial owners were considered to own undivided fractional interests in the real property for federal tax purposes. The risk here is that if the trustee has the authority to make other than nonstructural modifications to the property, the DST risks being reclassified as a business trust whose beneficial interests are incapable of being Replacement Property or Relinquished Property.

F. The "Pre-Packaged" Replacement Property.

In a true testament to the power of supply and demand, a "pre-packaged" real estate market has developed in large part to facilitate Section 1031 deferred like-kind exchanges (the "Secondary Market"). On the supply side of this market are companies like Home Depot, Walgreens, CVS, nationally prominent banks or any other large, publicly-traded company with multiple locations across the country. These companies, or more accurately, wholly-owned subsidiaries of these companies, are known as the "Tenants" in the pre-packaged market. In an attempt to grow quickly or cost-efficiently, or in an attempt to clean up the Tenant's balance sheet, the Tenant does the following: (1) the Tenant enters into a financing relationship with a nationally-recognized bank, such as Wells Fargo or Bank of America (the "Bank"), which agrees to assist in the Tenant's growth strategy by providing acquisition and construction loans for each new location; (2) the Tenant identifies an area and specific piece of property for a new location; (3) the Tenant forms a wholly-owned subsidiary, generally a disregarded LLC, which is a bankruptcy-remote, special purchase entity (an "SPE"); (4) after completing due diligence on the property, the SPE requests a loan from the Bank, purchases the property and builds a new facility on the property ("Store Front"); (5) the Tenant (or more likely a wholly-owned subsidiary of the Tenant) enters into a long-term lease with the SPE for use of the new location, typically 30+ years; and (6) once the construction is complete, the Tenant sells the SPE (and the associated long-term lease, loan and other supporting documentation) to an intermediary, such as a real estate holding company, a REIT or any other real estate investment company. In certain instances, the intermediary has previously agreed to buy a certain number (e.g., 50 locations across the country) or total value (e.g., $250 million) of properties from the Tenant once construction is complete. The intermediary then sells the SPEs to third parties, many of whom are looking for temporary Replacement Property in order to complete a like-kind exchange.

There are two main markets for the pre-packaged Store Fronts. First, these properties could be held and sold as an ordinary income-producing real estate investment. As mentioned above, the cash flow properties are more likely to be acquired as a true real estate investment. Alternatively, the Secondary Market also exists for these pre-packaged Store Fronts for like-kind exchange participants. Sellers of Relinquished Property who need to quickly identify and acquire Replacement Property pursuant to the safe harbor rules discussed above look to this

[114] 2004-2 CB 191.

Secondary Market as a place to "park" like-kind exchange proceeds while they look for other Replacement Property. This demand for pre-packaged Store Fronts makes the investment in the Store Fronts unusually liquid. For example, the equity in the Store Front (10+%) can be used as a capital contribution to a new entity, for which the taxpayer may be entitled to a preferred return, depending on the entity's organizational documents. Even some banks recognize the liquidity of the Store Fronts and will accept the equity in the Store Fronts as collateral for other loans. Store Fronts purchased in this Secondary Market are commonly sold within 60 days of being listed for sale, depending on the number of Store Fronts on the market at any particular time. Some of the pre-packaged Store Fronts also include the ability of the purchaser to have the debt on the properties "paid down" in order for the debt and equity in the Store Fronts to match the debt and equity of the Relinquished Property. After the acquisition of the Replacement Property is complete, the Bank may re-advance the portion of the purchase price that was "paid down".

Taxpayers acquiring the Replacement Property in this Secondary Market are subject to the same holding requirements as all other like-kind exchange participants. Therefore, the taxpayer should plan on *holding* these Store Fronts *for investment* (i.e. at least 12-18 months) before selling them. Often, the pre-packaged Store Fronts are considered as "parking arrangements" for like-kind exchange funds that allow the owners of the Store Fronts more time to find other real estate investments.

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EXHIBIT A
REV. PROC. 2002-22

Rev. Proc. 2002-22, 2002-1 CB 733, 03/19/2002, IRC Sec(s). 1031

Domestic "no rule" areas-exchange of property held for productive use or investment.

