THE TEXAS TAX LAWYER

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The Chair's Message

The 2001-2002 fiscal year will end in June. I am grateful to have had the opportunity to serve the Section over the past year. I want to thank my fellow officers, Council members, and the Section's committees for their encouragement, support, hard work and vision. Any success we have enjoyed over the past year is a tribute to the "can do" spirit of these individuals.

At the Section's annual meeting on Thursday, June 13, 2002, which will be held in Dallas, we will elect new officers and Council members. The Section's Nominating Committee has nominated the following persons to serve as officers for the 2002-2003 fiscal year: Robert Gibson (El Paso), Chair; Jack Taylor (Houston), Chair-Elect; David Wheat (Dallas), Secretary; and Bill Bowers (Dallas), Treasurer.

Tony Rebollo accepted a position with a firm in Columbia, South Carolina in February and resigned as a member of the Council. Gene Wolf (El Paso) has been nominated to fill the unexpired term. Gene, who has been a Council member, will move from a term expiring in 2004 to a term expiring in 2003. Steve Moore (Austin) has been nominated to fill Gene Wolf's unexpired term on the Council.

The Nominating Committee has nominated the following persons to serve as Council members with terms expiring in 2005: Tyree Collier (Dallas), Larry Jones (Dallas) and Allen Craig (Houston).

The following persons with unexpired terms will continue to serve on the Council: Jimmy Martens (term expiring 2003); Rosemary Shepard (term expiring 2003); Steve Erdahl (term expiring 2004); and Jeff Sher (term expiring 2004).

Our committees continue to plan outstanding conferences. Mark your calendars now for the following upcoming events: 18th Annual Federal Tax Institute – Hyatt Hill Country (Corporate and Partnership and Real Estate Committees), June 6-7, 2002; Advanced Tax Course with Tax Litigation Boot Camp – Houston (Continuing Education and Tax Controversy Committees), September 19-20, 2002; and International Tax Symposium (International Tax Committee), November 2002.

The Council has initiated a project to add continuing legal education materials to the Website. We will have more to report on this project in the coming months.

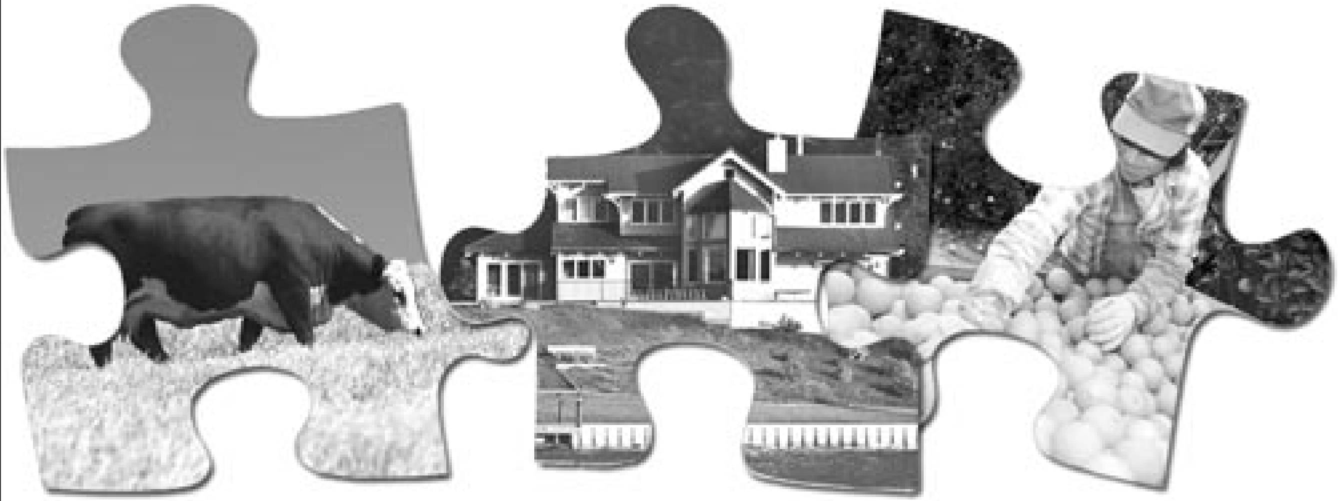
The Council has also voted to initiate an annual "Outstanding Tax Lawyer" award to recognize outstanding members of the Texas Tax Bar. (Special thanks to John Christian, Susan Burnette and Tony Rebollo for their hard work on this project.) The award will be given to one person each year who (1) is a member in good standing of the State Bar of Texas or an inactive member thereof; (2) has been licensed to practice law in Texas or another jurisdiction for at least ten years; and (3) has devoted at least 75 percent of his or her practice to taxation law. Current members of the Section may submit nominations. The Council will select the winner based on a set of criteria including reputation for expertise and professionalism within the community of tax professionals specifically and the broader legal community; authorship of scholarly works relating to taxation law; significant participation in the State Bar of Texas, American Bar Association, local bar associations, or other legal fraternities or organizations; significant contributions to the general welfare of the community; significant pro bono activities; reputation for ethics; mentorship of other tax professionals; experience on the bench relating to taxation law; experience in academia relating to taxation law; and other significant contributions or experience relating to taxation law. More information on the award and nomination forms will be forthcoming in the next few months.

William H. Hornberger
Chair, Section of Taxation
State Bar of Texas

WHAT'S UP WITH THE COMMITTEES

Name of Committee	Chair/Vice-Chair	Activities
Continuing Legal Education	Larry Jones, Chair Christina Mondrik, Vice-Chair	We are completing plans for the Advanced Tax Course in Houston on September 19 and 20, 2002.
Employee Benefits	Felicia F. Finston, Chair Randy Fickel, Vice-Chair	We are in the process of obtaining state bar approval for employee benefits as an area of legal specialization. In addition, we are working on scheduling periodic member meetings and/or seminars
Corporate Tax	Allen B. Craig, Chair Kenneth K. Bezozo, Vice-Chair	We are hosting the18th annual Texas Federal Tax Institute in San Antonio on June 6 and 7, 2002. In addition, we are working on a report to The Section of Taxation on "A Comprehensive Guide to Potential Tax Shelter Transactions."
Estate & Inheritance Tax	G. Edward Deery, Chair Stefnee Ashlock, Vice-Chair	In conjunction with the Tax-Exempt Organiza–tions Committee and the Planned Giving Council of Houston, we are currently planning a seminar on Charitable Giving and Planning Opportunities to be held tentatively in the early fall of this year in Houston
International Tax	Carol Peters, Chair Alexander G. McGeoch, Vice-Chair	We are holding luncheons on the third Thursday of each month at 11:45 a.m. at the Belo in Dallas.
Partnership & Real Estate Tax	Richard M. Fijolek, Chair Mitchell A. Tiras, Vice-Chair	We are co-hosting the18th annual Texas Federal Tax Institute in San Antonio on June 6 and 7, 2002.
Property Tax	G. Walter McCool, Chair Greg Dalton, Vice-Chair	We held our annual mid-year seminar at the Thompson Conference Center in Austin. Some 100 attorneys attended presentations on current case law developments, Public Information Act requests, due process in issues in tax collection, equal and uniform appraisal, ethics, and other timely property tax topics.
State & Local Tax	Steven D. Moore, Chair Daniel J. Micciche, Vice-Chair	We meet quarterly with the Texas Comptroller's Taxpayer Advisory Group, provide current development articles for the *Texas Tax Lawyer*, and continue to work on and maintain email communication database.
Tax Controversy	Josh O. Ungerman, Chair Elizabeth A. Copeland, Vice-Chair	We are sponsoring a special four hour evening course affiliated with the 2002 State Bar of Texas Advanced Tax Law Course entitled, "Tax Controversy College." The Tax Controversy College will take place from 6-10 p.m. on September 19, 2002, the first night of the 2002 State Bar of Texas Advanced Tax Law Course.

Tax-Exempt Finance	Bob Griffo, Chair James P. Plummer, Vice-Chair	We met in March and participants included tax attorneys from Dallas, Houston, Austin, San Antonio, and Los Angeles. We discussed current tax issues as well as updated members on the Bond Attorneys' Workshop, the ABA Tax Section Meeting, The Bond Buyer Texas Public Finance Conference, and the National Association of Bond Lawyers Tax Seminar. Mark Scott, Director of Tax-Exempt Bonds at the IRS TE/GE also participated in the meeting and answered questions. Other discussion topics included the IRS TE/GE Advisory Committee, the IRS Tax-Exempt Bond Audit Program, and pending Treasury Regulation Projects.
Tax-Exempt Organizations	Jeffrey E. Sher, Chair Tyree Collier, Vice-Chair	In conjunction with the Estate & Inheritance Tax Committee and the Planned Giving Council of Houston, we are currently planning a seminar on Charitable Giving and Planning Opportunities to be held tentatively in the early fall of this year in Houston.
Newsletter Editor	Gene Wolf, Chair Tina R. Green, Vice-Chair	Special thanks to my secretary, Mary Etter, for her tireless work on the *Texas Tax Lawyer*, to Tina Green for staying on top of the Committee Chairs and encouraging them to get their articles in on time, and to all the authors who devote their valued time and talent to making this a great publication.
Website	Steven D. Erdahl, Chair	Check out our website: www.texastaxsection.org. We are in the process of adding useful tax resources.



Annual Legal Seminar on Ad Valorem Taxation

The 16th Annual Legal Seminar on Ad Valorem Taxation will be held

Aug. 28 to 30

at the

Hyatt Regency Riverwalk Hotel in San Antonio.

This seminar is cosponsored by the State Bar of Texas Committee on Ad Valorem Taxation in conjunction with the Real Estate Center at Texas A&M University. For more information call Margaret Benedict at 979-845-9691.

The Texas A&M University System serves people of all ages, regardless of socioeconomic level, race, color, sex, religion, disability or national origin.

18th Annual Texas Federal Tax Institute

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Workouts and Restructuring in the New Economy – Fred T. Witt, Jr.
Cutting Edge Issues in Like-Kind Exchanges – Richard M. Lipton
The Future of the Transactional Tax Lawyer – Stefan F. Tucker and Stanley L. Blend
The Step Transaction Doctrine in Tax-Free Reorganizations – William M. Richardson and Jeffrey Paravano
Current Developments in Consolidated Returns – Don Leatherman
Tax Strategies for Financially Troubled Businesses – Elliot Freier

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FEATURED LUNCH SPEAKERS:

The Honorable B. John Williams – Chief Counsel of the Internal Revenue Service
Richard M. Lipton – Chair of the ABA Tax Section

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ESTATE AND GIFT TAX: RECENT DEVELOPMENTS

Randall K. Glover[1] and Paul F. Wright[2]

LETTER RULINGS

Separate Trusts Separate Annuity Separate Charitable Deduction

The IRS ruled that under IRC § 643(f) separate accounts established for multiple gifts will be treated as separate trusts for federal income tax purposes. The IRS also determined that separate annual distributions paid with respect to the gifts would constitute an IRC § 2522 guaranteed annuity that would qualify for the federal estate tax charitable deduction under IRC § 2055 (a) in the amount of the guaranteed annuity interest. In this ruling, a taxpayer established a trust. The trust agreement provided that the taxpayer would serve as initial trustee and a charitable beneficiary would receive annual distributions for approximately 40 years. Taxpayer intended to make two contributions to the trust. Separate accounts were to be established for the contributions, each would be invested separately and they would be not be commingled. Moreover, the funds within each account would not be used to fund any other account's annual distribution. The IRS concluded that the trust agreement contained the appropriate language under Treas. Reg. § 25.2522(c)-3(c)(2)(vi)(e). Further, the agreement included language that on the date each gift was made, a determinable amount would be payable to the Charity from the gift. Therefore, the IRS concluded the separate annual distributions would each constitute a guaranteed annuity within the meaning of IRC § 2522 (c)(2)(B) and Treas. Reg. § 25.2522(c)-3(e)(2)(vi) that qualified for the federal estate tax charitable deduction under IRC § 2055(a) in the amount of the guaranteed annuity interest. **PLR 200149016**.

Foundation Amendment Yields Disclaimer and Estate Tax Charitable Deduction

The IRS ruled that an amendment to a foundation agreement precluding a foundation trustee from any rights over disclaimed property would allow trustee's disclaimer to constitute a qualified disclaimer under IRC § 2518. The IRS also held that the amount passing to the foundation as a result of trustee's disclaimer, which would be held in a separate account and segregated from all other assets would qualify for an estate tax charitable deduction under IRC § 2055. The taxpayer and his wife formed an IRC § 509 private foundation. Taxpayer named his three children as trustees for the foundation. Taxpayer's will bequeathed a specific sum to the foundation and transferred the rest and residue of taxpayer's estate to his three children. Taxpayers will provided that should a child disclaim any portion of the residuary bequest, the disclaimed portion would pass to the foundation. One of taxpayer's children who was a Disclaiming Trustee decided to disclaim her share of the residuary estate. In conjunction with this disclaimer, all of taxpayer's children decided to amend the foundation agreement to include an article that would provide guidance for amounts received from disclaimers. The amendment provided that assets received by the foundation would be segregated into Special Accounts which would then be governed by Special Trustees. The amendment provided that a Special Trustee may not be a Disclaiming Trustee or a person who is under thirty and is a lineal descendant of a Disclaiming Trustee. The amendment also provided that the new article may not be revoked or amended to allow a Disclaiming Trustee or any person who is under age thirty and is a lineal descendant of a Disclaiming Trustee to control the ultimate disposition of a Special Account or remove a Special Trustee. The IRS ruled that in light of the fact that the Disclaiming Trustee would have no rights over the disclaimed property because of the foundation amendment, the disclaimer would constitute a qualified disclaimer. **PLR 200149015.**

Charitable Remainder Trusts

The IRS ruled that a Charitable Remainder Unitrust with five income beneficiaries met the requirements of IRC § 664(d)(2)(A) and (D). Taxpayer established a trust which provided for unitrust payments for five measuring lives. The trust also provided that as of the end of the calendar month preceding the death of the survivor of the designated beneficiaries, the payment of the unitrust payment to the survivor of them shall terminate and the trustee shall distribute the trust estate to a designated charity. The Trust instrument stated that the Trust is intended to qualify as a charitable remainder unitrust (CRUT) within the meaning of IRC § 664(d)(2), and is to be administered in a manner to be consistent with a CRUT. The Trust instrument also stated that any provision of the Trust and any provision of State law inconsistent with this intention would be of no effect. The IRS noted that, under § 4.01(38) of Rev. Proc. 2001-3, it generally will not rule in advance on the qualification of a CRUT with only one or two measuring lives. Since the Trust has five measuring lives, the IRS stated that § 4.01(38) of Rev. Proc. 2001-3 does not apply to it. The IRS discussed the requirements as set forth in IRC §§ 664 (d)(2)(A) and (D) and determined that the provisions of the Trust satisfy those requirements. **PLR 200150019.**

Timely Disclaimers

The IRS ruled that a disclaimer of interest in trust created prior to 1977 was timely. Decedent established an irrevocable trust for his grandchildren and the issue of his grandchildren. Decedent had two children and no grandchildren. Decedent's children were granted joint powers to close the class of decedent's grandchildren. The trust provided that if both children died without interest then a cousin should take a remainder interest in the trust. Cousin did not initially know of his interest in the trust. The trust agreement provided that upon termination if there are no grandchildren or issue of Decedent, the assets of the trust must be distributed to the heirs of Decedent in the proportions then fixed by State law. Decedent's children planned to release jointly their power to declare the class of Decedent's grandchildren closed. Cousin planned to execute a disclaimer of his interest in the trust. The IRS ruled that the power of Decedent's children to jointly declare during their lifetimes that the class of Decedent's grandchildren is closed does not constitute a general power of appointment nor would the declaration cause any part of the assets of the trust to be includable in either of their estates. The IRS provided that since the trust was created prior to 1977, the disclaimer by cousin was governed by Treas. Reg. § 25.2511-1(c)(2), and not by § 2518. The IRS further reviewed Jewett v. Commissioner, 445 U.S. 305 (1982) and noted that a disclaimer, if made within nine months of the date when cousin learned of his interest in the trust, is considered made within a reasonable time after he obtained knowledge of Decedent's transfer to the trust. Therefore, cousin's disclaimer would not constitute a gift under § IRC 2501. **PLR 200150020.**

Father executed a will creating Trust 1 and Trust 2. Mother was the primary beneficiary of both trusts during her life, and Father's children were permissible beneficiaries of Trust 2 after a specified date. Father and Mother both died, and taxpayer learned that she had an interest in Trust 1 and in Trust 2. She first learned that she had an interest in these trusts after reading Mother's will, which exercised a power of appointment over Trust 1 appointing the remainder of Trust 1 among Father's children. She subsequently located and read Father's will and met with an adviser, who informed her she was a remainder beneficiary of Trust 2. Taxpayer had no prior knowledge of any interests granted her under either trust. She never received or accepted any income or principal of Trust 2 and took no action that would preclude a disclaimer under state law. State law permits a beneficiary to disclaim in whole or in part the right of succession to any property or interest in property by delivering or filing a written disclaimer. State law provides a nine-month period for filing the disclaimer, dating from the time when the disclaimant gains actual knowledge of the existence of the interest. Taxpayer plans to disclaim her interest in Trust 2 by a date within nine months after the date when Mother died. The IRS applied the rationale of Jewett v. Commissioner, 455 U.S. 305 (1982), to the "reasonable time" standard of Treas. Reg. § 25.2511-1(c)(2), applicable to taxable transfers made prior to 1977, that create an interest in the disclaimant. The IRS concluded that taxpayer's disclaimer will be made within a reasonable time after she learned of her interest in Trust 2, for purposes of Treas. Reg. § 25.2511-1(c)(2). As a result, her disclaimer would not constitute a taxable gift under § 2501. **PLR 200202036.**

Gift Tax Charitable Deduction

In a ruling almost identical to prior PLR 200205008, the IRS ruled that a gift to charity of a fraction of a unitrust interest gives rise to deductions under IRC § 170 and IRC § 2522 for the present value of the fraction of a unitrust interest. Taxpayer created a charitable remainder unitrust. Trust was to pay to Taxpayer during his life and then for his wife's life a unitrust payment. Upon the death of Taxpayer and wife, the Trust would terminate and the principal and income would be distributed to certain charities. Taxpayer died and one of the charities requested that wife help with immediate funding needs. Wife proposed to transfer to charity a fraction of her unitrust interest. The IRS determined that under local law, wife's portion of her unitrust interest transferred free of trust to the charity merges with the charity's remainder interest and would qualify as a charitable deduction under IRC § 170. Regarding the charitable deduction under IRC § 2522, the IRS concluded that wife's proposed transfer of all right, title and interest that she owned in the unitrust interest was a transfer free of trust of an undivided portion of her entire interest in the property under § 25.2522(3)-3(c)(2)(i). Therefore, the IRS concluded that the present value of the undivided interest in the unitrust payment transferred by wife to the charity would qualify for a charitable deduction under IRC § 2522. **PLR 200207026.**

Powers of Appointment Will Not Result in Inclusion in Estate

The IRS found that the exercise of power of appointment over trusts to transfer property in further trust would not result in inclusion in estate. Taxpayer created two irrevocable trusts prior to her death and for the establishment of a third pursuant to the terms in her will. Taxpayer's grandson was granted testamentary nongeneral powers of appointment with respect to the three trusts. Grandson intended to execute a will that would direct that property from the three trusts would be held in three new family trusts. Grandson's proposed exercise of his testamentary limited powers of appointment would not create other powers that could be exercised under state law in a manner that postponed the vesting of any estate or interest or suspended the absolute ownership or power of alienation of property of the trusts, without regard to the date of creation of Grandson's original power under the trusts. The IRS reviewed Treas. Reg. § 26.2601-1(b)(1)(v)(A); Treas. Reg. § 26.2601-1(b)(1)(v)(B); and Treas. Reg. § 26.2601-1(b)(1)(v)(D), Ex. 6 and Ex. 7. The IRS concluded by ruling that the proposed exercise by Grandson of his testamentary nongeneral powers of appointment under the trusts would not result in a transfer in trust of property that is subject to the generation-skipping transfer tax. **PLR 200206045.**

Estate Tax Apportionment

The IRS ruled, that the Colorado estate tax apportionment statute applied to the estate tax generated by residuary bequests. Further, the IRS noted that any estate tax generated by the residuary bequests must be apportioned among all property passing to residuary beneficiaries that is not otherwise deductible and so does not generate any tax. In the instant ruling, decedent's will provided that decedent's personal representative must pay from the residuary estate or direct the Trust to pay all death taxes and governmental charges imposed and made payable under the laws of the United States or any state or country by reason of decedent's death. However, Decedent's will and trust failed to specify the residuary beneficiaries or assets that must bear the burden of paying federal estate taxes generated by the residuary bequests. The IRS reasoned that under the Colorado apportionment statute, decedent's intent determines whether the statutory apportionment rule applies to D's estate. The IRS ruled that the Colorado estate tax apportionment statute applied to estate tax generated by residuary bequests. The IRS citing Riggs v. Drago, 317 U.S. 95 (1942), held that applicable state law as to the devolution of property at death should govern the ultimate impact of the federal tax on the beneficiaries of an estate. Hence, the IRS citing In re Estate of Kelly, 584 P.2d 640 (Colo. App. 1978) held that the Colorado apportionment statute applied unless the testator expressed a clear and unambiguous intent that legacies and devises be transferred without deduction for taxes. Further, the IRS relying on In re Estate of Kelly, provided that a testator must make a clear and unambiguous manifestation of an intent to avoid apportionment; and this intent will not be inferred from vague and uncertain language. Ambiguous language would be interpreted in favor of apportionment. Accordingly, the IRS ruled that the Colorado apportionment applied to the estate tax associated with the residuary bequests. **PLR 200206024**.

Reformation of Testamentary CRUT Approved

The decedent's residuary estate was transferred by will to decedent's revocable inter vivos trust, which became irrevocable at decedent's death. The Trust agreement required the trustees to pay the trust's net income to decedent's son at least as often as quarterly, but did not permit the trustees to invade corpus for the benefit of the son or any beneficiary. At son's death, the trust corpus was to be divided into two equal shares. Each share would be held in a separate charitable trust, with income and corpus of those trusts to be used exclusively for a specified charitable purpose described in § 2055(a). The decedent's executor and the trustees filed a timely reformation proceeding petitioning the probate court to reform the Trust into a § 664(d)(2) charitable remainder unitrust. The court granted the petition requiring the trust to pay son a unitrust amount equal to 7.6 percent of the net fair market value of the trust's assets. Any excess income was to be added to principal. At son's death, the trust corpus will be divided into two equal shares, to be held by the charitable trusts as described above. IRS ruled that this was a qualified reformation of the trust, and the trust, as reformed, met the requirements of § 664(d) for a charitable remainder unitrust and would permit the estate to claim a deduction under § 2055(a). **PLR 200201026.**

Trusts keep grandfathered GST status

The IRS ruled that reformation of trust's income distribution provisions did not deprive trust of grandfathered exemption from tax. Decedent established a trust pursuant to the terms of Decedents will for the benefit of his daughter and her descendants. The trust originally provided that as long as Decedent's daughter is alive, or as long as any child of the daughter "then living" survives, and for a period of twenty one years after that, half of the trust income must be paid out to Decedent's daughter for her lifetime and the other half must be paid out to the grandchildren and heirs of their mother's blood until the last survivor of the grandchildren has died. The trust further provided that on the death of the last survivor of grandchildren and after the death of daughter, the corpus of the trust was to be divided into three equal parts and administered for twenty-one years pursuant to the terms of the trust. Subsequently, both of these provisions were reformed by court order to provide for distribution of the greater of the trust's annual net income or 6 percent of the Trust's total value as determined on the first day of each year. The IRS concluded that the trust met the requirements for the exception to the generation-skipping transfer tax provided by IRC § 1433 (b)(2)(A) of the Tax Reform Act of 1986 and Treas. Reg. § 26.2601-1(b)(1)(i). In applying Treas. Reg. § 26.2601-1(b)(4)(i), the IRS found that the court ordered reformation would not result in a shift of any beneficial interest in the trust to any beneficiary who occupies a generation lower than that of the persons who hold pre-reformation beneficial interest. Further, the IRS indicated that the reformation would not extend time for vesting of any beneficial interest in the trust beyond the period provided for in the trust. **PLR 200150016.**

In another GST exemption ruling, the IRS concluded that the transfer of assets to a subtrust, and modification of trustee provisions of trust did not deprive resulting trusts of grandfathered exemption from tax. The IRS determined that the Trust and Subtrust met the requirements for the exception to the generation-skipping transfer tax provided by § 1433(b)(2)(A) of the Tax Reform Act of 1986 and Treas. Reg. § 26.2601-1(b)(1)(i). The IRS provided that, under Treas. Reg. § 26.2601-1(b)(4)(i)(D)(2), a trust modification that is administrative in nature, that only indirectly increases the amount transferred would not be considered to shift a beneficiary interest in the trust. The IRS noted that the proposed modification of the subtrust would not result in a shift of any beneficial interest in the Trust to any beneficiary who occupies a generation lower than that of the persons holding the beneficial interest prior to the proposed modification. The IRS also found that the proposed modification would not extend the time for vesting of any beneficial interest beyond the period provided in the original Trust. Regarding the transfer of assets to a subtrust, the IRS ruled that the Trust's distribution of property to the Subtrust would not cause the Trust to realize gain or loss, provided that the Trust did not make a election under IRC § 643(e)(3). Particularly, the IRS discussed Rev. Rul. 56-437, holding that a partition of jointly held property is not a sale or other disposition of property. It also discussed Rev. Rul. 69-486, holding that a non-pro rata distribution of trust corpus by mutual agreement of the trust beneficiaries is a taxable exchange under IRC § 1001. Ultimately, however, the IRS cited the case of Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991); and Rev. Rul. 56-437, and held that the creation of the Subtrust and the distribution of assets from the Trust to Subtrust would not result in recognition of gain or loss under IRC § 1001 by the Trust or by Subtrust. The IRS also distinguished the discretionary authority of the trustees of the Trust to create and fund the Subtrust from the trustee's distribution in Rev. Rul. 69-486, which was created by mutual agreement of the beneficiaries rather than being authorized by the trust instrument or state law. **PLR 200207018.**

Husband and wife created an irrevocable trust under California before September 25, 1985. No additions, constructive or otherwise, were made to the trust after that date. Therefore, this trust was grandfathered from the application of the GST tax. Upon the death of both husband and wife, the trust instrument provided that the initial trust would split into separate trusts for each of the trustors' children. Sometime after the creation of the trust, the attorneys who drafted the trust instrument informed the trustors of a possible drafting error, giving each of the children a general power to appoint the trust property to themselves. Husband and wife thereafter decided to amend the trust to remove the general power, but husband died before the amendment occurred. The trustees of the trust then instituted an action to reform the trust to correct the scrivener's error. In connection with this action, the trustees submitted extensive documentation of discussions between the trustors and their attorneys, showing that when they established the trust they intended to give their children a limited power of appointment for life and a limited testamentary power of appointment. In view of the strong documentary evidence of the intent of husband and wife submitted by the trustees, the IRS concluded that the proposed reformation of the scrivener's error was consistent with California law as it would be applied by the highest court of that state. Further, as a result of the reformation, the trustors' children would have never had a general power of appointment over their trusts to cause them to be includable in their estates. Additionally, no lapse of powers of general powers of appointment would occur that could be considered a release of the power under §2514(e). The IRS determined that the trust met the requirements for the exception to the generation-skipping transfer tax provided by §1433(b)(2)(A) of the Tax Reform Act of 1986 and Treas. Reg. §26.2601-1(b)(1)(i). The proposed reformation of the trust was consistent with applicable state law as it would be applied by the highest court of the state. The IRS concluded that the proposed reformation would not affect the trust's grandfathered exemption from the §2601 tax and would not result in a transfer of property that would subject the children's trusts or distributions therefrom to the GST tax. **PLRs 200201017 and 200202020.**

The will of decedent, who died before Sept. 25, 1985, created two trusts (Trust A and Trust B). Bank and Daughter were the co-trustees of Trust A and Trust B. Daughter was an income beneficiary of Trust A and Trust B. Daughter had three living children (A, B, and C) who were income beneficiaries and contingent remainder beneficiaries of Trust A and Trust B. A had four living children, B had three living children, and C had no living children. Neither daughter, A, B, nor C had any deceased children. Trust A would terminate 21 years after daughter's death. Trust B would terminate 21 years from the death of the last to survive of Daughter, B, and C. Upon termination, the remaining property in each trust would be distributed on a per stirpes basis among the living descendants of Daughter. If no such descendants were then living, such distribution would be made to the heirs-at-law of decedent who were descendants of decedent's mother.

Daughter and Bank, as the co-trustees of Trust A and Trust B, planned to divide each of Trust A and Trust B into four separate trusts, resulting in eight new trusts. This division was permitted under state law. Immediately after this division all the separate trusts would have the same provisions as the trust from which they were derived. After the division, Daughter planned to petition to vary the terms of the trusts created by these divisions of Trust A and Trust B. Under such petition, two of the resulting trusts would each hold one-half of former Trust A and Trust B for the sole benefit of Daughter. Each of the other trusts would hold one-sixth of former Trust A and Trust B, and Daughter's three children would each be the sole beneficiary of a Trust A trust and a Trust B trust. After the court grants these amendments of the divided trusts, both Daughter and Bank plan to resign as trustees of the separate trusts other than Trust A1 and Trust B1. As permitted under state law, the sole beneficiary of each of the other separate trusts will designate himself and Bank as the co-trustees of that separate trust.

The IRS determined that Trust A and Trust B met the requirements for the exception to the generation-skipping transfer tax provided by §1433(b)(2)(A) of the Tax Reform Act of 1986 and Treas. Reg. §26.2601-1(b)(1)(i). The IRS found that, in accordance with Treas. Reg. §26.2601-1(b)(4)(i)(D), the proposed divisions of Trust A and Trust B would not result in a shift of any beneficial interest to any beneficiary who occupied a generation lower than that of the persons holding the beneficial interest prior to the proposed division and the court-ordered modifications. Further, the IRS found that the proposed court-ordered modifications would not extend the time for vesting of any beneficial interest beyond the period provided in D's will. The IRS ruled, accordingly, that the proposed divisions of Trust A and Trust B and the proposed court-ordered modifications would not cause the §2601 tax to apply to the resulting separate trusts or any future distributions from or termination of the separate trusts. The IRS further ruled that the proposed divisions of Trust A and Trust B, the proposed ratable allocations of the assets of Trust A and Trust B among the resulting separate trusts of each original trust, and the proposed court-ordered modifications of each separate trust would not constitute a transfer by any beneficiary that is subject to the §2501 gift tax. In addition, the partition of jointly held property would not result in sale or exchange treatment that could result in gain or loss to the trusts or their beneficiaries. Finally, the IRS determined that, after the proposed divisions of Trust A and Trust B and the proposed ratable allocations of the assets of Trust A and Trust B among the resulting separate trusts of each original trust, and the proposed court-ordered modifications of each separate trust, each of the resulting eight separate trusts would be treated as a separate taxpayer under §643(f). **PLR 200202033.**

Decedent created a trust that was irrevocable on Sept. 25, 1985, and no additions were made to the Trust after Sept. 25, 1985. Under the terms of the trust instrument, various trusts were established including a trust for decedent's daughter. Daughter was entitled to discretionary distributions of income and principal of the trust. She also had a limited power to appoint the trust by written instrument or will to her descendants, or if none, to the descendants of the decedent. Any interest appointed was required to vest within 21 years after the death of the survivor of the group composed of decedent and his issue who survived him. Daughter, who had three children, desired to divide her trust into three equal trusts to separate the interests of each of her three children and their respective families. The terms of each partitioned trust would be identical to those of the original trust for her benefit. The division was to be made under a statute of the state in which daughter resided that allowed the trustee, without the need for court approval, to divide a trust into two or more separate trusts if the trustee determined that the division was in the best interests of all persons with interests in the trusts and would not substantially impair the accomplishment of the trust's purposes. Further, the daughter intended to make a will exercising her limited power of appointment to appoint the remaining trust assets to each of her three children. The IRS determined that daughter's trust met the requirements for the exception to the generation-skipping transfer tax provided by §1433(b)(2)(A) of the Tax Reform Act of 1986 and Treas. Reg. §26.2601-1(b)(1)(i). The IRS concluded that, in accordance with Treas. Reg. §26.2601-1(b)(4)(i)(D), the proposed division of the trust would not result in a shift of any beneficial interest in the trust or the trusts resulting from the partitioning to any beneficiary who occupies a generation lower than that of the persons holding the beneficial interests prior to the proposed division. Further, the IRS found that the proposed division of the trust would not extend the time for vesting of any beneficial interest in the resulting trusts beyond the period provided in the trust. The IRS ruled, accordingly, that the proposed partition of the Trust would not cause the §2601 tax to apply to the resulting separate trusts or the Trust. **PLR 200203029.**

Decedent created a trust that was irrevocable on Sept. 25, 1985, and no additions were made to the Trust after Sept. 25, 1985. The trust at issue was funded in part, with stock of a family corporation and stock in family businesses. After the death of decedent's spouse, the family corporation became the sole income beneficiary of the trust, and was entitled to receive as much of the trust's income each year as the trustees deemed necessary, in their discretion, to "maintain, develop, upkeep, and preserve" the corporation's real estate. The trust's governing instrument provided that the trust would terminate 21 years after the death of the last to die of decedent's spouse, son, and daughters. It was represented, however, that the trustees intended to terminate the trust at an earlier date under discretionary power to that effect in the trust instrument. At some point after the death of the grantor and his spouse, their son became the sole owner of the family corporation that was a beneficiary of the trust. This resulted in an annual conflict as to the appropriate amount of income to distribute to the corporation each year. This conflict could not be resolved despite efforts to do so. As a result, the trustees, the corporation, and the grantor's daughters and their issue entered into a settlement agreement calling for a division of the trust into two trusts, retroactive to a specified date. In this connection, the trustees filed a complaint for discretionary relief in state court. The settlement agreement was later incorporated into an amended judgment issued by the court. Under the terms of the settlement, the corporation was entitled to receive income and principal from one of the trusts under the standard provided in the original trust agreement. These distributions could not, however, exceed the combined income of the two trusts resulting from the court-ordered division of trust. Any income or principal remaining in the trust at its termination would be distributed as part of the second trust for the benefit of the daughters and their issue, according to the terms of the original trust agreement.

