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THE CHAIR'S MESSAGE

This year, as in any presidential election year, we hear that we need to listen to the candidates, decide about the issues, and vote wisely. These are all, of course, simply specific examples of those rules we learned from our parents years ago:

1. Pay attention.
2. Make good decisions.
3. Try to make a difference.

Pretty good guidelines, in any context. As tax lawyers, they are rules we live by in our professional practice. They are also pretty good rules for weighing the benefits of actively participating in the State Bar Tax Section:

1. Pay attention. Tax law and the Tax Section are both changing. (Can we say "This is not your parents' Tax Section"?) From the Tax Section's most visible changes (the transformation of the Section's website at **www.texastaxsection.org** and the new newsletter format) to the less visible ones (our renewed emphasis on website and e-mail communication among Section members and on bringing younger members into the Section), the Tax Section officers, council members, committee chairs and co-chairs are working hard to ensure the value of Tax Section membership. As the tax law changes, the Section offers the opportunity to share insights, interpretations, and recommendations with respect to these changes.

2. Make good decisions. I'd ask you to think carefully about the benefits of participating in the Tax Section. In the sometimes desert-like competitive environment (Dare we say "unfriendly"?), the Tax Section offers an oasis of friendly communication among individuals who can share ideas – and ideals. It's an opportunity to form both professional contacts and personal friendships. Decide to participate. You and the Section will both benefit.

3. Try to make a difference. As tax professionals, we like to think that our judgment can change a deal or a lawsuit and make it better – and we're right. I'd like to think that most of us also harbor visions of Atticus Finch – and of making a difference beyond the scope of any particular deal, lawsuit or client. The Tax Section strives to make a difference – to the practice of Texas tax lawyers and to the legal profession. We need members from small and large cities, small and large firms, and solo practitioners. Each of us can make a difference – and the broader our base is, the more effective we are.

Your tasks for the day? First, fill out the Committee Selection form in this newsletter. The Committees are the core of the Section, and offer the best opportunity to meet and work with others who share your practice area interests and to become more involved in the Tax Section. Second, encourage at least one lawyer who does not already belong to the Section to join. Your tasks for the year? Commit to participate more actively, to share your thoughts with your fellow Committee and Section members, to check out the website – to make a difference.

The Chairs of the Tax Section who have preceded me for many years, and particularly my two immediate past Chairs, John Brusniak and Brent Clifton, have made a difference. Their hard work, dedication, and good ideas have made the Tax Section better. They've set an example for all of us.

Let's live up to their example in making the Tax Section a strong and valuable community of tax lawyers in Texas.

Cynthia M. Ohlenforst
Chair Section of Taxation,
State Bar of Texas

PROPERTY TAX LAW DEVELOPMENTS

John Brusniak, Jr. [1]

TEXAS SUPREME COURT

TAXPAYER WHO SETTLES VALUATION DISPUTE WITH TAXING AUTHORITIES AND PERFORMS CONTRACT FOR MANY YEARS MAY NOT LATER CLAIM VALUATION SCHEME WAS ILLEGAL.

Fort Worth Independent School District v. City of Fort Worth, 43 Tex.Sup.Ct. J. 742 (May 11, 2000).

In 1936, taxpayer/phone company was involved in protracted litigation with the city over the correct methodology to be used in valuing its easements which ran through the city. It settled this dispute and others, by agreeing to pay a portion of its gross receipts to the city "in lieu" of property taxes. It ceased making these payments in 1992 and claimed that these payments were illegal because they were not based on any recognized valuation methodology and because the appraisal district had replaced the city as the entity responsible for valuing property for taxation as of 1982. The Supreme Court disagreed with this analysis and ruled that the phone company could not challenge the illegality of the scheme since it had knowingly and voluntarily participated in the scheme for so many years. By doing so, it had waived its rights to contest the methodology. The court further ruled that "neither a taxing authority nor a taxpayer can circumvent the constitutional restrictions on, or requirements for, taxation merely by agreeing to settle a dispute. But by the same token, a fair settlement of a legitimate dispute that contemplates the market value of the property is not unconstitutional simply because it is not an appraisal and assessment done by standard procedure."

TEXAS COURTS OF APPEALS

BOOK VALUE OF INVENTORY MAY BE PROBATIVE OF MARKET VALUE.

Sears Roebuck and Co. v. Dallas Central Appraisal District, No. 05-99-00480-CV (Tex. App.–Dallas, August 9, 2000, no pet. h.) (to be published).

Taxpayer filed suit challenging valuation of inventory of merchandise. Appraisal district relied upon the book value of the inventory in its valuation process. The books were kept in accordance with generally accepted accounting techniques utilizing the lower of cost or market technique. Taxpayer claimed that inventory had to be appraised using appraisal techniques and that using accounting techniques was illegal. The court disagreed ruling that "book value of inventory may be probative of market value by either serving as some indication of market value or by being equivalent of market value...We decline Sear's invitation to hold that, as a matter of law, inventory book value derived according to generally accepted accounting principles is not equal to market value."

A TAXING UNIT IS ESTOPPED FROM CLAIMING JURISDICTION OVER A DELINQUENT TAX CASE IN DISTRICT COURT WHEN IT DID NOT DILIGENTLY PURSUE ITS CASE IN DISTRICT COURT AND SUBSEQUENTLY ENTERED INTO A SETTLEMENT AGREEMENT IN PROBATE COURT.

Phifer v. Nacogdoches County Central Appraisal District, No. 12-99-00262-CV (Tex. App.–Tyler, April 25, 2000, no pet. h.) (to be published).

Taxpayer died in 1973, and his wife was appointed administrator of his estate. No taxes were paid on the taxpayer's property thereafter. Taxing unit filed suit in district court in 1989. In 1994, following the rejection of its claim by the probate court, the taxing unit filed suit seeking to collect its taxes in the probate court. It entered into a settlement agreement in the probate court along with taxing units from five other counties agreeing to relinquish its statutory lien on the property in favor of a lien on sales proceeds from the sale of the entire estate. After the property sold, the taxing unit proceeded to obtain a judgment in the original district court proceeding for its taxes and foreclosure of its lien. The estate appealed this judgment. The court of appeals ruled that the normal rule granting jurisdiction over delinquent tax proceedings to the court in which the proceedings were first filed was waived by the taxing unit by its tardiness in pursuing that claim and by its subsequent voluntary, direct participation in the proceedings in the probate court.

SUBSIDIARY CORPORATION MAY NOT REPRESENT PARENT CORPORATION IN COURT WITHOUT A WRITTEN DESIGNATION OF AGENCY HAVING BEEN FILED WITH APPRAISAL DISTRICT; DESIGNATION OF SUBSIDIARY CORPORATION AS OWNER OF PROPERTY BY APPRAISAL DISTRICT ON ITS RECORDS DOES NOT CONFER JURISDICTION FOR PURPOSES OF SUIT; FAILURE BY TAXPAYER TO RAISE CLAIMS OF UNEQUAL APPRAISAL AT APPRAISAL REVIEW BOARD HEARING PROHIBITS RAISING SUCH CLAIMS IN COURT; STATUTE AUTHORIZING CORRECTION OF MISNOMER OF PARTIES DOES NOT CURE DEFECTS IN JUDGMENTS PRE-DATING THE STATUTE AND DOES NOT ALLOW FOR CORRECTION WHERE THE WRONG TAXPAYER HAS BEEN NAMED AS A PARTY TO A SUIT.

Torneau Houston, Inc. v. Harris County Appraisal District, No. 01-99-00550-CV (Tex. App.–Houston [1st Dist.] April 20, 2000, no pet. h.) (to be published).

Appraisal district, in its records and notices, showed subsidiary corporation to be owner of property. Taxpayer protested valuation of the property and subsequently filed suit in the name of the subsidiary, even though the property was owned by its parent corporation. Appraisal district sought and obtained a dismissal of the suit on the grounds that the suit had not been brought by the owner of the property. The court of appeals upheld the dismissal, ruling that the subsidiary corporation could not represent the parent corporation in these proceedings without having first filed a written designation of agency with the appraisal district. The fact that the appraisal district had erroneously designated the subsidiary as the owner of the property in its records did not cure this defect. Additionally, the subsidiary could not avail itself of the new statute authorizing belated corrections of misnomers because this suit was dismissed prior to the effective date of the new statute and more importantly, because the new statute did not authorize an amendment where an incorrect owner has been named, only the correc-

tion of technical errors in a taxpayer's name. Additionally, the court did not have jurisdiction over the taxpayer's claim for unequal appraisal because the taxpayer failed to raise this claim in its protest to the appraisal review board.

TAXPAYERS WHO FAILED TO RECORD THEIR DEED AT THE COURTHOUSE OR APPLY FOR A HOMESTEAD EXEMPTION WITH THE APPRAISAL DISTRICT COULD NOT LAWFULLY CONTEST THE RETROACTIVE REMOVAL OF THEIR HOMESTEAD EXEMPTION.

Dallas Central Appraisal District v. Brown, 19 S.W.3d 878 (Tex. App.–Dallas 2000, no pet. h.).

Taxpayers purchased a residence in 1992 and occupied it as their homestead. They failed to record their deed to the property in the deed records and to apply for a homestead exemption with the appraisal district. In 1997, the appraisal district learned that the prior owner was no longer occupying the property and removed the exemption which had been granted to the previous owner retroactively for five years. When the new owners subsequently applied for the exemption, the appraisal district granted them an exemption for the current tax year and the preceding tax year. It refused to grant the exemption for any other years. The court of appeals upheld the denial of exemption, ruling that the homestead exemption granted to the previous owners had terminated upon the sale of the property and that the appraisal district could not be held culpable for its failure to send a notice of appraised value to the new owners, as required by Section 25.19 of the Property Tax Code, when the new owners failed to record their deed at the courthouse.

TEXAS ATTORNEY GENERAL OPINIONS

ONCE A HOSPITAL DISTRICT HAS CONVERTED OPERATIONS FROM CHAPTER 282 OF THE HEALTH AND SAFETY CODE TO CHAPTER 286, IT HAS NO AUTHORITY TO HOLD AN ELECTION TO RAISE IT'S AD VALOREM TAX RATE.

Op. Tex. Att'y Gen. JC-0247 (2000).

A hospital district was created under the authority of Chapter 282 of the Health and Safety Code. That provision allows the commissioners court in a county with a population of 75,000 or less, with the approval of the voters, to create a hospital district. A provision in the code allows the voters to convert such a hospital district into a constitutionally authorized district. In such a conversion election, the voters are required to set the tax rate for the district. Subsequent to such an election, the hospital district wished to hold another election to raise its rate to the constitutionally authorized maximum rate. The attorney general ruled that the hospital district could not conduct such an election because there existed no constitutional or statutory authority for such an election. Once a tax rate is set in a conversion election, it will remain in force and may not be changed.

A MUNICIPAL TAX ABATEMENT GRANTED TO A TAXPAYER WHO IS SUBSEQUENTLY ELECTED TO THE CITY COUNCIL WHICH GRANTED THE ABATEMENT IS PROPORTIONATELY ABATED AS OF THE DATE ON WHICH THAT PERSON OFFICIALLY TAKES OFFICE.

Op. Tex. Att'y Gen. JC-0236 (2000).

A property owner, who had previously been granted a municipal tax abatement, was elected to the city council for the city which granted the abatement. The attorney general had previously ruled in JC-0155, that the election required the discontinuance of the abatement. In this opinion, the attorney general ruled that the abatement would need to be discontinued effective on the date on which the person actually took office, and it would need to be pro-rated for that tax year.

A HOSPITAL DISTRICT MAY CONTINUE TO LEVY AND COLLECT TAXES AFTER IT CEASES OPERATIONS AND LEASES THE FACILITIES TO A PRIVATE ENTITY PROVIDED THAT THIS IS IN THE BEST INTEREST OF THE CITIZENS; THE CLOSURE OF A HOSPITAL DOES NOT RELIEVE A HOSPITAL DISTRICT OF THE OBLIGATION OF PROVIDING SERVICES TO ITS NEEDY CITIZENS; THE DISTRICT MAY PROVIDE SERVICES TO NON-INDIGENT INDIVIDUALS PROVIDED IT CHARGES THOSE PERSONS FOR ITS SERVICES.

Op. Tex. Att'y Gen. JC-0220 (2000).

A county-wide hospital district could legally close its hospital and lease its facilities to a private entity which would continue to provide services to the indigent if this was in the best interest of the citizens of that county. The district could under those circumstances continue to levy and collect taxes. The closure of the hospital did not relieve the hospital district of its obligation to provide medical services to the needy citizens of the county. The district could provide services to non-indigent residents provided that those individuals were billed for the actual cost of the services.

END NOTE

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CURRENT DEVELOPMENTS IN ESTATE TAX

Michele Mobley [1]

1. The IRS issued final and temporary Regulations (T.D. 8890) defining the term "grantor" for purposes of applying the I.R.C. provisions dealing with trusts. Federal Register July 5, 2000.

The Regulations are effective July 5, 2000. The Regulations provide 9 examples of who is the grantor of a trust under given cirumstances. No substantive changes are made to the proposed and temporary Regulations issued August 10,1999.