Headnote:

[CAUTION: This Rev Proc has been modified by Rev Proc 2003-3, 2003-1 IRB 113.]

IRS has removed from its list of domestic "no-rule" or "limited rule" areas question of whether undivided fractional interest in real property (other than **Code Sec. 614;** mineral property) is an interest in a separate tax entity ineligible for tax-free exchange under **Code Sec. 1031(a)(1);** . Topic was added to list in 2000, with rulings and letters not to be issued pending further guidance. *Rev Proc 2000-46,* 2000-2 CB 438, is superseded. *Rev Proc 2002-3,* 2002-1 CB 117, is modified.

Reference(s): **¶ 10,315.03(40); ¶ 76,557.48(10); Code Sec. 1031;**

Full Text:

1. Purpose

This revenue procedure specifies the conditions under which the Internal Revenue Service will consider a request for a ruling that an undivided fractional interest in rental real property (other than a mineral property as defined in section 614) is not an interest in a business entity, within the meaning of § 301.7701-2(a) of the Procedure and Administration Regulations.

This revenue procedure supersedes Rev. Proc. 2000-46, 2002-2 C.B. 438, which provides that the Service will not issue advance rulings or determination letters on the questions of whether an undivided fractional interest in real property is an interest in an entity that is not eligible for tax-free exchange under § 1031(a)(1) of the Internal Revenue Code and whether arrangements where taxpayers acquire undivided fractional interests in real property constitute separate entities for federal tax purposes under § 7701. This revenue procedure also modifies Rev. Proc. 2002-3, 2002-1 I.R.B. 117, by removing these issues from the list of subjects on which the Service will not rule. Requests for advance rulings described in Rev. Proc. 2000-46 that are not covered by this revenue procedure, such as rulings concerning mineral property, will be considered under procedures set forth in Rev. Proc. 2002-1, 2002-1 I.R.B. 1 (or its successor).

2. Background

Section 301.7701-1(a)(1) provides that whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal law and does not depend on whether the entity is recognized as an entity under local law. Section 301.7701-1(a)(2) provides that a joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom, but the mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes.

Section 301.7701-2(a) provides that a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership.

Section 761(a) provides that the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and that is not a corporation or a trust or estate.

Section 1.761-1(a) of the Income Tax Regulations provides that the term "partnership" means a partnership as determined under §§ 301.7701-1, 301.7701-2, and 301.7701-3.

The central characteristic of a tenancy in common, one of the traditional concurrent estates in land, is that each owner is deemed to own individually a physically undivided part of the entire parcel of property. Each tenant in common is entitled to share with the other tenants the possession of the whole parcel and has the associated rights to a proportionate share of rents or profits from the property, to transfer the interest, and to demand a partition of the property. These rights generally provide a tenant in common the benefits of ownership of the property within the constraint that no rights may be exercised to the detriment of the other tenants in common. 7 Richard R. Powell, Powell on Real Property §§ 50.01-50.07 (Michael Allan Wolf ed., 2000).

Rev. Rul. 75-374, 1975-2 C.B. 261, concludes that a two-person co-ownership of an apartment building that was rented to tenants did not constitute a partnership for federal tax purposes. In the revenue ruling, the co-owners employed an agent to manage the apartments on their behalf; the agent collected rents, paid property taxes, insurance premiums, repair and maintenance expenses, and provided the tenants with customary services, such as heat, air conditioning, trash removal, unattended parking, and maintenance of public areas. The ruling concludes that the agent's activities in providing customary services to the tenants, although imputed to the co-owners, were not sufficiently extensive to cause the co-ownership to be characterized as a partnership. See also Rev. Rul. 79-77, 1979-1 C.B. 448, which did not find a business entity where three individuals transferred ownership of a commercial building subject to a net lease to a trust with the three individuals as beneficiaries.