The IRS determined that the trust met the requirements for the exception to the generation-skipping transfer tax provided by §1433(b)(2)(A) of the Tax Reform Act of 1986 and Treas. Reg. §26.2601-1(b)(1)(i). Under Treas. Reg. §26.2601-1(b)(4)(i)(B), the settlement agreement, as reflected in the court's judgment, was the product of arm's-length negotiations and was within the range of reasonable outcomes under the terms of the trust's governing instrument and the provisions of applicable state law. The terms of the settlement agreement reflected a compromise between the positions of the litigating parties and the parties' assessment of the relative strengths of their positions. Therefore, the division of the trust into separate trusts and the implementation of the administrative changes as provided in the court's judgment would not cause the trust to cease to be exempt from the §2601 tax by reason of its grandfathered status under §1433(b)(2)(A) of the Tax Reform Act of 1986 and Treas. Reg. §26.2601-1(b)(1). **PLR 200203030.**

Transfers to trusts were direct skips

Grantor and his wife created an irrevocable insurance trust for the benefit of their grandchildren, who were granted noncumulative withdrawal rights over gifts to the trust. Such withdrawal rights lapsed if not exercised within two months after notice was given to the trustee that a gift had been made and that a beneficiary had the right to withdraw the value of the contribution or payment to the trust. During the initial term of the trust, the trustee was required to pay to, or use for the benefit of, any of the grantor's grandchildren (other than two grandchild specifically excluded as beneficiaries), as much net income and principal of the trust that the trustee determined to be in their best interests for their education health, maintenance, and support in reasonable comfort. The trustee had discretionary authority to add excess income to principal, and to make distributions to any of the grantor's grandchildren who were eligible for distributions to the exclusion of any one or more of them, and could exhaust the principal of the Trust. On termination of the initial trust, it was divided into separate equal shares, one for each then living grandchild of the grantor. Such shares continued to be held in trust for two grandchildren, who were the sole beneficiaries from the date the initial trust was created until the division of the trust into separate shares for their benefit. Each grandchild was entitled to all the income from his or her trust, and to discretionary distributions of principal.

The grantor and his wife elected to treat gifts to the trust over several years as split gifts, subject only to gift tax. Neither the grantor nor his wife allocated any of their available §2631 generation-skipping transfer tax exemptions to the gifts to the trust. In addition, neither of them paid any generation-skipping transfer tax with respect to such gifts to the trust. The IRS explained that, because all the interests in the trust were held by skip persons, the trust met the definition of a skip person under §2613(a). Because in each case, the grantor and the grantor's spouse consented to split their gifts under §2513, each was treated as the transferor of one-half of all of their gifts to the trust under §2652(a)(2). The transfers that each of the grantor and the grantor's spouse were treated as making to the trust were direct skips as defined in §2612(c)(1). Therefore, the IRS ruled as requested that, pursuant to §2632(b)(1), an automatic allocation of the generation-skipping transfer tax exemption occurred as to the grantor and his spouse for each gift to the trust. **PLRs 200201002 and 200201003.**

Contribution of art collection, subject to restrictions, qualifies for §2055 deduction

The taxpayer owned an interest in 53 paintings, drawings, and watercolors created by various artists. Taxpayer contributed an undivided one-half interest in 32 pieces of the collection to a museum, retaining the other 50 percent undivided present interest in those works and all the interest in the remaining pieces. Taxpayer's will gave all of his remaining interest in the collection to the museum. A codicil to the will amended the provisions of the charitable gift conditioning the gift to the museum on it entering into an agreement regarding the collection with taxpayer's executors, with such agreement intended to affirm the terms and conditions of a proposed agreement between taxpayer and museum as it exists at taxpayer's death. The codicil further provided that the executors could include additional reasonable administrative provisions consistent with the terms and intent of the proposed agreement and of other agreements between taxpayer and museum consistent with the availability of an estate tax charitable deduction under §2055(a)(2) for the full value of the collection. A provision that is inconsistent with such a charitable deduction will be ignored. In general, the agreement between the taxpayer and the museum obligates the museum to exhibit the collection at its primary exhibition during standard hours, in an integrated and coherent manner, prominently displayed and identified as part of the collection contributed by the taxpayer and his spouse. The museum could loan portions of the collection under its standard operating policies. Sales and exchanges were allowed as long as they were consistent with the spirit of the collection and with substantially equivalent values to the pieces that were sold. The IRS ruled that the entire value of taxpayer's interest in the collection passing to the museum under his will qualified for the estate tax charitable deduction under § 2055. The amount allowable as an estate tax deduction was the fair market value of the property passing to charity, which was the full fair market value of taxpayer's interest in the collection as determined under § 2031 and § 2033. **PLR 200202032.**

No constructive receipt of interest and dividends by estate

The decedent died intestate and without heirs while a citizen of one foreign country and a resident of another. So far as was known, decedent was never a resident of the United States. A "Domiciliary Administrator" was appointed to marshal the decedent's assets. In the course of marshaling such assets, the Domiciliary Administrator found that the decedent had owned common stock in a number of U.S. publicly traded corporations, but was unable to locate the stock certificates. Further, the Domiciliary Administrator was not qualified, under the law, to receive the decedent's assets as they were located in the United States. Accordingly, the Domiciliary Administrator engaged the services of the "Original Ancillary Administrator" from the United States to assist in locating the decedent's assets in the United States. In attempting to locate the decedent's assets, the Original Ancillary Administrator wrote to each state treasurer to locate any abandoned property in the decedent's name. The administrator recovered unpaid interest and dividends on various bank accounts and stock from various state treasurers as a result of efforts to locate the decedent's United States assets. In most instances, the Original Ancillary Administrator was required to post "lost securities indemnification bonds" to recover such interest and dividends. In determining whether the estate would be required to recognize income from these dividends and interest, the IRS applied principles of constructive receipt in the light of Treas. Reg. § 1.451-1(a) and cases thereunder and noted that the basis of constructive receipt doctrine is essentially unfettered control by the taxpayer over the date of actual receipt. The IRS found no evidence that there was an intentional or unreasonable delay in appointing the Original Ancillary Administrator or in the administrator's recovery of the interest and dividends. The IRS also noted that the estate's control over the interest and dividends was subject to substantial restrictions and limitations, such as the requirement imposed by most states that a bond be posted. Therefore, the estate did not have unfettered control over the date of actual receipt of the interest and dividends, and the interest on the bank accounts and dividends on stock owned by the decedent should not be included in the estate's gross income until actually received. **PLR 200203006.**

Extension of time to file alternative valuation election granted

The decedent executed two revocable trusts on different dates. Decedent's will left the residue of decedent's estate to the second trust. The first trust provided that a named charity was to receive 30 percent of the residue of decedent's estate. The second trust provided that the charity was to receive 20 percent of such residue. Ambiguities in the decedent's will resulted in litigation after his death, and the estate's representative could not calculate the amount of estate tax due because of the uncertainties caused by the litigation. A Form 4768 (application for extension of time to file estate tax return) was filed on behalf of the estate, accompanied by a payment of the estimated tax due and a letter describing the uncertainties of the litigation. The IRS granted an extension of time to file Form 706, which was timely filed, but the personal representative of the decedent's estate did not unequivocally elect under § 2032 to value the estate as of the alternate valuation date. The Form 706 was filed on the due date, as extended, but the return preparer, an attorney, did not advise the personal representative to make the alternative valuation date election. The IRS later issued an estate tax closing letter, accepting the return as filed. Later, the return preparer advised the personal representative of decedent's estate that an alternative valuation date election should have been made on the original Form 706. A supplemental Form 706, reflecting the value of all assets included in the estate as of the alternative valuation date, was to be filed by the personal representative of decedent's estate. If the alternative valuation date were used, the value of decedent's estate and the amount of estate tax due is lower. No assets of the decedent's estate were distributed, sold, exchanged, or otherwise disposed of within the six months after decedent's death. The IRS granted an extension of time to file the election, acting pursuant to Treas. Reg. § 301.9100-1 and Treas. Reg. § 301.9100-3. **PLR 200203031.**

Transfer of trust assets by surviving spouse as trustee under court order not a gift

Husband and wife, residents of a non-community property state, established a joint revocable trust by conveying community property located in another state to the trust. The trust instrument provided for the creation of a Marital Trust and a Family Trust on the death of the first of them to die. The Marital Trust was to be funded with the surviving spouse's community portion of trust property, the surviving spouse's separate property, and a fractional share of the deceased spouse's property. This fraction was to provide the Marital Trust with the smallest amount that, "if allowed as a marital deduction, would result in the least federal estate tax being payable" by the deceased spouse's estate after allowing for the unified credit and the credit for state death taxes. The Family Trust would receive the balance of the trust's assets remaining after the Marital Trust is funded. The surviving spouse was entitled to all the income from the Marital Trust, plus discretionary principal distributions, and had the right to appoint its remaining assets pursuant to a general testamentary power of appointment. The surviving spouse was also entitled to discretionary distributions of income and principal from the Family Trust under an ascertainable standard. On the death of the surviving spouse, the remaining assets of the Family Trust or the Marital Trust, in default of the surviving spouse's exercise of the power of appointment, must be distributed among the descendants of husband and wife. Wife survived husband and became the sole trustee of the trust.

On the Schedule M of the estate's Form 706, an estate tax marital deduction was claimed for the entire value of the trust residue passing to both the Marital Trust and the Family Trust. Schedule M, as filed, did not reflect the direction that the Living Trust residue was to be divided into a Marital Trust and a Family Trust, and that only the Marital Trust would qualify for an estate tax marital deduction. Wife filed a complaint in county court against the return preparer and the attorney for the estate for their failure to advise her on these matters. The county court subsequently issued an order directing wife as trustee to fund the Family Trust with an amount of assets that would have resulted under the formula clause in the trust instrument, using assets that were fairly representative of the appreciation and depreciation of the entire assets of the trust between the date of husband's death and the date of funding. The IRS ruled that, under these circumstances, the transfer of assets from the trust by wife, in her capacity as trustee pursuant to the county court order, does not constitute a gift for purposes of the § 2501 gift tax. This transfer would also not result in inclusion in wife's estate under estate under § 2036. The property passing to the Marital Trust qualified for an estate tax marital deduction under § 2056(b)(5). The portion of the trust property used to fund the Family Trust did not qualify for the marital deduction, however, since the income of the Family Trust was payable to wife at the discretion of the trustee. Therefore, wife lacked a § 2056(b)(7)(B)(ii) qualifying income interest for life in that trust and it would not be includable in her gross estate under § 2044. **PLR 200203045.**

Disclaimers of unitrust interests in CRUT qualified

Decedent and her husband had established a CRUT to benefit each them for life. After the death of both wife and husband, the unitrust amount was payable equally to son and daughter. Decedent and her husband each retained the right to revoke the noncharitable interests by will; however, decedent did not exercise this right before her death. Husband also retained the right to designate the charitable beneficiary during his life. In failure of such designation, son and daughter, or the survivor of them, had the right to designate the charitable remainder beneficiary of the CRUT. If no charitable beneficiary was designated, a university named in the trust instrument would receive the CRUT remainder. Decedent and her husband also created a family charitable trust, which was classified as a § 509(a)(3) supporting organization for a community foundation classified as a publicly supported charity. Prior to decedent's death, husband designated the family charitable trust as the charitable remainder beneficiary for the CRUT, retaining the right to change such designation during his life. Decedent died without exercising her right to revoke the noncharitable interests in the CRUT. The trustees of the CRUT proposed a division of the CRUT into two separate trusts, with terms identical to the original trust agreement. One such CRUT (CRUT 1) would hold 50 percent of the assets attributable to decedent's contribution to the CRUT and the other CRUT (CRUT 2) holding husband's contribution. It was also proposed that son and daughter would execute qualified disclaimers of their interests in CRUT 1 within 9 months of decedent's death. Additionally, son and daughter renounced any right to designate charitable remainder beneficiaries with respect to CRUT 1. The IRS concluded that the proposed division of the CRUT would not change the total annual unitrust amount of the interests of the remainder beneficiaries. Therefore, the proposed division of the CRUT did not cause CRUT 1 and CRUT 2 to fail to qualify as charitable unitrusts under § 664. As a result of the disclaimers, husband was the only noncharitable beneficiary of CRUT 1. The IRS ruled, accordingly, that if the disclaimers are qualified disclaimers under § 2518 and § 2046, and if CRUT 1 otherwise qualifies as a charitable remainder unitrust under § 664, the value of the charitable remainder interest in CRUT 1 would qualify for the estate tax charitable deduction under § 2055, and the value of the unitrust interest in CRUT 1 passing to husband would qualify for the estate tax marital deduction under §2056(b)(8). **PLR 200204022.**

Property subject to pre-1942 general power not includable in decedent's estate

Beneficiary of trusts granted power to appoint trust property to beneficiary, beneficiary's estate, beneficiary's creditors, or the creditors of beneficiary's estate. Power was not limited by any ascertainable standard, and was not exercisable only in conjunction with another person. IRS noted that this power was a general power of appointment. Since the powers of appointment were created prior to Oct. 21, 1942, however, and since beneficiary never exercised the powers, the assets of the trusts were not includable in beneficiary's estate under §2041(a)(1). **PLR 200205033.**

Gift to charity of fractional unitrust interest gives deductions

Husband created a CRUT that paid unitrust amount to husband during his life, and then to wife if she survived husband. On the death of the survivor of husband and wife, the CRUT terminates and its principal and income will be distributed as follows to various qualifying charities. Following husband's death, wife agreed to assist one of the named charities with its immediate funding needs by transferring to the charity outright an undivided fractional share of her unitrust interest, which gift would continue for the duration of wife's unitrust interest. The other named remainder beneficiary of the CRUT consented to the transfer. The IRS determined that §170(f)(3)(B)(ii) and Treas. Reg. §1.170A-7(b)(1)(i) allow a charitable contribution deduction for the contribution. The IRS further concluded that the present value of an undivided interest in the unitrust amount transferred by wife to the charity qualified for a deduction under §2522. The value of such deduction was the present value of the distributions to be made to the charity. **PLR 200205008.**

Extension of time to make reverse QTIP election granted

Decedent created a lifetime trust, naming himself as trustee. Decedent was survived by his wife and a son. The trust instrument provided that, on decedent's death, the trust assets were to be divided into two trusts, a marital trust and a family trust. The marital trust was funded with the smallest amount of assets that would result in the lowest possible federal estate tax. The balance of the trust's assets passed to the residuary trust. The marital trust was to be further divided into exempt and non-exempt trusts if the executor made the § 2652(a)(3) election. The executor filed a timely Form 706 and made a QTIP election with respect to the exempt and non-exempt trusts, but failed to include a Schedule R with the return. Therefore, no § 2652(a)(3) reverse QTIP election was made with respect to the exempt marital trust and no allocation of decedent's § 2631 generation-skipping transfer tax exemption was made. The IRS subsequently issued a closing letter for the estate. Thereafter, a CPA discovered that a Schedule R had not been attached to the estate tax return and notified decedent's son, who was the executor of the estate. Son had retained a law firm and relied solely on the firm's advice with respect to all federal estate and generation-skipping tax matters, including the preparation of the Form 706. Son had no idea that he was required to make a reverse QTIP election to receive some tax benefits. Acting pursuant to Treas. Reg. § 301.9100-1 and Treas. Reg. § 301.9100-3, the IRS granted an extension of the time allowed by Treas. Reg. § 26.2652-2(b) to file the reverse QTIP election. The extension of time to file the reverse QTIP election did not, however, extend the time available to allocate decedent's § 2631 generation-skipping transfer tax exemption. Therefore, the automatic allocation rules of § 2632(c) and Treas. Reg. § 26.2632-1(d)(2) applied to the allocation of decedent's §2631 generation-skipping transfer tax exemption. **PLR 200205040.**

CASES

Nonresident Alien Encumbered Property Included in Estate at Full Market Value

The Tax Court held that a nonresident alien decedent's interest in real property which was subject to a promissory note and secured by a deed of trust was includable in his gross estate at full value, and not at net equity value, since the subject promissory note and State law afforded the lender a choice of remedies, including the imposition of personal liability. A corresponding deduction was also allowed to the extent permitted by IRC § 1053. In the instant case, the decedent, a nonresident alien for U.S. tax purposes, possessed at the time of his death interests in real property located in California. The decedent's interests in two of the real estate parcels located in California, one of which was subject to a promissory note secured by a deed of trust, were contained in his residuary estate. The estate contended that the real estate should be included in the gross estate at its net equity value, after offsetting the portion of indebtedness considered to burden the decedent's interest in the property. The estate utilized State law and argued that theoretical or remote possibility that an estate might have personal liability for the amount of the mortgage was not enough to establish a claim against it under IRC § 2053(a)(3). The IRS on the other-hand argued that because the decedent was personally liable for the indebtedness at issue by the terms of the promissory note, the full value of decedent's interest must be returned as part of the gross estate. The court agreed with the IRS, and cited *In Estate of Linderoth v. Commissioner, T.C. Memo. 1986-547* for the proposition that potential liability can be sufficient for purposes of Treas. Reg. 20.2053-7. **Estate of Fung v. Commissioner, T.C., No. 2173-00, 117 T.C. No. 21, 12/10/01.**

Executrix Held Responsible for Unpaid Tax Debt of Estate

The Court held that an Executrix is responsible for unpaid tax debt of an estate to the extent of the value of distribution she made and government is entitled to liens on real property. In this case, husband and wife executed a joint will and codicil. They had one son. When wife died, the joint will created a life estate for son in real property which passed under the will. When son died his will was admitted to probate. His widow qualified as the executrix of the estate. On son's federal estate tax return, only the value of one half of the remainder interest in the property passing on mother's death was returned. The IRS subsequently sent a notice of deficiency to father. The deficiency resulted from the contractual obligation under state law imposed on father under the joint will to make a present gift to son of his remainder interest in the property in which father was to have only a life estate. Father challenged the gift tax deficiency in the U.S. Tax Court, but he died while the case was pending. The IRS also sent a deficiency notice to son's estate because the remainder interest should have been included in son's gross estate. The estate challenged the gift tax deficiency in the U.S. Tax Court. The parties agreed by stipulation that the resolution of the case brought by father would control the issues before the Tax Court. The Tax Court found that the IRS correctly attributed gift tax liability to father as a result of the present gift of the remainder interest in real property to son upon the death of mother. The court of appeals upheld this decision. However, during the pendency of the appeal, son's widow quit claimed to a family trust all of her interest in the real property devised to her under son's will. Pursuant to the earlier stipulation, son's estate was required to include in its gross estate the value of the remainder interest in real property father was deemed to have given to son. As part of an agreement between the estate and the IRS to allow an estate tax deduction pursuant to IRC § 2053 before computing the estate tax deficiency, executrix was required to execute a Waiver of Restriction on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment. Therefore, transferee gift tax liability was assessed against the estate. Subsequently, the court entered a decision in the action brought by the estate and found a deficiency in estate taxes. The estate sought relief with respect to the assessment and the IRS granted the relief. However, the IRS pursued its claim for transferee gift tax liability and interest and filed a claim with the local probate court. Subsequently, the IRS learned that the probate had been closed without a final accounting. The IRS filed a petition to reopen the estate and then amended its complaint and sought to reduce to judgment the unpaid portion of transferee gift tax and interest. The IRS sought to collect the amount owed by foreclosing liens and selling property as well as holding the executrix liable for the debt. The IRS cited 31 U.S.C. § 3713(b) and illustrated that the executrix had actual knowledge of the tax debt and therefore should be held liable for this debt to the extent of the distribution that she made. **United States v. Bartlett, C.D. Ill., No. 99-CV-2060, 2/19/02.**

Transfer to Family Partnership Ruled to Be Indirect Gifts

The Court of Appeals held that Taxpayer who transferred land to a family partnership in which he owned 50 percent and his two sons each owned 25 percent made separate indirect gifts to his sons of 25 percent undivided interests in the land, and the gift is valued without reference to the sons' ownership of the land through the partnership after transfer. The taxpayer and his two children, formed a family partnership. The taxpayer and his wife executed two deeds, each one transferring an undivided 50 percent interest in the land to the partnership. On his gift tax return for the transfer, the taxpayer valued the land at $400,000. The taxpayer reported no gift tax due on the transfers, since the gift tax computed was more than offset by the maximum unified credit of $192,800. In the notice of deficiency, the IRS determined that the fair market value of the 50 percent interest in the land that the taxpayer gifted to his sons was $639,300. The IRS determined that the taxpayer had a gift tax deficiency of $168,577. After trial, the Tax Court held that the transfer was an indirect gift of undivided fractional shares of land and that the value of the gift to each son was $160,876. The taxpayer appealed. The Tax Court's decision was affirmed. The Court of Appeals noted that the Tax Court correctly held that the gift was an indirect gift of land, and not partnership interests. The Court of Appeals further noted that the Tax Court correctly interpreted the undisputed sequence of events to conclude that the taxpayer's sons already held their partnership interest when their father's deed of land became effective. Instead of completing a gift of land to a pre-existing partnership in which the sons were not partners and then establishing the partnership interests of his sons (which would result in a gift of a partnership interest), the taxpayer created a partnership in which his sons held established shares and then gave the partnership a taxable gift of land (making it an indirect gift of land to his sons). The Tax Court decision also dealt with the valuation of the land. The Court of Appeals noted that the Tax Court correctly focused its valuation inquiry on the moment between the taxpayer's transfer of the land and his sons' receipt of their interests because the gift tax is "measured by the value of the property passing from the donor." Second, applying this focus, the Tax Court correctly sought to "put [itself] in the position of a potential purchaser of the interest at that time" to find the fair market value. Based on the testimony from one of the taxpayer's experts, the Tax Court applied a 15 percent valuation discount to the gift because of characteristics of the undivided fractional interests in land, the lack of complete control over the parcel, the risk of disagreement about disposition of the land, and the possibility of partition of the land. The Tax Court was correct in not valuing the land by reference to the sons' ownership of the land through the partnership after transfer. The Tax Court correctly held that the parties' stipulation regarding a 33.5 percent discount for the sons' minority partnership interest did not apply in valuing the gift of land. Only characteristics of the gift, and not the donee's method of receiving the gift or the stipulated partnership interest discount, were relevant to discounting the value of the gift of land. **Shepherd v. Commissioner, 11th Cir., No. 01-12250, 2/28/02.**

General Power of Appointment Exercise Exempt From GST Tax

The Court of Appeals held that Decedent's transfer of property to her grandchildren by a general power of appointment under a trust that became irrevocable in 1976 was a generation-skipping transfer exempted by the 1986 Tax Reform Act from the GST tax. Decedent's husband died on May 20, 1976. A trust was established pursuant to his will in favor of his wife, providing her with the income for life plus such amounts of corpus as the trustees in their discretion should choose to give her, and the remainder on her death to be distributed "as my wife may appoint by a will or Codicil thereto specifically referring to and exercising this general power of appointment." When decedent in this case, died, pursuant to the terms of her will she exercised the general testamentary power of appointment over the trust by appointing all trust assets subject to it as follows ... ." Twofifths of the remainder of the trust was allocated in equal shares to her six grandchildren. The executor of the decedent's estate filed a tax return for her estate and paid a generation-skipping transfer tax of $2,043,357.55. Subsequently, the executor filed a claim for refund of this amount. Since no action was taken on the claim, the executor filed suit. The district court ruled for the IRS, and the executor appealed. The Court of Appeals held that the tax was paid upon a transfer of property by a general power of appointment under a trust that became irrevocable in 1976, and was therefore a generation-skipping transfer exempted by § 1433(b) of the Tax Reform Act of 1986 from the generation-skipping transfer tax imposed by 26 U.S. Code §§ 2601-2663. **Bachler v. United States, 9th Cir., No. 00-17239, 3/1/02.**

Heirs Must Share Estate Tax Liability

Decedent attempted to disinherit daughters through exercise of a general power of appointment over marital trust. Daughters successfully petitioned state court to obtain their proportionate share of the marital trust by having the decedent declared not to have had a general testamentary power of appointment. Each of the daughters was liable for her proportionate contribution to the federal and state estate taxes pursuant to the state's Uniform Estate Tax Apportionment Act. *Gordon v. Posner*, **Md. Ct. Spec. App., No. 2295, 1/31/02.**

Valuation of Closely-Held Stock

The tax court applied the discounted cash flow method of stock valuation to determine the fair market value of shares of stock in a closely-held corporation. The court then applied discounts for lack of marketability (25 percent) and lack of control (10 percent) to determine the fair market value of the decedent's stock as of the valuation date. **Estate of Heck v. Commissioner, T.C. Memo. 2002-34.**

Denial of Extension Request not Abuse of Discretion

The Commissioner did not abuse his discretion in (a) denying reconsideration of the estate's request under I.R.C. §6161 for extension of time to pay estate taxes; (b) denying estate's request for abatement of a §6651(a)(2) addition to tax for failure to pay; or (c) sustaining the proposed collection action. **Estate of Doster v. Commissioner, T.C. Memo. 2002-2.**

NOTICES, REGULATIONS, AND MISCELLANEOUS

IRS Revokes 2001 Split-Dollar Notice, Retains Rules for Existing Arrangements

The IRS has revoked a notice issued in 2001 on split-dollar life insurance arrangements. In the Notice, it provided assurances that it would not change the general rules for taxing split-dollar arrangements until it issues final regulations. For existing split-dollar arrangements, the IRS indicated that it will not impose tax on increases in the equity portion of the policy. It further states that employees will not be taxed on the termination of an equity split-dollar arrangement, as long as the employee recognizes income for the value of current life insurance protection. For existing arrangements that terminate before 2004, the notice indicates that the IRS will not tax the policy on "roll out," when the employer no longer has any interest in the policy. The notice also provides rules for arrangements created before final regulations are issued: (a) if the parties choose to treat employer premium payments as loans, IRS will not challenge reasonable efforts to comply with either the original issue discount rules of Sections 1271-1275, or the below-market loan rules of Section 7872, provided all payments before the first year of loan treatment are also treated as loans; and (b) for arrangements entered into before Jan. 28, 2002, in which the employer is entitled to full repayment of its premium payments, IRS will not apply Section 83 upon termination of the arrangement, if the arrangement terminates before Jan. 1, 2004, or if all employer payments (reduced by any repayments) are treated as loans, subject to Sections 1271-1275 and Section 7872.

IRS said it intends to issue proposed regulations on split-dollar arrangements that will provide new ways of treating split-dollar arrangements; however, the regulations would not take effect until final rules are issued. The IRS indicated that the proposed regulations would treat a split-dollar arrangement under one of two mutually exclusive methods, depending on who is the designated owner of the insurance policy—the employer or the employee: (a) If the employer were the designated owner, employer payments would be treated as a transfer of economic benefits to the employee, and current life insurance protection would be taxable under Section 61; (b) If the employee were the designated owner, employer-paid premiums would be treated as either (1) a series of loans, if the premiums must be repaid, or (2) compensation, if the premiums need not be repaid. The tax treatment would not depend on whether repayments were made from proceeds of the split-dollar arrangement. If employer payments were treated as loans, IRS said the loans would be subject to either Sections 1271-1275 or Section 7872.

In the notice, the IRS reissued "Table 2001" from Notice 2001-10, to be used in place of the "P.S. 58" rates or the insurer's rates, if lower, for one-year term insurance. Taxpayers may continue using P.S. 58 rates for arrangements entered into before Jan. 28, 2002, if the arrangement specified that P.S. 58 rates would be used. For arrangements entered into before it issues final split-dollar regulations, IRS said taxpayers should use Table 2001, but they may use the insurer's lower published rates for standard risk term insurance.

Comments on Notice 2002-8 may be submitted by April 28. The IRS is seeking comments on the rates to use for valuing current life insurance protection, and on the standards for allowing the use of the insurer's rates. The proposed regulations also will provide an opportunity to comment. **Notice 2002-8.**

Statute of Limitations as Applied to Grantor Trust

The national office concluded that the statute of limitations under IRC § 6501(a) is started by the filing of the tax return of the grantor, not the tax return of the grantor trust. Therefore, the statute of limitations will run for three years from the filing of the return of the grantor of the grantor trust. A grantor trust filed Forms 1041 for three consecutive years. The grantor trust returns contained no information relating to the trust's tax liability. A grantor tax information letter was attached to the return. Individual taxpayers used this information to complete and file their own returns. The IRS concluded that the statute of limitations for personal liabilities of all related individuals have been protected. **FSA 200207007.**

Generation Assignment

The IRS concluded that for purposes of IRC § 2651, two of three daughters are assigned to the second generation below the generation of the transferor. After Transferor was born, his father married his second wife. When father married his second wife, she had one son. Transferor's father never adopted son. Transferor bequeathed one million dollars according to his will, in trust, for each of his son's three daughters. Each daughter had a life estate in her trust and, at a respective daughter's death, the trust corpus would pass to her issue. Transferor was more than 37 1/2 years older than two of son's daughters. The IRS advised that Transferor did not adopt son and therefore IRC § 2651(b)(1) would not assign a generation to the daughters because they are not lineal descendants of a grandparent of Transferor. Likewise, IRC § 2651(b)(2) does not assign a generation to the daughters because they are not lineal descendants of the grandparent of Transferor's spouse. In addition, no generation assignment occurs under IRC § 2651(c) because the daughters were not married to Transferor or to any individual described under IRC § 2651(b). Accordingly, because there is no assignment under IRC §§ 2651(b) or 2651(c), a generation assignment must be based on the age differential between the transferor and the individual. Therefore, two of the three daughters are assigned to a generation that is two generations below the generation of Transferor because the age differential between Transferor and two of the Daughters exceeds 37 1/2 years. **TAM 200150003.**

Estate Tax Treatment of Family-Owned Business Interests

The Chief Counsel's Office advised that a lien created under IRC § 2057(i)(3)(P) is enforceable against a subsequent purchaser or creditor, but there are practical concerns about enforcement. The Taxpayer Relief Act of 1997 created IRC § 2057, a new estate tax election, permitting the deduction from an estate of the value of qualified family-owned business interests of up to $675,000. Note, however, that the election requires an agreement by the family members to the attachment of a lien, the § 2057(i)(3)(P) lien. This lien is filed on Form 668H. The Chief Counsel's Office advised that there are no specific requirements in § 2057 or § 6324B governing the method of describing personal property on the lien notice filed for a § 2057(i)(3)(P) lien. However, the IRS Chief Counsel's Office takes the position that the description is sufficient if it reasonably identifies the property. No review of such a lien by the Chief Counsel's Office is required only if the real property subject to the lien is inadequate or if the lien is secured only by personal property. The Chief Counsel's Office also pointed out that although a § 2057(i)(3)(P) lien is enforceable against a subsequent purchaser or creditor who purchases or executes against the encumbered property, enforcement poses practical problems. In fact, the Chief Counsel's Office noted that the IRS may have no way of knowing that the encumbered property has been transferred or executed upon. As a result, the IRS may not be able to locate the purchaser or creditor in order to enforce the lien. For this reason, the Chief Counsel's Office advises that a § 2057 lien should be secured by real property if possible. The Chief Counsel also suggests an escrow agreement for security in the form of stock. The Chief Counsel's Office further advised that, generally, a sale or transfer of the § 2057(i)(3)(P) lien property will trigger recapture tax under § 2057(f)(1)(B) unless the transfer is to a member of the family, qualifies for nonrecognition under § 1031 or § 1033, or is in the ordinary course of business. Further, the Chief Counsel's Office takes the position that a third party levy will also trigger recapture tax under § 2057(f)(1)(B). **CCA 200149033.**

Tax Rates, Annual Exclusion Gifts; GST Exemptions, and Other Items for 2002:

Estates And Trusts Taxable Income Rates

If Taxable Income Is:	**The Tax Is:**
Not Over $1,850	15% of the taxable income
Over $1,850 but not over $4,400	$277.50 plus 27% of the excess over $1,850
Over $4,400 but not over $6,750	$966.00 plus 30% of the excess over $4,400
Over $6,750 but not over $9,200	$1,671.00 plus 35% of the excess over $6,750
Over $9,200	$2,528.50 plus 38.6% of the excess over $9,200

Annual exclusion gifts:

The IRS provides that for calendar year 2002, the first $11,000 of gifts to any person (other than gifts of future interests in property) are not included in the total amount of taxable gift under § 2503 made during that year. Further, for calendar year 2002, the first $110,000 of gifts to a spouse who is not a citizen of the United States (other than gifts of future interests in property) are not included in the total amount of taxable gifts under §§ 2503 and 2523(i)(2) made during that year.