2. The IRS issued final Regulations (T.D. 8886) on actuarial tables for valuing annuities, interests for life or terms of years, and remainder or reversionary interests under I.R.C. § 7520. Federal Register, June 12, 2000.

The Regulations revise certain tables used for valuing partial interests in property to reflect the most recent mortality experience available. The Regulations are effective June 12, 2000. There are no substantive changes from the temporary regulations that were issued April 30, 1999.

3. On April 4, 2000, the IRS issued proposed Regulations relating to the use of an individual's life to measure the term of a charitable lead trust. 65 Fed. Reg. 17835 (April 5, 2000).

The Regulations are intended to preclude the use of an unrelated individual's life as the measuring life for a charitable lead trust, where the unrelated individual is seriously ill, but not "terminally ill" within the meaning of the I.R.C. § 7520 Regulations.

4. Sale of a private foundation's interest in a limited partnership to a third party is not an act of self-dealing, assuming foundation's managers or other disqualified persons receive no benefit from the sale.

F.S.A. 200015007

Decedent died five days after a family limited partnership was formed between a revocable trust created by decedent and a limited liability company created by the two trustees (son and advisor of decedent) of the revocable trust. Prior to the death of the decedent, the trust assigned part of its interest in the limited partnership to a private foundation operated by decedent's family for more than 30 years. The application of the self-dealing provisions of I.R.C. § 4941 was relevant in valuing the decedent's interest in the limited partnership.

The IRS stated that the sale of the foundation's partnership interest at fair market value to a disqualified person would be an act of self-dealing under I.R.C. § 4941. Such a sale to a third party would not be an act of self-dealing, assuming the foundation's manager's or other disqualified persons did not benefit from the sale.

5. The Fifth Circuit held an estate, as an assignee of a decedent's interest in a general partnership, did not possess with any degree of legal certainty a right of liquidation either under Texas state law or under the partnership agreement.

Adams v. United States, ____ F.3d ____, 2000-2 USTC ¶ 60,379 (5th Cir. July 5, 2000)

The decedent owned a 25% interest in a general partnership. Under Texas state law a general partnership dissolves upon the death of a partner, unless the partnership agreement provides otherwise. The partnership agreement did not provide otherwise. The IRS issued a deficiency notice based on an assumption that the partnership would liquidate. The Fifth Circuit determined that no clear answer existed as to whether the holder of an assignee interest had the right to force liquidation under Texas law. Therefore, the estate was entitled to redetermination of the applicability of valuation discounts for lack of marketability, lack of control, uncertain rights, and ownership of an undesirable mix of assets.

6. The Tax Court ruled against the application of I.R.C. § 2704(b) to a California limited partnership.

Harper Estate, 79 TCM 2232, TC Memo. 2000-202.

I.R.C. 2704(b) states that certain applicable restrictions on liquidation will be disregarded for valuation purposes. The Court found that the partnership agreement was not more restrictive than California state law and thus I.R.C. § 2704(b) did not apply. This decision follows the Kerr decision, 113 TC ___, No 30, CCH Dec. 53,667 on the same topic that involved Texas state law.

7. The IRA participant was taxed on the entire withdrawal from an IRA made to carryout a community property division upon divorce.

Bunney v. Commissioner, 114 T.C. No. 17 (2000), T.C. No. 20713-97.

A 1992 divorce judgment in California ordered equal division between the spouses of a participant's IRAs that were funded with community property. To carry out the judgment, the participant withdrew from those accounts and transferred most of the amount withdrawn to his former spouse. The Tax Court determined that the participant is taxable on the entire amount withdrawn and also liable for the early distribution penalty for the entire amount withdrawn. The Tax Court cited I.R.C.§ 408(g) in finding that the former spouse is not taxable on the distributions. No portion of the amount paid to the former spouse is excludable from the participant's income under I.R.C. § 408(d)(6) since the participant did not transfer an interest in the IRAs, but rather transferred proceeds withdrawn from the IRAs.

8. The IRS determined an IRA beneficiary can use her own life expectancy to determine her payout, even though the decedent did not use the beneficiary's life expectancy to determine the decedent's payout.

PLR 200018057.

The decedent named his daughter as beneficiary of his IRA prior to his required beginning date. The decedent received his distributions based on his single life expectancy, redetermined annually. The decedent "chose to accelerate receipt of his lifetime distributions" by not recalculating based on his life expectancy and that of his daughter as the designated beneficiary. After the decedent's death, the daughter could receive distributions from the IRA based on her own life expectancy without violating the "at least as rapidly rule" of I.R.C. § 401(a)(9)(B)(i).

END NOTE

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SIGNIFICANT DEVELOPMENTS APPLICABLE TO TAX-EXEMPT ORGANIZATIONS

Brian W. Crozier[1]

The following is a summary of selected current developments in the law applicable to tax-exempt organizations, prepared by Brian W. Crozier, 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").

A. LITIGATION

1. *Bishop Estate*. The Estate of Bernice Pauahi Bishop (the "Bishop Estate") is a charitable organization operating a school for native Hawaiian children. Following media reports[2], an investigation by the Hawaii Attorney General's Office began in the mid-1990s into allegations of misconduct against the Bishop Estate's trustees. Subsequently, the IRS also commenced an audit, in the course of which it alleged numerous violations of the tax law (e.g., excessive compensation, private benefit, improper lobbying and political activities, etc.). In January 1999, the IRS sent the Bishop Estate draft notices of proposed adjustments, proposing revocation of its exempt status retroactive to mid-1989. The state probate court then acted to terminate the trust powers of the incumbent trustees and appointed interim trustees to handle the IRS audit.

   In the course of the continuing negotiations, the IRS advised the Bishop Estate that its exemption would be revoked unless certain organizational concerns were adequately addressed. In February of this year, the parties (with the interim trustees acting on behalf of the Bishop Estate and with the approval of the probate court and the Attorney General) entered into a closing agreement, among the terms and conditions of which were permanent removal of the incumbent trustees and a large payment in lieu of taxes. In addition, such closing agreement requires that it and all attachments be made available to the public at the Bishop Estate's offices and on its Web site (www.ksbe.edu).

2. *Ferguson v. Commissioner*.[3] This case involved a donation of appreciated stock at a time when there was an outstanding tender offer to acquire at least 85 percent of the corporation's stock for cash. This is an important case in that it may expand the circumstances in which the assignment of income doctrine can potentially be applied by the IRS against donors of property.

   A number of cases have arisen over the years addressing contributions of corporate stock followed shortly thereafter by a transaction (e.g., redemption, liquidation, merger, dividend, etc.) in which the charity receives cash. The basic issue is whether the charity is treated as receiving the stock prior to the transaction (in which event there is no tax to the donor), or instead as receiving the cash from the donor (in which event the donor is taxed).

   In *Ferguson*, the Ninth Circuit affirmed the Tax Court's holding that the gain on the appreciated stock was taxable to the donor under the assignment of income doctrine. The Tax Court first determined the date on which the donation to the charitable donees was complete. It then determined that the right to income "ripened" at an earlier date (i.e., the date on which over 50 percent of the stock was tendered). The Ninth Circuit upheld the Tax Court's finding on the rationale that the possibilities of the merger failing to occur in the particular factual situation after such date were remote and hypothetical.

3. *Branch Ministries, et al v. Commissioner*.[4] In this case, the D. C. Circuit Court upheld the IRS revocation of a church's federal tax exemption as a result of its blatant political activities in connection with the 1992 presidential election.

   Shortly before the election, the church ran full-page advertisements in USA Today and another widely circulated newspaper critical of one of the candidates. The ads also stated that they were sponsored by the church and solicited charitable contributions. In 1995, following discussions between the parties, the IRS revoked the church's exempt status for engaging in political activity. The church challenged the revocation, arguing that it was in violation of the constitutional rights to free speech and free exercise of religion and that the IRS had engaged in selective prosecution. In 1999, the U. S. District Court granted summary judgment for the IRS.[5]

   On appeal, the D. C. Circuit rejected the church's arguments. Regarding the First Amendment claims, the court concluded the church had failed to prove that its constitutional rights had been substantially burdened, noting that it may still qualify as a 501(c)(3) organization if it refrains from further political activity, will not necessarily be liable for taxes, and may reapply for recognition of tax exemption. Regarding the allegation of selective prosecution, the D. C. Circuit found that the church failed to prove its claim because it did not demonstrate that other churches engaged in similar political activity (*e.g.*, placement of ads in newspapers with nationwide circulations opposing a candidate and asking for tax-deductible contributions to defray the cost of the ads) without losing their exemptions.

4. *Redlands Surgical Services v. Commissioner*.[6] This is an important case in which the Tax Court upheld IRS denial of tax exemption for an organization whose sole activity was serving as a general partner in a surgical center limited partnership.

   The Court based its decision on the totality of the facts and circumstances. The opinion gives the following factors supporting the conclusion that the request for exemption was properly denied: (a) the lack of any obligation on the for-profit partners to

put charitable objectives ahead of non-charitable ones; (b) the applicants' lack of control over the partnership sufficient to ensure furtherance of charitable purposes; (c) a long-term management contract giving too much control and an incentive to maximize profits to a for-profit entity; and (d) important competitive advantages flowing to the for-profit partners.

Secondly, the Court found that the applicant could not be exempt as an integral part of its tax-exempt affiliated hospital or parent organization because its activities were not substantially related to the exempt purposes of either. The Court noted that "the integral part doctrine requires the organization in question to provide necessary and indispensable services solely to an exempt organization to which it bears some legal or significant operational relationship."

5. The Sta-Home Health Agency, Inc. Cases.[7] This line of cases may result in the first court challenge to IRS imposition of "intermediate sanctions" under Section 4958. At issue are several transactions in which operations undertaken by three nonprofit organizations were transferred to for-profit entities owned by a director of the organizations and several family members following a change in Mississippi law which allowed such conversions.

The IRS has taken the position that the transfers resulted in "excess benefits" flowing from the nonprofits to the for-profits and thus to the directors and owners of the for-profit entities. In this regard, the taxpayers argued that they acted properly in reliance on an outside accountant's assessment of the value (which was negative based on liabilities exceeding assets) at the time of the transactions. In a notice of deficiency dated August 12, 1999, the IRS assessed total penalties in excess of $40 million against one of the individual directors of this organization.

Among other things, this case demonstrates the leverage of the IRS under Section 4958. The $40 million penalty amount was the result of the 25 percent "first tier" tax and then the 200 percent "second tier" tax on an "uncorrected" violation being levied on each transaction.

B. LEGISLATION

1. Political Organization Reporting and Disclosure. Passed in June of 2000 by Congress and signed into law by the President on July 1, 2000, Pub. L. 106-230 amends Section 527 of the Code to impose three reporting and disclosure requirements on political organizations described in Section 527: (1) an initial notice of status, (2) periodic reports of contributions and expenditures, and (3) annual returns. On August 9, 2000,[8] a proposed revenue ruling was issued providing questions and answers relating to the new Section 527(i) reporting and disclosure requirements.[9]

Form 8871, "Political Organization Notice of Section 527 Status," is the required form such entities file to notify the IRS of their Section 527 status. For an organization already in existence on June 30, 2000, Form 8871 was required to be filed by July 31, 2000.[10] Organizations formed after June 30, 2000, must file within 24 hours after the date established. Form 8871 requires disclosure of the organization's name, address, and electronic mailing address; its purpose; the names and addresses of its officers, highly compensated employees, contact person, custodian of records, and members of its Board of Directors; and the name and address of, and relationship to, any related entities.

Three types of organizations subject to Section 527 are not required to file Form 8871:

a. Organizations that reasonably anticipate annual gross receipts will always be less than $25,000;

b. Political committees required to report under the Federal Election Campaign Act; and

c. Organizations described in Section 501(c) that are subject to Section 527(f)(1) because they have made an "exempt function" expenditure.[11]

Copies of Form 8871 that have been filed are currently available at the IRS Web site. In addition, the organization is required to make a copy of these materials available for public inspection during regular business hours at its office in the same manner as applications for exemption of Section 501(c) organizations are made available. Section 6104.

As required by Section 527(j), a political organization is now required to periodically report contributions to the organization and expenditures made by the organization. Form 8872, "Political Organization Report of Contributions and Expenditures," requires the listing of contributors of $200 or more annually and expenditures[12] of $500 or more annually. (There is an exception for expenditures made or contributions received pursuant to binding contracts entered into on or before July 1, 2000.)

Some organizations are not required to file Form 8872. The organizations excepted from the filing requirements are:

a. Organizations not required to file Form 8871;

b. Political committees of a state or local candidate; and

c. State and local committees of political parties.

Form 8872 is publicly available in the same manner as Form 8871.

As of the date this outline was submitted, the IRS is still in the process of determining which forms will be used as annual returns by Section 527 organizations.

2. Section 170(f)(10) Split Dollar Arrangements. Section 170(f)(10) was introduced as a revenue offset in the Tax Relief Extension Act of 1999, which was enacted as part of the Ticket to Work and Work Incentives Improvement Act of 1999. It clarifies that no deduction is available for charitable contribu-

tions used (directly or indirectly) to pay premiums on a "personal benefit contract" that benefits a donor or members of a donor's family. It also imposes an excise tax on charities that pay such premiums equal to the amount of the premiums and requires charities to report the payment of premiums.