Where a sponsor packages co-ownership interests for sale by acquiring property, negotiating a master lease on the property, and arranging for financing, the courts have looked at the relationships not only among the co-owners, but also between the sponsor (or persons related to the sponsor) and the co-owners in determining whether the co-ownership gives rise to a partnership. For example, in <u>Bergford v. Commissioner</u>, 12 F.3d 166 (9^{th} Cir. 1993), seventy-eight investors purchased "co-ownership" interests in computer equipment that was subject to a 7-year net lease. As part of the purchase, the co-owners authorized the manager to arrange financing and refinancing, purchase and lease the equipment, collect rents and apply those rents to the notes used to finance the equipment, prepare statements, and advance funds to participants on an interest-free basis to meet cash flow. The agreement allowed the co-owners to decide by majority vote whether to sell or lease the equipment at the end of the lease. Absent a majority vote, the manager could make that decision. In addition, the manager was entitled to a remarketing fee of 10 percent of the equipment's selling price or lease rental whether or not a co-owner terminated the agreement or the manager performed any remarketing. A co-owner could assign an interest in the co-ownership only after fulfilling numerous conditions and obtaining the manager's consent.

The court held that the co-ownership arrangement constituted a partnership for federal tax purposes. Among the factors that influenced the court's decision were the limitations on the co-owners' ability to sell, lease, or encumber either the co-ownership interest or the underlying property, and the manager's effective participation in both profits (through the remarketing fee) and losses (through the advances). Bergford, 12 F.3d at 169-170. AccordBussing v. Commissioner, 88 T.C. 449 (1987), aff'd on reh'g, 89 T.C. 1050 (1987); Alhouse v. Commissioner, T.C. Memo. 1991-652.

Under § 1.761-1(a) and §§ 301.7701-1 through 301.7701-3, a federal tax partnership does not include mere co-ownership of property where the owners' activities are limited to keeping the property maintained, in repair, rented or leased. However, as the above authorities demonstrate, a partnership for federal tax purposes is broader in scope than the common law meaning of partnership and may include groups not classified by state law as partnerships. Bergford, 12 F.3d at 169. Where the parties to a venture join together capital or services with the intent of conducting a business or enterprise and of sharing the profits and losses from the venture, a partnership (or other business entity) is created. Bussing, 88 T.C. at 460. Furthermore, where the economic benefits to the individual participants are not derivative of their co-ownership, but rather come from their joint relationship toward a common goal, the co-ownership arrangement will be characterized as a partnership (or other business entity) for federal tax purposes. Bergford, 12 F.3d at 169.

3. Scope

This revenue procedure applies to co-ownership of rental real property (other than mineral interests) (the Property) in an arrangement classified under local law as a tenancy-in-common.

This revenue procedure provides guidelines for requesting advance rulings solely to assist taxpayers in preparing ruling requests and the Service in issuing advance ruling letters as promptly as practicable. The guidelines set forth in this revenue procedure are not intended to be substantive rules and are not to be used for audit purposes.

4. Guidelines For Submitting Ruling Requests

The Service ordinarily will not consider a request for a ruling under this revenue procedure unless the information described in section 5 of this revenue procedure is included in the ruling request and the conditions described in section 6 of this revenue procedure are satisfied. Even if sections 5 and 6 of this revenue procedure are satisfied, however, the Service may decline to issue a ruling under this revenue procedure whenever warranted by the facts and circumstances of a particular case and whenever appropriate in the interest of sound tax administration.

Where multiple parcels of property owned by the co-owners are leased to a single tenant pursuant to a single lease agreement and any debt of one or more co-owners is secured by all of the parcels, the Service will generally treat all of the parcels as a single "Property." In such a case, the Service will generally not consider a ruling request under this revenue procedure unless: (1) each co-owner's percentage interest in each parcel is identical to that co-owner's percentage interest in every other parcel, (2) each co-owner's percentage interests in the parcels cannot be separated and traded independently, and (3) the parcels of property are properly viewed as a single business unit. The Service will generally treat contiguous parcels as comprising a single business unit. Even if the parcels are not contiguous, however, the Service may treat multiple parcels as comprising a single business unit where there is a close connection between the business use of one parcel and the business use of another parcel. For example, an office building and a garage that services the tenants of the office building may be treated as a single business unit even if the office building and the garage are not contiguous.