Generation-skipping transfer tax exemption:

For calendar year 2002, the generation-skipping transfer tax exemption under § 2631, which is allowed in determining the "inclusion ratio" defined in § 2642, is $1,100,000.

Notice Of Large Gifts Received From Foreign Persons:

For tax years beginning in 2002, recipients of gifts from certain foreign persons may have to report these gifts under § 6039F if the aggregate value of gifts received in a taxable year exceeds $11,642. **Revenue Procedure 2001-59.**

IRS examines whether assets are includable in decedent's gross estate

In an examination of decedent's Form 706, IRS discovered personal financial statements showing a different net worth and several holding companies for real estate, indicating a pattern of tax avoidance and fraud. IRS believed that decedent's estate intentionally misrepresented the nature and value of the assets listed on the Form 706 and intentionally omitted significant other assets. The national office concluded that based on available information, additional assets would be includable in decedent's gross estate under IRC §§ 2033, 2036, 2038, and 2044; however, additional work would be required to ascertain the pertinent facts. **FSA 200205002.**

ENDNOTES

1 Bracewell & Patterson, L.L.P., 711 Louisiana, Suite 290, Houston, Texas 77002, rglover@bracepatt.com

2 Watkins & Warren, P.C., 5307 E. Mockingbird Lane, Suite 1010, Dallas, Texas 75206-0510, pfwright@watkinswarren.com

INTERNATIONAL TAX: RECENT DECELOPMENT

Alex McGeoch[1]

1. **WTO Ruling Against FSC Replacement Regime Affirmed**

On January 14, 2002, the Appellate Body of the World Trade Organization ("WTO") affirmed the finding of a WTO dispute settlement panel that the US replacement legislation for the Foreign Sales Corporation regime embodied in the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 ("ETI Act") violates the rules of the trade organization. The ETI Act was enacted by Congress in response to a February, 2000 WTO decision that the FSC rules violated the WTO rules.

The Appellate Body affirmed the following findings of the dispute settlement panel:

(a) the ETI Act confers a prohibited export subsidy under the WTO Subsidies Agreement;

(b) the ETI Act confers an export subsidy which violates US obligations under the WTO Agriculture Agreement;

(c) the ETI Act violates the national treatment provisions of the GATT agreement; and

(d) the ETI Act's transition rules violate the WTO's recommendation to withdraw the FSC subsidy effective November 1, 2000.

2. **New Treasury Regulations Ease Timely Filing Requirements for Foreign Taxpayers Filing US Returns**

A nonresident alien individual engaged in a trade or business in the United States is subject to US taxation on income effectively connected with that US business under Code section 871(b)(1). A foreign corporation is taxable in the same manner on effectively connected income under Code section 882(a)(1). Foreign corporations and nonresident alien individuals may deduct expenses against income effectively connected with a US business only if they file true and accurate US income tax returns. Prior to their amendment, Treasury Regulation Sections 1.874-1(b)(2) and 1.882-4(a)(3)(ii) provided that foreign taxpayers who missed filing deadlines were denied deductions except upon a showing of good cause arising from "rare and unusual circumstances."

The IRS amended the regulations on January 28, 2002, to ease the standards for relief from the filing deadlines. Under the amended regulations, the filing deadlines will be waived if the taxpayer, based on the facts and circumstances, shows that it acted reasonably and in good faith, despite failing to file a US income tax return (including a protective return) on time. Relief will not be granted to a taxpayer who knew a return was required, but did not file the return. To obtain relief from a filing deadline, a taxpayer must cooperate with the IRS in determining its US tax liability for the year for which the taxpayer did not file the return.

The new regulations apply the same standards for relief to individual and corporate taxpayers. Some of the factors considered in determining the taxpayer's reasonableness and good faith are:

the taxpayer identifies itself before the IRS discovers the failure to file;

the taxpayer became aware of the ability to file a protective return after the deadline for filing the protective return;

the taxpayer had not previously filed a US tax return;

the taxpayer failed to file a US income tax return because, after exercising reasonable diligence (taking into account the taxpayer's relevant experience and level of sophistication), it was unaware of the necessity for filing the return;

the failure to file a US tax return resulted from intervening events beyond the taxpayer's control; and

other mitigating or exacerbating circumstances exist.

The new regulations are applicable to open years for which applications for waivers of filing deadlines are filed on or after January 29, 2002.

3. **Tax Court Reversed by Fifth Circuit in Compaq Computer**

The Fifth Circuit reversed the Tax Court in *Compaq Computer Corp. et al. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001), holding that the Compaq had valid business reasons for entering into the transaction at issue even though Compaq primarily sought to obtain otherwise unavailable tax benefits. Specifically, Compaq purchased American Depository Receipts ("ADRs") "cum dividend" and sold the same ADRs "ex dividend." Although the trades were separated in time only by one hour, the actual settlement dates for the purchases and sales were four days apart. Compaq reported a capital loss on the sale of the ADRs and taxable income from the dividend distributions. Compaq claimed a foreign tax credit for foreign withholding taxes on the dividend distributions and it used the capital loss to offset part of its capital gain from selling stock in another corporation. The Fifth Circuit held that Compaq had both a pre-tax profit and an after-tax profit on the transaction, thereby establishing economic substance and a non-tax business purpose sufficient to validate the transaction for income tax purposes.

4. **Tax Court Denies Taxpayer's Attempt to Use Substance over Form Doctrine to Establish CFC Status for Foreign Corporation**

In *Framatome Connectors USA, Inc. v. Commissioner*, 118 T.C. No. 3 (2002), the taxpayer nominally owned 50% of the capital stock of a Japanese company and two unrelated foreign corporations each owned 25%. In order to enhance its foreign tax credit position, the taxpayer desired the Japanese company to be classified as a controlled foreign corporation ("CFC"). Code Section 957 provides that a foreign corporation is a CFC if US Shareholders own *more than* fifty percent of the foreign corporation's stock. The taxpayer alleged that in substance it held more than fifty percent of the vote and value of the Japanese company. The Tax Court held that the taxpayer was not entitled to application of the substance over form doctrine because it had acted with a tax-avoidance motive by not consistently treating the Japanese company as a CFC during each of the year's that it held 50% of its stock. Instead, the taxpayer first asserted that the company was a CFC only when changes in US tax laws made it advantageous for the taxpayer to do so. Moreover, the Tax Court held that even if it were to apply the substance over form doctrine, the taxpayer's claims that it held more than 50% of the corporation's vote or value due to control provisions in the corporation's organizational documents and shareholders' agreement were invalid. The Tax Court found instead that super-majority voting provisions gave veto power to the other shareholders and negated any claim that the taxpayer exercised control of the company.

5. **Extension of Time Permitted to Make Check-the-Box Election**

The IRS has granted taxpayers an automatic six-month extension to file an initial check-the-box election for entities that are newly created under state law if the following requirements are met:

1. The entity that did not timely file its check-the-box election must have failed to obtain its desired classification as of the date of its formation solely because Form 8832 was not timely filed;

2. The due date for the tax return of the entity's default classification (excluding extensions) for the taxable year beginning with the entity's formation must not have passed; and

3. The entity has reasonable cause for its failure to timely make the initial entity classification election.

ENDNOTE

1 Alexander G. McGeoch, Hunton & Williams, 1601 Bryan Street, 30th Floor, Dallas, Texas 75201; 214-979-3041; 214-880-0011 (fax); amcgeoch@hunton.com

PARTNERSHIP AND REAL ESTATE TAX: RECENT DEVELOPMENTS (PART I)

Brigham (Buddy) J. L. Sanders, David B. Parrish and Mitchell A. Tiras[1]

The following is a summary of selected current developments in the law applicable to partnership and real estate tax matters, prepared by Brigham (Buddy) J. L. Sanders, David B. Parrish and Mitchell A. Tiras of Locke Liddell & Sapp LLP, as a project of the Partnership and Real Estate Tax Committee. Unless otherwise indicated, all section references contained herein are references to the Internal Revenue Code 1986, as amended (the "Code") and all references to the Internal Revenue Service are abbreviated as "IRS."

1. REAL ESTATE

1.1 Sale of Residence

1.1.1 Gain on Deemed Sale of Residence Ineligible for Code's Exclusion. The IRS reviewed whether a taxpayer that makes an election under Section 311(e) of the Taxpayer Relief Act of 1997 ("TRA 97") can exclude from gross income under Section 121 of the Code any gain resulting from such election. Section 311(e) of TRA 97 allows a noncorporate taxpayer that is holding a capital asset on January 1, 2001 to elect to treat such capital asset as having been sold and then reacquired on such date for an amount equal to its fair market value, thus allowing a step up in basis and a new holding period. Section 121 of the Code provides that a taxpayer may exclude from gross income up to $250,000 ($500,000 in the case of certain joint returns) of gain realized on the sale or exchange of a taxpayer's principal residence if such property was used as the taxpayer's principal residence for an aggregate period of two years or more during the five year period ending on the date of the sale or exchange. The IRS held that an individual making an election under Section 311(e) of the TRA 97 may not utilize Section 121 of the Code to exclude any of the resulting gain on the deemed sale of residence from gross income. The IRS stated that such an election confers tax benefits on the electing taxpayer but also imposes a tax cost as well. Permitting the $250,000 gain exclusion under Section 121 would frustrate the balancing of benefits and burdens from such election. Rev. Rul. 2001-57, 2001-46 I.R.B. 488.

1.1.2 "Impact Fees" Increase Developer's Basis in Buildings. A taxpayer was in the business of developing, owing and leasing residential rental property. The taxpayer had purchased unimproved property and had planned to construct multi-family housing, which it would then rent to tenants. The local government imposed "impact fees" on the development. Impact fees are fees that are imposed in order to provide capital for offsite improvements for general public use, which improvements are necessitated by the new development. The IRS ruled that the impact fees paid by the developer had to be capitalized under Section 263A as an indirect cost allocable to the new residential rental property. Rev. Rul. 2002-9, I.R.B. 2002-10.

1.2 Like Kind Exchanges

1.2.1 OCC Offers Bank Units Latitude to Offer Holding Services for Property Exchanges. Federal law generally prohibits national banks from owning property other than bank premises. However, in a letter ruling made available November 27, 2001, the Office of the Comptroller of the Currency has stated that national bank subsidiaries, including limited liability companies, may temporarily hold property as qualified third parties in reverse like-kind exchanges (or reverse-Starker exchanges) pursuant to Rev. Proc. 2000-37, 2000-40 I.R.B. 308 until the taxpayer can relinquish the property it is currently holding. See Starker v. United States, 602 F.2d 1341 (9th Cir. 1979). *Corporate Decision No. 2001-30* (October 10, 2001).

1.2.2 Exchange of Conservation Easements. The taxpayer and other co-owners of a ranch ("Old Ranch") wanted to engage in a like-kind exchange with another party whereby the taxpayer and the other co-owners would convey a permanent conservation easement on the Old Ranch in exchange for the fee estate in a new ranch ("New Ranch") owned by the other party, with the New Ranch being burdened with a permanent conservation easement when received by the taxpayer and the other co-owners. The IRS concluded in the private letter ruling that if the proposed conservation easement is, by virtue of state law, an interest in real property, the exchange of a conservation easement in real property for a fee interest in other real estate that is also subject to a conversation easement will qualify as a tax-deferred exchange of like-kind property under Section 1031 of the Code, provided that the properties are held for productive use in a trade or business or for investment. The IRS noted that any boot (money or other property not of a like-kind) received in the exchange would be recognized, and that the taxpayer and the other exchanging co-owners must recognize the gain realized on the exchange of the portion of the Old Ranch used for residential purposes. Priv. Ltr. Rul. 2002-01-007 (Oct. 2, 2001).

1.2.3 <u>Disqualified Person</u>. Final regulations were issued amending and narrowing the definition of a "disqualified person" in Code Section 1031 like-kind exchanges. These changes to the applicable regulations (Treas. Reg. Section 1.1031(k)-1(k)(4)) are in response to recent changes in the federal banking law, especially the repeal of section 20 of the Banking Act of 1933 (commonly referred to as the Glass-Steagall Act). The specific amendment to the definition of a "disqualified person" provides that a bank or bank affiliate is not a "disqualified person" if the reason it would be a "disqualified person" is because it is a member of the same controlled group (as determined under Section 267(f)(1) of the Code, substituting "10 percent" for "50 percent") as a person that has provided investment banking or brokerage services to the taxpayer within the two year period described in Treas. Reg. Section 1.1031(k)-1(k)(2). This amendment applies to transfers of property made by a taxpayer on or after January 17, 2002. T.D. 8982 (Jan. 31, 2002).

1.2.4 <u>Involuntary Conversion Treatment</u>. A taxpayer entered into a transaction to sell certain property to a developer upon learning that the property was within the boundaries of a proposed renewal project. The taxpayer desired to receive tax-deferred treatment from the transaction as an involuntary conversion because the property was under a threat of condemnation by eminent domain. The IRS held that the condemnation threat was "sufficiently imminent" and, accordingly, allowed the taxpayer to have tax deferred treatment on the proceeds of the sale. Priv. Ltr. Rul. 2001-45-001 (Feb. 15, 2001).

1.3 REITs/RICs

1.3.1 <u>New Rules for Property Transfers to REITs, RICs</u>. The IRS issued temporary and proposed regulations on December 31, 2001 that impose income tax on property transferred from a corporation to a real estate investment trust ("<u>REIT</u>") or a regulated investment company ("<u>RIC</u>"). Under these temporary and proposed regulations, the taxpayers can elect to have a transfer of property from the corporation to the REIT or RIC on or after January 2, 2002 taxed as a deemed sale by the transferor under Section 337 of the Code, or to require the RIC or REIT that receives the property recognize gain under Section 1374 of the Code. However, more importantly, if no election is made, such transfer will be subject to Section 1374 treatment. The industry and tax practitioners have responded favorably to these new IRS rules since most REITs choose Section 1374 treatment to postpone the taxation rather than electing the deemed sale treatment. *Tax Community Favors New IRS Rules on Transfers of Property to REITs, RICs*, BNA -- Daily Tax Report, Jan. 3, 2002, p. G-6; T.D. 8975, 2002-4 I.R.B. 379.

1.3.2 <u>RIC Ownership of Partnership</u>. The IRS has issued a revenue procedure detailing the circumstances in which an RIC that holds a partnership interest will be treated as though it had directly invested in a partnership's assets. The IRS has ruled that a domestic corporation will be treated as a direct investor in the assets of a master partnership if the corporation: (i) has an open-end management investment company registration and elects RIC treatment; (ii) is a publicly-offered RIC; (iii) has invested all of its assets in one or more master partnerships registered as management companies; and (iv) receives shares of each master partnership income item, deduction, loss, gain and credit in proportion to its ownership percentage of capital interests in the master partnership. Rev. Proc. 2001-57, 2001-50 I.R.B. 577.

1.3.3 <u>Rental Income Ineligible for Offset Against PALs Under Self-Rental Rule</u>. Taxpayers, husband and wife, own two buildings from which they lease out and earn rental income. The husband is an attorney, serving as the president and sole shareholder of a corporation, a law firm and the lessee to one of the leased buildings ("<u>Law Building</u>"). The taxpayers reported passive income from the lease of the Law Building and a passive loss from the other building and offset the passive income and passive loss on their 1994 tax return. The Commissioner of the IRS ("<u>Commissioner</u>") found that the net income from the Law Building was nonpassive income since such property was rented to a corporation in which one of the taxpayers materially participated. The U.S. Tax Court agreed, granting summary judgment for the Commissioner. The taxpayers appealed. On appeal, the Seventh Circuit Court of Appeals affirmed the U.S. Tax Court's decision. *Krukowski v. Commissioner*, 279F.3d547, *aff'g* 114 T.C. 366 (2000).

2. PARTNERSHIPS

2.1 Allocation of Income under Section 482

A corporation contributed the right to receive license fees to a partnership in exchange for a partnership interest. An affiliated S corporation owned the remaining partnership interest in the partnership. After the contribution, the allocation of income from the licensing fees was shifted to the S corporation. Two issues discussed, among other issues, was (a) whether such contribution of the right to receive license fees was a contribution of property subject to Sections 721 and 704(c) of the Code and (b) whether Section 482 permits reallocation to the corporation of licensing-fee income that is contributed to the partnership.

The IRS Chief Counsel's Office found that the contribution of licensing fees that have already accrued at the time of contribution should be treated under Section 721 of the Code as an after-tax, cash contribution of licensing proceeds. Such corporation should have included the accrued amount of licensing fees in its gross income. Because cash is not Section 704(c) property, Section 704(c) of the Code would not apply to such contribution of accrued licensing fees to the partnership. However, the non-accrued licensing fees that the corporation contributed to the partnership should not be classified as property under either Sections 721 and 704(c) of the Code. The IRS Chief Counsel's office also found that the shifting of income from the corporation to the S corporation, an entity under the common control of an individual, resulted in the distortion of income not contemplated by the U.S. Congress when it enacted Section 721 of the Code, and thus the IRS may reallocate income to the corporation under the tax-evasion or clear-reflection-of-income principles of Section 482. Field Service Advice. 2001-49-019 (Aug. 31, 2001).

2.2 Partnership Anti-Abuse

Two unrelated U.S. corporations (Corp. 1 and Corp. 2) formed a foreign limited partnership ("FLP") in which, through various foreign affiliates, each owned fifty percent (50%) of the FLP. Corp. 1 and Corp. 2 formed the FLP in order to develop a specific project in a foreign country. Corp. 1 had the necessary manpower and expertise to implement the project and Corp. 2 had the necessary government contacts. Each of Corp. 1 and Corp. 2 received development fees from the project, although Corp. 2 received a substantially larger development fee than did Corp. 1. The IRS area counsel proposed to utilize Section 482 in order to reallocate the income from the FLP to Corp. 1 because it did not believe that Corp. 1 had received sufficient compensation from the FLP in return for its development activities. The IRS did not resolve this issue and decided to address it in supplemental advice. In addition to the Section 482 issue, the IRS area counsel wanted to determine whether the partnership anti-abuse rule, Treas. Reg. § 1.701-2(e), could apply with the effect of considering the transaction to involve the performance of development services by Corp. 1 for its affiliated foreign entities rather than for the FLP. The IRS area counsel was concerned that, even if Section 482 did apply, the "ultimate tax results" of the transactions were not clearly contemplated by Section 482. In a field service advisory, the IRS ruled that it was not appropriate to apply the anti-abuse rule in situations in which a partnership had substance and the form was not created in order to effectuate the alleged abuse. Accordingly, because Corp. 1 and Corp. 2 probably would not have been able to complete the project without the assistance of each other, the partnership had substance and, accordingly, the anti-abuse rule would not be applied. Field Service Advice *2002-05-021* (Oct. 26, 2001).

2.3 Partnership versus Disregarded Entity

A limited liability company ("LLC") has two members. It does not elect to be treated as a corporation for federal tax purposes. One of the members ("Limited Purpose Member") serves only to prevent the LLC from filing bankruptcy, liquidating, amending its charter, borrowing, or engaging in a business other than the one specified in its charter. The Limited Purpose Member has no interest in the LLC's capital, profits or losses and neither manages the enterprise nor has any management rights other than the limited rights described above. The IRS held in a private letter ruling that for federal tax purposes the Limited Purpose Member will not be treated as a member of the LLC. The other member, therefore, is the sole member of the LLC which does not elect to be treated as a corporation for federal tax purposes. Thus, the LLC will be treated as a disregarded entity for federal tax purposes. Priv. Ltr. Rul. 2002-01-024 (Oct. 5, 2001)

2.4 EINs: Disregarded Entities, Partnerships and Employment Taxes

The IRS has issued a revenue ruling that deals with the retention of an employer identification number ("EIN") in certain circumstances. The IRS has held that where a partnership that calculates, reports and pays its employment tax obligations under its existing EIN becomes a disregarded entity for federal tax purposes, the partnership is required to retain its EIN for employment tax purposes. For all other tax purposes, the partnership must use the taxpayer identification number of its owner. Further, the IRS has determined that where a disregarded entity that calculates, reports and pays its employment tax obligations under its own name and EIN becomes a partnership for federal tax purposes, the partnership must retain and use, for all federal tax purposes, the same EIN it used as a disregarded owner. Rev. Rul. 2001-61, 2001-50 I.R.B. 573.

2.5 Hardship Waiver and Electronic Filing

Section 6011(e) requires large partnerships (those with over 100 partners) to electronically file Form 1065. The Treasury Regulations under Section 6011(e) provide that the IRS can waive this requirement in the event that the large partnership can prove hardship. The IRS has set forth the procedure for a large partnership to follow in seeking a waiver. In order to get a waiver from the electronic filing requirement, a large partnership must file a written request with the IRS, which written request must be in accordance with the requirements of IRS Ann. 2002-3. IRS Ann. 2002-3 includes, among other requirements, a requirement that the taxpayer provide a detailed statement which (i) lists the steps the partnership has taken in an attempt to meet its requirement to file its return electronically, (ii) explains why the steps were unsuccessful, and (iii) details the hardship that would result from filing electronically, including any incremental cost to the partnership of complying with the electronic filing requirements. *IRS Explains Hardship Waiver for Large Partnership to Avoid Electronic Filing*, CCH Federal Tax Weekly (Jan. 17, 2002).

2.6 Invalid Partnerships in Installment Sale Tax Shelters

A corporate taxpayer sought to diversify some business groups. A transaction was proposed that involved the creation of two partnerships to generate capital losses that would offset other gains. The taxpayer and a foreign bank formed the two partnerships, purchasing private placement notes ("PPNs") and certificates of deposit ("CDs"). The partnerships sold the PPNs and CDs for cash and LIBOR notes in transactions structured as contingent installment sales. Ninety percent of the gains were allocated to the foreign bank partner in the partnerships and thus, were not subject to U.S. income tax. However, after the partnerships' tax year, the partnership interests held by the foreign bank were reduced through partnership redemptions and taxpayer acquisitions. Once the foreign bank became the minority partner, the partnerships distributed cash and LIBOR notes to the taxpayer, which in turn sold the LIBOR notes for cash. The taxpayer reported capital losses of $175 million on its 1990-91 tax returns. The U.S. Tax Court rejected any argument by the taxpayer that the transaction had any non-tax business purpose. It found that the purchases and sales of PPNs and CDs lacked economic substance and thus could not create gains or losses for federal tax purposes. The U.S. Tax Court, however, declined to address whether both partnerships were shams for federal tax purposes. The District of Columbia Circuit Court vacated and remanded the U.S. Tax Court decision in light of the opinion in *ASA Investerings Partnership v. Commissioner*, 201 F.3d 5050 (D.C. Cir. 2000) ("*ASA*"). The D.C. Circuit noted that this case was similar – perhaps even identical – to the tax shelter in *ASA* which it invalidated because the entire partnership and not the specific transactions at issue was a sham for tax purposes. The D.C. Circuit refused to affirm this case on the basis of *ASA* since the U.S. Tax Court's decision was based on the specific transactions, not the partnerships. The parties agreed that the sham transaction and sham partnership approach yield different conclusions. The court noted that the record strongly suggests that the partnerships in this case were sham partnerships organized for the sole purpose of generating tax losses to the taxpayer. Thus, fairness dictated that the court should not affirm the lower court's decision based on the partnerships being shams since the lower court addressed the transactions, not the partnerships, as being shams. Therefore, although the U.S. Tax Court opinion was vacated and remanded, the taxpayer should get little comfort from the D.C. Circuit's statements that there is strong evidence that the partnerships in this case were shams for federal tax purposes. *Saba Partnership v. Commissioner*, 273 F.3d 1135 (D.C. Cir. 2001), *vac'g and rem'g* T.C. Memo. 1999-359.

2.7 Partner's Basis in Partnership Not a Partnership Item for Jurisdiction Purposes

The IRS issued a notice of deficiency to the taxpayers, ruling that the taxpayer's husband's basis in a partnership was no more than his initial cash contributions into the partnership and thus, any losses over and above such amount were disallowed. The partnership from which the losses were disallowed was subject to the unified partnership procedures contained in Sections 6221-6234 of the Code. However, the IRS did not conduct a partnership-level examination of the partnership for the tax year at issue. The taxpayers argued that the U.S. Tax Court lacked jurisdiction over the tax deficiency in this case since no notice of final partnership administrative adjustment ("FPAA") was issued by the IRS to the partnership. The U.S. Tax Court held, however, that the taxpayer's husband's basis in the partnership, although affected by partnership items, was not itself a partnership item. Thus, the court concluded that it had jurisdiction to redetermine the taxpayer taxes for the year at issue. *Gustin v. Commissioner*, T.C. Memo. 2002-64.

2.8 Fraud by Tax Matters Partner Does Not Give Claims Court Jurisdiction to Rehear Partnership Items

An actor invested in a limited partnership. The actor then took a business deduction, a business energy credit and an investment tax credit on his individual return. The IRS challenged the partnership's business energy credit and found it to be worth $0 instead of $7,000,000. In addition, the IRS disallowed the partnership's entire loss, as it held that it had not been established that the partnership incurred the loss in a trade or business. The IRS then assessed negligence penalties and valuation overstatement penalties on the taxpayer. The taxpayer challenged the penalties in the Federal Claims Court. The taxpayer noted that the tax matters partner of the partnership ("TMP") was under a court order preventing the TMP from performing any activities on behalf of the partnership other than "administrative services." In spite of this, the TMP (i) consented to the extension of time that the IRS had to issue a final administrative adjustment to the partnership's tax return, (ii) commenced and maintained a partnership readjustment proceeding in the Tax Court, and (iii) entered into a stipulation with the IRS consenting to the terms of a proposed Tax Court decision. Moreover, the IRS apparently knew of the restrictions that were in place upon the TMP under the court order. Accordingly, the taxpayer argued that the TMP's actions were a fraud upon the Tax Court and that the partnership items that were supposedly resolved therein were still open for reexamination. The Federal Claims Court held that it had no subject matter jurisdiction over the issue because of the restrictions under Section 7422(h) with respect to actions regarding partnership items. The Federal Claims Court held that the issue of the lack of authority of the TMP and the government's alleged complicity therein should have been addressed at the Tax Court. *Conway v. United States*, 2001-2 USTC 50,601.

2.8 IRS Issues Final Unified TEFRA Partnership Audit Regulations

The IRS issued, on October 4, 2001, the final regulations regarding unified partnership proceedings for partnership tax years commencing on or after October 4, 2001. Some of the major changes contained in the final regulations include: (i) a settlement by the tax matters partner of a partnership that pertains to penalties binds the partners of the partnership, other than notice partners and a notice group's members; (ii) if the IRS fails to give a timely notice to a partner, a partner of the partnership has the right to choose whether to have the final partnership administration adjustment ("FPAA"), a decision from a court, a consistent settlement agreement, or a conversion to non-partnership items be applicable to the partnership items of the partner; (iii) a partnership cannot qualify for the small partnership exception when it has a partner who is a non-resident alien; and (iv) the IRS does not need to issue a FPAA after a TEFRA audit. *IRS Issues Final Unified TEFRA Partnership Audit Regs in Stepped-Up Offensive Against Shelter Activity*, CCH Federal Tax Weekly (October 11, 2001); T.D. 8965, 2001-43 I.R.B. 344.

ENDNOTE

1 Locke Liddell & Sapp LLP, 600 Travis, Suite 3400, Houston, Texas 77002; Telephone (713) 226-1200; Fax (713) 223-3717.

PARTNERSHIP AND REAL ESTATE TAX: RECENT DEVELOPMENTS (PART II)

Shilpa N. Jariwala and Vicki L. Martin[1]

The following is a summary of selected 2001 developments in the Federal income taxation of partnerships and real estate, prepared by Shilpa N. Jariwala and Vicki L. Martin, as a project of the Partnership & Real Estate Tax Committee, Richard M. Fijolek, chairperson. Unless otherwise indicated, all section references contained herein are references to the Internal Revenue Code of 1986, as amended.

A. Partnership Taxation.

1. Section 701 - Partners, Not Partnership, Subject to Tax.

(i) CCA 200128053 – A taxpayer's transfer of assets to a partnership followed by (i) a sale of the taxpayer's partnership interest to a buyer ten days later and (ii) a distribution of the partnership's assets to the buyer, should be recharacterized as a sale of the taxpayer's assets to the buyer followed by the creation of the partnership. Relying on Treasury Regulation Section 1.701-2, the Office of Chief Counsel concluded that the taxpayer and the buyer improperly used the rules in Section 732(b) and (c) to allow the buyer to increase the tax basis of the assets it received from the partnership.

2. Section 702 – Income and Credits of Partner.

(i) PLR 200137038 – A corporate partner of a partnership that receives dividends paid by the partnership's wholly-owned foreign sales corporation out of earnings and profits attributable to foreign trade income is entitled to a dividends received deduction under Section 245(c)(1)(A) with respect to the dividends distributed, and, under Section 702(a)(5) and Treasury Regulation Section 1.702-1(a)(5), the corporate partner must take into account separately its distributive share of the dividends received by the partnership from the foreign sales corporation.

3. Section 704 – Partner's Distributive Share.

(i) Katz v. Commissioner, 116 T.C. No. 2 (January 12, 2001) – Where a partner's bankruptcy estate retains beneficial ownership of his partnership interest as of the close of the partnership taxable year, the partner's distributive share for the entire partnership taxable year is reportable by the bankruptcy estate, not the bankrupt partner, and pre-petition partnership losses are properly reportable in their entirety by the partner's bankruptcy estate.

(ii) PLR 200105009 through PLR 200105013 and PLR 200105015 through PLR 200105027 – In eighteen similar PLRs, a limited partnership that serves as an investment vehicle for a fund may aggregate built-in gains and losses from assets contributed to the limited partnership by the fund with built-in gains and losses from revaluations of qualified financial assets held by the limited partnership for purposes of making Section 704(c)(1)(A) allocations and reverse Section 704(c) allocations, provided that a contribution or revaluation of property and the corresponding allocation of tax items with respect to the property are not made in an attempt to shift the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

(iii) PLR 200140060, PLR 200140062 and PLR 200140063 – In each of three similar PLRs, the IRS revoked a 2000 private letter ruling, in which a limited partnership's method of making Section 704(c) reverse allocations was a reasonable method and that the limited partnership could aggregate built-in gains and losses for purposes of making aggregate allocations under Section 704(c), because the limited partnership failed to identify sufficiently the limited partnership's partners or the assets contributed to the limited partnership.

(iv) FSA 200149019 – A partner's contribution of accrued licensing fees to a limited liability company treated as a partnership for Federal income tax purposes is viewed as an after-tax contribution of cash that is property under Section 721 but is not property under Section 704(c), and thus does not trigger application of Section 704(c).

4. Section 708 – Continuation of Partnership.

(i) Notice 2001-5 – A partnership terminating under Section 708(b)(1)(B) as a result of a sale or exchange of fifty percent or more of the total interest in partnership capital and profits within a twelve-month period is required to file a short-year final return for the taxable year ending with the date of its termination, even though the new partnership resulting from the termination will continue to use the employer identification number of the terminated partnership. The new partnership is required to file a return for its taxable year beginning after the date of termination of the terminated partnership.

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

(i) PLR 200111021, PLR 200113010 through PLR 200113015, PLR 200121016 and PLR 200125053 – In nine similar PLRs, for purposes of creating a "master/feeder" structure, the transfer of cash or securities or a diversified portfolio of cash and securities to a partnership was not a transfer to an investment company under Section 351(e) provided that there are no other transfers to the partnership except for transfers solely of cash and/or a diversified portfolio of stock and securities within the meaning of Treasury Regulation Section 1.351-1(c)(6)(i). Therefore, no gain or loss was recognized as a result of the contribution under Section 721(a).

(ii) PLR 200118039 through PLR 200118041 – In three similar PLRs, the IRS ruled that transfers of only cash or a portfolio of diversified stocks and securities to a trust classified as a partnership pursuant to Treasury Regulation Section 301.7701-3(b)(1)(i) in exchange for an interest in the partnership will not be transfers of property to a partnership that would be treated as an investment company within the meaning of Section 351(e) if the partnership were a corporation. As a result, the transfers will be accorded nonrecognition under Section 721(a).

6. Section 754 – Manner of Electing Optional Adjustment to Tax Basis of Partnership Property.

(i) PLR 200101016, PLR 200110023, PLR 200119018, PLR 200120023, PLR 200121050, PLR 200123049, PLR 200125065, PLR 200126027, PLR

200128052, PLR 200130025, PLR 200145016, PLR 200145022, and PLR 200145024 – In thirteen similar rulings, the IRS granted a partnership's request for an extension to make a Section 754 election to adjust the tax basis of partnership property.