Per the Senate Committee Report:[13]

The Committee is concerned about an abusive scheme referred to as charitable split-dollar life insurance . . . . Under this scheme, taxpayers typically transfer money to a charity, which the charity then uses to pay premiums for cash value life insurance on the transferor or another person. The beneficiaries under the life insurance contract typically include members of the transferor's family (either directly or through a family trust or family partnership). Having passed the money through a charity, the transferor claims a charitable contribution deduction . . . . If the transferor . . . paid the premium directly, the payment would not be deductible. Although the charity eventually may get some of the benefit under the life insurance contract, it does not have unfettered use of the transferred funds.

The Committee is concerned that this type of transaction represents an abuse of the charitable contribution deduction. The Committee is also concerned that the charity often gets relatively little benefit from this type of scheme, and serves merely as a conduit or accommodation party, which the Committee does not view as appropriate for an organization with tax-exempt status. In substance, the charity receives a transfer of a partial interest in an insurance policy, for which no charitable contribution deduction is allowed. While there is no basis under present law for allowing a charitable contribution deduction in these circumstances, the Committee intends that the provision stop the marketing of these transactions immediately.

C. REGULATIONS

1. Final Travel Tour Regulations. Final regulations were issued in February of 2000 (T.D. 8874) clarifying when the travel and tour activities of tax-exempt organizations are substantially related to the exempt purposes, or in the alternative when such activities may be subject to tax as an unrelated trade or business. Reg. § 1.513-7. In this regard, for-profit travel agents have been expressing concern for years about unfair competition from nonprofits.

   These regulations adopt the facts and circumstances approach, rather than enumerating any specific test to determine "relatedness" of travel tour activities to exempt purposes. Relevant facts and circumstances include, but are not limited to, how a travel tour is developed, promoted and operated. Reg. § 1.513-7(a). Under these regulations, the tax treatment for individual tours within an organization's travel tour program may differ.

2. Final Private Foundation Disclosure Regulations. Final private foundation disclosure regulations were issued and apply to returns due on or after March 13, 2000. Foundations subject to the new rules no longer have to publish the availability of their annual information returns on Form 990-PF in the newspaper, but will have to make them available for inspection and provide copies upon request under the same general rules now applicable to other exempt organizations. However, unlike other exempt organizations, a private foundation is required to disclose the names and addresses of its contributors.

3. Proposed Corporate Sponsorship Regulations. Prop. Treas. Reg. § 1.513-4 issued in March of 2000 provides guidance on the tax treatment of corporate sponsorship arrangements. These proposed regulations replace the regulations issued in proposed form in 1993 prior to enactment of Section 513(i) in 1997.

   Section 513(i) provides that "qualified sponsorship payments" are not taxed as unrelated business income. A qualified sponsorship payment is any payment made by a person engaged in a business where there is not an arrangement or expectation that such person will receive a substantial benefit in return (other than the use or acknowledgment of the name, logo or product lines of such person's business).

   The proposed regulations provide that a "substantial return benefit" is any benefit other than a use or acknowledgment of the sponsor's name or logo, or goods or services that have an insubstantial value[14] under existing IRS guidelines. Prop. Reg. § 1.513-4(c)(2)(i).

   The proposed regulations also provide that the right to be the exclusive sponsor of an activity is generally not a substantial return benefit. However, if the exempt organization agrees that competing products or services will not be sold, the proposed regulations provide that the sponsor has received a substantial return benefit. Prop. Reg. § 1.513-4(c)(2)(v)(B). The portion of the payment attributable to the "exclusive provider" arrangement will not be a "qualified sponsorship payment."

4. Proposed Accelerated Charitable Remainder Trust Regulations. In October of 1999, the IRS issued proposed regulations designed to prevent certain perceived abuses involving charitable remainder trusts.[15]

   The IRS concern here is with transactions in which an individual contributes highly appreciated assets to a charitable remainder trust, after which (instead of selling the assets) the trustee borrows money to make the required income payments. Because the trust has no current income, the taxpayer's objective under the current rules governing character of trust distributions is for the cash distribution to the income beneficiary to be treated as a non-taxable distribution of corpus.

   The proposed regulations address this abuse by modifying the tax treatment of distributions to the income beneficiary by creating a "deemed sale" rule. To the extent that an annuity or unitrust income distribution amount (a) is characterized in the hands of the recipient as trust corpus, and (b) was

made from an amount received by the trust that was neither a return of basis in any asset sold by the trust nor attributable to a contribution of money to the trust, the charitable remainder trust will in such event be treated as having sold a pro rata portion of trust assets.

5. Proposed Charitable Lead Trust Regulations. On April 4, 2000, proposed regulations were issued that are designed to address certain abuses involving charitable lead trusts. These proposed regulations limit the life that may be used for calculating the charitable term interest to the donor, the donor's spouse, or a lineal ancestor of all of the remaindermen. (See Prop. Regs. §§ 1.170A-6(c)(2), 20.2055-2, and 25.2522(c)-3.) The IRS is pursuing these proposed regulations to thwart publicized schemes in which an unrelated, seriously ill person is used as the measuring life for a donor's charitable lead trust.

D. IRS RULINGS, NOTICES, PROPOSED LEGISLATION, ETC.

1. LTR 199943047. This private letter ruling under the Section 4941 "self-dealing" rules involved a situation in which the residue of an individual's estate (including a number of businesses) was left to a private foundation, with the idea being that the estate would sell the businesses and distribute the cash to the foundation.

The ruling holds that the estate's sale to a former board member of the foundation who resigned just prior to the sale will not constitute self-dealing even though the facts indicate that such person was involved extensively in planning for the sale prior to his resignation. The IRS looked carefully at the particular facts (open bidding, outside advisors, etc.) in concluding that the former foundation manager could not exercise undue influence over the transaction.

This is a much more liberal interpretation of the self-dealing rules than the IRS previously presented in a 1976 revenue ruling in which the relevant facts were that the former foundation manager resigned five years prior to the transaction at issue and did not participate in planning such transaction while a foundation manager.[16]

2. Affinity Card Revenues. After losing several times on the issue, the IRS announced that it will not continue litigating affinity card cases that do not clearly point to unrelated business income being earned by the exempt organization. This announcement was made shortly after the release of the 9th Circuit's opinion for the taxpayers in the *Oregon State University Alumni Association, Inc. v. Commissioner* (193 F3d. 1098, 1999) in a memorandum signed by an official in the IRS EO Division's National Office (2000 TNT 46-4).

After noting that courts have repeatedly ruled that the income an exempt organization receives from affinity credit card arrangements is not subject to the unrelated business income tax, the memo states as follows:

> While we believe that in certain cases the income represents a payment for services provided by the exempt organizations, and the use of intangible property (the organization's name and membership), it is now clear that courts will continue to find the income to be excluded royalty income unless the factual record clearly reflects more than unsubstantial services being provided. Thus, further litigation in cases with facts similar to those decided in favor of the taxpayer should not be pursued. Accordingly, the suspense on these cases is being lifted as of the date of this memorandum and districts should close the cases.

3. Internet Activities. The IRS addressed Internet issues in both its 1999 and 2000 Exempt Organizations CPE texts. Although there is little yet in the way of existing precedent or formal guidance, the IRS position is that using the Internet to carry out an activity does not change the way the existing tax laws apply to that activity. As stated in 2000 Exempt Organizations CPE Text (p. 119):

> . . . the use of the Internet to accomplish a particular task does not change the way the tax laws apply to that task. Advertising is still advertising and fundraising is still fundraising. However, the nature of the Internet does change the way in which these tasks are accomplished.[17]

Because Internet activities by exempt organizations raise a number of potential issues and clearly are the subject of current IRS interest, additional developments in this area should be expected. Recent public statements by IRS officials anticipate that a request for public comments on Internet issues will be issued shortly.

4. Joint Committee Study. On January 28, 2000, the Joint Committee on Taxation released a study concerning disclosure of federal tax returns and return information with respect to tax-exempt organizations. The JCT Study made a number of recommendations, including the following:

a. The results of audits and closing agreements should be disclosed in unredacted form.

b. Expand the scope of Section 6104 to require the disclosure of all Forms 990-T and returns filed by "affiliated organizations."

c. Require the disclosure, and publication by the IRS, of World Wide Web site addresses.

d. Require annual notification to the IRS by organizations (other than churches) with revenues below the current filing threshold.

e. Disclose audit and examination information to state attorneys general and other non-tax officials with appropriate jurisdictional needs prior to the completion of the audit and when the IRS determines that the disclosure may facilitate resolution of the case.

f. Require public charities to provide a description of their lobbying activities on Schedule A

to Form 990 and to disclose expenditures for self-defense lobbying and non-partisan study, analysis and research that includes a limited "call to action."

5. Proposed Legislation Regarding Donor-Advised Funds. The President's budget submission to Congress for the fiscal year 2001 contained a recommendation that legislation be introduced setting standards for the administration of "donor-advised" funds.

   The Administration's explanation noted the increasing trend in the use of donor-advised funds, pointing out that for-profit financial institutions are now offering such funds to the public. The explanation also noted the absence of any minimum payout requirement and the lack of clear guidelines governing the operation of donor-advised funds. The concern is expressed that donors are being given the benefits normally associated with private foundations without the corresponding regulatory safeguards. The stated objective is "the continued growth of donor-advised funds by providing clear rules that are easy to administer, while minimizing the potential for misuse of donor-advised funds to benefit donors and advisors."

END NOTES

1. Brorby & Crozier, P.C., Attorneys at Law, 111 Congress Ave., Ste. 2250, Austin, Texas 78701
2. The Web site of the *Honolulu Star-Bulletin* (http://www.starbulletin.com) contains an archive of many articles covering the Bishop Estate situation.
3. 174 F.3d 997 (CA-9, 1999).
4. 2000 TNT 95-17 (D.C. Circuit, released May 12, 2000).
5. 40 F. Supp. 2d 15.
6. 113 T.C No.3 (July 19, 1999).
7. Stokeld, "IRS Imposes Intermediate Sanctions in Dispute Over Valuation," Exempt Organization Tax Review, Vol. 27, No.1, January 2000, p.28 (this article contains a listing of the Tax Court docket numbers for the eleven pending cases).
8. Because the new law was effective upon enactment, this proposed revenue ruling may be relied on by the affected organizations until the revenue ruling is finalized and issued.
9. 2000 TNT 155-3 (August 10, 2000).
10. IRS Notice 2000-36, I.R.S. 2000-33.
11. Under Section 527(e)(2), "exempt function" means influencing or attempting to influence the selection, nomination, election, or appointment of any individual to any federal, state, or local public office or office in a political organization, or the election of Presidential or Vice-Presidential electors.
12. However, organizations are not required to report "independent expenditures" as defined in Section 301 of FECA.
13. Reproduced in "Blue Book" containing General Explanation of Tax Legislation Enacted in 1999, at p.228.
14. Benefits have an insubstantial value only if the fair market value is not more than 2 percent of the payment or $74 (adjusted for inflation), whichever is less.
15. Prop. Reg. § 1.643-a(8).
16. Revenue Ruling 76-448.
17. The article (entitled "Tax Exempt Organizations and World Wide Web Fundraising and Advertising on the Internet") containing this quote covers current Internet fundraising practices and the IRS view as to their tax implications for charities and donors, as well as advertising and merchandising techniques and the IRS view as to their treatment under the unrelated business income provisions of the Code.

INTERNATIONAL TAX LAW

Carol L. Peters[1]

1. CASES

1.1. A U.S. consultant was held not to be carrying on business through a fixed base in Canada even though the consultant had substantial activity and a lengthy stay in Canada.

Dudney v. The Queen, 2000 Fed. Ct. App. 50 (Feb. 24, 2000) (Canada).

The Canadian Customs and Revenue Agency asserted jurisdiction to tax the income of a consultant who provided services to a client at the client's premises in Canada for more than a year. Canada claimed that this created a fixed base in Canada. The consultant did provide the services for a substantial period to the client at the client's offices in Canada. He had, however, 1) no freedom to use the facility except during normal business hours, 2) no ability to do work for other clients at the facility, 3) no exclusive space in the building and 4) no identification of himself or his business on the premises. Held: the consultant had no fixed base that would justify the imposition of Canadian income tax because 1) the consultant had no control over the premises and 2) the premises were not objectively identified with the consultant's business.

1.2. Foreign Sales Corporations are an illegal export subsidy and the FSC program must be discontinued by October 1, 2000.

WORLD TRADE ORGANIZATION, Appellate Decision WT/DS 108/1 (February 2000). Information on the WTO decision can be found at its web site at http://www.wto.org.

The World Trade Organization Appellate Body confirmed the WTO Panel Report from October 1999 concluding that the FSC program is an illegal subsidy to U.S. exporters under the WTO Agreements. The U.S. has until October 1, 2000 to discontinue or acceptably modify the FSC program or it will face trade sanctions. The U.S.

Treasury proposed changes to the FSC regime in early May, but the European Union believed the changes were insufficient.