For purposes of this revenue procedure, the following definitions apply. The term "co-owner" means any person that owns an interest in the Property as a tenant in common. The term "sponsor" means any person who divides a single interest in the Property into multiple co-ownership interests for the purpose of offering those interests for sale. The term "related person" means a person bearing a relationship described in § 267(b) or 707(b)(1), except that in applying § 267(b) or 707(b)(1), the co-ownership will be treated as a partnership and each co-owner will be treated as a partner. The term "disregarded entity" means an entity that is disregarded as an entity separate from its owner for federal tax purposes. Examples of disregarded entities include qualified REIT subsidiaries (within the meaning of § 856(i)(2)), qualified subchapter S subsidiaries (within the meaning of § 1361(b)(3)(B)), and business entities that have only one owner and do not elect to be classified as corporations. The term "blanket lien" means any mortgage or trust deed that is recorded against the Property as a whole.

5. Information To Be Submitted

.01. Section 8 of Rev. Proc. 2002-1 outlines general requirements concerning the information to be submitted as part of a ruling request, including advance rulings under this revenue procedure. For example, any ruling request must contain a complete statement of all facts relating to the co-ownership, including those relating to promoting, financing, and managing the Property. Among the information to be included are the items of information specified in this revenue procedure; therefore, the ruling request must provide all items of information and conditions specified below and in section 6 of this revenue procedure, or at least account for all of the items. For example, if a co-ownership arrangement has no brokerage agreement permitted in section 6.12 of this revenue procedure, the ruling request should so state. Furthermore, merely submitting documents and supplementary materials required by section 5.02 of this revenue procedure does not satisfy all of the information requirements contained in section 5.02 of this revenue procedure or in section 8 of Rev. Proc. 2002-1; all material facts in the documents submitted must be explained in the ruling request and may not be merely incorporated by reference. All submitted documents and supplementary materials must contain applicable exhibits, attachments, and amendments. The ruling request must identify and explain any information or documents required in section 5 of this revenue procedure that are not included and any conditions in section 6 of this revenue procedure that are or are not satisfied.

.02. Required General Information and Copies of Documents and Supplementary Materials.

.02. Generally the following information and copies of documents and materials must be submitted with the ruling request:

(1) The name, taxpayer identification number, and percentage fractional interest in Property of each co-owner;

(2) The name, taxpayer identification number, ownership of, and any relationship among, all persons involved in the acquisition, sale, lease and other use of Property, including the sponsor, lessee, manager, and lender;

(3) A full description of the Property;

(4) A representation that each of the co-owners holds title to the Property (including each of multiple parcels of property treated as a single Property under this revenue procedure) as a tenant in common under local law;

(5) All promotional documents relating to the sale of fractional interests in the Property;

(6) All lending agreements relating to the Property;

(7) All agreements among the co-owners relating to the Property;

(8) Any lease agreement relating to the Property;

(9) Any purchase and sale agreement relating to the Property;

(10) Any property management or brokerage agreement relating to the Property; and

(11) Any other agreement relating to the Property not specified in this section, including agreements relating to any debt secured by the Property (such as guarantees or indemnity agreements) and any call and put options relating to the Property.

6. Conditions For Obtaining Rulings

The Service ordinarily will not consider a request for a ruling under this revenue procedure unless the conditions described below are satisfied. Nevertheless, where the conditions described below are not satisfied, the Service may consider a request for a ruling under this revenue procedure where the facts and circumstances clearly establish that such a ruling is appropriate.

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.01. Tenancy in Common Ownership.

.01. Each of the co-owners must hold title to the Property (either directly or through a disregarded entity) as a tenant in common under local law. Thus, title to the Property as a whole may not be held by an entity recognized under local law.

.02. Number of Co-Owners.

.02. The number of co-owners must be limited to no more than 35 persons. For this purpose, "person" is defined as in § 7701(a)(1), except that a husband and wife are treated as a single person and all persons who acquire interests from a co-owner by inheritance are treated as a single person.

.03. No Treatment of Co-Ownership as an Entity.