7. Section 761 – Terms Defined.

(i) PLR 200139005 – A contractual relationship between parties pursuant to which one party purchases billings and collection services from the other party will not constitute a partnership under Section 761(a) and Treasury Regulation Section 1.761-1(a) for Federal income tax purposes.

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

(i) PLR 200102028 – The IRS held that a partnership will continue to be engaged in a preexisting line of business for purposes of its grandfathered exemption under Section 7704(g) from treatment under Section 7704(a) as a corporation notwithstanding the partnership's acquisition and operation of additional farming operations because such operations are closely related to the preexisting businesses of the partnership and do not constitute a "substantial new line of business" within the meaning of Treasury Regulation Section 1.7704-2(d)(1).

(ii) PLR 200110011 – The IRS held that an investment advisory firm's integration of a target's similar business activities after the firm's acquisition of the target does not end the firm's transition rule exemption from Section 7704(a); however, the firm's operation of the target's trade execution service through a wholly-owned limited liability company treated as a disregarded entity for Federal income tax purposes is a new line of business, and, if it becomes substantial within the meaning of Treasury Regulation Section 1.7704-2(c), the firm's election under Section 7704(g) will cease to be in effect.

(iii) PLR 200119008 – The IRS held that a publicly traded partnership's status as such within the meaning of Section 7704(a) is tested as of the effective date of the revocation of the partnership's election under Section 7704(g), not as of the start of the taxable year, and the tax on gross income under Section 7704(g) does not apply to the partnership's gross income accruing on or after the effective date of the revocation of the Section 7704(g) election.

9. Revenue Rulings.

(i) Revenue Ruling 2001-61 – The IRS ruled that if an entity classified as a partnership becomes a disregarded entity for Federal income tax purposes and if the disregarded entity chooses to calculate, report, and pay its employment tax obligations under its own name and employer identification number pursuant to Notice 99-6, the disregarded entity must retain the same employer identification number it used as a partnership for employment tax purposes. For all Federal income tax purposes other than employment obligations or except as otherwise provided in regulations or other guidance, a disregarded entity must use the taxpayer identification number of its owner. Similarly, if an entity classified as a disregarded entity for Federal income tax purposes calculates, reports, and pays its employment tax obligations under its own name and employer identification number pursuant to Notice 99-6 and if the Federal income tax classification of that entity changes to a partnership, the partnership must retain the same employer identification number it used as a disregarded entity.

10. Proposed & Final Treasury Regulations.

(i) Taxable Years of Partner and Partnership – Because the IRS and Treasury Department believe that other provisions of the Code and Treasury Regulations provide adequate guidance on the time for including gain or loss from a partnership distribution or from a sale or exchange of a partnership interest, the inclusion rule in Treasury Regulation Section 1.706-1(a)(2), providing that any gain or loss from a partnership distribution or from a sale or exchange of all or part of a partnership interest is includible in the partner's gross income for the taxable year in which the payment is made, is proposed to be removed. These regulations propose to modify the current regulations to reflect the required taxable year of a partnership consistent with the Tax Reform Act of 1986, (Public Law 99-512, 100 Stat. 2362). See Treasury Regulation Section 1.706-1.

(ii) Determination of Basis of Partner's Interest – The IRS issued proposed regulations coordinating Section 705 and Section 1032, providing that if (i) a corporation acquires an interest in a partnership that holds stock in that corporation or where the partnership subsequently acquires stock in its corporate partner in an exchanged tax basis transaction, (ii) the partnership does not have an election under Section 754 in effect for the year in which the corporate partner acquires its interest in the partnership, and (iii) the partnership later sells or exchanges the stock in its corporate partner, then the increase or decrease in the corporate partner's tax basis in its partnership interest resulting from the sale or exchange of the stock equals the amount of gain or loss that the corporate partner would have recognized, absent the application of Section 1032, for the year in which the corporation acquired the interest if a Section 754 election had been in effect. The proposed regulations further provide that the determination of tax basis as set forth therein may not be avoided through the use of tiered partnerships or other arrangements. See Treasury Regulation Section 1.705-2.

(iii) Continuation of Partnership – The IRS issued final regulations describing the prescribed form and the resulting tax consequences of partnership mergers and divisions. These regulations affect both partnerships under state law and limited liability companies treated as partnerships under Federal income tax law. Pursuant to the final regulations, the IRS will respect the form of a partnership merger or division under applicable state law if the partnership undertakes either the Assets-Over Form or the Assets-Up Form. Generally, when two partnerships merge, assets are transferred from one partnership to another at the entity level in exchange for interests in the resulting partnership, and the interests are then distributed to the partners in liquidation of the terminating partnership (the Assets-Over Form). However, if the assets are transferred to the partners in a liquidating distribution of the partnership and then contributed by the former partners to another partnership, the final regulations would treat the transaction as the Assets-Up Form. No combination of the two forms will be allowed. The regulations also address the consequences of a partnership division in which more than one resulting partnership is a continuing partnership. Under the final regulations, one partnership will be treated as transferring assets and liabilities of the prior partnership to the resulting partnerships. This transferor partnership will file a partnership return for the taxable year of the divided partnership and will retain that partnership's employer identification number. Furthermore, all continuing partnerships continue to remain subject to any elections made by the prior partnership, but continuing partnerships other than the transferor partnership must file separate returns with new employer identification numbers. See Treasury Regulations Section 1.708-1, Section 1.752-1 and Section 1.752-5.

(iv) Corresponding Adjustment to Tax Basis of Assets of a Distributed Corporation Controlled by a Corporate Partner – The IRS issued final regulations conforming Treasury Regulation Section 1.1502-34 to a technical correction enacted in Section 311(c) of the Community Renewal Tax Relief Act of 2000 (Public Law 106-554, 114 Stat. 2763) and added a regulation under Section 732 reflecting that correction. These regulations reflect this statutory provision clarifying that the determination of whether a corporate partner has control of a distributed corporation for purposes of Section 732(f) shall be made by applying the special aggregate stock ownership rules of Treasury Regulation Section 1.1502-34. See Treasury Regulation Section 1.732-3 and Section 1.1502-34.

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

(i) Section 6221 – Tax Treatment Determined at Partnership Level.

(A) Overstreet v. Commissioner, T.C. Memo. 2001-13 (January 22, 2001).

(B) Serfustini v. Commissioner, T.C. Memo. 2001-183 (July 23, 2001).

(ii) Section 6223 – Notice to Partners of Proceedings.

(A) Rhone-Poulenc Surfactants and Specialties, L.P. v. Commissioner, 87 AFTR2d Par. 2001-872 (3rd Cir. 2001).

(B) Myers v. Commissioner, T.C. Summary Opinion 2001-141 (September 14, 2001).

(iii) Section 6224 – Participation in Administrative Proceedings; Waivers; Agreements.

(A) Procherenko v. United States, 87 AFTR2d Par. 2001-690 (Fed. Cir. 2001).

(iv) Section 6226 – Judicial Review of Final Partnership Administrative Adjustments.

(A) St. David's Healthcare System, Inc. v. Commissioner, 88 AFTR2d Par. 2001-5039, (5th Cir. 2001).

(B) Hoyt and Sons Ranch Property Ltd. NV v. Commissioner, T.C. Memo. 2001-282.

(v) Section 6229 – Period of Limitations for Making Assessments.

(A) Ruggiero v. Commissioner, T.C. Memo. 2001-162.

(B) Conway v. United States, Fed.Cl. No. 96-786 (August 22, 2001).

(C) CC&F Western Operations Limited Partnership v. Commissioner, 88 AFTR2d Par. 2001-5625 (1st Cir. 2001).

(D) Madison Recycling Associates, et al. v. Commissioner, T.C. Memo. 2001-85 (April 9, 2001)

(vi) Section 6231 – Definitions and Special Rules.

(A) Phillips v. Commissioner, 88 AFTR2d Par. 2001-5599 (9th Cir. 2001).

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

1. Section 856 Definition of REIT.

(i) PLR 200101012 – The IRS concluded that a REIT's income from providing internet access, cable television, telephone, security, and private shuttle bus services will constitute "rents from real property" under Section 856(d).

(ii) PLR 200103033 – The IRS found that a REIT's provision of telecommunications services to its tenants is similar to the provision of utilities services and ruled that the provision of telecommunications services will not prevent the REIT's share of otherwise qualifying income from qualifying as "rents from real property" under Section 856(d)(1) and that the amounts the REIT receives or accrues for providing these services, if otherwise qualifying, will constitute "rents from real property" within the meaning of Section 856(d)(1)(B).

(iii) PLR 200106016 – The IRS held that, with regard to web site costs provided to commercial rental properties by a wholly-owned subsidiary of a partnership in which a REIT owns an interest, the allocation of such costs in proportion to aggregate amounts received or accrued from the properties was reasonable for purposes of applying the one percent minimum threshold of Section 857(d)(7)(B).

(iv) PLR 200115023 – The IRS ruled that a REIT's request for an automatic change in its method of depreciating various assets resulting in a positive Section 481 adjustment that will be includable in income for four taxable years should not be taken into account in determining whether the REIT meets the gross income tests of Section 856(c)(2) and (3).

(v) PLR 200119010 – The IRS ruled that payments under a cost reimbursement arrangement by an operating partnership to its general partner that is a REIT, where all expenses are treated for Federal income tax purposes as expenses of the partnership incurred on its behalf and not as expenses of the REIT, will not constitute gross income to REIT for purposes of Section 856(c) if the parties are not in the business of providing services of the type that will be covered by the reimbursement arrangement, the parties will not derive any profit from the reimbursement arrangement, the REIT will not deduct any of the partnership's share of the reimbursed costs as expenses and the REIT will treat the reimbursements as a repayment of a non-interest bearing advance.

(vi) PLR 200127024 – The IRS held that a REIT's allocable share of payments received pursuant to a break-up fee in a merger agreement will not be includable in the REIT's income for purposes of determining whether the REIT has satisfied the gross income tests of Section 856(c)(2) and Section 856(c)(3).

(vii) PLR 200132008 – The IRS held that stock in a lessee of a REIT's properties received by the REIT pursuant to a Chapter 11 bankruptcy reorganization that is immediately transferred in an irrevocable assignment by the REIT to trusts for the benefit of the REIT's shareholders does not constitute securities held by the REIT for purposes of Section 856(c)(4) or Section 856(d)(2).

(viii) PLR 200140026 – The IRS concluded that the performance by a REIT or the limited partnership in which it owns an interest of obligations required of them under a naming rights agreement will not be considered services furnished or rendered by the REIT to a tenant under Section 856(d)(7)(A)(i), and payments under the naming rights agreement will not constitute impermissible services income under Section 856(d)(2)(C); however, the REIT's allocable share of any amounts received or accrued by the limited partnership as part of the payment under the naming rights agreement will fail to meet the Section 856(d) definition of "rents from real property."

(ix) Revenue Ruling 2001-29 – The IRS held that a REIT can be engaged in the active conduct of a trade or business within the meaning of Section 355(b) solely by virtue of functions with respect to rental activity that produces income qualifying as "rents from real property" within the meaning of Section 856(d).

C. Real Estate Mortgage Investment Conduits ("REMIC").

1. Section 860D – REMIC Defined.

(i) PLR 200101017, PLR 200117030, PLR 200117032, PLR 200124015 and PLR 200131010 – In three similar PLRs, the IRS granted requests for an extension of the time allowed by Treasury Regulation Section 1.860D-1(d)(1) to elect REMIC status under Section 860D(b).

D. Real Estate Taxation.

1. Section 121 – Exclusion of Gain from Sale of Principal Residence.

(i) INFO 2000-0367 – The owner of a condominium who moved out of the condominium four years ago and has not been able to sell the condominium because of a depressed real estate market does not meet the "use" requirement of Section 121 and cannot receive guidance from the IRS as to whether the "unforeseen circumstances" provision allows the taxpayer to claim Section 121 exclusion on its sale because the proposed regulations under Section 121 do not provide a definition for "unforeseen circumstances."

(ii) PLR 200104005 – The IRS held that gain from the sale of a taxpayer's residence whose ownership had previously been transferred to a trust for the benefit of taxpayer is excludable under Section 121 only to the extent the taxpayer is deemed to own a portion of the property in the trust pursuant to Section 678(a)(1), with the rest of the gain taxable to the trust as the owner of the residence.

(iii) PLR 200119014 – The IRS announced the revocation of PLR 200004022, which held that where a partnership produces no income, conducts no enterprise, and serves no business purpose, the taxpayers who wholly own the partnership are treated as owning a residence for the period of time in which it is held by the partnership. In the revocation, the IRS concluded that the partnership's ownership of the residence does not count as ownership by the partners.

(iv) PLR 200124011 – Where a taxpayer sold a residence otherwise qualifying for an exclusion under Section 121 in 1996 but did not file an income tax return or pay tax for 1996, the IRS held that because the statute of limitations for making a claim for credit or refund for 1996 had not expired, the taxpayer's income tax return for 1996 can be now filed with an election to exclude the gain from the sale of the residence under Section 121 as that section was in effect in 1996.

(v) Revenue Ruling 2001-57 – The IRS held that if an individual elects under Section 311(e) of the Tax Reform Act of 1997 (Public Law 105-34, 111 Stat. 788) to treat the individual's principal residence as being both sold and reacquired on January 1, 2001 for an amount equal to its fair market value on that date, then the individual cannot exclude from gross income under Section 121 any of the gain from the deemed sale.

2. Section 280A – Disallowance of Certain Expenses in Connection With Business Use of Home, Rental of Vacation Homes, Etc.

(i) CCA 200121070 – With regard to a taxpayer who rented a portion of his residence to his employer and who used the residence in performing services as an employee of the employer, the IRS concluded that the taxpayer may deduct home mortgage interest, real property taxes, and personal casualty losses to the extent permitted by Section 163, Section 164, and Section 165(c)(3) and (h); however, the taxpayer may not deduct otherwise allocable trade or business expenses under Section 162, business casualty losses under Section 165(c)(1), or depreciation under Section 167, to the extent those expenses and losses are attributable to the use of the residence by the taxpayer as an employee in performing services for the employer.

(ii) Tokh v. Commissioner, 88 AFTR2d Par. 2001-5653 (December 14, 2001) – The Seventh Circuit rejected the taxpayer's home office deduction, because the taxpayer's home was not the taxpayer's principal place of business and the home office was not maintained for the convenience of the taxpayer's employer.

(iii) Dixon v. Commissioner, 88 AFTR2d Par. 2001-5137 (July 23, 2001) – The Ninth Circuit upheld the Tax Court's decision rejecting the taxpayer's deduction for home office expenses because he failed to establish that a portion of his dwelling was used exclusively on a regular basis as his principal place of business.

(iv) Allison v. Commissioner, T.C. Summary Opinion 2001-161 (October 11, 2001) – A taxpayer who is in the business of selling training equipment and supplies to public schools claimed fifty percent of his apartment was used solely for his business and was denied a deduction for use of the space because, although there was evidence that the taxpayer performed some office activities in certain rooms of his apartment, the taxpayer did not use those rooms exclusively for his business.

(v) Morcos v. Commissioner, T.C. Summary Opinion 2001-114 (July 26, 2001) – The court held that the taxpayers were entitled to deductions for rental expenses for a carriage house that was separate from their residence, but rental expenses for rooms in their residence and expenses for landscaping are subject to the limitations under Section 280A(c)(5).

(vi) Romer v. Commissioner, T.C. Memo. 2001-168 (July 6, 2001) – The court held that the taxpayer, a commercial pilot and aircraft salesman, was not entitled to a home office deduction because he failed to establish that there was no office space available to him at his place of employment and that he spent more time at his home office on aircraft sales than he did traveling.

(vii) Harris v. Commissioner, T.C. Summary Opinion 2001-42 (March 27, 2001) – The court held that a taxpayer in the business of tax return preparation was not entitled to a home office deduction because the areas of the taxpayer's residence that were claimed as a home office were not used exclusively and regularly in the taxpayer's tax return preparation business during the years in question and the taxpayer's home was not his principal place of business during any of the those years.

3. Section 1031 – Exchanges of Property Held for Productive Use or Investment.

(i) PLR 200109022 – The IRS held that multiple exchanges of properties by a taxpayer that maintains a program of like-kind exchanges and that has entered into a master exchange agreement with a qualified intermediary will be treated as separate and distinct like-kind exchanges that qualify for nonrecognition under Section 1031.

(ii) PLR 200111025 – The IRS held that an accommodation party used to facilitate a like-kind exchange that is not acting on the taxpayer's behalf but for its own account and that does not have a business purpose of acting as an agent will not adversely affect an exchange otherwise qualifying for nonrecognition treatment under Section 1031.

(iii) PLR 200118023 – The taxpayer's use of its wholly-owned entity that is disregarded for Federal income tax purposes as an intermediary to facilitate an exchange under Section 1031 will constitute a direct acquisition of replacement property in the exchange.

(iv) TAM 200126007 – The IRS ruled that multiparty exchange transactions were part of a transaction or a series of transactions structured to avoid the purposes of Section 1031(f) and denied nonrecognition treatment Section 1031(a) for each of the exchanges.

(v) TAM 200130001 – The IRS held that taxpayers did not qualify for exchange treatment because they failed to meet the requirements for use of a qualified intermediary. Specifically, the taxpayers did not produce sufficient evidence of compliance with the requirement that written notice of the assignments be given to the purchasers of the relinquished property pursuant to Treasury Regulation Section 1.1031(k)-1(g)(4)(v), and neither of the two exchange agreements that the taxpayers entered into expressly limited their right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period pursuant to Treasury Regulation Section 1.1031(k)-1(g)(4)(i) and (ii).

(vi) PLR 200131014 – The IRS ruled that the taxpayer's transfer of replacement property to a wholly-owned limited liability company that is disregarded for Federal income tax purposes did not violate the requirement of Section 1031(a)(1) that the replacement property be used in a trade or business or held for investment by the taxpayer after the exchange.

(vii) PLR 200148042 – The IRS ruled that the taxpayer's inclusion of a statement in a qualified exchange agreement that the qualified intermediary is acting solely as the taxpayer's agent for all purposes except Federal income tax purposes has no adverse affect on the qualification of the qualified exchange agreement under Revenue Procedure 2000-37.

(viii) PLR 200151017 – The IRS ruled that where two sister corporations, as part of a transferor group, enter into a qualified exchange agreement, transfer relinquished property and identify replacement property, but merge pursuant to Section 368(a)(1)(A) reorganization before the replacement property is received, the surviving corporation steps into the shoes of the merged corporation for purposes of receiving the replacement property that the merged corporation had identified prior to the merger and the exchanges will still qualify for nonrecognition treatment under Section 1031(a).

(ix) PLR 200137032 – The IRS held that an exchange of cooperative interests in an apartment building for condominium deeds to the same apartments will qualify for nonrecognition under Section 1031(a) provided that all the other requirements of Section 1031 are met.

(x) Florida Industries Investment Corporation and Subsidiaries v. Commissioner, 87 AFTR2d Par. 2001-749 (11th Cir. 2001) – The court upheld the Tax Court's findings that the taxpayer was not entitled to nonrecognition treatment because the property exchanged did not qualify as like-kind property, the taxpayer failed to identify the replacement property and the taxpayer had control over the proceeds from the sale of the relinquished property.

(xi) Bundren v. Commissioner, T.C. Memo. 2001-2 (January 5, 2001) – The court held that the tax basis for replacement property received in an exchange qualifying for nonrecognition treatment immediately after the like-kind exchange was equal to the taxpayer's carryover tax basis in the relinquished property less any boot received by the taxpayer in the exchange plus closing costs pursuant to Section 1031(d).

(xii) Smalley v. Commissioner, 116 T.C. No. 29 (June 14, 2001) – The court held that taxpayers who exchanged standing timber for standing timber and land had a bona fide intent to acquire like-kind property before the end of the one hundred eighty-day exchange period and had no actual or constructive receipt of property under Treasury Regulation Section 1.1031(k)-l(j); thus, the taxpayers qualified for nonrecognition treatment under Section 1031(a).

4. Section 1033 – Involuntary Conversions.

(i) PLR 200109005 – The IRS ruled that a taxpayer's exercise of an option to purchase a building that he leased qualifies as replacement property for taxpayer's building that was destroyed in a fire, and the involuntary conversion can be deferred under Section 1033.

(ii) PLR 200118010 – The IRS ruled that noncontrolling interests in a corporation's stock are involuntarily converted into money within the meaning of Section 1033(a)(2) when the sale of the stock was made under a threat of condemnation of the underlying property of the corporation, and the reinvestment of the proceeds in common or preferred stock of public utilities and public utility mutual funds constitutes reinvestment in property similar or related in service or use within the meaning of Section 1033(a)(2)(A) because the risks to the taxpayers with respect ownership in the corporation's stock are comparable to the risks of investing in publicly traded common or preferred stock of public utilities and public utility mutual funds.

(iii) TAM 200126010 – The IRS held that a taxpayer is eligible for involuntary conversion treatment under Section 1033 for settlement proceeds consisting of the present value of the cost to replace a product used in the taxpayer's manufacturing facility that had to be removed due to the mandate of a state agency.

(iv) PLR 200145001 – The IRS ruled that a taxpayer's sale of the property to a third party qualifies as an involuntary conversion under Section 1033 resulting from the threat or imminence of condemnation pursuant to Revenue Ruling 81-180.

E. Other Related Issues.

1. Section 162 – Trade or Business Expense.

(i) TAM 200147012 – The IRS held that the taxpayer may deduct the fair market value of land previously received by it tax-free under the Alaska Native Claims Settlement Act (Public Law 92-203, 85 Stat. 688) and conveyed to an Alaska city as required by Section 14(c)(3) of same.

(ii) United Dairy Farmers, Inc. v. United States, 88 AFTR2d Par. 2001-5373 (6th Cir. 2001) – The Sixth Circuit affirmed a U.S. District Court holding that expenditures made by the taxpayer to remediate contaminated soil is an improvement of the property as compared to the condition of the property at the time of acquisition, and, as a result, the taxpayer is required to capitalize the remediation costs.

(iii) Bright v. Commissioner, T.C. Summary Opinion 2001-164 (October 16, 2001) – The court held that, because the taxpayers were not engaged in a trade or business of renting or selling real property, they could not deduct expenses related to their sale of real estate.

2. Section 165 – Losses.

(i) Barmes v. Commissioner, 87 AFTR2d Par. 2001-1048 (7th Cir. 2001) – The Seventh Circuit upheld the Tax Court's previous decision to deny the taxpayers' casualty loss deduction for the restoration of a stagnated pond, holding that the damage to the pond occurred gradually and that the taxpayers did not present any evidence that a sudden, unexpected event caused it to stagnate.

(ii) Johnson v. Commissioner, T.C. Memo. 2001-97 (April 24, 2001) – The court held that the taxpayer could not take a theft loss deduction based on the court-ordered foreclosure of his home (characterized by the taxpayer as "judicial theft of real estate") and further concluded that even if the foreclosure order been deemed improper, the loss of taxpayer's residence through foreclosure would not be considered a casualty or theft loss within the meaning of Section 165.

(iii) Torre v. Commissioner, T.C. Memo. 2001-218 (August 13, 2001) – The court held that the taxpayer could not take a casualty or theft loss deduction from the sale of his house, which the taxpayer claims was motivated by alleged hostility and racism from police and neighbors, because the alleged harassment would not qualify as a "sudden or cataclysmic event" under Section 165(c)(3) and the taxpayer failed to show serious physical damage or destruction to the property.

(iv) Mitchell v. Commissioner, T.C. Memo. 2001-269 (October 4, 2001) – The Tax Court ruled that the taxpayers could not deduct losses related to their farming activity because they did not have the requisite profit motive and could not deduct expenses from a purported rental property because they failed to show that the property had been converted into rental property from their residence.

(v) Boyle v. Commissioner, T.C. Memo. 2001-235 (September 10, 2001) – The court held that the taxpayer was not allowed to deduct a casualty loss on a burned warehouse because the taxpayer's tax basis in the property did not exceed the insurance recovery thereon.

3. Section 183 – Activities Not Engaged in for Profit.

(i) Epic Associates 84-III et al. v. Commissioner, T.C. Memo. 2001-64 (March 19, 2001) – In considering whether a limited partnership was engaged in activities for profit, the court stated that the profit motive determination must be made at the partnership level and concluded that the general partner of the limited partnership engaged in the activities of the limited partnership in an actual and honest objective of making a profit.

4. Section 263A – Capitalization.

(i) Pelaez and Sons, Inc. v. Commissioner, 87 AFTR2d Par. 2001-874 (11th Cir. 2001) – The Eleventh Circuit affirmed the Tax Court decision and held that a taxpayer must capitalize pre-productive development costs for growing citrus trees.

(ii) Hutchinson et al. v. Commissioner, 116 T.C. No. 14 (March 14, 2001) – The court held that, although a real estate developer was entitled to allocate estimated construction costs under the alternative cost method of Rev. Proc. 92-29, the court concluded that the interest capitalization rule of Section 263A(f) applied and prevented the allocation of the estimated interest expenses.

5. Section 453 – Installment Method.

(i) Notice 2001-22 – The IRS stated, that a taxpayer who sold property in an installment sale on or after December 17, 1999 and reported the sale on the accrual method in a return filed by April 16, 2001 has the Secretary's consent to revoke its election out of the installment sale method; however, the revocation will not be effective unless the taxpayer files an amended return before the statute of limitations expires for the year of the sale and for any other affected tax year.

6. Section 465 – Deductions Limited to Amount at Risk.

(i) PLR 200120020 – The IRS ruled that, for purposes of Section 465(b)(6)(A), a limited partnership's liabilities consisting of unsecured debt and outstanding advances under a line of credit, all of which are nonrecourse to the partners of the partnership including its REIT general partner, will be treated as qualified nonrecourse financing as to which no one has personal liability and is considered to be secured by the partnership's assets (including the partnership's proportional share of the properties owned by its subsidiaries that qualify as partnerships for Federal income tax purposes).

7. Section 469 Passive Activity Losses and Credits Limited.

(i) FSA 200102018 – The IRS ruled that with regard to taxpayers that entered into oil and gas exploration agreements with a management company through their limited partnership and an S corporation, the losses reported by the taxpayers in connection with the activities conducted by the limited partnership are nonpassive activity losses because the taxpayers own a general partnership interest in the limited partnership and, as such, have liability with respect to the working interests. However, the working interest exception is not applicable to the oil and gas interest activities of the S corporation because the shareholders' liability is limited to their investment in the S corporation; thus, losses reported by the taxpayers in connection with the S corporation's activities would be passive activity losses.

(ii) Hillman v. Internal Revenue Service, 88 AFTR2d Par. 2001-5118 4th Cir. 2001) – The court held that because Section 469(a) prohibits a taxpayer from deducting passive activity losses from nonpassive activity gains, an S corporation shareholder is barred from offsetting passive deductions of self-charged management fees against the nonpassive income from the same management fees earned by the S corporation.

(iii) PLR 200144013 – The IRS held that amounts expended for the purchase of real estate will be considered passive activity expenditures and, to the extent that debt proceeds are used to acquire property used in a passive activity, the interest attributable to the debt constitutes a passive activity deduction.

ENDNOTE

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

PROPERTY TAX: RECENT DEVELOPMENTS

John Brusniak, Jr.[1]

TEXAS COURTS OF APPEALS

ANY PERSON CLAIMING AN INTEREST IN A PROPERTY HAS STANDING TO SUE ON AN APPRAISED VALUE; REVERSIONARY ESTATES OWNED BY TAX-EXEMPT LESSORS MAY NOT BE TAXED; LEASEHOLD ESTATES ARE TO BE TAXED AT MARKET VALUE; FEE SIMPLE SALES ARE NOT COMPARABLES FOR LEASEHOLD ESTATES.

Panola County Fresh Water Supply District Number One v. Panola County Appraisal District, No. 06-00-00120-CV (Tex. App.–Texarkana, January 31, 2002, no pet. h.) (to be published).

A tax-exempt entity which leased lakeside lots to individuals sued the appraisal district challenging the methodology by which the appraisal district was valuing the lots contending that the valuation method resulted in the inclusion of the reversionary estate owned by the tax-exempt entity in the leasehold value; thereby creating an illegal lien on the tax-exempt entity's property. The appraisal district contended that the tax-exempt entity was not the owner of the property and therefore did not have standing to sue. The court overruled the appraisal district's challenge finding that "one who claims an interest in property" is deemed to be a property owner under the provisions of the tax code for purposes of challenging an appraised value. The court further determined that the use of "fee simple" sales transactions in valuing taxable leasehold properties would improperly result in the taxation of the reversionary estate belonging to the tax-exempt entity and as a result such sales could not be used for valuation purposes; however, the court ruled that limiting the value of the leasehold estate to the amount of rent being paid annually was not appropriate where market sales of leasehold estates were available to be analyzed.

INTERSTATE ALLOCATION OF AIRCRAFT VALUATION ARE NOT PROPER SUBJECTS OF MOTIONS TO CORRECT VALUATIONS UNDER SECTION 25.25(C)(3).

Curtis C. Gunn, Inc. v. Bexar County Appraisal District, No. 04-01-00470-CV (Tex. App.–San Antonio, January 9, 2002, no pet. h.). (to be published).

Taxpayer owned an aircraft which it leased to an interstate charter service. The taxpayer filed annual renditions with the appraisal district, but did not contest any of the valuations of the aircraft during the normal appeals period. The taxpayer subsequently filed a motion to correct error pursuant to Section 25.25(c)(3) of the Texas Tax Code seeking to obtain a three year retroactive interstate allocation of the valuation of the aircraft reflective of its out of state travel. The court refused to grant such an allocation ruling that Section 25.25(c)(3) was not a proper means for obtaining such a correction since the aircraft had in fact been "located" within the boundaries of the appraisal district. It ruled that such relief could only be obtained during the course of the normal appeals process.

TEXAS ATTORNEY GENERAL OPINIONS

A PRIVATE DELINQUENT TAX COLLECTION ATTORNEY MAY NOT MAKE DONATIONS OF PROPERTY OR SERVICES IF THE DONATION IN EFFECT REFUNDS A PORTION OF THE COMPENSATION WHICH THE ATTORNEY RECEIVES UNDER THEIR COLLECTION CONTRACT.

Op. Tex. Att'y Gen. JC-0443 (2001).

A private attorney is allowed to contract with a county to collect taxes and to receive as compensation, pursuant to Section 6.30 of the Texas Tax Code, a statutory collection penalty of up to twenty percent of the total taxes, interest and penalties which are collected. Such an attorney wished to make a donation of personnel, equipment or dollars back to the county to enhance the county's delinquent tax collection efforts. The Attorney General ruled that such a donation would be illegal if it "in effect refunds part of his or her compensation to the county" because the collection penalty is intended solely to provide compensation for the contract attorney.

ENDNOTES

1 Brusniak Harrison & McCool, P.C., 17400 Dallas Parkway, Suite 112, Dallas, Texas 75287-7305, (972) 250-6363, (972) 250-3599 fax.

STATE TAX: RECENT DEVELOPMENTS

Steve Moore[1]

Franchise Tax—Selected Appellate Decision

Rylander v. Fisher Controls International, Inc., 45 S.W.3d 291 (Tex. App.–Austin 2001, *no pet. h.*), contains a good description of the history and application of the Texas "throwback" rule, which derives from Section 171.1032 of the Texas Tax Code. In particular, the *Fisher* Case determines whether, from 1991 through 1993, *Fisher's* sales into states where it had nexus, but was not required to pay an income based tax, were required to be "thrown back" into its Texas apportionment formula numerator. The relevant Tax Code provision during such period authorized the "throw back" if the taxpayer was "subject to taxation" in the foreign state. *Fisher* argued that if it was not required to pay an income based tax in each foreign state then it was not "subject to taxation," and the Comptroller argued that regardless of each foreign state's actual legislative enactments, if an income based tax could have been constitutionally imposed by the foreign state, then *Fisher* was "subject to taxation." Based largely on legislative history, the Austin Court of Appeals affirmed the trial court judgment in favor of *Fisher*. Please note that legislative changes effective since 1994 make the ultimate technical holding of the *Fisher* case inapplicable under current law, but the case is still very worthy of review for its reasoning.

Sales Tax—Selected Proposed Rule Amendments

The Comptroller is considering the proposal of amendments to Rule 3.300 concerning manufacturing and processing, which are based on changes made to Section 151.3181 of the Texas Tax Code by Senate Bill 1125 from the 77th Texas Legislature (2001). The primary changes to Rule 3.300 involve the divergent use of equipment purchased under an exemption certificate as manufacturing equipment. The changes under consideration include:

"(k) Divergent use.

(1) A manufacturer who issues a resale certificate to purchase tangible personal property tax free and subsequently uses the item for a nonexempt purpose must remit the tax to the comptroller based on the purchase price of the item or the fair market rental value of the item. See 3.285 of this title (relating to Resale Certificate; Sales for Resale) and 3.346 of this title (relating to Use Tax).

(2) A manufacturer who issues an exemption certificate to purchase tangible personal property tax free and subsequently uses the item for a nonexempt purpose is responsible for tax based on the divergent use. For divergent use that occurs prior to October 1, 2001, a manufacturer owes tax based on the purchase price or the fair market rental value of the equipment. See 3.287(e) of this title (relating to Exemption Certificates). For divergent use that occurs after September 30, 2001, a manufacturer owes tax based on the guidelines that are provided in paragraph (3) of this subsection.