The U.S. has on July 27, 2000 taken a further step in rectifying the FSC issue. On that date the U.S. House Ways & Means Committee ordered favorably reported the "FSC Repeal and Extraterritorial Income Exclusion Act of 2000" (H.R. 4986). This Act would repeal the FSC and put in place changes that would impact U.S. exporters and certain foreign producers of goods. The Act was passed by the House on September 13.

2. REGULATIONS

2.1. Proposed regulations on mergers involving disregarded entities issued.

Prop. Treas. Regs. § 1.368-2, 65 Fed. Reg. 31115, 23 I.R.B. 1226.

The proposed regulations provide that a merger of a tax disregarded entity into a corporation will not qualify as a section 368(a)(1)(A) tax-free reorganization. This transaction will, instead, be treated as the transfer of the assets of the disregarded entity by the owner of that entity to the acquiring corporation. The preamble to the regulations confirms that this transaction may still qualify as a tax-free transfer under section 351 or sections 368(a)(1)(C), (D) or (F).

A merger of a corporation into a tax disregarded entity will be treated as though the owner of the disregarded entity acquired all the target corporation's assets. This transaction will also not qualify as a section 368(a)(1)(A) tax-free reorganization because the owner of the disregarded entity is not a party to the state or federal law merger. This transaction can qualify as tax free under other IRC provisions under the right facts.

2.2. Final section 367(b) regulations issued to apply to exchanges on or after February 23, 2000.

Treas. Regs. §1.376(b)-1, 6 I.R.B. 466.

These regulations principally adopt the 1991 proposed regulations.

2.3. Final regulations issued on application of tax treaties to U.S. source dividends, interest, royalties and other investment income earned by foreign persons through a fiscally transparent entity.

Treas. Regs. § 1.894-1, 65 Fed. Reg. 40993, T.D. 8889 (July 3, 2000).

The final regulations apply to payments on or after June 30, 2000 and address whether the law of an entity, an entity holder or both applies in determining "fiscal transparency". The regulations also address other tax treaty issues resulting from the use of entities that are classified as pass through entities for U.S. tax purposes, but not for foreign tax purposes and vice versa.

2.4. Corrections issued to Section 367(e) regulations to remove controversial basis step-down provisions.

Treas. Regs. §§ 1.367(e)-1, -2, T.D. 8834, 65 Fed. Reg. 11467.

On March 3, 2000, the IRS and Treasury removed the basis step-down provision which required a foreign distributee to take a basis in the distributed assets no greater than fair market value, even if a built-in loss in the assets was not recognized. The corrections are effective as of the effective date of the original version of the regulations (August 9, 1999).

The regulations did not address the controversial anti-abuse rule which would deny nonrecognition treatment in a foreign to foreign check the box or actual liquidation. However, in PLR 200015006, the Service ruled that no gain or loss would be recognized on three different foreign to foreign check the box liquidations without addressing the broad anti-abuse rule.

3. IRS PRONOUNCEMENTS

3.1. A single member LLC that is treated as a pass-through entity cannot be certified as a U.S. resident for income tax treaty purposes.

Ltr. Rul. 200019042.

Technical assistance sufficiently described in heading.

3.2. The IRS revoked Ltr. Rul. 9133034 which allowed a taxpayer to retroactively apply the fair market value method of interest expense apportionment via amended returns.

Ltr. Rul. 200004043.

Letter ruling sufficiently described in heading.

3.3. New procedures for CFCs to automatically revoke a one-month deferral election to conform the CFC's tax year to the tax year of its majority U.S. shareholder.

Rev. Proc. 2000-11, 3 I.R.B. 309.

Revenue procedure sufficiently described in heading.

3.4. Service issued guidance on qualified intermediary withholding agreements and the requirements for application.

Rev. Proc. 2000-12, 4 I.R.B. 387.

Revenue procedure sufficiently described in heading.

3.5. Service announces that the self-regulation system for qualified intermediary withholding agents is only appropriate in certain cases.

Ann. 2000-48, 23 I.R.B. 1243.

The IRS is hesitant to allow financial institutions in jurisdictions that are tax havens or bank secrecy jurisdictions apply for a qualified intermediary with-

holding agreement. The IRS will impose increased or more rigorous audit requirements or stricter enforcement standard to businesses in these jurisdictions. The IRS will begin making determinations of which jurisdictions meet these criteria immediately.

4. MISCELLANEOUS

4.1. The OECD issued a draft proposal discussing e-commerce treaty issues on March 24, 2000.

The report and group's reasoning can be obtained on the OECD's web page at http://www.oecd.org//daf/fa/treaties/tcofecom.pdf.

The Technical Advisory Group discussing this issue consists of representatives of ten countries, including the U.S. The proposal identifies 26 common factual situations involving e-commerce and discusses the character of the revenue that would arise in each case. The TAG representatives do not have unanimity in their positions for every scenario and will continue to discuss their differences over the coming months.

4.2. In November of 1999, the OECD issued guidelines for advance pricing agreements.

These guidelines may be found at the OECD web side at http://www.oecd.org.

The guidelines are essentially consistent with the APA programs that have been adopted by member countries and will provide some stimulus for additional countries to adopt APA programs.

END NOTE

1. Strategic Planning Division, Tax Department, Exxon Mobil Corporation, 5959 Las Colinas Boulevard, Irving, Texas 75309; 972-444-1614, 972-444-1645 (fax); clpeter@erenj.com.

STATE TAX UPDATE

Steven D. Moore[1]

Sales Tax

In *Fleming Foods of Texas, Inc. v. Carole Keeton Rylander et al*, 6 S.W.3d 278 (Tex. 1999), the Texas Supreme Court held that pursuant to Section 111.104 of the Texas Tax Code a taxpayer who pays tax to a vendor, rather than directly to the State may request a refund from the State without having to first obtain an assignment from the vendor who collected and remitted the tax. The issue is important and common because the vendor who collects the tax will often not have the same statute of limitations as the purchaser. The differences are often caused by audits, administrative appeals, or extension agreements. Section 111.104 of the Texas Tax Code states that "a tax refund claim may be filed with the comptroller by the person who paid the tax [in this case Fleming Foods]."[2] Despite this language, the Comptroller argued that the current Section 111.104 was a recodification of prior law that expressly prevented refund claims by anyone except those that paid taxes "directly to the state."[3] When it enacted Section 111.104, the Texas Legislature stated the "Act was intended as a recodification only, and that no substantive change in law [was] intended."[4] The Texas Supreme Court's opinion holds that the unambiguous language of the current statute controls over the prior statute, despite the legislative history; otherwise, "people of this State could not rely on the letter of the law . . . [and] Citizens, lawyers who represent them, judges and members of the Legislature would be required to research the law that preceded every codification."[5]

In *Carole Keeton Rylander, et al, v. Bandag Licensing Corp.*, 2000 WL 564178, (Tex. App.–Austin 2000), the Texas Comptroller appealed a trial court decision declaring the State of Texas did not have jurisdiction to tax an Iowa corporation. The corporation's only substantial contact with Texas was a certificate of authority to transact business in the State. The corporation had no tangible property or payroll in the State, but it did license certain intangible assets for use in Texas. The Austin Court of Appeals ruled that the Iowa corporation's passive holding of a license to do business, without any other physical presence, did not establish nexus for the Texas franchise tax. The Court of Appeals ruled, on procedural grounds, that the receipt of royalty payments from intellectual property used in Texas did not establish nexus in this case. Importantly, the Austin Court of Appeals upheld the trial court's award of attorneys fees to the Iowa corporation under the Uniform Declaratory Judgments Act.

In *Haber Fabrics Corp. v. Carole Keeton Rylander, et al*, 13 S.W.3d 845 (Tex. App. - - Austin, *no writ*) the Comptroller unsuccessfully appealed a trial court decision holding a taxpayer's activities constituted "processing," thereby allowing the taxpayer to qualify to make exempt purchases of electricity as a manufacturer. *Haber's* activities included buying manufacturers' fabric bolt seconds; sorting and drying them when wet; physically inspecting the large bolts for defects; physically cutting out defective portions of the bolts; and selling the remaining, smaller, "first quality" pieces to retailers such as Walmart. The Trial Court judge had reasoned that Haber Fabrics "took an unmarketable product and turned it into something marketable."[6] The Trial Court judge also found that Haber Fabrics did not alter an already completed product merely "to fit the needs of the ultimate user,"[7] thereby distinguishing the case from *Calvert v. Julian Gold, Inc.*, 479 S.W.2d 328 (Tex. Civ. App.-- 1972, *writ ref'd n.r.e.*); and *Delta Pipe Fabricators v. Bullock*, 638 S.W.2d 652 (Tex. App.--Austin 1982, *writ ref'd n.r.e.*).

In *Residential Information Services v. Carole Keeton Rylander, et. al*, 988 S.W.2d 467 (Tex. App.--Austin 1999, *writ denied*), the Austin Court of Appeals upheld a trial court determination that a lease termination fee was subject to sales tax as part of the consideration paid for a lease of tangible personal property. The taxpayer leased computer equipment from IBM Credit Corporation and made lease payments for several years, but then negotiated an early termination of the lease, which required the taxpayer to pay IBM Credit Corporation $11,641,441 as an early termination fee. The taxpayer paid sales tax on the termination fee and subsequently filed the suit to obtain a refund. The taxpayer argued that the termination payment was not for the lease of tangible personal property, but was solely for the "intangible

benefit of extinguishing its future contractual obligations."[8] The Austin Court of Appeals found that the sales tax applied to the total consideration for the lease, and gave deference to a Texas Comptroller Rule stating that "a charge imposed for the early termination of a lease" is taxable.[9] The Austin Court of Appeals reasoned that the early termination payment was not for an intangible right, but instead represented the increased rental amount that would have been charged if the parties had initially entered into a shorter lease.

In *Rylander v. Associated Technics Co.*, Inc., 987 S.W.2d 947 (Tex. App.--Austin 1999, *no writ*), the Austin Court of Appeals agreed with the taxpayer and ruled that asbestos abatement services--including the removal of asbestos from a building--are exempt from sales tax. The Comptroller agreed that once dislodged from the real estate, the disposal of asbestos was exempt from tax as provided in Section 151.0048 (a)(3) of the Texas Tax Code, but the Comptroller argued that the separation of the asbestos from the real estate structure was taxable "real property repair and remodeling" under Section 151.0047 of the Tax Code.[10] The Court was influenced by the fact asbestos abatement is not two discrete activities, as argued by the Comptroller, and by the probability that the Comptroller's narrow interpretation would deter the legislative purpose of encouraging asbestos abatement.

Franchise Tax

In *Nabisco, Inc. v. Rylander*, 992 S.W.2d 678, (Tex. App.--Austin 1999, *writ denied*), the Austin Court of Appeals upheld a trial court judgment against the taxpayer. Nabisco argued that food sales made to Texas buyers should be deleted from the Texas franchise tax apportionment numerator despite the fact that such items were stored and finally delivered from Nabisco's Texas warehouses. The Texas Tax Code excludes sales of "food that is exempted from the [Texas sales tax]" from the franchise tax apportionment numerator "if the items are shipped from outside this state . . ."[11] Nabisco shipped food from outside the state to Texas warehouses where it awaited final delivery. The Comptroller's Rule 3.549(e)(20)[12] provides that the exclusion "does not apply when the manufacturer ships the items from outside Texas to an outlet or storage facility in Texas and later sells them." Nabisco argued that legislative history behind the Tax Code supported excluding all exempt food sales from the franchise tax apportionment numerator and that the timing of its sales prior to delivery into Texas made Section 171.104 of the Tax Code ambiguous. The Austin Court of Appeals agreed that Section 171.104 of the Tax Code was ambiguous with respect to the timing of sales, but nevertheless found that the Comptroller's Rule was a reasonable interpretation of the ambiguous statute.

In *Rylander v. 3 Beall Bros. 3, Inc.*, 2 S.W. 3d 562 (Tex. App.--Austin 1999, *writ denied*), the Austin Court of Appeals reversed the trial court's summary judgment in favor of the taxpayer. The taxpayer's case was that the so-called "additional tax"[13] imposed in the year a Texas taxpayer ceases to be subject to the earned surplus component of the Texas franchise tax was unconstitutional as to fiscal year taxpayers, because calendar year taxpayers, by definition, pay the additional tax over a shorter period of time when they withdraw from doing business in Texas. The Austin Court of Appeals, however, found that the "additional tax" looked back to cover only the period of previously untaxed earned surplus, and therefore, was reasonably related to the State's revenue purposes and was not in violation of the U.S. or Texas Constitution.

Administrative Policies

Comptroller Rylander reviewed the scope of the sales tax exemption for medical supplies and broadened policy statements to include: (i) wound care dressings and certain skin closure supplies when dispensed under an oral or written prescription of a licensed physician; and (ii) IV systems when used to administer fluids, electrolytes, blood and blood products, and drugs to patients.[14]

END NOTE

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

2. Tex. Tax Code Ann. § 111.104 (a) (Vernon Supp. 2000).

3. Act of Apr. 5, 1979, 66th Leg., R.S., ch. 59, § 1, art. 1.11A(1), 1979 Tex.Gen. Laws 96, 96.

4. Act of May 29, 1981, 67th Leg., R.S., ch. 389, § 40, 1981 Tex. Gen. Laws 1490, 1787.

5. *Fleming Foods*, 1999 WL 374119 at p.5.