.03. The co-ownership may not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying any or all of the co-owners as partners, shareholders, or members of a business entity, or otherwise hold itself out as a partnership or other form of business entity (nor may the co-owners hold themselves out as partners, shareholders, or members of a business entity). The Service generally will not issue a ruling under this revenue procedure if the co-owners held interests in the Property through a partnership or corporation immediately prior to the formation of the co-ownership.

.04. Co-Ownership Agreement.

.04. The co-owners may enter into a limited co-ownership agreement that may run with the land. For example, a co-ownership agreement may provide that a co-owner must offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition (see section 6.06 of this revenue procedure for conditions relating to restrictions on alienation); or that certain actions on behalf of the co-ownership require the vote of co-owners holding more than 50 percent of the undivided interests in the Property (see section 6.05 of this revenue procedure for conditions relating to voting).

.05. Voting.

.05. The co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of the Property, any leases of a portion or all of the Property, or the creation or modification of a blanket lien. Any sale, lease, or re-lease of a portion or all of the Property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners. For all other actions on behalf of the co-ownership, the co-owners may agree to be bound by the vote of those holding more than 50 percent of the undivided interests in the Property. A co-owner who has consented to an action in conformance with this section 6.05 may provide the manager or other person a power of attorney to execute a specific document with respect to that action, but may not provide the manager or other person with a global power of attorney.

.06. Restrictions on Alienation.

.06. In general, each co-owner must have the rights to transfer, partition, and encumber the co-owner's undivided interest in the Property without the agreement or approval of any person. However, restrictions on the right to transfer, partition, or encumber interests in the Property that are required by a lender and that are consistent with customary commercial lending practices are not prohibited. See section 6.14 of this revenue procedure for restrictions on who may be a lender. Moreover, the co-owners, the sponsor, or the lessee may have a right of first offer (the right to have the first opportunity to offer to purchase the co-ownership interest) with respect to any co-owner's exercise of the right to transfer the co-ownership interest in the Property. In addition, a co-owner may agree to offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition.

.07. Sharing Proceeds and Liabilities upon Sale of Property.

.07. If the Property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners.

.08. Proportionate Sharing of Profits and Losses.

.08. Each co-owner must share in all revenues generated by the Property and all costs associated with the Property in proportion to the co-owner's undivided interest in the Property. Neither the other co-owners, nor the sponsor, nor the manager may advance funds to a co-owner to meet expenses associated with the co-ownership interest, unless the advance is recourse to the co-owner (and, where the co-owner is a disregarded entity, the owner of the co-owner) and is not for a period exceeding 31 days.

.09. Proportionate Sharing of Debt.

.09. The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.

.10. Options.

.10. A co-owner may issue an option to purchase the co-owner's undivided interest (call option), provided that the exercise price for the call option reflects the fair market value of the Property determined as of the time the option is exercised. For this purpose, the fair market value of an undivided interest in the Property is equal to the co-owner's percentage interest in the Property multiplied by the fair market value of the Property as a whole. A co-owner may not acquire an option to sell the co-owner's undivided interest (put option) to the sponsor, the lessee, another co-owner, or the lender, or any person related to the sponsor, the lessee, another co-owner, or the lender.

.11. No Business Activities.

.11. The co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property (customary activities). See Rev. Rul. 75-374, 1975-2 C.B. 261. Activities will be treated as customary activities for this purpose if the activities would not prevent an amount received by an organization described in § 511(a)(2) from qualifying as rent under § 512(b)(3)(A) and the regulations thereunder. In determining the co-owners' activities, all activities of the co-owners, their agents, and any persons related to the co-owners with respect to the Property will be taken into account, whether or not those activities are performed by the co-owners in their capacities as co-owners. For example, if the sponsor or a lessee is a co-owner, then all of the activities of the sponsor or lessee (or any person related to the sponsor or lessee) with respect to the Property will be taken into account in determining whether the co-owners' activities are customary activities. However, activities of a co-owner or a related person with respect to the Property (other than in the co-owner's capacity as a co-owner) will not be taken into account if the co-owner owns an undivided interest in the Property for less than 6 months.