(3) A manufacturer must remit tax in the following manner on divergent use that occurs after September 30, 2001.

(A) No tax is due if the divergent use occurs in any month after the fourth anniversary of the equipment purchase date. Equipment that is purchased before October 1, 1997, is not subject to tax on divergent use that occurs after October 1, 2001.

(B) Except as provided by subparagraph (C) of this paragraph, a manufacturer owes tax on an item if the divergent use occurs in the month of, or during any month before, the fourth anniversary of the date of purchase. The amount of the tax that is due for the month in which the divergent use occurs is equal to 1/48 of the purchase price multiplied by the percentage of divergent use during that month multiplied by the applicable tax rate when the divergent use occurs.

(i) The 48-month period that is used in calculating divergent use begins when the equipment is purchased.

(ii) The amount of divergent use for a month can be measured either in hours or by applicable output as follows:

(I) the divergent use percentage for a month is computed by taking the total divergent use hours of operation of the equipment in a month and dividing that amount by the total hours of operation of the equipment during the same month; or

(II) the divergent use percentage for a month is computed by taking the total output of the equipment during the period of divergent use in a month and dividing that amount by the total output of that equipment during the same month.

(C) A manufacturer who uses equipment in a divergent manner in the month of, or during any month before, the fourth anniversary of the date of purchase owes no tax on that use if the divergent use percentage in that month is 5.0% or less.

(D) A manufacturer who purchases non-capitalized equipment repair parts or consumables for equipment that is routinely used in both exempt and nonexempt manners may elect to pay tax on the repair parts or consumables by applying the divergent use percentage of the equipment as provided by paragraph (2)(B) of this subsection for the month during which the manufacturer purchased the repair parts or consumable items.

(E) A manufacturer who purchases repair labor for equipment may owe tax if the manufacturer uses the qualifying exempt equipment for both exempt and nonexempt purposes. If the manufacturer was using qualifying equipment in an exempt manner at the time when the repair was needed, then no tax is due on the repair. If the manufacturer was using the qualifying equipment in a nonexempt manner when the repair was needed, then tax is due on the purchase price of the repair. If a manufacturer cannot determine whether the equipment was being used in an exempt or nonexempt manner at the time of the repair, then the manufacturer may pay tax on the purchase price of the repair multiplied by the divergent use percentage as provided by paragraph (2)(B) of this subsection for the month in which the purchase of the repair service was made."

The Comptroller is also considering the proposal of amendments to Rule 3.286 concerning seller's and purchaser's responsibility, which are based on legislative changes from the 77th Texas Legislature (2001). The proposed changes to Rule 3.286 reflect the following legislative actions.

House Bill 1098 amended Section 151.052 of the Texas Tax Code, effective September 1, 2001, so that printers may accept a multistate exemption certificate from a purchaser if the printed materials are produced by a web offset or rotogravure printing process and the materials are delivered by the printer to a fulfillment house or the United States Postal Service for distribution to third parties located both in Texas and outside of Texas. The purchaser who gives the certificate is then responsible for reporting and paying sales or use taxes to the Comptroller on those printed materials that are subject to tax.

Senate Bill 1123 amended various provisions of Chapters 111 and 151 of the Texas Tax Code to provide for certain penalties for various criminal offenses.

Senate Bill 640 added Sections 111.0625 and 111.0626 to the Texas Tax Code. The new sections provide that taxpayers who remitted $100,000 or more in sales or use tax during the proceeding state fiscal year must file sales or use tax returns and payments electronically.

Finally, the Comptroller has proposed additional amendments to Rule 3.286 providing specific information regarding the sales or use tax responsibilities of direct sales organizations and their independent salespersons. The Comptroller reports that these changes are based on its long-standing policy.

For example, subsections (d)(6) and (d)(7) of the Rule would be amended as follows if the proposed amendments are adopted:

"(6) Direct sales organizations must collect and remit tax from independent salespersons as follows.

(A) If an independent salesperson purchases a taxable item from a direct sales organization after the customer's order has been taken, then the direct sales organization must collect and remit sales tax on the actual sales price of the taxable item.

(B) If an independent salesperson purchases a taxable item before the customer's order is taken, then the direct sales organization must collect and remit the tax from the salesperson based on the suggested retail sales price of the taxable item.

(C) Taxable items that are sold to an independent salesperson for the salesperson's use are taxed based on the actual price for which the item was sold to the salesperson at the tax rate that was in effect for the salesperson's location.

(7) A printer is a seller of printed materials and is required to collect tax on sales. However, a printer who is engaged in business in Texas is not required to collect tax if:

(A) the printed materials are produced by a web offset or rotogravure printing process;

(B) the printer delivers those materials to a fulfillment house or to the United States Postal Service for distribution to third parties who are located both in Texas and outside of Texas; and

(C) the purchaser issues an exemption certificate that contains the statement that the printed materials are for multistate use and the purchaser agrees to pay to Texas all taxes that are or may become due to the state on the taxable items that are purchased under the exemption certificate. See subsection (f)(4) of this section for additional reporting requirements.

Sales Tax Selected Recent Hearing Decision

In Hearing 39,468 (January 11, 2002) the Comptroller reviewed whether a national floral association's "mercury network fees" were subject to Texas sales tax. The findings of fact included:

"The mercury network fees were scheduled on Exam 1000 of the audit. The mercury network is used by FTD members to route orders to members in the locale of the recipient of the item. Members are required to pay a fee for hardware and software that *allows them access to the network*. Members also receive monthly activity statements, and reports showing the members outgoing and incoming orders, and the amount of commission due to the member or Petitioner from orders processed through the network. (Petitioner's mainframe receives, routes, tracks, and stores the relevant data necessary to compile the above-referenced reports. (Source: Administrative Hearings Section's Position Letter of February 16, 2001.)" (*emphasis added*)

While the auditor had originally found the network fees to represent payments for taxable information services, the Administrative Hearings Section of the Comptroller's Office argued the services should be taxed as data processing services or the rental of tangible personal property. The ALJ held that based on the limited facts provided, the service and equipment combination was taxable as data processing services or rental of tangible personal property, or some combination thereof. The case might prove important in related contexts because of its reference to network access charges.

ENDNOTES

1 Steven D. Moore, Jackson Walker L.L.P., 100 Congress, Suite 1100, Austin, Texas 78701; 512-236-2000; 512-236-2002 (fax); smoore@jw.com.

TAX CONTROVERSY: RECENT DEVELOPMENTS

Josh O. Ungerman[1]

Internal Revenue Service criminal investigation's role in the fight against terrorism.

Some criminal investigation special agents have set aside their traditional criminal investigation duties and have been transferred to assist in America's war against terrorism. Since September 11, criminal investigation special agents have conducted grid searches at the terrorist crash sites at World Trade Center and in Pennsylvania, sifted through rubble searching for evidence at the New York landfill and provided additional security at several locations.

The most well publicized effort of criminal investigation special agents in the war against terrorism has been participation in the Air Marshal Program. Many criminal investigation special agents have completed specialized Air Marshal training and are currently actively working as Air Marshals. Retired special agents throughout the United States have received recall letters soliciting their participation in the Air Marshal Program as part of the war against terrorism.

Additional activities of criminal investigation special agents include the following:

A. **Strategic Information Operations Center (SIOC)** – IRS criminal investigation managers and agents review financial leads on terrorism.

B. **Joint Terrorism Task Force (JTTF)** – IRS criminal investigation support has increased since September 11 in the JTTF's run by the FBI.

C. **Operation Green Quest** – Criminal investigation special agents with an expertise in money laundering are assisting in this treasury hosted multi-agency initiative which targets sources of funding for terrorist organizations.

D. **Office of Foreign Assets Control (OFAC)** – Criminal investigation special agents help to identify terrorist's fund-raising activities and pursue leads to determine if legal cause exists to forfeit assets of terrorist fund-raising activities in this jointly coordinated activity between the Department of Treasury, the Deputy Attorney General and the Department of Justice.

E. **Anti-Terrorism Task Forces** – Criminal investigation special agents are participating in anti-terrorism task forces which have been established in each district by the United States Attorney at the behest of the Attorney General.

F. **High Intensity Money Laundering & Related Financial Crime Area (HIFCA) Task Forces** – Criminal investigation special agents are assisting in these task forces located in the Northern District of Illinois (Chicago), Northern District of California (San Francisco), New York/New Jersey, San Juan/Puerto Rico, Los Angeles. A HIFCA designed to address cross-border currency smuggling covers from Texas/Arizona to and from Mexico.

Ninth Circuit affirms conviction under Internal Revenue Code § 7202 for failure to pay over taxes withheld from employees in a statutory construction case of first impression.

U.S. v Gilbert, *88 AFTR 2.d 2001-6009 (9th Cir. Sept. 24, 2001)*. The Appellant owned and operated a business which provided security guards to private companies. As such, the company was required to collect, account for, and pay the IRS withholding tax for each employee. The company did in fact collect and account for the withholding taxes, but the company failed to pay over the withholding taxes to the Internal Revenue Service. The owner and operator of the business was indicted on six counts of willful failure to collect and pay over tax under 26 U.S.C. § 7202, one count of tax evasion under 26 U.S.C. § 7201, one count of willful failure to file a tax return under 26 U.S.C. § 7203 and one count of willfully subscribing to a false statement under 26 U.S.C. § 7206(1). The jury found the Appellant guilty of three counts of willful failure to collect and pay over tax under 26 U.S.C. § 7202.

The Appellant raised a statutory construction issue of first impression for the Ninth Circuit. The issue is whether a 26 U.S.C. § 7202 conviction requires both failing to account for and pay withholding tax.

The Ninth Circuit began its analysis by acknowledging that when the legislative will has been expressed in reasonably plain terms, the language must ordinarily be regarded as inclusive. However, the Circuit Court further emphasized that if the plain language of the statutes renders the meaning reasonably clear, a court will not investigate further unless the application leads to unreasonable or impractical results. The Circuit Court concluded that even if the Appellant's construction of § 7202 was not necessarily inconsistent with the plain meaning of the statute, that nonetheless the Appellant's construction leads to unreasonable or impractical results. In doing so the Ninth Circuit followed the Second Circuit's opinion of *U.S. v. Evangelista*, 122 F.3d 112 (2nd Cir. 1997) and the Third Circuit's opinion in *U.S. v. Thayer*, 201 F.3d 214 (3rd Cir. 1999). Additionally, the Circuit Court noted that the Supreme Court's decision in the civil counterpart to § 7202, § 6672, in *Slowdov v. U.S.*, 436 U.S. 238 (1978) supported the Circuit Court's interpretation of § 7202. The Circuit Court relied on *dicta* by the Supreme Court that the general purpose of § 6672 (Civil) and § 7202 (Criminal) is that a person must both withhold and pay over the tax. Thus, the Circuit Court concluded that a person who fails to perform only one of the required duties is subject to conviction under § 7202.

The Appellant also argued that the applicable statute of limitations for § 7202 is actually three years as opposed to the six years determined by the District Court. The Appellant argued that § 6531(4) does not apply to § 7202. Even though the Appellant cited some District Court cases, the Circuit Court decided to follow three prior Appellate Court opinions which all held that the six year statute of limitations under § 6531(4) applies to Internal Revenue Code § 7202. The Circuit Court relied on *U.S. v. Gollapudi*, 130 F.3d 66 (3rd Cir. 1997) and *U.S. v. Evangelista*, 122 F.3d 112 (2nd Cir. 1997) and *U.S. v. Porth*, 426 F.2d 519 (10th Cir. 1970).

Failure to object to mistrial bars subsequent double jeopardy defense to second prosecution.

U.S. v. Streett, *88 AFTR 2.d 2001-6462 (4th Cir. Oct. 18, 2001 Unpublished Opinion)*. The appellant doctor, his wife, and his CPA appealed a District Court order denying their Joint Motion to Dismiss tax charges. The appellants were charged with conspiracy to obstruct the Internal Revenue Service under 18 U.S.C. § 371 and making false tax returns under 26 U.S.C. § 7206(1). The appellant's jury trial lasted two and one-half days. After approximately three hours of deliberation, the jury then informed the Court that it could not reach a unanimous verdict on any of the charges. The Court responded by returning the jurors to the jury room to consider whether "there are questions or other items of evidence that the jury has not seen that you think might be of assistance." The Court next asked the government whether it would like the Court to declare a mistrial to which the government responded that it would first like to hear "whether the jurors have any additional questions or evidence they want to look at and see what happens then." The Court then turned to defense counsel and asked whether defense counsel had anything to add to which defense counsel replied "not at this time, your Honor."

The jury returned and informed the Court that no additional assistance would help reach a unanimous decision and the Court asked the government what it wanted to do. The government responded "I would say we need a mistrial, your Honor." The Court then turned to defense counsel and asked defense counsel whether he wanted to add anything to which defense counsel replied "No, sir." At this point, the trial Court declared a mistrial and returned the jurors to the jury room so that the Court could ask if there was any further matters that need to be taken up. Defense counsel responded only that he wanted to postpone a meeting with the probation office and one of the defendants.

A little more than a month later the grand jury returned a second indictment which included additional charges of making material false statements to the Internal Revenue Service in violation of 18 U.S.C. § 1001. Other false statements involved the same conduct which was charged as overt acts in the original conspiracy count of the original indictment.

The double jeopardy clause provides that no person shall "be subject for the same offense to be put twice in jeopardy of life or limb." The double jeopardy clause permits a retrial following a mistrial as long as "taking all the circumstances into consideration, there's a manifest necessity" for declaring the mistrial. The Fourth Circuit noted that it had long been established that the failure of the jury to agree on a verdict is an instance of "manifest necessity." The Circuit Court also emphasized that the double jeopardy clause bars retrials where bad faith conduct of a judge or prosecutor threatens the harassment of the accused by declaration of mistrial which would afford the prosecution a more favorable opportunity to convict the defendant. The Circuit Court concluded that regardless of a bad faith conduct argument, a defendant who fails to take advantage of the opportunity to object to a trial Court's declaration of a mistrial impliedly consents to the mistrial and could not successfully raise a double jeopardy defense to further prosecution before a second jury.

The Circuit Court found that defense counsel failed to object to the trial Court's declaration of a mistrial despite given the opportunity to do so on not one but two separate occasions. The Circuit Court characterized the defense counsel's actions at a minimum as failure to object to the mistrial declaration and at a maximum as affirmatively acquiescing to the mistrial declaration. Both actions bar successfully raising a double jeopardy defense to the second prosecution before a new jury.

Defense counsel should carefully consider the appropriate course of action when a mistrial appears imminent. In this case, an Allen change was not given to the jury. Defense counsel should be prepared for a second prosecution following a mistrial and know that the failure to object to the trial Court's declaration of a mistrial will bar a successful double jeopardy challenge of the second prosecution.

Former IRS attorney convicted in stock scheme.

U.S. v. Tanner, *DC Nevada No. CR-S-00-0193-KJD LRL (Nov. 19, 2001)*. Max Tanner, a former IRS attorney, was convicted of tax evasion, filing false income tax returns, money laundering, mail fraud, wire fraud, and conspiracy. Mr. Tanner and others organized and promoted the fictitious merger between a Las Vegas company, Maid Aide, and a Florida trucking company to lure brokers into pushing Maid Aide stock on potential investors. The pump and dump scheme worked beautifully and resulted in the price of Maid Aide stock reaching a high of $9.37 and subsequently falling to $0.13 a share. As a result of the scheme Mr. Tanner sold around $2 million of Maid Aide stock and evaded the payment of all taxes on the stock sale proceeds. Finally, in order to hide his proceeds from the illegal pump and dump stock scheme, Mr. Tanner utilized a foreign bank account.

Sixth Circuit allows disbarred lawyer acting pro-se to raise grouping and restitution issues in Motion to Vacate sentence under 28 U.S.C. § 2255 based upon ineffective assistance of Counsel.

Wineberger v. U.S.A., *268 F.3d 346 (6th Cir. Oct. 5, 2001)*. In the early 1990's, the now ex-attorney fraudulently diverted over a million dollars from his client's funds for his own personal use and evaded Federal income taxes on his ill-gotten gains. The ex-attorney's counsel failed to adequately object and preserve objections regarding the grouping of tax and fraud counts for purposes of calculating an adjusted offense level for sentencing and restitution ordered to the victims and the IRS. The Sixth Circuit permitted the grouping and restitution challenges to be reviewed for the first time in the 28 U.S.C. § 2255 Motion as part of the successful claim that counsel provided ineffective assistance as defined in *Strickland v. Washington*, 466 U.S. 668 (1984).

The Sixth Circuit rejected the ex-attorney's argument that the District Court improperly failed to group his tax (26 U.S.C. § 7201) and fraud (18 U.S.C. § 1341 – mail fraud and 18 U.S.C. § 2314 – interstate transportation of money) counts for purposes of calculating the adjusted offense level for sentencing purposes. The ex-attorney received a two-level multi-group enhancement from the District Court. The Circuit Court upheld the District Court and found that the ex-attorney's fraud counts and the tax count consisted of different elements, affected different victims, and involved different criminal conduct.

Restitution was considered under the predecessor to the mandatory Victims Restitution Act, 18 U.S.C. § 3663A in effect at the time which was the Victims and Witness Protection Act, 18 U.S.C. § 3663. The Circuit Court held that the District Court failed to consider whether the ex-attorney would have the ability to pay the amount of restitution ordered, the effect of the ex-attorney's disbarment on the ability to pay the restitution ordered, did not consider other non-legal abilities the ex-attorney possessed to be able to pay the restitution ordered and did not review the financial need of the ex-attorney and his dependents which would affect the ex-attorney's ability to pay the full amount of restitution ordered. The District Court's failure to consider these factors rendered the District Court's analysis under 18 U.S.C. § 3664(a) inadequate.

The Sixth Circuit rejected the District Court's restitution order as it related to tax years for which the ex-attorney had not pled guilty. The Sixth Circuit cautioned that a District Court could order a defendant to pay restitution conditioned upon supervised release solely for crimes which the defendant was actually charged and convicted. The Sixth Circuit noted the exception to the general rule of 18 U.S.C. § 3663(a)(3) which authorizes an agreement between the parties to pay restitution for relevant conduct not included in the charge and conviction. The government argued that it intended the District Court to be given the discretion to order the ex-attorney to pay the IRS for the full amount of tax included in the plea agreement and the relevant conduct. The Sixth Circuit held that the plea agreement did not provide for restitution merely on relevant conduct as required by 18 U.S.C. § 3663(a)(3), and accordingly, was improper.

District Court holds defendant's Motion under 28 U.S.C. § 2255 to modify the sentence as premature while defendant's direct appeal of the sentence to the Circuit Court remains pending.

U.S. v. Zats, ***88 AFTR 2.d 2001-6611 (U.S.D.C. Ed. Penn. Oct. 26, 2001)*****.** The defendant, a debt collection attorney, pled guilty to conspiracy to commit mail fraud, wire fraud and a tax offense in violation of 18 U.S.C. § 371 and tax evasion in violation of 26 U.S.C. § 7201. On September 11, 2000 the defendant was sentenced to thirty-three months. The defendant mistakenly believed that the one-year statute of limitations in 28 U.S.C. § 2255 expired on September 11, 2001. Accordingly, the defendant filed his motion under 28 U.S.C. § 2255 requesting a revision of his sentence to permit him to spend the remainder of the term in home detention rather than prison. The defendant's claim was based upon the defendant's argument that the government acted in bad faith in failing to file a Federal Rule of Criminal Procedure 35(b) Motion for Downward Departure based on substantial assistance provided after sentencing. The defendant also requested a sentence reduction based upon humanitarian and financial hardship reasons.

The one-year statute of limitations in 28 U.S.C. § 2255 only begins to run at the expiration of the time for filing a direct appeal. At the time of filing the 28 U.S.C. § 2255 motion, the defendant's direct appeal of his sentence and the two-level enhancement under United States sentencing guidelines 3A1.1 due to vulnerable victims was still pending. The District Court noted that if the defendant is successful in his appeal that the District Court would be required to correct the sentence at that time. The District Court also noted that if the appeal were unsuccessful, the defendant maintains the right to file a petition for Writ of Certiorari to the Supreme Court. The statute of limitations for filing a § 2255 petition only begins to run when the Supreme Court rules on the Writ of Certiorari. On the other hand, if the defendant chose not to file a petition for Writ of Certiorari, the one-year period for filing a § 2255 petition would begin to run ninety days after the Circuit Court rendered it's decision.

The District Court did note that while it possessed jurisdiction to consider a defendant's § 2255 motion, a collateral attack on a sentence would be generally inappropriate if the possibility of further direct review remained open. The District Court noted that the advisory committee note to Rule 5 of the rules governing 28 U.S.C. § 2255 proceedings provides "… that the orderly administration of criminal justice precludes considering such a motion absent extraordinary circumstances …" thus the District Court concluded that the orderly administration of the criminal justice system in the case at hand precluded consideration of the § 2255 motion while the defendant's direct appeal of his sentence was pending. The Court also concluded that no extraordinary circumstances existed which might permit a collateral attack on a sentence while the sentence is at issue in a direct appeal.

Appellate Court denies petition for Writ of Coram Nobis and rejects District Court's recharacterization of Appellant's petition for Writ of Coram Nobis as a 28 U.S.C. § 2255 petition.

U.S. v. Carpenter, ***88 AFTR 2.d 2001-7086 (10th Cir. Nov. 29, 2001)*****.** The Appellant pled guilty to conspiracy to defraud the United States by filing for joint income tax refunds under 18 U.S.C. § 286 while the Appellant was an inmate in the Oklahoma Department of Corrections. The Appellant's plea agreement provided that he defrauded the government of $91,240.06 and the Appellant was sentenced to thirty months in prison to be served after the completion of his current Oklahoma state prison sentence. Almost four years after pleading guilty, the Appellant filed a petition for Writ of Coram Nobis. The District Court interpreted the Appellant's Coram Nobis petition as a 2255 Habeas petition and rejected it as untimely because it was not brought within the one-year time limit in 28 U.S.C. § 2255. The Appellant argued that a portion of the $91,240.06 figure, which he agreed to in his plea agreement, should not have been attributable to him because at the time a portion of the returns were filed, which make up the $91,240.06 figure, he was in restrictive housing and subsequently sent to a different prison in Oklahoma which happened to be located in a different Federal district.

Initially the Tenth Circuit rejected the District Court's recharacterization of the Appellant's petition for a Writ of Coram Nobis as a 28 U.S.C. § 2255 Habeas petition. Next the Circuit Court discussed the extraordinary remedy of a Writ of Coram Nobis.

A Writ of Coram Nobis is appropriate only under circumstances compelling such action to achieve justice. The Circuit Court noted that courts will only issue a Writ of Coram Nobis to correct "errors of fact" that through no negligence on the part of a defendant were not part of the original record and "would have prevented rendition of the judgment questioned." The Circuit Court listed the following requirements for the granting of a Writ of Coram Nobis:

A. The existence of an error of fact;
B. The error of fact was unknown at the time of trial; and
C. The error of fact is of a fundamentally unjust character which would probably have altered the outcome of the challenged proceeding had it been known.

A defendant must demonstrate the exercise of due diligence in raising the issue and that the information used to challenge the sentence was not previously available to a defendant. Additionally, a defendant must exhaust all otherwise available remedies including post-conviction relief under 28 U.S.C. § 2255. Most importantly for the purposes of the instant case, the Circuit Court stressed that a Writ of Coram Nobis is usually only applied in cases where a petitioner has served his sentence and is no longer in custody or in cases where a petitioner has not yet begun serving the challenged sentence. In other words, a prisoner in custody is barred from seeking a Writ of Coram Nobis. The Circuit Court concluded that the Appellant's Coram Nobis petition would not prevail because the Appellant was currently in custody for the Federal tax fraud conviction and the Appellant failed to exhaust his 28 U.S.C. § 2255 remedies. The Circuit Court also noted that for purposes of 28 U.S.C. § 2255, a person is "in custody" for any sentence for which he is currently serving or for any sentence that "has been ordered to run consecutively to another sentence under which the defendant is in custody at the time of filing the challenge." Thus, a prisoner currently in state custody may bring a 28 U.S.C. § 2255 petition challenging a Federal sentence that is scheduled to run consecutive to a state sentence.

ENDNOTE

1 Josh O. Ungerman specializes in civil and criminal Tax Litigation and is a partner with the law firm of Meadows, Owens, Collier, Reed, Cousins & Blau, L.L.P., 901 Main Street, Suite 3700, Dallas, Texas 75202-3725; (214) 744-3700; (214) 747-3732 (fax); jungerman@meadowsowens.com

TAX-EXEMPT ORGANIZATIONS: RECENT DEVELOPMENTS

Tyree C. Collier[1]

TEXAS COURTS OF APPEALS

ANY PERSON CLAIMING AN INTEREST IN A PROPERTY HAS STANDING TO SUE ON AN APPRAISED VALUE; REVERSIONARY ESTATES OWNED BY TAX-EXEMPT LESSORS MAY NOT BE TAXED; LEASEHOLD ESTATES ARE TO BE TAXED AT MARKET VALUE; FEE SIMPLE SALES ARE NOT COMPARABLES FOR LEASEHOLD ESTATES.

Panola County Fresh Water Supply District Number One v. Panola County Appraisal District, No. 06-00-00120-CV (Tex. App.–Texarkana, January 31, 2002, no pet. h.) (to be published).

A tax-exempt entity which leased lakeside lots to individuals sued the appraisal district challenging the methodology by which the appraisal district was valuing the lots contending that the valuation method resulted in the inclusion of the reversionary estate owned by the tax-exempt entity in the leasehold value; thereby creating an illegal lien on the tax-exempt entity's property. The appraisal district contended that the tax-exempt entity was not the owner of the property and therefore did not have standing to sue. The court overruled the appraisal district's challenge finding that "one who claims an interest in property" is deemed to be a property owner under the provisions of the tax code for purposes of challenging an appraised value. The court further determined that the use of "fee simple" sales transactions in valuing taxable leasehold properties would improperly result in the taxation of the reversionary estate belonging to the tax-exempt entity and as a result such sales could not be used for valuation purposes; however, the court ruled that limiting the value of the leasehold estate to the amount of rent being paid annually was not appropriate where market sales of leasehold estates were available to be analyzed.

INTERSTATE ALLOCATION OF AIRCRAFT VALUATION ARE NOT PROPER SUBJECTS OF MOTIONS TO CORRECT VALUATIONS UNDER SECTION 25.25(C)(3).

Curtis C. Gunn, Inc. v. Bexar County Appraisal District, No. 04-01-00470-CV (Tex. App.–San Antonio, January 9, 2002, no pet. h.). (to be published).

Taxpayer owned an aircraft which it leased to an interstate charter service. The taxpayer filed annual renditions with the appraisal district, but did not contest any of the valuations of the aircraft during the normal appeals period. The taxpayer subsequently filed a motion to correct error pursuant to Section 25.25(c)(3) of the Texas Tax Code seeking to obtain a three year retroactive interstate allocation of the valuation of the aircraft reflective of its out of state travel. The court refused to grant such an allocation ruling that Section 25.25(c)(3) was not a proper means for obtaining such a correction since the aircraft had in fact been "located" within the boundaries of the appraisal district. It ruled that such relief could only be obtained during the course of the normal appeals process.

TEXAS ATTORNEY GENERAL OPINIONS

A PRIVATE DELINQUENT TAX COLLECTION ATTORNEY MAY NOT MAKE DONATIONS OF PROPERTY OR SERVICES IF THE DONATION IN EFFECT REFUNDS A PORTION OF THE COMPENSATION WHICH THE ATTORNEY RECEIVES UNDER THEIR COLLECTION CONTRACT.

Op. Tex. Att'y Gen. JC-0443 (2001).

A private attorney is allowed to contract with a county to collect taxes and to receive as compensation, pursuant to Section 6.30 of the Texas Tax Code, a statutory collection penalty of up to twenty percent of the total taxes, interest and penalties which are collected. Such an attorney wished to make a donation of personnel, equipment or dollars back to the county to enhance the county's delinquent tax collection efforts. The Attorney General ruled that such a donation would be illegal if it "in effect refunds part of his or her compensation to the county" because the collection penalty is intended solely to provide compensation for the contract attorney.

The following is a summary of selected current developments in the law applicable to tax-exempt organizations, prepared by Tyree C. Collier of Jenkens & Gilchrist, P.C., as a project of the Tax-Exempt Organization Committee, Jeffrey E. Sher, chairperson. Unless otherwise indicated, all section references contained herein are references to the Internal Revenue Code of 1986, as amended (the "Code").[2]

A. LITIGATION

1. Arkansas State Police Association.[3] The Eighth Circuit has affirmed the Tax Court's 2001 decision in this case that the income received by the Association from a third party, resulting from the third party's publication of the Association's magazine, is not royalty income exempt from the unrelated business income tax ("UBIT") because the publisher was merely acting as an agent of the Association. The court did not give any weight to the fact that each of the agreements between the Association and the publisher were entitled

"Royalties and Licensing Agreement." The court noted that each issue of the magazine contained a "President's Message" provided by the Association, the magazine's front cover stated it was "The Official Publication of the Arkansas State Police Association," an unpaid officer of the Association spent 15 to 20 hours per year on magazine-related activities such as reviewing pre-publication copies, the publisher's personnel told potential advertisers that they were calling "on behalf of the Arkansas Police Association," and checks for advertising fees were made payable to the Association. While the Service also argued that the Association was engaged in substantial activities that would prevent royalty treatment, the court held that it would have reached the same decision even if the Association had "spent very little time working on the magazine."

2. Landmark Legal Foundation.[4] The court of appeals for the D. C. Circuit ruled in this case that the Service is not required to disclose under the Freedom of Information Act information related to requests made by third parties for the Service to audit or investigate certain exempt organizations. The protected information includes the identities of both the third parties and exempt organizations involved and the meaningful contents of such communications. The case arose out of an attempt by Landmark Legal Foundation to investigate whether the Service had been selectively auditing conservative nonprofit organizations and whether particular government officials were prompting any such audits. The court decided in favor of the Service in spite of the fact that the Service had actually disclosed a small portion of the requested information, and that such disclosure had to be considered as a strike against the Service's contention, since one relevant factor considered by the court is the consistency of the Service's position over time.

3. Intermountain Health System HMO Cases. In September 2001, the Tax Court decided three related cases denying 501(c)(3) exemptions for nonprofit HMOs created and controlled by Utah-based Intermountain Health System because the organizations did not serve a charitable purpose.[5] The court noted that the organizations at issue offered their plans to a broad cross section of the community, including substantial numbers of Medicaid participants, and offered several different plans with a range of prices. In spite of that fact, however, the court refused to grant the exemptions because the organizations did not employ their own physicians to a significant degree (and thus were more like an insurance company than a provider of health care services) and did not offer free or reduced-cost health care services or insurance to needy persons. The court also held that the organizations did not qualify for 501(c)(3) exemption as "integral parts" of the overall 501(c)(3) system because nearly 80% of the care was provided by physicians with no direct link to one of the system's tax-exempt affiliates, resulting in the overall activity being unrelated to the system's exempt purpose. Because of its decision that the organizations dis not satisfy the requirements of Section 501(c)(3), the court did not reach the issue of whether exemption would be precluded by Section 501(m), which provides that an organization cannot be exempt under Section 501(c)(3) or (4) if the provision of commercial-type insurance is a substantial part of its activities.

4. North Louisiana Rehabilitation Center. A federal district court recently ruled that a rehabilitation center was correct in classifying its medical directors as independent contractors rather than employees.[6] The court held that the hospital satisfied the safe harbor provisions of section 530 of the Revenue Act of 1978 because it treated all individuals holding substantially similar positions as independent contractors, it filed all required tax returns on a consistent basis, and it had a reasonable basis for treating the medical directors as independent contractors.

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

1. Final Intermediate Sanction Regulations. On January 21, 2002, the Service issued T.D. 8978, publishing final regulations under Section 4958. Section 4958 imposes punitive excise taxes on certain insiders who engage in "excess benefit transactions" with organizations exempt under Section 501(c)(3) or (4) and can also impose more limited excise taxes on officers and directors who knowingly approve of such transactions. An excess benefit transaction is generally a transaction in which an insider receives compensation in excess of reasonable compensation or receives goods or money in a sale, purchase, or exchange with the exempt organization that have a value in excess of the value of the goods or money provided to the exempt organization. A transaction can also be considered an "excess benefit transaction," to the extent provided in regulations, if it involves a sharing of an exempt organization's revenues with an insider.

   The final regulations make only a few relatively minor changes from the temporary regulations that were issued in January 2001. The most important change may be that an organization's management company is treated per se as an insider covered by Section 4958 under the final regulations, while the temporary regulations applied a facts and circumstances test to management companies. The final regulations, like the temporary regulations, do not address the applicability of the "excess benefit transaction" rules to arrangements that involve the sharing of an exempt organization's revenues with an insider. The final regulations became effective January 23, 2002.