6. *See* Haber Fabrics Trial Court Findings of Fact and Conclusions of Law; Conclusion of Law No. 5.

7. *See* Haber Fabrics Trial Court Findings of Fact and Conclusions of Laws; Conclusion of Law No. 3.

8. *Residential Information Services*, 988 S.W.2d at 469.

9. 34 T.A.C. § 3.294(d) (1998).

10. Tex. Tax Code Ann. §§ 151.0048 & 151.0047 (Vernon Supp. 2000).

11. Tex. Tax Code Ann. § 171.104 (1) (Vernon 1992).

12. 34 T.A.C. § 3.459(e)(20) (West 1999).

13. Tex Tax Code Ann. § 171.011 (West 1992).

14. *Tax Policy News*, July 1999, p.4 (published by the Texas Comptroller of Public Accounts).

LEGISLATIVE UPDATE: TEXAS STATE AND LOCAL TAXES (PART TWO)

John D. Christian[1]

The Comptroller's publication number 96-687, "Legislative Update" (December 1999) summarizes legislation passed during the 1999 session that affects state and local taxes. The first part of the legislative update, relating to franchise and sales/use taxes, was reprinted by permission in the May 2000 issue of *Texas Tax Lawyer*. This is the second part, relating to the other taxes and fees administered by the Comptroller, and to the general powers and duties of the agency.

ALL TAXES ADMINISTERED BY THE COMPTROLLER

House Bill 3211
Rules on Acceptance of Charge Cards and Debit Cards
Effective—September 1, 1999

House Bill 3211 amends Section 403.023, Government Code, which previously authorized the Comptroller to adopt rules concerning the acceptance of credit cards for the payment of fees, taxes, and other charges assessed by state agencies. The amendment allows the Comptroller to also adopt rules concerning the acceptance of charge cards and debit cards for such payments.

Written Approval
Effective—October 1, 1999

This bill also authorizes the Comptroller to establish procedures to ensure that an attorney, accountant, or other representative who files a document on behalf of a taxpayer is entitled to take that action. This can be done by filing a written authorization of for the taxpayer in whose name or on whose behalf the document is submitted. An officer, director, or other employee of the taxpayer whose duties include administering the taxpayer's responsibilities may sign the authorization. This will clarify procedures for both the state and tax practitioners and will help ensure that confidential information and access to taxpayer accounts is not available to unauthorized persons.

Senate Bill 1321
Interest on Delinquent Taxes
Effective—January 1, 2000

This bill changes the interest rate charged on delinquent taxes for report periods originally due after December 31, 1999 to a variable interest rate. The 12 percent yearly interest rate continues to apply to delinquent taxes for report periods originally due on or before December 31, 1999. The variable rate is the prime rate plus one percent as published in the Wall Street Journal on the first day of each calendar year that is not a Saturday, Sunday, or legal holiday. This interest rate applies to delinquent taxes imposed under Title 2 of the Tax Code and begins accruing 60 days after the due date.

There are several exceptions: A purchaser of a motor vehicle who fails to pay the motor vehicle sales or use taxes by the due date owes penalty but no interest. Interest on inheritance tax begins to accrue on the original due date of the taxes, unless the due date is extended. Interest on delinquent fuel taxes paid under the International Fuels Tax Agreement (IFTA) will continue to accrue at a rate of 12 percent per year.

Interest on Refunds
Effective—January 1, 2000

The bill also authorizes the Comptroller to pay the same variable interest rate on refunds of amounts erroneously paid for report periods due on or after January 1, 2000. The interest begins to accrue 60 days after the date of payment or the due date of the tax report, whichever is later. Interest does not accrue on a credit taken on a taxpayer's return, nor does it accrue on a refund for a report period due before January 1, 2000. Fuels taxes paid under the International Fuels Tax Agreement (IFTA) and amounts paid under Title 6, Property Code, (unclaimed property) do not earn interest.

Settlement Authority
Effective—August 30, 1999

The bill amends Sections 111.101 and 111.102 to allow the Comptroller to settle a claim for a tax, penalty, or interest if the Comptroller conclusively determines that the total costs of collecting the total amount due would exceed the amount due or that the total costs of defending a denial of the claim would exceed the amount claimed.

Prior to this amendment, the Comptroller was authorized to settle taxes before a petition for redetermination was filed if the amount of tax due was $300 or less and as part of redetermination order if the tax due was not more than $1,000. In both cases, the cost of collection had to exceed the amount of tax due.

BOAT AND BOAT MOTOR SALES AND USE TAX

House Bill 579
Boat Tax Paid by Purchaser
Effective—September 1, 1999

Under this bill, if a purchaser paid to a dealer the sales tax imposed on the purchase of a boat or boat motor and the dealer failed to remit the tax to the state, the dealer rather than the purchaser will be held liable for the tax. However, the purchaser must provide documentation (a sales contract, bill of sale, or purchase receipt) proving that the tax was paid to the dealer.

CIGARETTE AND TOBACCO PRODUCTS TAXES

House Bill 3211
Reporting and Notification Changes
Effective—October 1, 1999

This bill changes the due date for the Texas Distributor Monthly Report of Cigarettes and Tax Stamps, the Texas Distributor Monthly Report of Cigars and Tobacco Products, and the Texas Manufacturer Monthly Report of Cigars and Tobacco Products to the last day of each month following the report period. The bill provides that a taxpayer must file a written request for redetermination not later than the 30th day after the date a notice of deficiency is issued, rather than the 15th working day after it is received. The bill also allows the Comptroller to notify taxpayers of permit suspensions or revocations, deficiency determinations, and redetermination hearings by personal service or regular mail rather than certified mail.

House Bill 3600
Importing and Transporting Cigarettes into Texas
Effective—September 1, 1999

A person who imports and personally transports 200 or fewer cigarettes into this state from a foreign country must pay the cigarette tax and have a tax stamp affixed to each individual package of cigarettes. A person who imports and personally transports 200 or fewer cigarettes into this state from another state is still not required to pay the cigarette tax if the person uses the cigarettes and does not sell them or offer them for sale.

Senate Bill 15
Prohibited Sales of Cigarettes
Effective—September 1, 1999

The bill removes an offense under Section 154.504 from the list of Class A misdemeanors. Section 154.504 provides that a person commits an offense and is subject to a $100 fine if the person sells cigarettes in quantities less than an individual package containing at least 20 cigarettes.

Senate Bill 16
Tobacco Compliance Grant Program
Effective—September 1, 1999

This bill allows the Comptroller to work with other local law enforcement agencies, in addition to county sheriffs and municipal police departments, to enforce restrictions on the sale of tobacco products to persons under 18 years of age. The bill also expands the tobacco compliance grant program to include all local law enforcement agencies. Effective September 1, 1999, county constables and school-based police departments, in addition to county sheriffs and municipal police departments, may apply for tobacco compliance block grants awarded by the Comptroller to be used in enforcing the restrictions on the sale of tobacco products.

Senate Bill 17
An Opportunity for a Hearing
Effective—September 1, 1999

Starting September 1, 1999, a notice and an opportunity for a hearing are required before the Comptroller may take disciplinary action against a cigarette permit holder and/or a cigars and tobacco products permit holder for tobacco compliance violations. Prior to this change in the law, a notice and a hearing were required before the Comptroller could take disciplinary action against a permit holder for tobacco compliance violations.

Senate Bill 451
Direct Access to Tobacco Products
Effective—September 1, 1999

To make it more difficult for persons under 18 years of age to purchase cigarettes and tobacco products, the Health and Safety Code prohibits most retailers from giving their customers direct access to such products and to vending machines containing such products. The law lists several exceptions to this rule, and this bill adds an exception for package stores. As a result, customers on the premises of a business licensed as a package store under the Texas Alcoholic Beverage Code may have direct access to cigarettes and tobacco products and to vending machines containing cigarettes and tobacco products.

Senate Bill 1122
"Grey Market" or "Repatriated" Cigarettes
Effective—September 1, 1999

It is illegal to place Texas cigarette tax stamps on packages of cigarettes that are labeled "For Export Only," "U.S. Tax Exempt," "For Use Outside U.S.," or that have any other wording indicating that the manufacturer did not intend to sell the cigarettes in the United States. In addition, cigarette tax stamps may not be affixed to cigarette packages that are imported into the U.S. after January 1, 2000, in violation of 26 U.S.C. Section 5754. Packages of cigarettes must comply with the Cigarette Labeling and Advertising Act concerning labels, warnings, and other information placed on a package of cigarettes to be sold within the United States. The package labeling must not violate federal trademark or copyright laws. Also, effective September 1, 1999, selling improperly labeled cigarettes in Texas, whether stamped or unstamped, is a deceptive trade practice.

FUELS TAXES

House Bill 3159
Tax Exemption and New Fee For Commercial Passenger Vehicles Operating On Fixed Routes
Effective—September 1, 1999

The law was amended to exempt diesel fuel used exclusively by commercial motor vehicles to transport passengers for compensation or hire between points in Texas on fixed or scheduled routes. To qualify for the tax exemption, the commercial motor vehicle must have a registered gross weight of more than 26,000 pounds or be designed to transport more than fifteen passengers, including the driver. This exemption does not apply to diesel fuel sold to a political subdivision. Persons using diesel fuel that qualifies for this exemption will be assessed a new school fund benefit fee of $0.04875 per gallon, which will be credited to the available school fund.

An entity that qualifies for the exemption must pay the motor fuel tax to its supplier on all purchases of diesel fuel, then file a claim for refund with the Comptroller in the calendar month following the month in which the diesel fuel is used while traveling fixed or scheduled routes in this state.

Persons using diesel fuel that qualifies for this exemption will be assessed a new school fund benefit of $0.04875 per gallon, which will be credited to the Available School Fund. The amount of school fund benefit fee due for each monthly reporting period will be paid from the proceeds of an entity's monthly claim for refund of motor fuel taxes.

Senate Bill 329
Odd-Numbered Years
Effective—September 1, 2001

Permitted gasoline distributors and diesel fuel suppliers will no longer be required to make an early prepayment for the motor fuel taxes due in August of odd-numbered years. The estimated prepayment is still due in August of 1999 and in August of 2001.

Senate Bill 1547
Changes to the Fuels Tax Code
Effective—September 1, 2000

Under this bill, a number of significant changes have been made to the current Motor Fuels Tax Code.

• The bill will require all common and contract carriers operating in Texas to register with the Comptroller and file quarterly reports showing detailed information on the interstate and intrastate transportation of motor fuels.

• New restrictions have been placed on the use of signed statements for tax-free purchase of diesel fuel. A person who wants to use a signed statement to purchase up to 10,000 gallons per month of dyed diesel fuel for off-highway use is required to apply to the Comptroller for an end user number to be used in conjunction with a signed statement. The end user number may only be used to purchase tax-free dyed diesel fuel from a permitted supplier. An end user must pay tax when purchasing undyed (clear) diesel fuel but is eligible to file for a refund on fuel used in off-highway equipment.

A person who uses diesel fuel exclusively for an agricultural purpose in off-highway equipment and wants to issue a signed statement to purchase less than up to 10,000 gallons per month of tax-free dyed or undyed (clear) diesel fuel is required to apply to the Comptroller for an agricultural user exemption number to be used in conjunction with a signed statement. An agricultural user may furnish a permitted supplier a signed statement for purchasing dyed or undyed diesel fuel.

• The bill eliminates the previous bonded user permit and replaces it with a dyed diesel fuel bonded user permit and an agricultural bonded user permit. A dyed diesel fuel bonded user permit allows a person to purchase only dyed diesel fuel tax free for use in off-highway equipment. A dyed diesel fuel bonded user must pay tax when purchasing undyed (clear) diesel fuel but is eligible for a refund on fuel used in off-highway equipment.

• An agricultural bonded user permit allows a person to purchase dyed and undyed diesel fuel to be used exclusively for off-highway agricultural purposes. Only agricultural users will be able to purchase tax free undyed (clear) diesel fuel.

• A person who imports motor fuel to a destination in Texas or exports motor fuel to a location outside this state by any means must possess a shipping document for the fuel created by the terminal or bulk plant at which the fuel was received. The shipping document must contain specific information and copies must be maintained by the terminal, the bulk plant, the carrier, the permitted distributor or supplier, the importer, the exporter, and the person receiving the motor fuel for a period of four years.

• The bill requires that a person who acquires motor fuel for import by cargo tank into Texas must obtain an import verification number from the Comptroller before importing fuel into the state.

• The bill requires that a person obtain a diversion number from the Comptroller before diverting a delivery of a single cargo tank of motor fuel from the destination state printed on the shipping document.

• The records maintained by a diesel fuel supplier must include itemized statements showing by load number the number of gallons of both dyed and undyed diesel fuel received for export, exported, and imported.

• The bill requires that the seller of dyed diesel fuel post a notice stating "Dyed Diesel Fuel, Nontaxable Use Only, Penalty for Taxable Use" at each location where fuel is sold. The seller must provide this notice to every person that purchases dyed diesel fuel.