.12. Management and Brokerage Agreements.

.12. The co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than annually, with an agent, who may be the sponsor or a co-owner (or any person related to the sponsor or a co-owner), but who may not be a lessee. The management agreement may authorize the manager to maintain a common bank account for the collection and deposit of rents and to offset expenses associated with the Property against any revenues before disbursing each co-owner's share of net revenues. In all events, however, the manager must disburse to the co-owners their shares of net revenues within 3 months from the date of receipt of those revenues. The management agreement may also authorize the manager to prepare statements for the co-owners showing their shares of revenue and costs from the Property. In addition, the management agreement may authorize the manager to obtain or modify insurance on the Property, and to negotiate modifications of the terms of any lease or any

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indebtedness encumbering the Property, subject to the approval of the co-owners. (See section 6.05 of this revenue procedure for conditions relating to the approval of lease and debt modifications.) The determination of any fees paid by the co-ownership to the manager must not depend in whole or in part on the income or profits derived by any person from the Property and may not exceed the fair market value of the manager's services. Any fee paid by the co-ownership to a broker must be comparable to fees paid by unrelated parties to brokers for similar services.

.13. Leasing Agreements.

.13. All leasing arrangements must be bona fide leases for federal tax purposes. Rents paid by a lessee must reflect the fair market value for the use of the Property. The determination of the amount of the rent must not depend, in whole or in part, on the income or profits derived by any person from the Property leased (other than an amount based on a fixed percentage or percentages of receipts or sales). See section 856(d)(2)(A) and the regulations thereunder. Thus, for example, the amount of rent paid by a lessee may not be based on a percentage of net income from the Property, cash flow, increases in equity, or similar arrangements.

.14. Loan Agreements.

.14. The lender with respect to any debt that encumbers the Property or with respect to any debt incurred to acquire an undivided interest in the Property may not be a related person to any co-owner, the sponsor, the manager, or any lessee of the Property.

.15. Payments to Sponsor.

.15. Except as otherwise provided in this revenue procedure, the amount of any payment to the sponsor for the acquisition of the co-ownership interest (and the amount of any fees paid to the sponsor for services) must reflect the fair market value of the acquired co-ownership interest (or the services rendered) and may not depend, in whole or in part, on the income or profits derived by any person from the Property.

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6. Effect On Other Documents

Rev. Proc. 2000-46 is superseded. Rev. Proc. 2002-3 is modified by removing sections 5.03 and 5.06.

7. Drafting Information

The principal authors of this revenue procedure are Jeanne Sullivan and Deane Burke of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact Ms. Sullivan or Mr. Burke at (202) 622-3070 (not a toll-free call).

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HAVE YOU EVER READ A REGULATION THAT COULD BE IMPROVED?

Bob Probasco

Of course! We all have. One of the primary objectives of the State Bar of Texas Tax Section is to help address this – improving the substance and administration of state and federal tax laws, one regulation or rule at a time.

WHAT WE DO

To make their regulations more effective, departments and agencies – including the IRS and the Texas Comptroller's Office – typically issue the regulations in proposed form first. They then solicit and consider comments from the public before finalizing the regulations. This "notice and comment" process is an important component of the rule-making process. The Tax Section often provides comments to the departments or agencies as part of that process, and representatives may also testify on the Section's behalf at public hearings on the proposed regulations. Under appropriate circumstances and with appropriate approval, the Section can even offer suggestions on final regulations for which the agency has not proposed changes or requested comments.

All such comments, to be filed on behalf of the Section, must be approved by our Committee on Government Submissions ("COGS"). But COGS is primarily a facilitator committee, coordinating and assisting with the process. The primary work of identifying regulations for comment and drafting those comments is done by individual members of the Section, usually organized by the appropriate substantive committee with responsibility for that particular area of tax law. Many individual members offer their time and experience to produce quality feedback on the proposals.