2. Telecommunications Agreements Result in Rents from Real Property. The Service ruled in two private letter rulings that an exempt organization's receipt of income from telecommunications agreements with respect to real property the organization leases to third parties will be treated as rents from real property and, therefore, will not be subject to UBIT.[7] Title holding companies exempt under Sections 501(c)(2) and 501(c)(25) and charities exempt under Section 501(c)(3) sometimes own and lease real properties, such as apartment complexes and office buildings, where it is common for the landlord to derive income from telecommunica-

tion agreements. For example, an organization that owns an apartment complex might enter into an agreement with a third party granting the third party the exclusive right to market cable and telephone services to the residents in exchange for a fee that is fixed or based on a percentage of the third party's revenue or both. Such agreements often require the property owner to provide brochures and order forms to its tenants.

Income from such services is not considered "rent from real property," which is exempt from UBIT, unless the service is "usually and customarily rendered in connection with the rental of rooms or other space for occupancy only." Private letter rulings issued in the last several years have held that such agreements result in "rents from real property" when received by real estate investment trusts, and those rulings should be applicable to organizations exempt under Section 501(c). Nevertheless, these rulings are the first to actually address the issue in the context of organizations exempt under Section 501(c). These rulings are also particularly useful because they are quite broad in describing the types of telecommunications agreements that would be considered "rents from real property." In that regard, they mention a wide range of potential services, including all types of multichannel television, video-on-demand, Internet access and data transmission services, video services, telephone services, radio services, ancillary security services, ancillary medical services, and other information retrieval services. The rulings also cover a range of potential payment types, including fixed fee, flat fee per tenant, flat fee per service, and percentage or percentages of gross revenues.

3. Gainsharing Allowed. The Service's EO technical manager told an audience in February that the Service has issued a letter stating that tax-exempt health-care providers may use so-called "gainsharing" arrangements without violating the requirements for exemption and that the letter should be released by the Service by the end of the first quarter of 2002.[8] Such arrangements typically attempt to provide incentives for saving costs by paying the physician a percentage of costs that are saved, compared to a fixed base, provided that quality of care does not also decrease. The Service had been unwilling to rule favorably on such arrangements for several years until the Centers for Medicare & Medicaid Services (formerly known as the Health Care Financing Administration or HCFA) approved the arrangements last year.

4. Joint Venture Ruling with Non-Exempt Partners. The Service has ruled in a technical advice memorandum that an organization whose sole activity is to serve as general partner of and manage a partnership that has exempt and non-exempt partners and that operates an MRI facility is exempt under Section 501(c)(3).[9] The non-exempt partners were brought in to the partnership because of a need for extra funds to pay for the necessary equipment. The MRI facility operates pursuant to a certificate of need issued by the state that requires that the facility maintain an open staff, treat all patients in need regardless of ability to pay, provide indigent care, and accept Medicare and Medicaid patients. The facility's actual patient mix has included 19 to 22 percent Medicare patients, 1 to 2 percent Medicaid patients, and 1 to 2 percent indigent care patients. The facility has never turned away a patient unable to pay for care, and provides written statements to patients stating that they have a right to treatment regardless of their ability to pay. The facility also provides some community education in addition to its medical services.

The Service ruled that the facility was operated in a charitable manner and that the organization, therefore, qualified for 501(c)(3) exemption, in spite of the fact that the partnership agreement involved did not require that the partnership be operated in a 501(c)(3) manner. It is generally believed, based on Rev. Rul. 98-15, that an exempt organization's participation in a partnership will not be regarded as an exempt activity by the Service unless the partnership agreement requires the partnership to operate for an exempt purpose. In this case, the existence of the certificate of need, which essentially imposed the requirement that the organization operate in a 501(c)(3) manner, may have led the Service to rule favorably.

ENDNOTES

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

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

3 *Arkansas State Police Association, Inc. v. Commissioner*, No. 01-2255, 2002 U.S. App. LEXIS 3480 (Eighth Circuit, March 6, 2002).

4 *Landmark Legal Foundation v. Internal Revenue Service*, 267 F.3d 1132 (D.C. Cir. 2001).

5 *IHC Health Plans Inc. v. Commissioner*, T.C. Memo 2001-246 (Sept. 19, 2001); *IHC Group Inc. v. Commissioner*, T.C. Memo 2001-247 (Sept. 19, 2001); and *IHC Care Inc. v. Commissioner*, T.C. Memo 2001-248 (Sept. 19, 2001).

6 *North Louisiana Rehabilitation Center, Inc. v. United States*, 179 F. Supp. 2d 658 (W. D. La. 2001).

7 PLR 200147058 (Nov. 26, 2001); PLR 200148074 (Aug. 7, 2001).

8 As of the writing of this article in early March, the Service had not yet released the letter to the general public.

9 TAM 200151045 (July 25, 2001).

THE NEW PROPOSED REGULATIONS REGARDING MERGERS WITH DISREGARDED ENTITIES

By Stuart Miller[1]

The Internal Revenue Service (the "IRS") issued revised Proposed Treasury Regulations ("Proposed Regulations") on November 15, 2001. The Proposed Regulations allow certain state law mergers involving disregarded entities to qualify as tax-free reorganizations under Section 368(a)(1)(A) of the Internal Revenue Code ("Code") of 1986, as amended. The Proposed Regulations will replace the proposed regulations circulated in May of 2000 which concluded that mergers involving disregarded entities could not qualify as tax-free reorganizations under Code Section 368(a)(1)(A). Given the widespread use of disregarded entities such as single member limited liability companies that have not elected to be taxed as corporations, qualified REIT subsidiaries, and qualified subchapter S subsidiaries, the adoption of the Proposed Regulations should facilitate the completion of many acquisitions.

Assuming all of the other elements necessary for a tax-free reorganization are present, a merger involving a disregarded entity can qualify as a tax-free merger under Code Section 368(a)(1)(A) under the Proposed Regulations provided that the merger is effected pursuant to the corporate laws of the United States, a state in the United States, or the District of Columbia and, as a result of such transaction, the following events occur simultaneously at the effective time of the transaction:

1. All of the assets and liabilities (other than those distributed or discharged in the transaction) of each member of one or more of the combining units (each a "transferor unit") become the assets and liabilities of one other combining unit (the "transferee unit"); and

2. The combining entity of each transferor unit ceases its separate legal existence for all purposes.

A "combining entity" is a business entity that is a corporation which is not a disregarded entity. A "combining unit" is a combining entity and all disregarded entities, if any, the assets of which are treated as owned by such combining entity for federal income tax purposes. A "disregarded entity" is defined to mean a business entity that is disregarded as an entity separate from its owner for federal tax purposes.

The practical effect of these Proposed Regulations is that the merger of a target corporation into a disregarded entity subsidiary of an acquiror qualifies as a tax-free reorganization under Code Section 368(a)(1)(A) because a "combining unit" is merging into another "combining unit" and the transferor unit ceases its separate legal existence. The merger of a disregarded entity into an acquiror, however, would not qualify under Code Section 368(a)(1)(A) because the entire "combining unit" is not merging into the acquiring unit and each member of the transferor unit will not cease its separate legal existence. The reasoning behind this distinction is that the IRS believed that allowing a disregarded entity to merge into an acquiror could result in a divisive transaction that could possibly circumvent the elaborate statutory requirements for tax-free spin-offs found in Code Section 355.

It should be noted that a transaction involving a disregarded entity will only qualify as a statutory merger under Code Section 368(a)(1)(A) if all of the entities involved are domestic. The preamble to the Proposed Regulations indicates, however, that the IRS is considering issuing separate guidance for transactions that involve one or more foreign corporations.

The following are examples of how the Proposed Regulations operate. In each of the examples, X is a disregarded entity subsidiary of Y corporation, W corporation owns 100% of Y corporation and Z is an unrelated corporation.

- A merger of Z into X where Z's shareholders receive Y stock qualifies as a tax-free reorganization under Code Section 368(a)(1)(A).

- In the above example, if the Z shareholders received W stock instead of Y stock, the transaction would also qualify as a tax-free reorganization under Code Sections 368(a)(1)(A) and 368(a)(2)(D) as a forward triangular merger.

- A merger of Z into X where Z's shareholders receive equity in X, and after the transaction X is treated as a partnership, would not qualify as a tax-free reorganization under Code Section 368(a)(1)(A).

- A merger of X into Z would not qualify as a tax-free reorganization under Code Section 368(a)(1)(A).

While excluding certain types of transactions, the Proposed Regulations allow for transactions involving disregarded entities having a single corporate owner to qualify as a statutory merger under Code Section 368(a)(1)(A). These Proposed Regulations, if approved, will establish new business planning opportunities for tax practitioners.

ENDNOTE

1 Haynes and Boone, LLP, 1000 Louisiana, Suite 4300, Houston, Texas 77002, (713)547-2224 (direct), (713)236-5643 (fax), stuart.miller@haynesboone.com

DONOR-ADVISED FUNDS: AN ALTERNATIVE TO PRIVATE FOUNDATIONS

Michele Mobley[1]

I. Introduction

There has been an explosion of interest in donor-advised funds. There presently are estimated to be 600 donor-advised funds operating in the United States, as compared to some 26,000 private foundations. Historically, donor-advised funds were offered primarily by community foundations, with the first donor-advised fund reportedly started in 1931 at the New York Community Trust. Now such funds are offered by other public charities, such as the Jewish Communal Fund, formed in 1972. For a discussion of the historical development of donor-advised funds, *see* Bjorklund, *Charitable Giving to a Private Foundation and the Alternatives, the Supporting Organization and the Donor-Advised Fund*, SE 86 ALI-ABA 73 (June 2000) (hereafter "*Bjorklund*"). In recent years professional money-managers also have established public charities that operate donor-advised funds. The Fidelity Charitable Gift Fund, a donor-advised fund created in 1991, recently was ranked as the fifth largest charity in the United States, after only the Salvation Army, the Y.M.C.A. of the USA, the American Red Cross, and the American Cancer Society. *See* THE CHRONICLE OF PHILANTHROPY (November, 2000). The Fidelity Charitable Gift Fund manages some $2.5 billion in assets from 22,000 donors. Following Fidelity's lead, many other financial institutions also have started a donor-advised fund, including Vanguard, Schwab, and T. Rowe Price. Lewin, *Mutual Fund Giants are Now Competing for Charitable Donors, Too*, THE NEW YORK TIMES (January 21, 2001). In addition, high tech entrepreneurs are turning to donor-advised funds as a way to make charitable gifts, get an income tax deduction, and avoid the administrative upkeep of a private foundation. Hafner, *As Dot-Com Windfalls Shrink, Gifts Don't*, THE NEW YORK TIMES, (November 20, 2000). This article discusses what a donor-advised fund is, how it operates, what law governs it, and compares charitable contributions to a donor-advised fund to contributions to a private foundation.

II. Making a Contribution to a Donor-Advised Fund

In a donor-advised fund, a donor makes a contribution to a public charity operating the donor-advised fund (the "sponsoring charity"). The contribution is subject to an agreement (the "contribution agreement") between the sponsoring charity and the donor that the donor, or other designated persons, will have the right to give non-binding advise to the sponsoring charity regarding how portions of the contribution (or proceeds from the contribution) later will be distributed to other charities (the "recipient charities"). The sponsoring charity generally places the contribution into a separate fund or separate account, called by the name of the donor, or such other name as the donor may select. The donor, or other person selected by the donor, then proceeds to give non-binding advice to the sponsoring charity regarding what distributions should be made from the donor's donor-advised fund account. The sponsoring charity legally must have the right to disregard the donor's advice. Distributions can be made from the account to recipient charities over a number of years, and the donor can make additional contributions to the account over the years. Thus, the donor gives advise on which charities should receive grants, and on the amount and timing of those grants. The donor-advised fund then sends checks to the recipient charities, either anonymously, or specifying the name of the donor's donor-advised fund account. As a grant-making organization, the donor-advised fund thus operates much like a private foundation.

The sponsoring charity will have a minimum amount that must be contributed to open a donor-advised fund account. This minimum generally ranges from $10,000 to $250,000, depending on the terms of the particular fund. The sponsoring charity also will charge a fee for administering the fund, although the fee is usually nominal.

The terms of the contribution agreement generally place limits on the nature of the advice. For example, under the governing documents of the particular donor-advised fund, there may be a minimum amount that will be distributed to a recipient charity, and a maximum number of advisory requests that the donor can make each year. Many donor-advised funds provide that the recipient charities must be public charities (i.e. cannot be private, non-operating foundations). Many donor-advised funds also require a certain percentage of the account assets to be distributed to the sponsoring charity, or to causes the sponsoring charity supports, such as 50% must be distributed for the use or benefit of a particular university, or all distributions must be to charities promoting a particular religion. The donor-advised fund account cannot be used to satisfy the donor's pledges or to benefit the donor in any way.

In addition, many donor-advised funds place limits on how quickly funds must be disbursed from the account to the recipient charities – such as within the lifetime of the donor, or within a certain number of years after the donor's death, or at least 5% of the account assets must be distributed to recipient charities per year. The 5% distribution requirement is intended to mimic the minimum annual distribution requirement from a private foundation.

A key issue in donor-advised funds, discussed further below, is how much control the donor may have over how the donor-advised fund account is invested. Some donor-advised funds allow the donor no ability to control investments, others offer only a limited range of investment options from which the donor must pick, and others permit the donor to direct investments. The donor-advised funds run by charities established by the professional money managers, of course, limit fund investments to a select group of mutual funds run by the money manager.

Since the exact terms of contribution agreements vary from one fund to the next, a donor may want to consider several different donor-advised funds and select one that meets the donor's goals regarding controlling investments and regarding the timing of distributions from the account to the recipient charities. A list of certain donor-advised funds and how to contact them is attached as Exhibit A. The list is adapted from the *Bjorklund* article.

In exchange for giving up ultimate control over distributions from the donor-advised fund account, the donor is relieved of the administrative burdens and the investment responsibility that come with a private foundation. The donor-advised fund account is not subject to the reporting requirements of a private foundation, is not subject to the excise taxes that apply to private foundations, and the donor does not have to file a tax return for the donor-advised fund account. Donor-advised funds thus offer a convenient way to make charitable gifts while still retaining influence over grants made with the assets placed in a donor-advised fund account. Many of the larger donor-advised funds even allow advice to be given on-line, as well as contributions to the donor's account to be made on-line, if securities are being contributed to the account. See, for example, www.charitablegift.org, a site run by The Fidelity Charitable Gift Fund.

III. Tax Aspects of Contributions to Donor-Advised Funds

A. Income Tax Deduction Limits for Individuals

For a lifetime contribution to a donor-advised fund, the donor receives an immediate income tax charitable contribution deduction. The donor's contribution to a donor-advised fund generally is treated as a contribution to a public charity, thus the public charity income tax contribution deduction limits of Section 170(b)(1)(A) apply. All section references in this paper refer to the Internal Revenue Code of 1986, as amended. An individual donor who gives cash to a public charity, a private operating foundation, a flow-through foundation, and a pooled common fund can take an income tax charitable contribution deduction of up to 50% of the donor's adjusted gross income. By contrast an individual donor who makes a cash contribution to a private foundation (other than the three types of private foundations listed previously) receives an income tax charitable contribution deduction of up to 30% of the donor's adjusted gross income. A few donor-advised funds are operated by private foundations and as to those, the lower deduction limits for private foundations apply.

An individual donor who gives appreciated property, such as appreciated marketable securities, is eligible for an income tax charitable contribution deduction of 30% of the donor's adjusted gross income for gifts made to a public charity, a private operating foundation, a flow-through foundation, and a pooled common fund. Such a contribution to a private foundation (other than the three types of private foundations listed previously) is subject to a cap of 20% of the donor's adjusted gross income. In addition, gifts of appreciated property to a private foundation generally can be deducted only at basis, not at fair market value. Section 170(e)(5), which was made permanent in 1998, permits gifts of qualified appreciated stock to private foundations to be deducted at fair market value. Qualified appreciated stock is stock (i) for which market quotations are available on an established securities market, (ii) which is capital gain property of the donor, and (iii) in a company of which the donor and the donor's family will have contributed less than 10% in value, counting prior contributions.

Income tax charitable contribution deductions that cannot be used in the year of the contribution can be carried forward for up to five years. Thus the contribution can be deducted over a total of six years.

Section 170(d)(1) imposes a hierarchy in which the income tax charitable contribution limits for individuals are applied. The hierarchy is:

1. Cash gifts to public charities; then
2. Cash gifts to private foundations; then
3. Gifts of 30% capital gain property; then
4. Gifts of 20% capital gain property.

As a public charity, a donor-advised fund thus is a "50% charity" for income tax charitable contribution deduction purposes. A donor who gives stock to a donor-advised fund, of course, avoids capital gains. This is one reason why the financial institutions have been successful in launching donor-advised funds. Stock can be moved easily from the donor's account at Schwab, for example, to a donor-advised fund account at Schwab. The donor recognizes no capital gain when the donor-advised fund sells the stock. The deduction limitations on gifts to most private foundations of appreciated property (other than qualified appreciated stock) also make public charity donor-advised funds an attractive way to give appreciated property.

To receive the income tax contribution deduction, the contribution must be a completed gift. This means that the donor's role in recommending grant requests for distributions from the donor-advised account to the recipient charities must be advisory only. The governing body of the donor-advised fund itself retains ultimate authority to authorize distributions from the donor-advised fund account, and thus can reject the donor's advice. See, for example, Pollard v. Commissioner, 786 F.2d 1063 (11th Cir. 1986) (finding donor must surrender control over gift for it to qualify as a charitable contribution).

B. Income Tax Deduction Limits For Corporations

Contributions by a corporation are limited under Section 170(b)(2) to 10% of the corporation's taxable income, computed without regard to (1) net operating loss carryback; and (ii) capital loss carryback.

C. Gift Tax Unlimited Deduction

For a lifetime contribution to a donor-advised fund, as to any public charity or private foundation, the donor also receives an unlimited gift tax deduction under Section 2522. If the requirements of Section 6019 are met, there is no need to file a gift tax return reporting the gift to the donor-advised fund.

D. Estate Tax Unlimited Deduction

For a contribution at death to a donor-advised fund, as to any public charity or private foundation, the donor's estate receives an unlimited estate tax charitable contribution deduction under Section 2055.

IV. Law Governing Donor-Advised Funds

There is no statutory framework specifically governing donor-advised funds. This has caused uncertainty regarding the precise limitations on donor-advised funds – namely what is a donor-advised fund, how the fund must operate, and how a fund can be certain it is income-tax exempt. The term "donor-advised fund" is not in the Treasury Regulations. The Preamble to the Temporary Regulations issued January 10, 2001 to Section 4958, governing the excise tax on excess benefits provided to disqualified persons of public charities, states that the IRS and the Treasury Department considered, but declined to adopt at the time, a special rule regarding how excess benefits should be determined with regard to donors or advisors of donor-advised funds. *See* Treasury Decision 8920. Thus, donor-advised funds do appear to be under consideration by the IRS and the Treasury Department.

A key distinction between public charity status and private foundation status is the level of donor control. Private foundations are subject to many limitations, described below, because of the high level of donor control. Public charities are subject to reduced scrutiny and higher contribution deduction limits because the donor has less control. Donor-advised funds test the limits of donor control over contributions that still can be treated as contributions to public charities. *See generally, McCown, Major Charitable Gifts – How Much Control Can Donors Keep and Charities Give Up?* JOURNAL OF TAXATION (November, 1999).

A. Component Fund Regulations

In the absence of any specific guidance regarding donor-advised funds, the Regulations governing component funds are often used as a guide to determine when a donor has retained too much control over the contribution. Some foundations are structured as multiple, separate trusts. The foundation does not have legal title to the assets in the separate trusts, but the trusts are treated as part of the foundation, namely a component fund of the foundation, for tax purposes, if certain criteria are met. The §1.170A-9(e)(11) Regulations describe the rules governing organizations that seek component-fund treatment.

1. Requirements to be a Single Entity Community Trust Composed of Component Funds: These Regulations are lengthy, but can be summarized as follows:

(a) Publicly Supported: To qualify as a public charity, a community trust must be publicly supported. It is required to meet either the 33 1/3 percent of support test of Reg. 1.170A-9(e)(2) or the facts and circumstances test of Reg. 1.170A-9(e)(3).

(b) Name: The organization must be commonly known as a community trust, fund, foundation or other similar name conveying the concept of a capital or endowment fund to support charitable activities . . . in the community or area it serves. Reg. 1.170A-9(e)(11)(iii).

(c) Common Governing Instrument: All funds of the organization must be subject to a common governing instrument. Reg. 1.170A-9(e)(11)(iv).

(d) Common Governing Body: The organization must have a common governing body or distribution committee. The governing body must possess and actually be willing to exercise the following powers:

(i) to modify any restriction or condition on the distribution of funds if, in the governing body's sole judgment, such restriction or condition becomes unnecessary, incapable of fulfillment, or inconsistent with the community's charitable needs;

(ii) to replace a participating trustee, custodian or agent for breach of fiduciary duty under state law; and

(iii) to replace a trustee, custodian or agent for failure to produce a reasonable return of net income over a reasonable period of time. Reg. 1.170A-9(e)(11)(v).

(e) Role of Governing Body: The governing body must actively monitor each component trust or fund to see that such fund or trust is administered in accordance with the terms of the fund or trust's governing instruments as well as accepted standards of fiduciary conduct to produce a reasonable return of net income, with due regard to preservation of principal, in furtherance of the community trust's exempt purposes. Reg. 1.170A-9(e)(11)(v)(F).

(f) Common Reporting: The community trust must prepare periodic common financial reports, treating all funds as funds of the community trust. Reg. 1.170A-9(e)(11)(vi).

If an organization meets the requirements for component part treatment, the organization will be treated as a single entity, rather than as an aggregation of separate funds.

2. Requirements to be a Component Fund: A particular trust or fund which meets the following requirements will be treated as a "component part" of the single entity if such trust or fund meets certain requirements as set forth in Reg. 1.170A-9(e)(11)(ii):

(a) Transfer to Community Trust: The particular fund or trust must be created by a gift, bequest, legacy, devise or other transfer to an organization treated as a single entity; and

(b) No Material Restrictions: The particular fund or trust may not be directly or indirectly subjected by the donor to any material restriction or condition with respect to the transferred assets. Material restrictions are discussed below.

If the component-part requirements are not met, the failed component part will be treated as a separate trust, corporation or association, and would likely be treated as a private foundation because, standing alone, it would fail the public-support test. Reg. 1.170A-9(e)(14). *See Bjorklund* at 93.

B. Material Restrictions Regulations

Treasury Regulation 1.507-2(a)(8)(iv)(A) sets forth the "material restrictions" Regulations, including several factors to determine whether a donor has retained too much control over a component fund. The material restrictions Regulations originally were drafted to apply to terminations of private foundations. They have since been applied in the component fund context and in the donor-advised fund context.

The Regulations list the following factors as indications that a donor has not retained too much ability to direct distributions:

"1. There has been an independent investigation by the staff of the public charity evaluating whether the donor's advice is consistent with specific charitable needs most deserving of support by the public charity (as determined by the public charity);

2. The public charity has promulgated guidelines enumerating specific charitable needs consistent with the charitable purposes of the public charity and the donor's advice is consistent with such guidelines;

3. The public charity has instituted an educational program publicizing to donors and other persons the guidelines enumerating specific charitable needs consis-

tent with the charitable purposes of the public charity;

4. The public charity distributes funds in excess of amounts distributed from the donor's fund to the same or similar types of organizations or charitable needs as those recommended by the donor; and

5. The public charity's solicitations (written or oral) for funds specifically state that such public charity will not be bound by advice offered by the donor."

Reg. 1.507-2(a)(8)(A)(2).

The Regulations list these factors as indications that the donor has retained too much ability to direct distributions:

"1. The solicitations (written or oral) for funds by the public charity state or imply, or a pattern of conduct on the part of the public charity creates an expectation, that the donor's advice will be followed;

2. The advice of a donor (whether or not restricted to a distribution of income or principal from the donor's trust or fund) is limited to distributions of amounts from the donor's fund, and the factors described in paragraph (a)(8)(iv)(A)(2)(i) or (ii) of this section are not present;

3. Only the advice of the donor as to distributions of such donor's fund is solicited by the public charity and no procedure is provided for considering advice from persons other than the donor with respect to such fund; and

4. For the taxable year and all prior taxable years the public charity follows the advice of all donors with respect to their funds substantially all of the time."

Reg. 1.507-2(a)(8)(A)(3).

If the factors listed in the Regulations indicate too much donor control, the donor-advised fund will be treated as a private foundation. The component fund Regulations technically do not apply to organizations structured such that contributions are simply held in separate accounts of the organization, but these Regulations nevertheless have been used as a guide in considering the level of donor control. Today most charitable organizations and newer community foundations are structured with separate accounts rather than component funds.

C. Pooled Common Fund/Donor-Directed Fund

A donor-advised fund is different from a donor-directed fund, also called a pooled common fund. A pooled common fund is defined in the Internal Revenue Code. A pooled common fund is a private foundation, but the higher income tax contribution deduction limits that apply to public charities also apply to pooled common funds. A pooled common fund is described in Section 170(b)(1)(E)(iii) as follows:

> a private foundation all of the contributions to which are pooled in a common fund and which would be described in section 509(a)(3) but for the right of any substantial contributor (hereafter in this clause called "donor") or his spouse to designate annually the recipients, from among organizations described in paragraph (1) of section 509(a), of the income attributable to the donor's contribution to the fund and to direct (by deed or by will) the payment, to an organization described in such paragraph (1), of the corpus in the common fund attributable to the donor's contribution; but this clause shall apply only if all of the income of the common fund is required to be (and is) distributed to one or more organizations described in such paragraph (1) not later than the 15th day of the third month after the close of the taxable year in which the income is realized by the fund and only if all of the corpus attributable to any donor's contribution to the fund is required to be (and is) distributed to one or more of such organizations not later than one year after his death or after the death of his surviving spouse if she has the right to designate the recipients of such corpus.

A pooled common fund thus does not offer the flexibility regarding the timing of distributions and the amount of distributions that the donor-advised fund offers.

D. The Private Letter Rulings

Donor-advised funds are described in only ten private letter rulings. These are described briefly below:

PLR 8836033 approves the transfer of all assets of a private foundation to a donor-advised fund of a community foundation. The private foundation would continue to exist only to give advice on the distribution of funds from the donor-advised fund.

PLR 8936002 finds that administering a donor-advised fund is within an existing charity's exempt purpose and will not jeopardize the charity's income tax exemption. Fees charged by the donor-advised fund will not be unrelated business taxable income. Donors had some direction and involvement with distributions, but final decisions as to distributions of funds were held by the charity. There was no evidence of private benefit through abusive commissions, noncharitable projects, or insider payments to donors.

PLR 9412039 approved a donor-advised fund established as a separate fund within a private foundation. The fund was designed to hold contributions from the trustees of the private foundation. At the death of the last to die of the husband and wife who created the private foundation, the assets in the donor-advised fund account would revert to the private foundation. An advisory committee was established to recommend distributions from the donor-advised fund account to other recipient charities, but the board of the private foundation was not bound to follow the recommendations of the advisory committee. The donor-advised fund account was treated as an integral part of the foundation, not as a separate entity.

PLR 9532027 finds that a disclaimer made by two sons of property that then passed to two donor-advised fund accounts over which the sons had the ability to give advise, was nevertheless a qualified disclaimer. The sons had no binding authority to direct distributions from the donor-advised fund accounts.

PLR 9807030 approves a transfer made by a private foundation of 10% of its assets to a donor-advised fund of a community trust. If necessary to most effectively accomplish the general purposes of the community trust, the community trust's board had the power to direct distributions of the donor-advised fund account despite recommendations made by the private foundation's board.

PLR 200009048 approves a private foundation's transfer of all of its assets to a donor-advised fund of a public charity. After the transfer the private foundation planned to dissolve, and the private foundation's board would simply serve as an advisory committee to recommend recipient charities to receive distributions from the donor-advised fund account. There were no material restrictions on the public charity's use of the donor-advised fund assets.

PLR 200037053 provides that contributions placed through an Internet-based donor-advised fund run by a charity called Philanthropic Research, Inc do constitute support from the general public for purposes of meeting the public support tests of Section 170(b)(1)(A)(vi) and Section 509(a)(1). The IRS reached this result because the charity is the owner of the contributed assets due to the dominion and control the charity has over the fund assets in performing due diligence over donor recommendations for distributions to recipient charities of donor-advised fund assets.

PLR 200050048 approves an existing private foundation's distribution of its assets in two equal shares, with one share going to an existing donor-advised fund, and the other share going to a newly created private foundation that was in the process of seeking tax-exempt status. The Ruling primarily addresses the issues raised by the transfer of assets from one private foundation to another private foundation.

PLR 200123069 and PLR 200123071 approve the merger of a private foundation and a community foundation that operated a donor-advised fund and determine that the community foundation will continue to be an exempt charitable organization under Section 501(c)(3). Interestingly, the rulings state "we express no opinion as to the effect of the existence or operation of donor-advised funds on [the community foundation's] continued tax exemption under Section 501(c)(3) of the Code."

E. Case Law

Only three reported cases discuss entities that appear to be donor-advised funds. None of the cases uses the term "donor-advised fund."

1. National Foundation, Inc.: In *National Foundation, Inc v. United States*, 13 Cl. Ct. 486, 60 AFTR 2d 87-5926, 87-2 USTC 9602 (1987), the United States Court of Claims found that National Foundation, Inc. was a public charity, not a private foundation. A donor could establish a charitable account with National Foundation, Inc. by paying a $100 application fee and making at least a $500 initial contribution. Half of the application fee was paid to "charitable development officers" who were lawyers, accountants, stockbrokers, trust officers, insurance underwriters, ministers, and officers of other public charities. Fundraising and administrative costs of 8 1/2% were deducted, then the funds were donated to the selected charitable project if approved by the Board of National Foundation, Inc. In considering a project distribution request, the Board was directed to consider several factors as follows:

(1) the project must be clearly be of a type described in section 501(c)(3) of the Internal Revenue Code; (2) the project or disbursement must serve a public purpose and must not result in private gain or inurement to any individual; (3) each project application or request for disbursement must be supported by adequate documentation; (4) the scope of the project must be adequately described on a statement of proposed financial activity; (5) if the requested donee is an organization, there must be proof that the organization is a qualified tax-exempt entity; and (6) the board must determine that it can effectively administer the project given its proposed scope, level of activities, geographic location, and other factors.

If a proposal was rejected, the donor could receive back the contributed funds, allow the funds to be contributed to a qualified charity, or allow the funds to be retained by National Foundation, Inc. All of the contributed funds were invested as a single fund, and subaccounts were maintained through records of the organization.

The IRS argued that no charitable purpose was served, and that this structure merely allowed private foundations to escape IRS scrutiny and the burdens of private foundation classification. The IRS also argued that the donors retained ultimate control over the funds contributed.

The court found that National Foundation, Inc. was a public charity, that offered another way to harness the sensitivity to local community needs and the charitable creativity of public minded citizens throughout the country.

2. Fund for Anonymous Gifts: Ten years later, in *Fund for Anonymous Gifts v. I.R.S.*, 1997 WL 198108, 79 AFTR 2d 97-2520, 97-2 USTC 50,710 (U.S. D.C. for the District of Columbia 1997), vacated in part by *Fund for Anonymous Gifts v. IRS*, 1999 WL 334519, 83 AFTR 2d 99-1796, 99-1 USTC 50,440 (D.C. Cir. 1999), the IRS initially won and the Fund was determined not to qualify as income tax exempt. The D.C. Circuit, however, found that the Fund was income tax exempt and remanded to the District Court for a determination as to whether the Fund was a private foundation or a public charity. The application for exemption described a trust with a sole, individual trustee established to administer donor-advised funds in which the donor would instruct the trustee to distribute funds on an anonymous basis and the donor could direct investment of the contributed funds. The IRS found the entity was not income tax exempt, and argued that the structure was merely designed to avoid the private foundation rules. The District Court objected to the investment control retained by the donors, and compared the level of control to the Fidelity Charitable Gift Fund in which donors can select among a very limited number of funds and have no continuing control over investments. Prior to appeal to the D.C. Circuit, the trust was retroactively amended to prohibit donor-control over investments. The IRS argued on appeal that the Fund was merely an administrative conduit for a donor's contributions. The D.C. Circuit called the IRS's position on donor control "incoherent," and stated that the government was "unable at oral argument and is unable a year later, to offer any understandable reason why, apart from the control provision (now removed), [the Fund] is not a section 501(c)(3) organization."

3. Estate Preservation Services: In *United States v. Estate Preservation Services*, 202 F. 3d 1093, 85 AFTR 2d 2000-603 (9th Cir. 2000), the Court affirmed a preliminary injunction entered against two promoters of allegedly abusive tax shelter advice. In addition to certain non-charitable strategies, the promoters established an organization called New Dynamics Foundation ("NDF"). NDF issued a brochure and a manual to mar-

ket "donor-directed foundations." The court found that this literature strongly suggested that the grantor of such a donor-directed foundation could expect to retain significant dominion and control over the assets deposited in the donor's foundation, and amass assets tax-free. The promoters marketed the foundations as a way to build a large portfolio, maintain control over the donor's money, and provide for continued income during retirement. According to a brochure, to access "warehoused" wealth in the foundation, a donor simply submitted an "expenditure request." According to the information submitted, only one such request was ever rejected and charitable use of disbursed funds was never verified.