• Under the amended law, a person is prohibited from operating a motor vehicle on a public highway in this state with taxable motor fuel that contains dye unless the use of dyed diesel fuel is lawful under federal law. Taxable diesel fuel containing dye may be used in state and local government vehicles or busses.

• Prior to the effective date of this bill, permitted distributors and suppliers were allowed a deduction of two percent of the taxable gallons of gasoline or diesel fuel sold or used as compensation for collecting, accounting, reporting, keeping records, and remitting the tax collected to the Comptroller. This bill prohibits the Comptroller from allowing the two-percent deduction unless the tax is timely paid to the Comptroller.

HOTEL OCCUPANCY TAX

House Bill 1014
Exemptions
Effective—September 1, 1999

Under this bill, a nonprofit organization or corporation exclusively operated for cleaning beaches is exempt from the state hotel occupancy tax. Organizations qualifying for this exemption should request a letter of exemption from the Comptroller's Office.

The definition of an "institution of higher education" has been amended to include only Texas organizations defined in Section 61.003, Education Code. This means that out-of-state public and private universities and colleges are no longer exempt from state hotel tax. The amendment does not affect the exemption for Texas public or private universities and colleges located in Texas, or independent school districts or public or private elementary and secondary schools of this and other states.

The new law requires an allocation of state hotel tax revenues to an eligible general-law coastal municipality. One percent of the state hotel tax collected from hotels located in the city of South Padre Island will be allocated to the city for use in cleaning and maintaining public beaches in the city.

House Bill 3211
More Exemptions
Effective—October 1, 1999

This bill codifies a 1996 district court decision regarding the hotel tax exemption for federal government agencies and their employees traveling on official business. Federal government agencies and their employees traveling on official business may claim a hotel tax exemption with the hotel. State agencies and state employees (except state employees issued a special hotel tax exemption identification card) must pay the state and local hotel tax to the hotel. The state agency may request a refund of the hotel tax paid from the Comptroller and from appropriate city and county taxing authorities.

INSURANCE TAX

House Bill 1837
Flat Tax Rates for Property and Casualty and Title Insurers; Definition of Premium for Independently Procured Insurance; Retaliatory Tax Clarification
Effective—for tax years beginning on or after January 1, 2000

Prior to the enactment of this bill, licensed property and

casualty and title insurers paid premium taxes using tiered tax rates based on their qualifying investments in Texas as compared to the same types of investments in other states. With this change in the statutes, property and casualty insurers are subject to a flat tax rate of 1.6 percent, and title insurers are subject to a flat 1.35 percent tax rate.

This bill made clarifications and other changes to the retaliatory tax statute applicable to licensed insurers domiciled in states other than Texas. The retaliatory tax is due from these insurers when their state of domicile assesses a higher aggregate tax and fee burden on Texas domestic insurers operating in their state than the State of Texas assesses on such insurers operating in Texas. The bill also clarified the definition of premium for taxation purposes of insurance "independently procured" outside the State of Texas from non-licensed insurers when such insurance was on Texas risks. Such taxes are due from policyholders at a 4.85 percent tax rate.

House Bill 3211
Surplus Lines Tax Account Revisions; .Exemptions for Certain Coverage for Higher Education Employees and Public School Employees
Effective—October 1, 1999

This bill removes the requirement for licensed Texas surplus lines agents to maintain a separate tax trust account for taxes collected on policies sold through the surplus and excess lines insurance market. It requires agents to make prepayments of such taxes by the 15th of the month following the month in which $70,000 or more in premium taxes due the state accrues and further provides that agents may report and pay such premium taxes on either a premium-received or premium-written basis. These changes take effect January 1, 2000, and apply to reporting periods beginning on or after that date.

This bill also clarified existing premium tax exemptions for licensed insurance companies and health maintenance organizations writing group insurance coverages under the Texas College and University Employees Uniform Insurance Benefits Act and under the Texas Public School Employees Group Insurance Act. Premiums on such insurance are exempt from all state taxes, including premium and maintenance taxes and other regulatory fees.

In addition, this bill changed the due date for premium taxes on insurance "independently procured" outside of this state from non-licensed insurers. Such taxes are due from policyholders. The previous due date was March 1 of the year following the issuance of such policies, and the new due date is May 15, the same as the original due date for franchise tax.

House Bill 3697
Disposition of Certain Surpluses of the Workers' Comp Insurance Fund
Effective—August 30, 1999

The Texas Workers' Compensation Insurance Fund (the Fund) was created by the Legislature in 1991 to act as the insurer of last resort in the placing of workers' compensation insurance in this state. The Legislature authorized the issuance of $300 million in revenue bonds to provide initial operating expenses and provide coverage through the Fund. The payment on these bonds was made by assessing a maintenance tax surcharge against all insurers writing workers' compensation insurance in this state. Approximately $200 million has been collected from such insurers and "certified self-insurers" for bond debt payment purposes.

Since the Fund was required to insure any employers requesting workers' compensation coverage, regardless of their loss experiences, the Fund was granted a 2 percent premium and maintenance tax credit each year, equal to 2 percent of their premium for the year, to offset anticipated losses. The Fund was also excluded from being a member of the Property and Casualty Insurance Guaranty Fund Association.

Recently the Fund has retired the remaining bond debt; therefore, the surcharge will no longer be collected. This bill requires the Fund to refund, out of its surplus, all of the surcharge paid by such insurers and certified self-insurers. The insurers are required to refund the surcharge on a pro-rata basis to all policyholders with policies effective during the periods beginning January 1, 1991 through December 31, 1996.

In addition, the bill removes the 2 percent tax credit and, effective January 1, 2000, makes the Fund a member of the Guaranty Fund Association.

Senate Bill 530
Single Non-Profit Trust Exemption
Effective—January 1, 2000

Prior to enactment of this bill, insurance premiums on certain group health, accident, and life policies covering municipal and county employees were exempt from premium taxes. The bill expands the exemption to include coverage for employees of hospital districts and employees of county or municipal hospitals where the premiums are paid from a single non-profit trust for the sole purpose of funding such benefits.

MOTOR VEHICLE SALES OR USE TAX

House Bill 351
Civil Liability/Audit of County Tax Assessor-Collector
Effective—September 1, 1999

This bill establishes the Comptroller's authority to audit a county tax assessor-collector's records and the time period within which the Comptroller may commence a civil action against the tax assessor-collector. If the Comptroller conducts an audit, it must be initiated within one year of the end of the assessor-collector's term of office and completed not later than the second anniversary of the date the term of office ends. The Comptroller may then commence a civil action against the assessor-collector no later than four years after the audit is completed. If the Comptroller does not conduct an audit, any civil action must be brought within four years from the end of the assessor-collector's term of office.

House Bill 2140
New Residents/Leased Vehicles
Effective—September 1, 1999

This bill increases from $15 to $90 the use tax imposed on a new resident of Texas who brings into the state a motor vehicle that was registered previously in the new resident's name in another state or foreign country.

The bill also imposes the new resident use tax on a motor vehicle brought into Texas by a new resident who leased the vehicle in another state or foreign country. In the

past, a new resident was required to pay 6.25 percent motor vehicle use tax on such leased vehicles brought into the state.

House Bill 3072
Taxable Value/Cash Back
Effective—August 30, 1999

This bill provides that a purchaser may reduce the taxable purchase price of a new vehicle by the total amount allowed by the dealer on a traded-in vehicle, including any cash equity given back to the purchaser.

House Bill 3211
Available Fair Market Value Deductions for Leasing Companies
[Editor's Note: Bill effective—October 1, 1999]

This provision clarifies that a leasing company may deduct the fair market value of a vehicle retired by certain other leasing companies in computing the taxable value of a purchase of a new vehicle. In order to qualify to use another leasing company's retired vehicle as a deduction, one of the companies must hold at least 80 percent beneficial interest in the other leasing company; or one of the leasing companies must acquire all of its vehicles exclusively from franchised dealers whose franchiser shares common ownership with the other leasing company.

Unremitted Tax Paid To A Motor Vehicle Dealer
[Editor's Note: Bill effective—October 1, 1999]

This amendment clarifies that a purchaser who paid tax to a dealer will not be held liable for motor vehicle sales tax if the dealer failed to submit the tax and file the paper work to transfer the title and registration. The purchaser must give the county tax-assessor collector documentation that tax was paid to the dealer. The county tax-assessor will notify the Comptroller of the dealer's failure to remit the tax.

Senate Bill 977
Timber Operations
Effective—October 1, 2001

Senate Bill 977 exempts the purchase, purchase for lease, and rental of a machine or trailer used primarily for timber operations.

OYSTER SALES FEE

Senate Bill 1685
Fees on Oysters
Effective—June 19, 1999

Under this bill, the responsibility for collecting the Oyster Sales Fee is transferred from the Texas Department of Health (TDH) to the Comptroller. The Comptroller is required to collect a fee of $1 per barrel of oysters from the first certified shellfish dealer who harvests, purchases, handles, or processes oysters taken from Texas waters. For purposes of assessing the fee, three 100-pound containers of oysters are the equivalent of one barrel of oysters.

A certified shellfish dealer may not purchase or pack oysters in containers that, when packed, exceed 110 pounds in weight. A dealer who violates this weight limit is liable for a penalty of $5 for each container that exceeds 110 pounds.

The Oyster Sales Fee, and any penalty for exceeding the weight limit, are due not later than the 20th day of the month following the month in which the barrel of oysters was handled. A dealer who fails to pay the fee or penalty by the due date is liable for an additional penalty of 10 percent of the amount of the fee or penalty due.

Under the bill, the Comptroller is required to certify to the TDH that a fee is past due, and to certify to the TDH when a certified shellfish dealer has refused to pay the fee, penalty, or additional penalty on written demand. This office will send a monthly report to the Texas Department of Health listing the amount of oyster sales fees and any penalties that are collected.

PETROLEUM PRODUCT DELIVERY FEE

House Bill 2816
Fee Rate Change
Effective—September 1, 1999

This bill decreases the Texas petroleum product delivery fee by 25 percent. The decreased fee will apply to petroleum products withdrawn from a bulk facility and delivered into a cargo tank or barge or imported into this state on or after September 1, 1999. The bill provides that the fee will not be collected when the unobligated balance in the petroleum storage tank remediation account equals or exceeds $100 million dollars, rather than $125 million as the law provided in the past. The expiration date of the reimbursement program is changed from September 1, 2001 to September 1, 2003, and the fee may not be collected on or after March 1, 2002.

SEVERANCE TAX

House Bill 2104
Two-Year Inactive Wells
Effective—June 19, 1999

This bill extends the application period for the current ten-year exemption for oil or gas produced from a well that has been certified by the Texas Railroad Commission as a "two-year inactive well." (In spite of the name, there can be one month of production during that two-year period.) The application period now ends on August 31, 2009, rather than August 31, 1999. Under the bill, the Commission may designate two-year inactive wells through February 28, 2010, rather than February 29, 2000. (This bill and House Bill 2615 were both passed with identical language for the two-year inactive well exemption.)

House Bill 2615
High-Cost Gas Wells and Two-Year Inactive Wells
Effective—August 30, 1999

This bill extends the application period for the current ten-year exemption for oil or gas produced from a well that has been certified by the Texas Railroad Commission as a "two-year inactive well." (In spite of the name, there can be one month of production during that two-year period.) The application period now ends on August 31, 2009, rather than August 31, 1999. Under the bill, the Commission may designate two-year inactive wells through February 28, 2010, rather than February 29, 2000.

This bill also extends the current reduced tax rate exemption for high-cost wells to include wells spudded or completed after August 31, 2002, and before September 1, 2010.

Senate Bill 115
Extension of the Oil-field Cleanup Regulatory Fee for Crude Oil and Natural Gas
Effective—August 30, 1999

The bill deletes the language which stated that this fee would end on August 31, 1999. Because the fee no longer has an ending date, it can only be suspended if the balance in the Oil-field Cleanup Fund equals or exceeds $10 million.

Senate Bill 290
Exemptions
Effective—March 11, 1999

This bill created a temporary exemption from the severance tax for oil and gas produced from certain low producing wells or leases on or after February 1, 1999 and before August 1, 1999. The exemption applied to oil from oil wells producing no more than 15 barrels of oil per day per well. The monthly average price of oil also had to be below $15 per barrel of oil as reported on NYMEX (New York Mercantile Exchange) for three consecutive months prior to the reporting period.

The bill also provided for a temporary exemption for gas from gas wells producing not more than 90 mcf of gas per day and casinghead gas from oil wells producing no more than 15 barrels of oil per day per well. The monthly average price of gas also had to be below $1.80 per mcf as reported on NYMEX for three consecutive months prior to the reporting period.

The exemption for crude oil was the only part of this temporary exemption to meet all of the requirements for price levels and only for the reporting months February 1999, March 1999, and April 1999. The reporting months of May 1999, June 1999, and July 1999 were lost for this exemption because the price of oil was above $15 per barrel during at least one of the three consecutive months prior to these reporting months. The average price for gas never fell below $1.80 per mcf, so the temporary gas exemption never went into effect.