Our experience has been that the agencies sincerely appreciate responses to their proposals, even if they ultimately do not agree. Our suggestions reflect practical experience that the agencies may not have and contribute to better final regulations. Under the guidance of prior COGS Chairs Dan Baucum and Stephanie Schroepfer, the Tax Section established a strong reputation within the agencies as one of the best source of comments to proposed regulations. We take a collaborative, rather than confrontational, approach and make practical suggestions. We comment on a wide range of proposals, more than most other state bars. Most importantly, we target our suggestions. Rather than trying to prepare a lengthy, comprehensive response that addresses all aspects of the proposed regulations, we generally choose just a few issues that deserve particular attention or for which we think our perspective may be particularly helpful. The substance of our comments sometimes is as brief as one or two pages. Agencies appreciate such focused responses that don't waste time and effort analyzing minor aspects of the regulations with limited effect.

The agencies, taxpayers, and tax practitioners benefit from better and more considered regulations. The Tax Section benefits from a higher profile and prestige for the contributions. And the Tax Section members who work on the projects benefit from the exposure, within the

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Tax Section and from publication of comments in the national tax media. It's a win-win situation, for all involved.

RECENT PROJECTS

Our comments letters are included in each issue of *Texas Tax Lawyer*, as applicable, and are also posted to the Tax Section's website. Our recent projects include the following:

- The Texas Comptroller's Office has issued several proposed rules in the Texas Administrative Code this fiscal year. **Charolette Noel** and other members of the State & Local Tax Committee (including **David Colmenero**, **David Cowling**, **Karen Currie**, **Sandi Farquharson**, **Justin Hepworth**, **Ira Lipstet**, **Kirk Lyda**, **Sam Megally**, **Cindy Ohlenforst**, and **Alyson Outenreath**) further strengthened the Tax Section's relationship with the Comptroller's Office by submitting thoughtful responses to virtually all significant proposals. These rules have addressed a wide range of issues, including aircraft, sales for resale, timely filing and payment, and tax responsibilities/nexus. The committee's accomplishments are especially impressive due to the very short time frame typically available for preparing and submitting comments.

- Last fall, the IRS issued proposed regulations under Section 7602, which would allow third-party private contractors to participate in a summons interview. **Richard Hunn** and **Rob Morris** of the Tax Controversy Committee submitted comments – the only ones received by the IRS on these proposed regulations – that pointed out practical problems with, and the questionable legality of, allowing outside parties to actually question the witness under oath in a summons interview. This issue has been receiving a lot of attention recently, as a result of the IRS engagement of the law firm Quinn Emanuel Urquhart & Sullivan LLP for a transfer pricing audit of Microsoft. Media accounts of the controversy continue to mention our submission, months after it was filed.

- The Employee Benefits Committee has completed two important projects this fiscal year. The Texas Department of Insurance issued an informal working draft of rules concerning professional employer organizations sponsoring partially or fully self-funded/self-insured employee health benefit plans. **Henry Talavera** and **Jim Griffin** submitted comments and also attended a stakeholder meeting in Austin to discuss the draft rules. Their experience and expertise helped them point out potential conflicts with the Patient Protection and Affordable Care Act ("ACA") and ERISA, as well as the probable economic effects of the draft rules on PEO's and other co-employment relationships. As a result of their practical experience with co-employment arrangements and in-depth familiarity with relevant law like ACA and ERISA, TDI singled out Henry and Jim as part of a small group to work further with TDI on finalizing the rules. More recently, Henry and **Karen Suhre** worked with the Real Estate, Probate and Trust Law Section of the State Bar to draft a bill to amend the Texas Property Code regarding the treatment of inherited IRAs.

JOIN US!

You don't need to be one of the top Texas experts in tax law to participate. If you've ever read a regulation and thought about how you might have written it differently, you have what it takes to write comments on proposed regulations. If you read a particular proposed regulation that you would like to see changed, contact the Chair of the appropriate substantive committee (see our website for contact information) and volunteer to help. Even if you haven't run across a particular problem, you can express your interest in any upcoming projects to committee Chairs – they often can use some additional participants to share the effort. And if you have any questions about the process or would like to discuss further, feel free to contact any of the members of the COGS committee:

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We hope you'll consider participating!