F. IRS CPE Text for Exempt Organizations

The IRS discusses donor-advised funds in its 2000 Continuing Professional Education for Exempt Organizations text. The Service described the following factors in approving donor-advised fund applications:

1. The organization expects that its grant distributions for the year will equal or exceed five percent of its average net assets on a fiscal year rolling basis. If this level of grant activity is not attained, the organization will identify the named accounts from which grants over the same period totaled less than five percent of each account's average assets. The organization will then contact the donor-advisors of those accounts to request that they recommend grants of at least this amount. If a donor-advisor does not provide the qualified grant recommendations, the organization is authorized to transfer up to five percent of assets from the donor-advisor's named account to the charity selected by the organization.

2. The organization will add language to its promotional materials which indicates that the organization will investigate allegations of improper use of grant funds for the private benefit of donor-advisors.

3. The organization will add language to its grantee letters to the effect that grants are to be used by grantees exclusively in furtherance of charitable purposes, and cannot be used for the private benefit of donor-advisors.

G. The Clinton Proposal

President Clinton's 2001 budget proposal contained specific legislation directed at donor-advised funds. Attached as Exhibit B is the general explanation from the Treasury Department of the budget proposal provisions regarding donor-advised funds. President Bush is likely to renew the effort to legislate the parameters of donor-advised funds.

The goals of the Clinton proposed legislation were to make donor-advised funds easy to use, to encourage growth of donor-advised funds, and to minimize abuses in terms of benefits to donors and their advisors. A donor-advised fund is defined in the proposal as "any segregated fund (or account) maintained by a charity for contributions received from a particular donor (or donors) as to which there is an understanding that the donor or the donor's designee may advise the charity regarding the investment or distribution of any amounts held in the fund."

A charity operating a donor-advised fund as its primary activity could qualify as a public charity only if three conditions are met: (1) there are no "material restrictions" or conditions preventing the charity from freely and effectively employing the assets held in, and income from, its donor-advised funds in furtherance of the charity's exempt purposes; (2) distributions from the donor-advised fund are made only to public charities, private operating foundations, and governmental entities; and (3) at least 5% of the net fair market value of the charities aggregate assets held in donor-advised fund accounts are distributed annually, with a 5 year carry-forward for excess distributions. A charity would be treated as having the operation of a donor-advised fund as its primary activity if the charity has more than 50% of its assets in donor-advised funds. The proposed legislation thus would not have permitted grants to be made to private non-operating foundations from a donor-advised fund.

A charity not meeting these requirements would be classified as a private foundation. Charities that do not operate a donor-advised fund as their "primary activity" also would be required to comply with the three requirements, but a failure to do so would not cause such charities to be treated entirely as private foundation – rather the charity's assets held in donor-advised funds would be subject to the private foundation rules and excise taxes.

The proposal codified factors of Regulation 1.507-2(a)(8), listed above, as the relevant factors in measuring donor control and determining what constitutes a "material restriction." Regularly following the donor's advice would not have endangered the status of the fund as a public charity under the Clinton proposal. The definition of "disqualified person" under Section 4958 (intermediate sanctions) would include the fund's donor or other advisor to a fund maintained by a public charity, as well as such person's family and controlled entities. The definition of disqualified person under Section 4941 also would include the donor or other advisor to a donor-advised fund maintained by a private foundation as well as such person's family and controlled entities. The proposal imposes sanctions on the donor only when transactions between the fund and a donor are unfair to the fund. The proposal does not prohibit all transactions between the fund and donors.

The charitable community, on the other hand, has proposed a bright-line rule that prohibits a donor from engaging in transactions with the donor-advised fund. The proposal from the charities generally makes Section 4941 apply to donor-advised funds. Such a restriction would give the donor-advised funds a legal reason to say "no" to donors.

One commentator describes the Clinton proposal as compared to the charities proposal as follows. The charities that sponsor donor-advised funds and the Treasury department have developed two models for regulation. One model would treat donor-advised funds as public charities, but would subject individual donors to the limitations applicable to private foundations, particularly the disqualified person rules of Section 4941. The other model would regulate both donor-advised funds and donors as public charities. The donor would not be forced to remain arm's length from the donor-advised fund. See Jones, Regulating Donor Advised Funds, 75-May Fla. B.J. 38 (May 2001). For a discussion of other suggested approaches to regulating donor-advised funds, see Bjorklund.

The donor-advised fund operates in a manner that donors do not have ultimate control over distributions from their donor-advised fund account. In this way, donor-advised funds avoid the restrictions applicable to private foundations. However, as a practical matter, a donor-advised fund that ignores the advice of the donors very often is not likely to be successful in attracting donors. Thus, as a practical matter although not a legal matter, despite the donor-advised fund's governing documents, donors do have significant control over the timing, amount, and recipients of grants from the donor's donor-advised fund account. Regulations governing the operation of donor-advised funds would be helpful in clarifying where the limit is on donor control over contributions to a public charity.

V. Comparing a Donor-Advised Fund to a Private Foundation

The primary advantage of a private foundation over a donor-advised fund is the level of control a donor can retain over the charitable grants made from the foundation and the level of control the donor can retain over investments made with assets held in the private foundation. Family foundations also are credited with several non-tax benefits, such as (1) creating a formal structure for giving that creates a business-like approach, (2) perpetuating a family's charitable activities, (3) helping wealthy family members find a meaningful role in the community, and (4) creating a family legacy and tradition. *See* Beckwith, *Donor Involved Philanthropy – Charitable Donor-Advised Funds: Opportunities, Risks, and Alternatives*, SF68 ALI-ABA 365 (2001). These non-tax benefits also would apply to a family's donor-advised fund account, but in a diluted form due to the limits on the family's ability to legally control the donor-advised fund account.

A disadvantage of a private foundation over a donor-advised from a tax perspective, is the lower income tax contribution deduction limits, 30%/20% rather than 50%/30% of AGI as discussed above, that apply to private foundations as compared to a donor-advised fund that is treated as a public charity.

A second disadvantage of a private foundation is the excise taxes that are imposed to discourage those involved with private foundations from financially benefiting themselves.

Private foundations are subject to several excise taxes. Each excise tax is discussed below:

1. Excise Tax on Investment Income. Private foundations (other than operating foundations) must pay a tax of 2% on net investment income as defined by IRC § 4940(c). IRC § 4940(a). The tax may be reduced to 1% in cases where a foundation meets certain criteria regarding distributions for charitable purposes. IRC § 4940(e).

2. Excise Tax on Self-Dealing. Self-dealing (defined in IRC § 4941(d)) between a private foundation and a disqualified person may be sanctioned by the imposition of a 5% excise tax on the self-dealer. IRC § 4941(a). The tax is based on the aggregate amount involved in the self-dealing transactions during the tax year. If the self-dealing act is not corrected within a certain period of time, the tax will increase to 200% of the amount involved. IRC § 4941(b). Foundation managers who knowingly participate in an act of self-dealing between a private foundation and a disqualified person may be liable for a 2.5% initial tax and an additional 50% tax if the situation is not corrected. IRC § 4941(a)(2), (b)(2). Self-dealing is defined as any direct or indirect:

(a) Sale or Exchange of Property. Sale or exchange, or leasing, of property between a private foundation and a disqualified person;

(b) Loans. Lending of money or other extension of credit between a private foundation and a disqualified person;

(c) Goods or Services. Furnishing of goods, services or facilities between a private foundation and a disqualified person;

(d) Compensation. Payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person;

(e) Prohibited Use. Transfer to, or use by the benefit of, a disqualified person of the income or assets of a private foundation; and

(f) Payments to Government Officials. Agreement by a private foundation to make any payment of money or other property to a government official (as defined in IRC § 4946(c)), other than an agreement to employ such individual for any period after the termination of his government service if such individual is terminating his government service within a 90-day period. IRC § 4941(d)(1).

A disqualified person is defined to include one of a number of prohibited relationships set out at IRC § 4946(a)(1) and includes (among others) a substantial contributor to the foundation, a foundation manager, an owner of more than 20-35% of an entity which is a substantial contributor to a foundation and family members of the foregoing. A foundation manager is defined as an officer, director, a trustee of a foundation (or individual having similar powers) and (with respect to any act (or failure to act)), the employees of the foundation having such authority or responsibility. IRC § 4946(b).

3. Excise Tax on Failure to Distribute Income. Private foundations which are not operating foundations must pay an initial tax of 15% on income which is undistributed as of the first day of the second tax year following the year at issue. IRC § 4942(a). If all the income is not distributed by the end of the taxable period (as defined in IRC § 4942(j)(1)), an additional 100% tax is imposed on the remaining amount. IRC § 4942(b). Essentially, "undistributed income" is the amount by which the distributable amount, computed based on a 5% minimum investment return, exceeds expenditures for charitable purposes. IRC § 4942(c).

4. Excise Tax on Excess Business Holdings. A 5% initial tax is imposed on a private foundation which has holdings in any business enterprise which are in excess of what is permissible as defined by IRC § 4943(c)(2). IRC § 4943(a). The tax is based on the value of the excess holdings. An additional 200% tax may be imposed if the foundation has not disposed of the excess holdings within a certain time period (i.e., if at the close of the taxable period with respect to such holdings, the foundation still has excess holdings in such enterprise.) IRC § 4943(b).

Excess business holdings means, with respect to the holdings of any private foundation in any business enterprise, the amount of stock or other interest in the enterprise which the foundation would have to dispose of to a person other than a disqualified person in order for the remaining holdings of the foundation in such enterprise to be permitted holdings. IRC § 4943(c). Permitted holdings are:

(a) 20% Rule. In the case of a corporation, 20% of the voting stock reduced by the percentage of the voting stock owned by all disqualified persons (unless the higher 35% total described below applies.) IRC § 4943(c)(2)(A).

(b) 35% Rule. If the private foundation and all disqualified persons together do not own more than 35% of the voting stock of the incorporated business enterprise, and it is established to the satisfaction of the Secretary of the Treasury that effective control of the corporation is in one or more persons who are not disqualified persons with respect to the foundation, the 20% requirement of IRC § 4943(c)(2)(A) is replaced by a 35% threshold. IRC § 4943(c)(2)(B).

(c) De Minimis Exception. There is a de minimis rule whereby private foundations owning not more than 2% of both voting stock and value of a corporation will not be deemed to be in violation of the excess holding requirements. IRC § 4943(c)(2)(C).

(d) Application to Partnership Interests. Similar permitted holding requirements to those of corporations apply to ownership in partnerships. IRC § 4943(c)(3).

5. <u>Excise Tax on Investments That Jeopardize Charitable Purposes</u>. An initial tax of 5% on any amounts invested in a manner that jeopardizes a private foundation's charitable purposes may be imposed on the foundation, and a 5% tax may be imposed on a manager who knowingly participates in the making of such an investment. IRC § 4944(a). Additional taxes of 25% and 5% may be imposed on the foundation and manager, respectively, if the jeopardizing investment is not remedied within a certain period of time. IRC § 4944(b). A jeopardizing investment is made when the foundation managers fail to exercise ordinary business care and prudence under the circumstances in providing for the long-term needs of the foundation in carrying out its charitable purposes. Reg. § 53.4944-1(a)(2).

6. <u>Excise Tax on Taxable Expenditures</u>. Taxable expenditures are expenses incurred by a private foundation in carrying on propaganda, influencing legislation, influencing the outcome of a public election, making a grant to an individual for travel or study, or making a grant to certain types of organizations. IRC § 4945(d). Initial taxes of 10% and 2.5% may be imposed on such expenditures, payable by the foundation and management, respectively, who knowingly participated. IRC § 4945(a). Additional taxes of 100% and 50% may be imposed on the foundation and management, respectively, if the expenditures are not corrected within a certain time period (i.e., within the taxable period.) IRC § 4945(b).

7. <u>Termination Tax</u>. An organization's private foundation status may be terminated at the request of the organization or upon certain willful acts of the foundation giving rise to liability for any of the excise taxes listed at 2-6 above. IRC § 507(a). Upon the termination of private foundation status, a termination tax is imposed, consisting of the lesser of the aggregate tax benefit the foundation received from its IRC § 501(c)(3) status, or the value of the net assets of the foundation. IRC § 507(c). This would result in disgorging all tax benefit obtained during the period of the entity's exempt status. CAVEAT: Termination and/or dissolution of a tax exempt organization may have onerous unintended tax consequences. The potential impact of the termination tax should be taken into account before proceeding with the planned termination of the entity.

8. <u>Form 990-PF</u>. In addition to Form 990, which most tax-exempt organizations must submit annually, and in addition to Schedule A of Form 990, which all charitable organizations must file subject to de minimus exception, private foundations must file Form 990-PF with the IRS each year. See IRC § 6033(a)-(c). This form requires a private foundation to report a large amount of information regarding the foundation's finances, operations, programs, activities, managers, and related data. The chart attached as Exhibit C compares donor-advised funds to private foundations.

IV. CONCLUSION

Donor-advised funds thus offer a convenient way for donors to carry on long term charitable giving through grant making without the burdens or restrictions of private foundations.

ENDNOTES

1 Shareholder, Estate Planning & Tax, Group Graves, Dougherty, Hearon and Moody, Austin, Texas, 512.480.5770, mmobley@gdhm.com.

EXHIBIT A
SELECTED DONOR-ADVISED FUNDS

This list is adapted from the Bjorklund article cited on p. 1 of the paper.

1) Community foundation. A potential donor can locate a community foundation by consulting a local financial or tax advisor or by contacting the Council on Foundations in Washington, D.C. at (202) 466-6512.

2) The Fidelity Charitable Gift Fund.
82 Devonshire Street, F35
Boston MA 02109
1-800-682-4438
www.chartiablegift.org

3) The National Philanthropic Trust Company ("NPT").
One Pitcairn Place
Suite 3000
Jenkintown, PA 19046
(888) 878-7900
www.nptrust.org

4) Vanguard Charitable Endowment Program.
The Vanguard Group
P.O. Box 3075
Southeastern, PA 19398-9917
Tel.: 1-888-383-4483
Fax: 1-888-426-3273

5) The American Gift Fund
The American Guaranty and Trust Company
220 Continental Drive, Suite 401
Newark, DE 19713
Tel.: 1-800-240-4248
Fax: (302) 731-2828
www.giftfund.org

6) The Bessemer National Gift Fund
Bessemer Trust
630 Fifth Avenue
New York, NY 10111
Tel: (212) 708-9100
Fax: (212) 265-5826
E-mail: wealth@bessemer.com.

7) The Ayco Charitable Foundation L.P.
P.O. Box 8009
Clifton Park, NY 12065-8009
1-800-335-5353

8) The Charitable Gift Fund
Maxus Foundation
The Maxus Investment Group
1301 East Ninth Street
Cleveland, OH 44114
Tel.: (216) 687-1004
Fax: (216) 687-1001
www.maxusgroup.com.

9) The Fund for Charitable Giving
PNC Bank, New England
125 High Street
Oliver Street Tower
Boston, MA 02110-2713
Tel.: 1-800-225-2310.

10) Funding Exchange
666 Broadway, Suite 500
New York, NY 10012
(212) 529-5300

11) The Tides Foundation
P.O. Box 29903
San Francisco, CA 94129-0903
(415) 561-6400

12) The Philanthropic Collaborative, Inc.
Room 5600
30 Rockefeller Plaza
New York, NY 10112
(212) 649-5949

13) CAF America
King Street Station
Suite 150
1800 Diagonal Street
Alexandria, VA 22314
(703) 549-8931

14) The American Ireland Fund
320 Park Avenue
Fourth Floor
New York, New York 10022
(212) 224-1286

15) The Giving Back Fund
230 Congress Street
Boston, MA 02110
(617) 556-2820
Fax: (617) 426-5441
www.givingback.org

16) University Donor Advised Funds. Many universities offer donor-advised funds. Check with the university in which the donor has an interest.

17) Christian Community Foundation
P.O. Box 4880
Woodland Park, CO 80866-4880
(719) 687-8784
Fax: (719) 687-8780

18) Jewish Communal Fund
130 East 59th Street, Suite 1204
New York, NY 10022
(212) 752-8277
Fax: (212) 319-6963

19) Jewish Community Foundation
5700 Wilshire Boulevard
Suite 2000
Los Angeles, CA 90036
(213)761-8700
Fax: (213)761-8720

20) Jewish Community Endowment Foundation
843 St. Georges Avenue
Roselle, NJ 07203
(908)298-8200
Fax: (908)298-8220

21) National Catholic Community Foundation
1210C Benfield Boulevard
Millersville, MD 21108
1-800-757-2998

22) National Christian Charitable Foundation
1275 Peachtree St. NE, Suite 700
Atlanta, GA 30309
(404)888-7444
Fax: (404)870-4843

EXHIBIT B
TREASURY DEPT. EXPLANATION OF BUDGET PROPOSAL PROVISIONS REGARDING DONOR-ADVISED FUNDS

The Joint Committee on Taxation's Report

On March 6, 2000, the Joint Committee staff issued its Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal. The "Description of Proposal" and "Analysis" sections are reprinted below.

Description of Proposal

The proposal would provide that a charitable organization which has, as its primary activity, the operation of one or more donor-advised funds may qualify as a public charity only if: (1) there is no material restriction or condition that prevents the organization from freely and effectively employing the assets in such donor-advised funds, or the income therefrom, in furtherance of its exempt purposes; (2) distributions are made from such donor-advised funds only as contributions to public charities (or private operating foundations) or governmental entities; and (3) annual distributions from donor-advised funds equal at least five percent of the net fair market value of the organization's aggregate assets held in donor-advised funds (with a carry forward of excess distributions for up to five years). Any charity that maintains more than 50 percent of its assets in donor-advised funds would be deemed to meet this primary activity test.

Failure to comply with any of these requirements with respect to any donor-advised fund would result in the organization's being classified as a private foundation and, therefore, being subject to the current-law private foundation rules and excise taxes.

In addition, the proposal would require any other charitable organization that operates one or more donor-advised funds, but not as its primary activity, to comply with the above three requirements. If such an organization (e.g., a school that operates donor-advised funds) fails to satisfy these requirements with respect to its donor-advised funds, the organization's public charity status would not be affected, but all assets maintained by the organization in donor-advised funds would be subject to the current-law private foundation rules and excise taxes.

Under the proposal, a "donor-advised fund" would be defined as any segregated fund (or account) maintained by a charity for contributions received from a particular donor (or donors) as to which there is an understanding that the donor or the donor's designee may advise the charity regarding the investment or distribution of any amounts held in the fund. However, the term "donor-advised fund" would not include any fund (or account) as to which such advice is limited to the use to be made by the charity for its own operations (rather than grants to be made by the charity to third parties) of amounts held in the fund. The term would not include a contribution to charity where the donor, at the time of making the contribution, specifies a charitable recipient, but retains no advisory rights (e.g., certain contributions to an organization such as the United Way).

Under the proposal, the definition of "material restriction" generally would be based on present-law regulations under section 507. However, the proposal provides that the existence of a material restriction will not be presumed merely because a charity regularly follows a donor's advice.

The proposal also would amend the definition of disqualified person under section 4958 to clarify that a person who is a donor or a designated advisor to a particular donor-advised fund maintained by any public charity (and such person's family members and controlled entities) will be treated as having substantial influence with respect to any transactions involving that particular fund. In addition, the proposal would amend the definition of disqualified person to include any person who is a donor or a designated advisor to a particular donor-advised fund maintained by a private foundation (and such person's family members and controlled entities) for purposes of applying section 4941 (self-dealing rules) to transactions involving that particular fund.

Under the proposal, the Treasury Department would be granted authority to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the proposal, including regulations interpreting the "no material restriction" requirement, and regulations describing procedures sufficient to ensure that distributions from donor-advised funds are made only as contributions to eligible entities.

Effective date.--The proposal relating to the public charity status of certain charitable organizations operating donor-advised funds would be effective for taxable years beginning after the Treasury Department issues final regulations interpreting the "no material restriction" requirement with respect to donor-advised funds. The proposed amendments to sections 4946 and 4958 would be effective for transactions occurring on or after the date of enactment.

Analysis

In recent years, the number and value of "donor-advised funds" maintained by charitable organizations has grown. A donor-advised fund is a separate fund, but not a separate entity, within a public charity. A donor's contributions are accounted for separately within the public charity's records, and often the donor is permitted to name a fund after the donor or the donor's family, thus providing a name recognition benefit similar to that of a private foundation. Charitable organizations maintaining donor-advised finds generally permit a donor to claim a current charitable contribution deduction for amounts contributed to the charity and to provide ongoing advice regarding the investment or distribution of such amounts. Certain financial institutions have formed charitable entities for the purpose of offering such donor-advised funds, and other existing charities, including universities, have begun operating donor-advised funds. Although these donor-advised funds resemble the separate funds maintained by community trusts, the rules governing their operation are unclear under present law.

While some charities that maintain donor-advised funds voluntarily have adopted minimum annual payout requirements, there is concern that amounts maintained in donor-advised funds are not being distributed currently for charitable purposes. The lack of uniform guidelines governing the operation of donor-advised funds also raises concerns that such funds may be used to provide donors with the benefits normally associated with private foundations (such as control over grantmaking), without the regulatory safeguards that apply to private foundations. Some argue that legislation is needed to reduce the potential for donor-advised being used to obtain current tax benefits for donors and advisors without safeguards to ensure that the donated amounts are used for charitable purposes. It is also argued that the application of clear and administrable rules to donor-advised funds will promote the continued growth of such funds.

Opponents of the proposal argue that there are no demonstrated abuses that require the enactment of restrictions on donor-advised funds. It can be argued that the proposal could have a chilling effect on the creation and funding of donor-advised funds because the proposal would not be effective until Treasury regulations are issued defining what constitutes a material restriction or condition.

The proposal would rely on the Treasury regulations defining what constitutes a "material" restriction or condition that prevents an organization from freely and effectively employing the assets in its donor-advised funds, or the income therefrom, in furtherance of its exempt purposes. Critics of the proposal claim that the factors enumerated in the sec. 507 regulations are unclear and can be difficult to apply. They argue that reliance upon these present-law regulations does not provide clear guidance for the establishment or maintenance of donor-advised funds. On the other hand, reliance upon whether the charitable organization has the legal right to control such funds may be inadequate to address the complex financial structure of some organizations.

Although the proposal applies to any public charity that operates donor-advised funds, it is not clear that the proposal would apply to supporting organizations (a subcategory of public charity) that can function as donor-advised funds but that may not meet the proposal's definition of donor-advised fund in all cases. A supporting organization typically is funded by a donor and his or her family rather than by the general public, and receives its public charity status by virtue of its relationship to one or more public charities. Some supporting organizations have been criticized for violating (at least in spirit) the restrictions on control and for functioning as donor-advised funds. Nevertheless, because the charitable recipients of a supporting organization generally must be designated in the supporting organization's charter, it is possible that such an organization would not be deemed to operate donor-advised funds, as defined in the proposal.

The proposal fails to clarify what happens to an organization that maintains donor-advised funds if it fails to meet one or more of the requirements to maintain its public charity status in a particular year and is reclassified as a private foundation. For example, the proposal does not specify whether it is possible for the organization to regain its public charity classification promptly and, if so, what procedures would apply. Similarly, the proposal leaves ambiguous whether a donor-advised fund may designate a successor donor-advisor.

In addition, some may criticize the proposal on the grounds that it imposes a substantial penalty on an organization--loss of public charity status-for small or unwitting mistakes by an organization that maintains the donor-advised funds as its primary activity. Critics argue that the proposal should address this issue, possibly through Treasury regulations.

EXHIBIT C
COMPARISON: DONOR-ADVISED FUND – PRIVATE FOUNDATION

The following chart is adapted from Wruck & Monroe Family Foundations: Donor Advised Funds and Supporting Organizations as Alternatives to Private Foundations, available through the Planned Giving Design Center at www.pgdc.net and from Brietstein, Donor-Advised Funds: A Good Vehicle for Charitable Planning, Estate Planning 81, 83 (February 2002).

COMPARISONS	DONOR-ADVISED FUND	PRIVATE FOUNDATION
Tax-exempt status	Generally shares public charity status with sponsoring charity	Must establish separate tax exempt status as private foundation through filing Form 1023
Charitable deduction for cash gifts	50% of donor's adjusted gross income in any one year	30% of donor's adjusted gross income in any one year
Charitable deduction for gifts of long-term capital gain property	Deduction for full fair market value, limited to 30% of donor's adjusted gross income in any one year	Deduction for full fair market value, limited to 20% of donor's adjusted gross income in any one year
Donor control	Donor or other designated person is allowed to make recommendations as to investments and grants, but sponsoring charity makes final decisions	Donor retains complete control over investments and grant making, limited only by IRS requirements
Minimum payout requirements	None, except by charity's policy	Must pay out for charitable purposes at least 5% of asset value regardless of annual income.
Creating the foundation	Established by agreement with community foundation or other sponsoring charity	Nonprofit corporation or trust organized as a private foundation

COMPARISONS	DONOR-ADVISED FUND	PRIVATE FOUNDATION
Start-up costs	No cost to donor	Requires substantial legal, accounting, and operational costs similar to corporate start-up
Administration and operating costs	Provided by charity	Must establish, acquire, and manage on its own
Record keeping	None by donor	Donor has full responsibility
Annual costs	Minimal, usually set by charity on a break even basis	Can be costly including administration, accounting, and audit
Annual taxes	None	Generally income tax exempt, but subject to excise tax of up to 2% of net investment gain including capital gains
Tax Reporting	None by donor	Federal and often state returns required
Investments	Provided by the charity, sometimes with donor's advice	Must establish, research and manage own investment vehicles.
Fiduciary responsibility	Charity fulfills fiduciary responsibilities	Private foundation board has full fiduciary responsibility
Personal liability	None by donor	Yes for board members and sometimes donors

TAX CONSIDERATIONS UPON THE SALE OF U.S. INTANGIBLES TO A FOREIGN RELATED PARTY

Martin M. Van Brauman[1]

Introduction

For various reasons, a U.S. developer of intangible property ("IP") may want to sell certain foreign territorial rights of the IP to a related foreign party instead of transferring rights by a license agreement. The foreign party may derive certain economic benefit and prestige from owning the local jurisdictional rights. The IP may represent industrial patents that are filed under U.S. and international patent conventions.[2] The sale of the foreign territorial rights may be treated as a sale of the know-how derived from the patents, or certain territorial ownership to the international patents may be sold by assignment with patent applications filed in the foreign jurisdiction.[3]

To limit the scope of this article, the facts assume that the ownership rights to the particular foreign market of the use of the U.S. patents and international patents would be treated as know-how. The facts assume that the U.S. developer wants to sell only certain manufacturing know-how to its foreign affiliate in a limited territory. Since I.R.C. § 482 applies to sales between controlled parties, the facts assume that an arm's length amount for the intangible property is charged and transfer pricing is not an issue in either jurisdiction.[4] Section 482 governs only the amount of consideration received in a taxable transfer between controlled parties.[5]

Under the general U.S. rules, the sale of an intangible gives rise to capital gain income and a license gives rise to royalty (ordinary) income. For a third-party sale, the gain on the sale will be a capital gain under section 1221 or, if the intangible is used in the taxpayer's trade or business, under section 1231.[6] However, the general rules may change with a sale to a related party by requiring ordinary income treatment of the sale proceeds. The transaction would be treated still as a sale under U.S. tax law and by the foreign jurisdiction.

Prior to determining whether capital gain treatment for sales to foreign related parties are possible, the intangible property to be transferred must be identified by documentation and the transfer agreement must indicate clearly a sale instead of a license agreement. Various U.S. Code sections place limitations on obtaining U.S. capital gains treatment with a sale to a controlled foreign entity. The various I.R.S. reporting forms for controlled entities require the determination of income and deductions pursuant to U.S. tax laws, creating differences from how foreign tax jurisdictions determine their tax liabilities on the same operation.

However, the U.S. parent may have accumulated net operating losses in the U.S. and need to generate U.S. source ordinary income from a profitable foreign operation without increasing foreign source income (perhaps in an excess limitation position for foreign tax credits) and without triggering a foreign withholding tax on dividends.[7] Thus, a U.S. sale to a foreign controlled entity may produce desirable tax benefits, depending upon the facts.

The Intellectual Property Must be Identified

Before determining whether a sale or a license agreement is drafted as intended, the transfer agreement must identify the intangible property involved for U.S. and especially for foreign tax purposes. Since either amortization or royalty deductions will reduce foreign tax liabilities, foreign tax authorities may examine closely related-party transactions to determine the actual property transferred and its purported value in relationship to the claimed deductions. With controlled parties, the tax authorities would expect arm's-length documentation, supporting the purchase price.

When a patent has been "applied for," a patent attorney has identified the intangible by a written description. A patent is an exclusive right conferred by governmental authority affording the patent holder the exclusive right to make, use and sell an invention for the duration of the patent. Patents are created under the legislation of each country concerned and are valid only for the territory of that country and for the statutory period of the grant. Although international treaties exist with respect to aspects of patent law, it is generally necessary to apply for patent rights in each country where the invention will be exploited.

Under the Internal Revenue Code (the "Code"), intangible property is defined by section 936(h)(3)(B), which is essentially identical to the definition in the section 482 regulations.[8] Section 936(h)(3)(B) defines intangible property to include any patent, invention, formula, design, pattern, know-how, method, program, system, procedure, survey, study, forecast, estimate, technical data, or any similar item. An item is considered to be a "similar item," if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.[9]

Items such as software programs, training videos, equipment design, testing procedures and methods, testing standards, diagrams, flowcharts and training and policy manuals may be considered to be physical representations of the intellectual property. To constitute property the items as a whole must be proprietary, or capable of being legally protected, and distinguishable from similar items of other manufacturers.[10]

Know-how is a term commonly used to describe a wide range of technical information, which may or may not be eligible for protection under patent, trademark, or copyright laws pertaining to commercial and industrial products and processes. The term includes knowledge that is not legally protected, but protected by confidentiality agreements or trade secret laws. A trade secret is business information that is not generally known and not readily ascertainable by proper means by other persons. A trade secret is any formula, pattern, device or compilation of information which is used in a business and which gives an advantage over competitors who do not know or use it. A wide variety of technical and nontechnical materials and information can qualify as a trade secret.

To preserve trade secret status, the owner must take reasonable steps to maintain the secrecy of the information. Most countries have general legal doctrines under which confidential business information may not be obtained or used in an unauthorized manner.

The term "know-how" is not defined in the Code and U.S. Treasury Regulations (the "regulations"), but has been described in rulings and procedures.[11] The Internal Revenue Service (the "Service") has described know-how clearly as secret processes or formulae, but has relied upon a facts and circumstances analysis to determine if other types of know-how should be treated as "property." In Rev. Rul. 55-17, the Service stated that:

> [w]hile manufacturing "know-how" is of a nonpatentable nature, it is something that its possessor can grant to another for a consideration. The right to use such "know-how" is not materially different from the right to use trade-marks, secret processes and formulae, and, if the right thereto is granted as part of a licensing agreement, it becomes, in effect, an integral part of the bundle of rights acquired under such agreement.[12]

Under Rev. Rul. 64-56, the Service stated subsequently that:

> [t]he term "property" for purposes of section 351 of the Code will be held to include anything qualifying as "secret processes and formulas" within the meaning of sections 861(a)(4) and 862(a)(4) of the Code and any other secret information as to a device, process, etc., in the general nature of a patentable invention without regard to whether a patent has been applied for . . ., and without regard to whether it is patentable in the patent law sense . . . Other information which is secret will be given consideration as "property" on a case by case basis.[13]

The Service has indicated that a transferred know-how must be legally protected in the hands of the transferee in order to qualify as "property" and the transferor must transfer the right to enjoin others from use or disclosure of the technology in the territory or field of transfer.[14] The unqualified transfer in "perpetuity" of the exclusive right to make, use and sell an unpatented but secret process or similar secret information within a country is treated as a transfer of property.

The transfer of know-how is recognized as a transfer of property "if the transferred rights extend to all of the territory of one or more countries and consist of all substantial rights therein, the transfer being clearly limited to such territory, notwithstanding that rights are retained as to some other country's territory."[15] The unqualified transfer of the exclusive right to use a trade secret, until it becomes public knowledge and no longer protectible under the applicable law of the country where the transferee is to operate, is a transfer of property in perpetuity for purposes of Rev. Rul. 64-56.[16]

Rev. Rul. 64-56 and Rev. Rul. 71-564 indicate the Service's position that know-how must be secret to qualify as property and non-secret know-how only qualifies, if it is in the form of ancillary and subsidiary services to the transfer of another qualifying property. Under Priv. Ltr. Rul. 1999-14-012, the Service stated that:

> "know-how" is secret in that it is known only by Fcorp A and those confidential employees who require the "know-how" for use in the conduct of the activities to which it is related . . . [and] . . . [a]dequate steps have been taken to safeguard the "know-how" against unauthorized disclosure.[17]

The U.S. courts have agreed with the secrecy requirement and have limited the secrecy requirement to the time of transfer, even though the secret formula or process subsequently was discoverable.[18] In the Ofria case, the U.S. Tax Court held that:

> [e]ven through a secret may be disclosed by independent investigation through chemical analysis or reverse engineering, as long as the information is not generally known in the trade, the owner of the secret possesses a valuable right that may be sold to others who wish to avoid the expense and delay required for independent development of the trade secret.[19]

In the *DuPont* case, the U.S. Claims Court held that "[u]nless there is some special reason intrinsic to the particular provision . . ., the general word "property" has a broad reach in tax law . . ." and "[f]or section 351, in particular, courts have advocated a generous definition of 'property'."[20] The 11th Circuit in Stafford stated that "to be section 351 property an item cannot be valueless . . . [b]ut, other than this possible requirement as to value, the cases seem to impose no significant limitation on the term 'property.'"[21] The mere fact that a particular know-how has a determinable value establishes it as "property" under U.S. case law. Thus, a transfer pricing study by being able to determine a value has defined a "property."