Senate Bill 329
Odd-Year Prepayments
Effective—September 1, 2001

This bill eliminates the estimated prepayment of oil and gas severance taxes for the reporting month of July, due on August 15 of each odd-numbered year. Because the effective date is September 1, 2001, the odd-year prepayment will still have to be made on August 15, 1999, and August 15, 2001.

SPECIAL FEES

House Bill 1983
911 Fees
Effective—September 1, 1999

This bill expands the Comptroller's duties to audit for and collect the fees and surcharges imposed and administered by the Commission on State Emergency Communications under Subchapter D, Chapter 771, Health and Safety Code:

• the 9-1-1 emergency service fees collected by local exchange service providers, wireless service providers, and certain business service users and remitted to the commission, and

• the 9-1-1 equalization surcharge collected by intrastate long-distance service providers and remitted to the commission.

If the Comptroller audits a service provider that collects these fees or surcharges, the bill requires the Comptroller to also audit the service provider's collection and disbursement of the fees and surcharges. The commission may also notify the Comptroller of any irregularity that may indicate that an audit of a service provider collecting these fees or surcharges is warranted. The Comptroller, rather than the commission, will collect past due fees and surcharges and recover the costs of collection from service providers or business service users.

END NOTE

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

TAX CONTROVERSY: RECENT DEVELOPMENTS

Anthony E. Rebollo[1]

1. TAX CONTROVERSY CASES

[Criminal Cases]

1.1 Dismissal of criminal allegations was appropriate where the tax law was unclear. The indictment in the case charged the defendant with failing to report an “ownership interest” in an S corporation, in violation of 26 U.S.C. § 7206(1). The court agreed with the district court’s determination that “the tax law provided [the defendant] no notice that failure to report an ‘ownership interest’ was criminal,” citing a number of cases for the proposition that criminal prosecutions may not rely on vague or highly debatable points of law.

United States v. Pirro, 212 F.3d 86 (2d Cir. 2000).

1.2 Filing Status Is a Material Matter for 26 U.S.C. § 7206(1) Convictions.

United States v. Scarberry, 2000-1 U.S.T.C. ¶ 50,272 (10th Cir. 2000).

1.3 “Obviousness” as a defense against materiality was rejected since it “would render the taxpayer with an ill-gotten refund if his scheme worked, yet allow him to claim immateriality if he got caught.”

United States v. Cordero, No. 99-1363, 2000 U.S. App. LEXIS 810 (2nd Cir. Jan. 21, 2000).

[Partnership Cases]

1.4 Tax Court refused to respect family limited partnership, concluding that assets transferred to the family partnership should have been included in the decedent's estate since he had continued to enjoy possession, and right to income from the transferred assets during his life.

Estate of Charles E. Reichardt v. Commissioner, 114 T.C. No. 9 (Mar. 1, 2000).

1.5 Family limited partnership was respected, despite the fact that the transferor, who had been diagnosed with cancer, died unexpectedly (from another, unrelated cause) just two days after the partnership was created. The court found that "the primary purpose of the partners in forming the partnership was a desire to preserve the family ranching enterprise for themselves and their descendants."

Church v. United States, 2000-1 U.S.T.C. ¶ 60,369 (W.D. Tex. 2000).

1.6 In valuing interests in limited partnerships that owned and operated apartment complexes, the court rejected the estate's suggested marketability discount for the interest of 35 percent and the government's suggested marketability discount of 15 percent, ultimately concluding that a marketability discount of 20 percent was appropriate.

Estate of Etta H. Weinberg, et al. v. Commissioner, 79 T.C.M. 1507 (2000).

1.7 The Fifth Circuit disagreed with the district court's conclusion that there should be no discount applied to the value of an estate's 25 percent interest as assignee of the decedent in a family partnership.

Adams v. United States, No. 99-10497, 2000 U.S. App. LEXIS 15593 (5th Cir. July 5, 2000).

[Trust Fund Cases (Responsible Persons)]

1.8 General partner argued that "taken together, I.R.C. § 6671(b) and 6672(a) are incompatible with, and therefore preempt, the provision of the Texas Uniform Partnership Act that makes partners jointly and severally liable for the debts of the partnership." The Fifth Circuit disagreed, holding that the Service was entitled to hold the general partner jointly and severally liable for all debts and obligations of the partnership, including unpaid taxes, under state law.

Remington v. United States, 210 F.3d 281 (5th Cir. 2000).

1.9 The First Circuit has held that, as a matter of law, in deciding whether a person qualified as a responsible individual for imposition of the Trust Fund Recovery Penalty, evidence for any period other than that when taxes were unpaid could not be considered: "Responsibility during one period does not equate to responsibility in all periods."

Vinick v. United States, 205 F.3d 1(1st Cir. 2000).

[Tax Court Jurisdiction]

1.10 Tax Court has jurisdiction under I.R.C. § 6015(e)(1)(A) to review Service's denial of innocent spouse relief under section 6015(f).

Fernandez v. Commissioner, 114 T.C. 21 (T.C. May 10, 2000).

1.11 Tax Court has subject matter jurisdiction under I.R.C. § 6330(c)(2)(B) to review Service's administrative decision arising from a due process hearing. The case, however, was dismissed for failure to state a claim upon which relief could be granted since the taxpayer failed to raise any issue relevant under § 6330(c)(2)(A), which would have included spousal defenses for collection, challenges to the appropriateness of the intended collection action, or alternate means of collection.

Van Fossen v. Commissioner, 79 T.C.M. 2049 (2000).

[Bankruptcy]

1.12 A bankruptcy court awarded taxpayers emotional distress damages for a stay violation. Finding that "peace of mind is invaluable," the bankruptcy court awarded debtors $1,000 for the trauma they experienced in receiving Notices of Intent to Levy from the Service.

In re Covington, 2000-1 U.S.T.C. ¶ 50,334 (Bankr. D. S.C. 2000).

[Wrongful Levy Cases]

1.13 The Government levied on the taxpayer's property on the grounds that it was a "nominee, transferee, alter ego, agent and/or holder of a beneficial interest" in another taxpayer. The Fifth Circuit, however, held that the United States had failed to meet its burden to establish, by substantial evidence, a nexus between the taxpayer and the property levied upon. The Court also based its decision on "the IRS' failure to follow its own internal operating procedures [which] is a further indication that it did not have cause to believe the [taxpayer] was the later ego [of another entity]."

Oxford Capital Corp. v. United States, 211 F.3d 280 (5th Cir. 2000).

[Income v. Non-Taxable Source]

1.14 The Tax Court held that unexplained bank deposits of $86,155 were loans, rather than gross receipts, despite the absence of any supporting documentation. The taxpayers were viewed as credible witnesses and the Tax Court therefore stated that "we are satisfied that there was a true debtor-creditor relationship [between the taxpayers and various relatives, friends and unnamed family members] and that this relationship created an unconditional enforceable obligation to repay the monies advanced."

Quantum Company Trust, et al. v. Commissioner, 79 T.C.M. 1964 (2000).

1.15 The Tax Court held that withdrawals of $81,000 from a joint bank account were nontaxable gifts, as opposed to compensation. The issue in the case was whether the withdrawals from the taxpayer's mother's account represented income from services performed by the taxpayer. Although the taxpayer admitted that he had performed services for his mother in prior years, and it was unclear how he had treated funds withdrawn during those earlier years, the Tax Court held that the $81,000 at issue was a gift from the taxpayer's mother made out of love and affection. Although taxpayer's mother did not testify at trial, the court found that the taxpayers were credible witnesses and accepted the taxpayer's testimony that he had performed no services for his mother during the year at issue.

Kropp v. Commissioner, 2000 Tax Ct. Memo. LEXIS 178 (April 25, 2000).

[Attorney's Fee Award]

1.16 Attorney's fees were awarded under Section 7430 for litigation costs incurred in connection with the Service's determination that the accuracy-related penalty applied to a question regarding the taxpayer's tax home. The Tax Court awarded the taxpayer litigation costs, holding that "We do not believe it reasonable for respondent to assert an accuracy related penalty under Section 6662(a) in a case of first impression involving the unclear application of an amendment to the Internal Revenue Code."

Mitchell v. Commissioner, 2000 Tax Ct. Memo. LEXIS 174 (April 21, 2000).

END NOTE

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DEFENDING CRIMINAL TAX CASES AFTER THE IRS REORGANIZATION

Charles J. Muller[1]
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I. OVERVIEW.

The IRS Restructuring and Reform Act of 1998 ("RRA") was signed into law by President Clinton on July 22, 1998. Although its provisions dealt with a wide variety of important changes in the tax laws and the basic structure of the Internal Revenue Service, it was passed with overwhelming approval by the House of Representatives and the Senate.

Probably the single most obvious, immediate impact of the RRA has been on the Service's level of enforcement and interaction with taxpayers. Indeed, the effect was so great that neither the press nor Congress was able to ignore the fact that the very process of restructuring–as well as the extensive training occasioned by procedural and substantive tax law changes–had resulted in a substantial IRS slowdown and decreases in activity. All branches of the Service were affected, but most noticeable were the decrease in visibility of the Collection Division and Criminal Investigation Division. See, e.g., "IRS Cutting Hunt for Tax Fraud," Dallas Morning News (December 15, 1999), p. 14A.

Parts VI and VII of this outline focus on the RRA's impact on the Criminal Investigation Division and District Counsel's review of criminal tax cases. Although those changes are significant and will form the basis of the authors' presentation, many aspects of defending a criminal tax case remain unchanged. This paper, therefore, begins with an overview of the most commonly charged federal tax violations and the methods of proof used by the Government to establish these violations. The paper then discusses fundamental principles which should be understood and considered by defense counsel from the early stages of the investigation to the civil aftermath following the final disposition of the criminal investigation.

II. TYPICAL FEDERAL TAX CRIMES.

A. Attempts to Evade Tax. Internal Revenue Code section 7201 makes it a felony to willfully attempt to evade or defeat any tax imposed by the Code, including income and excise taxes. See, e.g., U.S. v. Thompson, 806 F.2d 1332 (7th Cir. 1986). The attempt may take any form, such as understating income or overstating or claiming false deductions or credits. The most common manner of an attempt to evade is the filing of a false income tax return. See, U.S. v. Caswell, 825 F.2d 1228, 1230 (8th Cir. 1987); and U.S. v. Felak, 831 F.2d 794, 798 (8th Cir. 1987). While this is an "attempt" crime, the Government must, nevertheless, establish that there is an additional tax due and owing. Lawn v. U.S., 355 U.S. 339 (1958); and Sansone v. U.S., 380 U.S. 343 (1965).

B. Fraud and False Statements. It is a felony to willfully subscribe a materially false tax return or other document which contains, or is verified by, a written declaration that the document is made under the penalties of perjury. Code § 7206(1). In order to obtain a conviction, the Government need only show that the defendant knowingly made a significant false statement on a return or other document, such as a document attached to the return. See, e.g., U.S. v. Marabelles, 724 F.2d 1374, 1380 (9th Cir. 1984). It need not establish that the defendant was attempting to evade taxes, or even that he had a tax liability. See, e.g., U.S. v Jernigan, 411 F.2d 471 (5th Cir. 1968), cert. denied, 396 U.S. 927 (1969).

C. Failure to File. Code section 7203 makes it a misdemeanor for any person who is required to make a return, pay any tax or keep records, to willfully fail to fulfill those requirements. Defense counsel must be sensitive to the fact that a misdemeanor failure to file case can easily be transformed into the felony of attempted evasion. All the government needs to "upgrade" the charge to a felony is the failure to file or pay coupled with some "affirmative act" to evade -- a single false statement to an I.R.S. Special Agent such as "I don't know" may be sufficient. Spies v. U.S., 317 U.S. 492 (1943).

D. Klein Conspiracy. The general federal conspiracy statute provides that any person who enters into an agree-

ment with another to impede or impair the lawful functions of a governmental agency is guilty of the crime of conspiracy. 18 U.S.C. § 371. The conspiracy offense is a felony. The offense is often referred to as a "Klein-type conspiracy" because that was the name of the first case applying the general conspiracy statute in the tax setting. United States v. Klein, 247 F.2d 908, 915 (2d Cir. 1957).

E. Section 7212(a). Any person who corruptly, or by force or threats of force (including any threatening letter or communication), attempts to intimidate or impede any U.S. officer or employee acting in an official capacity under the internal revenue laws, or obstructs and impedes (or attempts to obstruct and impede) the administration of the internal revenue laws is guilty of a crime. This is a broadly worded statute. See, e.g., U.S. v. Popkin, 943 F.2d 1535 (11th Cir. 1991), cert denied, 112 S. Ct. 1760 (1992), involving an attorney who was convicted under section 7212 because he created a corporation which enabled a client to launder money, which constituted a "corrupt interference" because the corporation secured an unlawful benefit for the client. See also Part XI, herein, discussing the Government's policies regarding the application of this statute.

F. False Claims for Refund. It is a felony to present to the government a false, fictitious, or fraudulent claim. See 18 U.S.C. § 287. False claims for tax refund of taxes are also covered by this statute. See, e.g., U.S. v. Drape, 668 F.2d 22, 26 (1st Cir. 1982); U.S. v. Miller, 545 F.2d 1204, 1212 n. 10 (9th Cir. 1976), cert. denied, 430 U.S. 930 (1977).