Whether all of the substantial rights to an intellectual property have been transferred for the treatment as a sale is a question of facts and circumstances under the common law "all substantial rights" test. The measure of ascertaining what has or has not been transferred is to examine what rights have been retained by the transferor. The "all substantial rights" test is the same as the section 1235 "all substantial rights" test, except that limited geographic transfers and limited use transfers are permitted under the common law test. Congress has provided safe harbors for characterizing certain transfers of intellectual property, such as section 1235 for the sale of patents by individual inventors.[22]

U.S. Patent Transfers

As defined by U.S. law, a patent grants its owner the right to exclude others from making, using, or selling the invention in the United States and its territories and possessions as well as the right to exclude others from importing the patented invention into the United States.[23] The term of U.S. patents is 20 years from the filing of the patent application.

Section 1235 is a special provision for the U.S. inventor that provides for long-term capital gains treatment regardless of whether the payments are payable periodically or contingent on the productivity, use, or disposition of the patent. Otherwise, the U.S. inventor would realize ordinary income, since the property would not qualify as a capital asset or section 1231 property but would be treated as inventory.

The provision can apply to the transfer of patent rights before the patent or patent application is in existence, or can apply to an invention that is not patented and for which a patent has not been applied for so long as the invention could be patented.[24] Section 1235 applies to patents and patentable inventions held by a "individual whose efforts created such property."[25] Section 1235 will apply to trade secrets/know-how that are otherwise patentable.[26] Also, a trade secret/know-how that is incidental to a patent will be treated as part of the patent.[27]

The provision applies only where the holder transfers all substantial rights that are of value at the time the rights to the patent are transferred.[28] Each of these rights must be transferred. An exclusive agreement transferring all of these rights for the useful life of the patent will satisfy the "all substantial rights" requirement. The reservation of any of these rights will not satisfy the "all substantial rights" requirements.

The circumstances of the whole transaction, rather than the particular terminology used in the instrument of transfer, are considered in determining whether or not all substantial rights to a patent are transferred in a transaction.[29] The following examples are situations in which the "all substantial rights" requirements are not satisfied for sale treatment:

1. transfers limited in duration to less than the remaining life of the patent,[30]

2. transfers that are limited geographically within the country of issuance,[31]

3. transfers that are limited to particular fields of use within trades or industries if the patent covers other valuable fields of use,[32]

4. any agreement that reserves the right to terminate the transfer "at will,"[33] or

5. the retention by the transferor of an absolute right to prohibit sublicensing or sub-assignment by the transferee and the failure to convey the right to use or sell the patent.[34]

Corporations, S corporations and partnerships do not qualify as holders for section 1235 treatment. In the case of partnerships, the regulations provide that each individual partner may qualify as a holder as to his share of the patent owned by the partnership.[35] Usually, the inventor is an employee under contract to assign ownership of any patents developed over to the employer.

If a section 1235 status exists, the holder would not be effected by any transfer or sale of the <u>foreign rights</u> to the patent or know-how, since section 1235 status only applies to U.S. rights and protection. There would not be any transfer of any U.S. rights for the U.S. patent or know-how, which would apply to section 1235. Although a patent cannot be limited geographically within the country of issuance, i.e., the U.S., the "section 1235" inventor with the corresponding foreign patent on the U.S. invention is able to retain the U.S. patent and transfer the foreign patent.

Section 197 Intangible

When an asset that is used in a trade or business or for the production of income has a useful life that extends beyond the taxable year, the cost of acquiring the asset must be capitalized and recovered through depreciation or amortization deductions over the expected useful life of the asset. Section 197 allows taxpayers an amortization deduction for the capitalized costs of acquiring section 197 intangibles.

For purposes of the Code, an "amortizable section 197 intangible" is to be treated as property of a character that is subject to the allowance for depreciation provided in section 167.[36] Thus, an "amortizable section 197 intangible" held for more than one year generally qualifies as property used in a trade or business for purposes of section 1231 and is not a capital asset for purposes of section 1221.[37]

Section 197 does not apply to intangibles created, but rather to intangibles acquired.[38] Under the Code and regulations, the term "amortizable section 197 intangible" does not include any section 197 intangible that was created by the taxpayer.[39] Without the cost of acquiring the asset, there is nothing to capitalize and recover through depreciation or amortization deductions. The creators of the intangible assets generally expense the costs of creating the intangible.

A non-depreciable intangible would not be treated as a section 1231 asset, but would qualify as a capital asset if it is not treated as inventory under section 1221. For section 1231 to apply, the property must be used in a trade or business which means depreciable property that has been held more than the long-term capital gains holding period.[40] The term "capital assets" includes all classes of property not specifically excluded by section 1221. Thus, a patent may qualify as a capital asset under section 1221 if it is not inventory.[41]

Sale versus License Under Common Law Principles

Transfers of intangibles not within the scope of section 1235 must be characterized under common law principles. Although the Code does not provide a clear determination when a transfer of know-how is a sale or a license, the Service has adopted guidelines similar to the rules of section 1235, requiring a transfer of "all substantial rights." A transfer of an intangible that fails to confer a right with respect to excluding others from either manufacturing, using or selling an intangible within a geographic area results in a license.[42]

To qualify as a sale rather than a license, the transfer of know-how must be in perpetuity or until legal protection is lost and must be exclusive as to the territory or field in which the license is granted.[43] The Service has indicated that the transferred know-how must be legally protected in the country of transfer in order to qualify as "property" and the transferor must transfer the right to enjoin others from use or disclosure of the technology in the territory or field of transfer.[44]

The requirements for a complete sale of perpetual transfer, exclusive use and the right to a monopoly of the transferred intangible are not defeated by the transferor's retention of certain rights. These rights include the retention of legal title for infringement suit purposes and the right of termination for breach, bankruptcy, insolvency, and quality/quantity requirement purposes.[45]

Retaining rights to future development is a substantial right withheld with respect to intellectual property.[46] "Subsequent development" language should be addressed within the terms of any transfer agreement. Any sale document should convey the right to use, sell and further develop the intangible property on a geographic basis.

The primary concern is that a transfer agreement creates a license transaction as opposed to a sale of the property, assuming that the parties intend a sale. The sale price can be a contingent sale price based on the use or productivity of the intangible. The factors that are relevant in determining whether a transfer of intangible property is a sale or a license include the following:

1. the existence of a useful life of the property at the end of the purported lease term (a useful live exceeding the lease term is an indication that the transfer is a lease and not a sale);[47]

2. whether the amount paid by the transferee is based on its use of the property (a payment by the transferee prior to acquiring the property and not related to the amount that the transferee will use the property is an indication of a sale and not a lease);[48]

3. whether at the end of the purported lease term the property is to be returned to the transferor (a requirement that the property be returned to the transferor indicates a lease and not a sale);[49]

4. in the case of a single up-front payment by the transferee, whether the payment discounts the estimated residual value from what would otherwise be the market price of an initial sale transaction (a lease is indicated if the payment approximates the fair market value of the property on the date of transfer less its expected residual value);[50] and

5. whether the transferor or the transferee bears the risk of loss and is liable for taxes imposed as a result of the transfer (a sale is indicated if the transferee is responsible for risk of loss and/or the taxes resulting from the transfer).[51]

The sale of an intangible gives rise to capital gain income and a license gives rise to royalty (ordinary) income that is sourced to where the intangible is used. The transfer of exclusive rights to use an intangible for its remaining lifetime in a specific geographical area constitutes a sale rather than a license. A licensing of intangible property conveys less than a complete transfer. Generally, the term is shorter than the useful life of the intangible.

Under the foreign tax jurisdiction, the acquiring foreign party would trade a royalty deduction with a license agreement for the amortization of the IP under a sale transaction. Depending upon the local country's tax laws for the amortization of intangibles compared to royalty deductions, actual foreign net income may increase or decrease on the foreign return and the U.S. parent's tax return may require a recalculation of amortization under U.S. tax law.

A license gives rise to royalty income, which under sections 861(a)(4) and 862(a)(4) is sourced to where the intangible is used. A sale of an intangible property by a U.S. resident is sourced in the U.S., except for a sale of an intangible in which the payments in consideration of such sale are contingent on the productivity, use, or disposition of the intangible.[52] The general seller-residence rule of section 865(a) applies only to the extent that the payments in consideration of such sale are not contingent on the productivity, use, or disposition of the intangible. With contingent payments, the foreign jurisdiction may treat the sale as a license and the payments as deductible royalty payments but subject to withholding tax.

Thus, the source of contingent payments are determined in the same manner as if such payments were royalties.[53] The contingent payments are sourced under sections 861(a)(4) and 862(a)(4) based on the location of use of, or right to use, the intangible (the royalty rule). The deemed royalty source rule may be beneficial to a U.S. seller from an excess foreign tax credit situation. The foreign use of the intangible by the transferee treats the payments as foreign source income to the transferor and eligible to be offset by any excess foreign tax credits of the transferor.

If a sale created U.S. source income, a transferor would be unable to claim foreign tax credits with respect to such income. The contingent sales amounts received by the U.S. parent from the foreign subsidiary would be treated as a foreign source, non-passive (general limitation) income.[54]

If a controlled taxpayer acquires an interest in intangible property from another controlled taxpayer (other than in consideration for bearing a share of the costs of the intangible's development), then appropriate allocations to reflect an arm's length consideration for the acquisition of the interest in such intangible must be made under the rules of sections 1.482-1 and 1.482-4 through 1.482-6.[55] An interest in an intangible includes any commercially transferable interest, the benefits of which are susceptible of valuation.[56]

US Capital Gain Limitations on Sales to Foreign Related Parties

Under the Code, the various capital gain limitation provisions are designed to prevent the owner of property to benefit from capital gain treatment on the sale and for the related purchaser to take depreciation on the step-up in basis. Sections 1239 and 1249 re-characterize the gain from any sale proceeds between related parties as ordinary income. Section 1239 concerns depreciable or amortizable property. Section 1249 pertains to intangible property treated as a capital asset or a section 1231 property and sold to a controlled foreign corporation.

Section 1249

Gain from the sale or exchange of a patent, process, know-how or other similar property to any foreign corporation by any U.S. person[57] which controls such foreign corporation is treated as ordinary income if such gain would otherwise be gain from the sale or exchange of a capital asset or section 1231 property. Only the gain is re-characterized and any loss would remain as a capital loss.

Controlled is defined as more than 50 percent of the total combined voting power of all classes of stock entitled to vote.[58] The section 958 rules for determining direct and indirect stock ownership applies.[59]

Section 1239

Section 1239 applies to any gain, not loss, recognized upon the sale or exchange of an "amortizable section 197 intangible," directly or indirectly, between related persons.[60] Any gain recognized to the transferor is treated as ordinary income. "Related persons" means a person and all "controlled entities."[61] The controlled entity is defined as more than 50 percent of the value of a corporation's stock, more than 50 percent of the capital interest or profits interest of a partnership, and any related person under section 267(b) and (c).

The legislative history of section 1239 indicates that the section applies only if the sale property is depreciable property under section 167 (or section 197) and is depreciable property in the hands of the transferee. Section 1239 does not apply to property that was not a depreciable asset in the hands of either the transferor or the transferee.[62] An intangible property that is not an amortizable section 197 intangible in the hands of either the transferor or transferee is not of a character subject to an allowance for depreciation under section 167 and is not subject to section 1239.[63]

The Tax Court has held that section 1239 applies strictly to depreciable property.[64] Prior to sales or exchanges on March 1, 1984 under section 1239(e), patent applications were not treated as depreciable property and not subject to section 1239. In *Lan Jen Chu v. Commissioner*, the transfer of the patent application (prior to the enactment of section 1239(e)) to a corporation controlled by the transferor resulted in capital gains, not ordinary income, since the patent application was not property subject to depreciation for purposes of section 1239.[65] The court stated that "the legislative history of § 1239 convinces us that this section was intended to apply only to depreciable property."

Failure to actually realize income or to take deductions for depreciation is not crucial if the transferee was entitled to depreciation deductions.[66] In *Twentieth Century Fox*, the court held that although no depreciation was available due to the transferee's adoption of the income forecast method of computing depreciation, depreciation would have been allowable under the straight-line method available under section 167. In *512 W. 56th St. Corp. v. Commissioner*, the court held that a building need not be currently depreciable to be "property of a character subject to the allowance for depreciation," even though the property has been fully depreciated or depreciation has not been taken.[67]

If the transferor created the intangible property and the transferee is a foreign entity that does not require the recalculation of amortization under U.S. rules, section 1239 should not apply. However, U.S. tax rules usually apply for controlled foreign entities. If the foreign entity were not a controlled entity, section 1239 would not apply by definition. The U.S. reporting requirements for controlled foreign entities result in section 197 amortization rules applying to the U.S. tax return reporting of the foreign operations.

Reporting Requirements for Related Parties

For outbound transfers of intangible property, there are various reporting requirements to review based upon whether the foreign transferee is a corporation or a partnership. The U.S. corporation would be subject to current U.S. tax on the net income of a foreign branch under U.S. principles. Foreign law would determine the taxable income of the local entity for foreign tax purposes, but branch income, deductions, amortizations, loss and foreign taxes paid would be recalculated on the U.S. tax return under U.S. tax law, which would subject the foreign intangible to section 197 amortization.

A transfer by sale of intangible property would not be subject to section 367(d) or 6038B. Section 367 applies to transactions with foreign parties that provide for nontaxable treatment of certain gains realized on organization, reorganization, or liquidation of corporations. Section 367(d) recharacterizes a nontaxable transfer of intangible property as a taxable sale. Section 6038B applies to transfers to a foreign corporation under sections 332, 351, 354, 355, 356, 361, or to a partnership under section 721 or a section 336 distribution to a non-U.S. person.

Also, Form 926 would not apply to the sale transaction. Pursuant to section 367(d) or 6038B(a)(1)(A), a U.S. citizen or resident, domestic corporation, an estate or trust (other than a foreign estate or trust) must file Form 926 to report transfers of U.S. tangible and intangible property (even unappreciated property) to a foreign corporation. If the transferor is a partnership (domestic or foreign), the partners are required to comply with section 6038B and file Form 926 and each partner is treated as a transferor of its proportionate share of the property.

Section 6038

Section 6038 would require the reporting of transactions between a U.S. person and any foreign corporation or foreign partnership when the U.S. person owns 10 percent or more of the foreign entity. Form 5471 would report the sale and purchase of intangible property for foreign corporations by 10 percent or more U.S. shareholders.[68] Form 8865 would report the sale and purchase of intangible property for foreign partnerships by 10 percent or more U.S. partners.[69]

Form 5471

The sale of intangible property to a controlled foreign corporation by its U.S. shareholder or other related persons would be reported on Schedule M of Form 5471. Also, Schedule H would determine the foreign corporation's earnings and profits for U.S. tax purposes and amortization allowances would be determined under U.S. section 197 rules.

Form 8865

Form 8865 is used to report the information required under section 6038 (reporting with respect to foreign partnerships), section 6038B (reporting of transfers to foreign partnerships), or section 6046A (reporting of acquisitions, dispositions and changes in foreign partnership interests). A U.S. person who holds more than a 50 percent ownership in the capital, profits and losses of the partnership is required to file a complete partnership return based upon U.S. tax law. The constructive ownership rules of section 267(c)(excluding section 267(c)(3)) apply.

A more than 50 percent U.S. partner of a foreign partnership must file Schedule B of Form 8865. Schedule B is the income statement for the trade or business income. Intangible property is subject to U.S. rules for amortization and a Form 4562 is required, applying the 15-year period for section 197 intangibles. The final trade or business income or loss amount is reported on the partner's K-1. Also, transactions between a 10 percent or more U.S. partner and the foreign partnership are required to be reported on Schedule N of Form 8865.

Conclusion

For both the U.S. and foreign jurisdictions, the intellectual property must be defined clearly. The identification under U.S. tax law standards should satisfy foreign jurisdictional requirements for the allowance of foreign amortization of the acquired intangible property. The primary focus would be the documentation of supporting an arm's-length sale price. Most foreign jurisdictions adopt the internationally recognized OECD "arm's-length rule" and require transfer-pricing documentation, which would identity the property.

The characterization of cross-border transfers of intellectual property as either sales or licenses are determined separately for each tax jurisdiction. A sale under U.S. law may be treated as a license under foreign law, depending upon the method and timing of payment.

Under the general U.S. rules, the sale of an intangible gives rise to capital gain income and is sourced to the seller. The rules still apply to a sale to a related party if direct and indirect ownership is 50 percent or less. However, the rules change with a sale to a controlled party (more than 50 percent ownership) by requiring ordinary income treatment of the sale proceeds. Also, controlled entities are required to recalculate amortization under section 197 for U.S. reporting purposes. Thus, the transferred intangible property would be an "amortizable section 197 intangible" in the hands of the controlled-party transferee and subject to section 1239 disallowance of capital gain treatment. A foreign controlled corporation would be denied capital gain treatment under section 1249.

A U.S. transferor of technology must exam the tax implications in the U.S. and in the destination country. The characterization and treatment within each tax jurisdiction will determine foreign tax credit consequences (sourcing), withholding tax obligations, capital gain or ordinary income treatment and amortization or royalty deductions.

ENDNOTES

1 Martin M. Van Brauman is a partner with Bennack & Lowden L.L.P. He was formerly a Senior Attorney (International Specialist) with the Office of Chief Counsel, Internal Revenue Service. B.E., Vanderbilt University; J.D., St. Mary's University; M.B.A.(Beta Gamma Sigma) and LL.M.(Taxation), Southern Methodist University.
Board Certified - Tax Law - Texas Board of Legal Specialization.
Adjunct Professor, Southern Methodist University, School of Law, LL.M. Tax Program and University of Texas at Dallas, Masters of Accounting Program.
mvanbrauman@blllp.com
www.blllp.com

2 The OECD Guidelines would classify the intangibles as "commercial intangibles" created through technological reseach and development activities.

3 Although international treaties exist with respect to aspects of patent law, it is generally necessary to apply for patent rights in each country where the invention will be exploited. If the particular country is a signatory to the Paris Convention of Industrial Property, an application for registration of a patent must be filed with the appropriate governmental patent office in the country.

4 A multinational company will need to comply with the transfer pricing documentation obligations for each country to avoid penalties or double taxation. The OECD model documentation set is recommended to provide a uniform method to satisfy multiple countries. The model recommends (1) to have documents that verify the arm's-length nature of the tested transactions, (2) to document the entire transaction not just the sale price and (3) to include the standard elements such as characterizing the business, the intercompany transactions, selecting and applying the methodology and validating the arm's-length pricing.

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

6 Treas. Reg. § 1.1221-1(c).

7 For example, gains realized by a U.S. resident from the sale of intangible assets to a Japanese resident corporation are exempt from withholding tax under the U.S./Japan tax treaty unless the gains are in the nature of a royalty. The gains are in the nature of a royalty if they are contingent on the productivity, use or disposition of the property. Arts. 14(3)(b), 16(2). Thus, the consideration for a sale of technology can avoid treatment as royalty income subject to the 10% withholding tax.

8 Treas. Reg. § 1.482-4(b).

9 Treas. Reg. § 1.482-4(b)(6).

10 *See* Rev. Rul. 64-56, 1964-1 C.B. (Pt.1) 133.

11 "Technical knowledge and methods of a nonpatentable nature are commonly referred to as 'know-how'." Priv. Ltr. Rul. 87-200-01 (January 2, 1987)(citing to Rev. Rul. 55-17, 1955-1 C.B. 388).

12 Rev. Rul. 55-17, 1955-1 C.B. 388, *modified by* Rev. Rul. 64-56, 1964-1 (Part 1) C.B. 133, *amplified* by Rev. Rul. 71-564, 1971-2 C.B. 179.

13 Rev. Rul. 64-56 at 134.

14 Rev. Rul. 64-56, 1964-1 (Part 1) C.B. 133; Myers v. Commissioner, 6 T.C. 258, 263 (1946).

15 Rev. Rul. 64-56 at 135.

16 Rev. Rul. 71-564, 1971-2 C.B. 179.

17 Priv. Ltr. Rul. 1999-14-012 (December 31, 1998).

18 DuPont v. United States, 288 F.2d 904 (Ct.Cl. 1961); Ofria v. Commissioner, 77 T.C. 524 (1981), *nonacq*., 1983-1 C.B. 1; U.S. Mineral Products v. Commissioner, 52 T.C. 177 (1969); Wall Products v. Commissioner, 11 T.C. 51 (1948), *acq*., 1949-1 C.B. 4.

19 Ofria v. Commissioner , 77 T.C. at 544.

20 DuPont v. United States, 471 F.2d 1211, 1218 (Ct.Cl. 1973).

21 United States v. Stafford, 727 F.2d 1043, 1052 note 14 (11th Cir. 1984).

22 Congress believed capital gains treatment under section 1235 would encourage individual inventors to create patents. Section 1253 is a safe harbor for trademarks and trade names.

23 35 U.S.C. §§ 154 and 271.

24 Treas. Reg. § 1.1235-2(a); Meiners v. Commissioner, 42 T.C. 653 (1964); Philbrick v. Commissioner, 27 T.C. 346 (1957); Gilson v. Commissioner, 48 T.C.M. 922 (1984).

25 I.R.C. § 1235(b)(1).

26 Treas. Reg. § 1.1235-2(a).

27 Bell Intercontinental Corp. v. United States, 381 F.2d 1004 (Ct.Cl. 1967).

28 Treas. Reg. § 1.1235-2(b)(1).

29 Treas. Reg. § 1.1235-2(b).

30 Treas. Reg. § 1.1235-2(b)(1)(ii); Oak Manufacturing v. Commissioner, 301 F.2d 259 (7th Cir. 1962)(Section 1235 did not apply to a 15-year exclusive license of a 17-year patent).

31 Treas. Reg. § 1.1235-2(b)(1)(i); Kueneman v. Commissioner, 68 T.C. 609 (1977)(upholding validity of the regulation).

32 Treas. Reg. § 1.1235-2(b)(1)(iii); Mros v. Commissioner, 493 F.2d 813 (9th Cir. 1974); Fawick v. Commissioner, 436 F.2d 655 (6th Cir. 1971).

33 Treas. Reg. § 1.1235-2(b)(4); Young v. Commissioner, 269 F.2d 89 (2d Cir. 1959)(right to cancel with 6 months notice).

34 Treas. Reg. §1.1235-2(b)(3).

35 Treas. Reg. § 1.1235-2(d)(2).

36 Omnibus Budget Reconciliation Act of 1993, Conference Report on § 197, H.R. Rep. 213, 103d Cong., 1st Sess. 672-696 (1993).

37 *Id*.

38 I.R.C. § 197(c)(2); Treas. Reg. § 1.197-2(d)(2).

39 Omnibus Budget Reconciliation Act of 1993, Conference Report on § 197, H.R. Rep. 213, 103d Cong., 1st Sess. 672-696 (1993).

40 I.R.C. § 1231(b).

41 Treas. Reg. § 1.1221-1(c). A patent in the hands of a professional inventor may not qualify under section 1221, since it will be considered inventory or stock in trade. Section 1235 allows capital gain treatment for inventors.

42 FSA 2000-06-024 (November 5, 1999).

43 Rev. Rul. 71-564, 1971-2 C.B. 179; Rev. Rul. 64-56, 1964-1(Part 1) C.B. 133.

44 Rev. Rul. 64-56, 1964-1 (Part 1) C.B. 133; Myers v. Commissioner, 6 T.C. 258, 263 (1946).

45 Coplan v. Commissioner, 28 T.C. 1189, 1190 (1957); Myers v. Commissioner, 6 T.C. 258, 260 (1946).

46 Norgren v. Commissioner, 268 F.Supp. 816, 819-20 (D. Colo. 1967).

47 Larsen v. Commissioner, 89 T.C. 1229, 1267 (1987).

48 Gershwin v. United States, 153 F.Supp. 477 (Ct.Cl. 1957).

49 Estate of Thomas v. Commissioner, 86 T.C. 412, 434 (1985).

50 *Id*.

51 Swift Dodge v. Commissioner, 692 F.2d 651 (9th Cir. 1982).

52 I.R.C. § 865(d)(1)(A).

53 I.R.C. § 865(d)(1)(B).

54 I.R.C. § 865(d).

55 Treas. Reg. § 1.482-7(a)(2).

56 *Id*.

57 U.S. person as defined in I.R.C. § 7701(a)(30).

58 I.R.C. § 1249(b).

59 Treas. Reg. §§ 1.1249-1(b); 1.957-1.

60 Omnibus Budget Reconciliation Act of 1993, Conference Report on § 197, H.R. Rep. 213, 103d Cong., 1st Sess. 672-696 (1993).

61 I.R.C. § 1239(b).

62 FSA 1997-132 (February 11, 1997).

63 Priv. Ltr. Rev. 1999-440-45 (August 11, 1999)(the U.S. trademark being distributed between related persons and was used in the trade or business of the transferee was not an amortizable section 197 intangible because of the anti-churning provisions of section 197(f)(9)).

64 Lan Jen Chu v. Commissioner, 486 F.2d 696 (1st Cir. 1973).

65 *Id*.

66 Twentieth Century-Fox Film Corporation v. Commissioner, 372 F.2d 281, 285 (2d Cir. 1967).

67 512 W. 56th St. Corp. v. Commissioner, 151 F.2d (2d Cir. 1945). See Priv. Ltr. Rul. 86-460-10 (July 21, 1986).

68 Treas. Reg. § 1.6038-2(f)(11)(iii).

69 Treas. Reg. § 1.6038-3(g)(2)(ii).

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TAX SECTION LEADERSHIP ROSTER

Officers

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

Robert V. Gibson (Chair Elect)
Krafsur Gordon Mott P.C.
4695 N. Mesa
El Paso, Texas 79912
915-545-1133, Ext. 878
915-545-4433 (fax)
rgibson2@elp.rr.com (home)
rgibson@krafsur.com (work)

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

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

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

Cynthia M. Ohlenforst (Immediate Past Chair)
Hughes & Luce, LLP
1717 Main Street, Suite 2800
Dallas, Texas 75201-7342
214-939-5512
214-939-5849 (fax)
ohlenfc@hughesluce.com

Council Members

Susan Burnette Term expires 2002
Whittenburg Whittenburg & Schachter, P.C.
P.O. Box 31718
Amarillo, Texas 79120
806-345-5700
806-372-5757 (fax)
sburnette@whittenburglaw.com

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

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

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

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

Steven D. Erdahl Term expires 2004
14026 Overlook Lane
Forney, Texas 75126
214-334-5229 (mobile)
stevenerdahl@aol.com

Jeffrey E. Sher Term expires 2004
Fizer, Beck, Webster, Bentley & Scroggins
1360 Post Oak Blvd., Suite 1600
Houston, Texas 77056-3022
713-840-7710
713-963-8469 (fax)
jsher@fizerbeck.com

Gene Wolf Term expires 2004
Kemp Smith, P.C.
221 North Kansas, Suite 1700
El Paso, Texas 79901
915-533-4424
915-546-5360 (fax)
gwolf@kempsmith.com

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COMMITTEE	CHAIR	VICE CHAIR
1. Continuing Legal Education Council Liaison: Jimmy Martens 512-346-5558 jfmartens@smbllp.com	Larry Jones Townsend & Jones 8100 Lomo Alto, Suite 238 Dallas, Texas 75225 214-696-2661 214-696-9979 (fax) larry@tjtaxlaw.com	Christina Mondrik Stahl, Martins & Bernal, L.L.P. 7320 N. MoPac, Suite 210 Austin, Texas 78731 512-346-5558 512-346-2712 (fax) cmondrik@smbllp.com
2. Corporate Tax Council Liaison: David Wheat 214-969-1468 dwheat@tklaw.com	Allen B. Craig, III Gardere Wynne Sewell & Riggs, L.L.P. 1000 Louisiana, Suite 3400 Houston, Texas 77002-5007 713-276-5570 713-276-5555 (fax) craal@gardere.com	Kenneth K. Bezozo Haynes and Boone, L.L.P. 901 Main Street, Suite 3100 Dallas, Texas 75202 214-651-5568 214-200-0365 (direct fax) 214-651-5940 (fax) bezozok@haynesboone.com
3. Employee Benefits Council Liaison: Rosemary Shepard 281-293-1939 rosemary.t.shepard@usa. conoco.com	Felicia A. Finston Vinson & Elkins LLP 2001 Ross Avenue, Suite 3700 Dallas, Texas 75201-2975 214-220-7990 214-220-7716 (fax) ffinston@velaw.com	Randy Fickel Gardere Wynne Sewell LLP Thanksgiving Tower 1601 Elm Street, Suite 3000 Dallas, Texas 75201 214-999-3000 214-999-4667 (fax) rfickel@gardere.com
4. Estate and Inheritance Tax Council Liaison: Robert Gibson 915-545-1133 rgibson@krafsur.com	G. Edward Deery Fulbright & Jaworski, LLP 1301 McKinney, Suite 5100 Houston, Texas 77010-5151 713-651-3752 713-651-5246 (fax) gdeery@fulbright.com	Stefnee Ashlock Fizer, Beck, Webster, Bentley & Scroggins 1360 Post Oak Blvd., Suite 1600 Houston, Texas 77056 713-840-7710 713-963-8469 (fax) sashlock@fizerbeck.com
5. External Relations	Vacant	
6. International Tax Council Liaison: Steve Erdahl 972-718-2197 stevenerdahl@aol.com	Carol L. Peters Exxon Mobil Corporation 5959 Las Colinas Blvd. Irving, Texas 75039 972-444-1135 972-444-1505 (fax) carol.l.peters@exxonmobil.com	Alexander G. McGeoch Worsham Forsythe Wooldridge, LLP 1601 Bryan Street, 30th Floor Dallas, Texas 75201 214-979-3041 214-880-0011 (fax) amcgeoch@worsham.net
7. Partnership/Real Estate Council Liaison: Bill Powers 214-855-4340 bbowers@jenkens.com	Richard M. Fijolek Haynes & Boone, L.L.P. 901 Main Street, Suite 3100 Dallas, Texas 75202-3789 214-651-5570 214-200-0378 (fax) fijolekr@haynesboone.com	Mitchell A. Tiras Locke, Liddell & Sapp, LLP 600 Travis Street, Suite 3400 Houston, Texas 77002-3095 713-226-1144 713-223-3717 (fax) mtiras@lockeliddell.com
8. Property Tax Committee Council Liaison:	G. Walter McCool Brusniak Harrison & McCool, P.C. 17400 Dallas Parkway, Suite 112 Dallas, Texas 75287 972-250-6363 972-250-3599 (fax) mccool@txtax.com	Greg Dalton Of Counsel Cordray & Goodrich, P.C. 3306 Sul Ross Houston, Texas 77098 713-630-0600 713-630-0017 (fax) gdalton@cgpc-law.com

9. State Tax Committee

Council Liaison:
John Christian
512-495-8623
jchristian@velaw.com

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

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

10. Tax Controversy

Council Liaison:

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

Elizabeth A. Copeland
Oppenheimer, Blend, Harrison & Tate, Inc.
711 Navarro, Suite 600
San Antonio, Texas 78205-1796
210-224-2000
210-224-7540 (fax)
ecopeland@obht.com

11. Tax-Exempt Finance

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

Bob Griffo
Winstead Sechrest & Minick, PC
5400 Renaissance Tower
1201 Elm Street
Dallas, Texas 75270-2199
214-745-5400
214-745-5390 (fax)
bgriffo@winstead.com

James P. Plummer
Fulbright & Jaworski L.L.P.
300 Convent Street, Ste. 2200
San Antonio, Texas 78205-3792
210-224-5575
210-270-7205 (fax)
jplummer@fulbright.com

12. Tax-Exempt Organizations

Council Liaison:
Susan Burnette
806-372-5700
sburnete@whittenburglaw.com

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

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

13. Newsletter Editor

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

Tina R. Green
Patton, Haltom, Roberts,McWilliams, & Greer, LLP
Century Bank Plaza, Suite 400
2900 St. Michael Drive
P. O. Box 6128
Texarkana, TX 75505-6128
903-334-7000
903-334-7007 (fax)
tgreen@pattonhaltom.com

14. Website

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

Steven D. Erdahl
14026 Overlook Lane
Forney, Texas 75126
214-334-5229 (mobile)
stevenerdahl@aol.com

Board Advisors

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

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

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Return completed form to: R. David Wheat
1700 Pacific Avenue, Suite 3300
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