G. Other Offenses. In addition to the offenses discussed above, other bases upon which tax or tax-related offenses may be charged include the following: (1) the general, federal aiding and abetting statute set forth at 18 U.S.C. § 2; (2) Code section 7206(2), which provides that the willful aiding or assisting in the preparation of any materially false tax return or other document is a felony; and (3) the mail fraud statute, 18 U.S.C. § 1341. However, the Tax Division's position is that specific criminal law provisions of the Internal Revenue Code should form the focus of prosecutions when essentially tax law violation motives are involved. DOJ Manual, Section 6-4.211(1).

III. TYPES OF CRIMINAL TAX INVESTIGATIONS.

There are two basic types of tax investigations: administrative investigations and grand jury investigations. See, DOJ Manual, Sections 6-4.110 et seq.

A. Administrative Investigations. An administrative investigation is conducted by one or more IRS special agents, sometimes in combination with one or more IRS revenue agents. The primary tool for compulsory obtaining of information during an administrative investigation is the IRS summons. When the IRS issues a summons to certain "third-party recordkeepers," such as a taxpayer's attorney, accountant, bank, credit card company, the IRS is required to give the taxpayer identified in such summons, written notice of the issuance of the summons. See Code § 7609. The taxpayer is given certain statutory rights to bring an action in court to contest the enforcement of the summons.

B. Grand Jury Investigations. Criminal tax crimes may also be investigated by a traditional grand jury. DOJ Manual, Section 6-4.12 et seq. While the Tax Division of the Department of Justice may originate a tax grand jury investigation, most grand jury investigations of tax violations are so-called "add on" investigations. See DOJ Manual, Section 6-4.122 and Tax Division Directive No. 86-59. An "add on" grand jury investigation means that the tax investigation originates as the result of an investigation by the United States Attorney of other offenses.

IV. THE GOVERNMENT'S PRINCIPAL METHODS OF PROOF.

When the Government proceeds on a charge which requires proof of unreported tax, it will generally use one or some combination of the following methods of proof:

A. Direct. The specific items method of proof involves establishing the defendant's income and/or expenses by direct evidence, i.e., testimonial and documentary evidence as to the amount of income received (or expenses incurred), by the defendant. For example, this may include evidence such as testimony that the defendant was paid certain amounts, or documentary evidence such as canceled payroll checks, payroll records, Forms W-2 and 1099, canceled checks received from customers or the like, receipts, etc. The objective is to prove that the defendant earned more money than was reflected on the defendant's returns, or that reported deductions or expenses are either nonexistent or overstated.

B. Indirect. There are several indirect methods of proving an understatement of income: the net worth, expenditures and bank deposits methods.

1. The Net Worth Method. A description of the net worth method is set forth in U.S. v. Sorrentino, 726 F.2d 876, 879-880 (1st Cir. 1984):

> The Government makes out a prima facie case under the net worth method of proof if it establishes the defendant's opening net worth (computed as assets at cost basis less liabilities) with reasonable certainty and then shows increases in his net wroth for each year in question which, added to his nondeductible expenditures and excluding his known nontaxable receipts for the year, exceed his reported taxable income by a substantial amount. See Holland v. United States, 348 U.S. 121, 125, 75 S. Ct. 127, 130, 99 . Ed. 150 (1954); McGarry v. United States, 388 F.2d 862, 864 (1st Cir. 1967), cert. denied, 394 U.S. 921, 89 S. Ct. 1178, 22 L. Ed. 2d 455 (1969). The jury may infer that the defendant's excess net worth increases represent unreported taxable income if the Government either shows a likely source, Holland, 348 U.S. at 137-38, 75 S. Ct. at 136, or negates all possible nontaxable sources, United States v. Massei, 355 U.S. 595, 78 S. Ct. 495, 2 L. Ed. 2d 517 (1958); the jury may further infer willfulness from the fact of underreporting coupled with evidence of conduct by the defendant tending to mislead or conceal. Holland, 348 U.S. at 125, 75 S. Ct. at 130.

2. The Expenditures Method. The expenditures method of proof is a variation of the net worth method. The reason for using the expenditures method of proof in some situations, as opposed to the net worth method, is discussed in Taglianetti v. U.S., 398 F.2d 558, 562 (1st Cir. 1968), aff'd, 394 U.S. 315 (1969).

> The government proceeded on a "cash expenditures" theory. This is a variant of the net worth method of establishing unreported taxable income. Both proceed by indirection to overcome the absence of direct proof. The net worth method involves the ascertaining of a taxpayer's net worth positions at the beginning and end of a tax period, and deriving that part of any increase not attributable to reported income. This method, while effective against taxpayers who channel their income into investment or durable property, is unavailing against the taxpayer who consumes his self-determined tax free dollars during the year and winds up no wealthier than before. The cash expenditure method is devised to reach such a taxpayer by establishing the amount of his purchases of goods and services which are not attributable to the resources at hand at the beginning of the year or to non-taxable receipts during the year. (Footnotes omitted.)

3. The Bank Deposits Method. The mechanics of the bank deposit method were described in U.S. v. Boulet, 577 F.2d 1165, 1167 (5th Cir. 1978), cert. denied, 439 U.S. 1114 (1979), as follows:

> To prove its charges, the government relied upon one of the two traditional indirect methods of proof, analysis of the taxpayer's bank deposits and cash expenditures. Under this method, all deposits to the taxpayer's bank and similar accounts in a single year are added together to determine the gross deposits. An effort is made to identify amounts deposited that are non-taxable, such as gifts, transfers of money between accounts, repayment of loans and cash that the taxpayer had in his possession prior to that year was deposited in a bank during that year. This process is called "purification." It results in a figure called net taxable bank deposits.
>
> The government agent then adds the amount of expenditures made in cash, for example, in this case, cash the doctor received from fees, did not deposit, but gave to his wife to buy groceries. The total of this amount and net taxable bank deposits is deemed to equal gross income. This is in turn reduced by the applicable deductions and exemptions. The figure arrived at is considered to be "corrected taxable income." It is then compared with the taxable income reported by the taxpayer on his return. [Footnote omitted.]

V. PROSECUTION STANDARDS: THE CRITERIA FOR A GOOD CRIMINAL TAX CASE FROM THE GOVERNMENT'S STANDPOINT.

A. Historical Criteria for Criminal Tax Cases. The Chief Counsel's Directives Manual set forth certain criteria applicable to criminal tax prosecutions. Although the standards may be dated at this point, they provide some historical perspective for gauging the types of cases traditionally worked by CID.

1. Criminal prosecution was recommended under I.R.C. § 7201 if the average yearly additional tax for criminal purposes is $2,500 or more in cases which use the specific item method of proof and involve uncomplicated fact patterns.

2. In I.R.C. § 7201 cases that utilized an indirect method of proof or involved complex and sophisticated evasion schemes, criminal prosecution was recommended if the additional tax for criminal purposes totals at least $10,000 for the prosecution period, and the additional tax for criminal purposes for any single year within that period is at least $3,000.

3. Criminal prosecution was recommended under I.R.C. § 7203 (in non-community property states) and under I.R.C. § 7206(1) only if the evidence indicates that the average yearly additional tax for criminal purposes would be $2,500 or more. Criminal prosecution was recommended under I.R.C. § 7203 (in community property states) only if the evidence indicates that the average yearly additional tax of a married person, for criminal purposes, would be $1,500 or more.

4. Investigative preference was/will be given to cases that span three prosecution years rather than cases involving violations provable as to only one or two years. This preference is particularly relevant where an indirect method of proof is utilized to establish the criminal violation.

B. Current Standards. Although the current "dollar limits" are not public record, preference is given to cases which, taking into account the "tax loss" and other factors relevant under the Sentencing Guidelines, produce a sentence which calls for prison time.

VI. THE INTERNAL STRUCTURE OF THE CRIMINAL INVESTIGATION DIVISION ("CID") AND ITS POST-RRA REORGANIZATION.

A. Overview of the Reorganization. Under the restructuring plan, after October 8, 2000, there will no longer be District Directors and functional activities formally called Examination and Collection. The reorganization of CID has already taken place, effective July 3, 2000. After the reorganization, Appeals and CID will continue under their present names, albeit in restructured form with line management to the national office. The regional offices as they are structured today will no longer exist. At the field level, the civil side of the IRS will be organized as four operating divisions: Wage and Investment Income (W&I), Small Business and Self-Employed (SB/SE), Large and Middle Size Businesses (MSB), and Employee Plan/Exempt Organization/State/Local Government Service Organizations (TE/GE). Within each of these divisions, there will be the entire range of activities and services. For example, SB/SE will service 25 million filers. Within that division, the Market Segment Specialization Program (MSS) will be used for occupations (farmers, truck drivers, doctors, and artists) and industries (garment manufacturers, retailers, and computer companies). Counsel will be reorganized along the lines of the IRS. It is anticipated that taxpayers will be able to obtain assistance from the IRS in an easier and faster manner since there will be more storefront locations, telephone service, and Internet access. Oversight function will continue in the form or "areas" rather than "regions" and will be organized according to operating divisions.

B. CID Line Authority. The position of "chief" CID in the field has been abolished. That title instead now belongs to Mark Mathews, who heads up Criminal Investigation in Washington and reports directly to the Commissioner. The head of a CID field unit is now called a "Special Agent in Charge" (SAC), a title which corresponds to that of the head of an FBI field office. There are now three SACs in Texas, one in Dallas (Michael Lacenski), one in Houston (Jack Harris) and one in San Antonio (Paul Varville). The Dallas SAC has jurisdiction over all CID matters for Texas areas which are in the Eastern and Northern federal judicial districts. The Houston SAC has jurisdiction over all CID matters for Texas areas which are in the Southern federal judicial district. The San Antonio SAC has jurisdiction over all CI matters for Texas areas which are in the Western federal judicial district.

C. Staffing Issues and Structure.

1. Reduced Number of Agents. CID has recently experienced a reduction of its available investigative staffing resources and is expected to continue to see a decline over the next several years due to both voluntary and mandatory retirements. This problem is not unique to CID, as other law enforcement bureaus within the Treasury Department are experiencing similar resource problems.

2. Base and Structure of Activities. According to the reorganization plan, almost all of the current Midstates Region is now included in geographic areas numbered 4 and 5. The only current state within the region not included in either one of those new areas is Arkansas. Arkansas is now included in area number 3 which is headquartered in Atlanta.

    a. Area No. 5 Includes Texas.

       Area No. 5 will include Texas, Oklahoma, Montana, Wyoming, Nevada, Utah, Colorado, Arizona and New Mexico. Donald Wanick is the CI Director of Field Operations in Area 5. The location for the area No. 5 manager will be Dallas. The proposed SAC locations within area No. 5 are Oklahoma City, Dallas/Fort Worth, Houston, San Antonio, Las Vegas, Denver and Phoenix. There are no Super SAC positions proposed for area No. 5. In fact, there are only three Super SAC positions proposed nationwide – Chicago, Los Angeles and New York. The only proposed location change for the SACs in area No. 5 from their current locations will be movement of the CID district office from Austin to San Antonio.

3. Alignment with SBSE. In its proposed reorganization, CID will probably have the closest working relationship with the Small Business and Self Employed operating division (SBSE), since it was perceived that this operating division would be a valuable source of Title 26 cases for CID's inventory. Nonetheless, referrals for criminal investigations could emanate from any of the new operating divisions.

D. CID's Investigative Efforts. CID recently drafted an interim compliance strategy identifying three separate segments of its investigative efforts.

1. "Legal Source" Cases. The first segment is Legal Source Tax Cases, which are commonly referred to as Title 26 cases since most of its inventory could be described as traditional Title 26 tax cases. This segment does include some Title 18 violations, such as those under §§ 286 (conspiracy to defraud the government by submission of false claims), 287 (false, fictitious or fraudulent claims) and/or 371 (conspiracy to defraud the United States). CID's priority areas for this segment for FY2000 include Abusive Foreign and Domestic Trust Cases; the Return Preparer program; the Questionable Refund Program and the Non-Filer Program.

2. "Illegal Source" Cases. The second segment of CID's investigative efforts is Illegal Source Financial Crimes. This segment includes Title 18 and Title 26 violations as well as money-laundering violations. The priority area in this segment is the issue of Healthcare Fraud.

3. Narcotics Cases. The third segment of CID's investigative efforts is labeled as Narcotics Related Financial Crimes. The offenses investigated under this segment include both tax and money-laundering violations. CID has made a decision, based in part upon the Webster report, to decrease the gap between its applied staffing resources for this segment and the amount of reimbursable funds it receives for participation in these type of investigations.

E. Net Effect of Organizational Changes Under the Reorganization. Prior to July 3, 2000, the local CID field office reported to two different bosses – the local District Director and the regional Director of Investigations (CID). Under the reorganization plan now in effect, the Special Agent in Charge of a field office reports directly to a CI Director of Field Operations who is part of the CI national office. Except for the Commissioner and his/her Deputy, there will no longer be non-CID officials in the chain of command for CI.

VII. POST-RRA ROLE OF COUNSEL IN THE ANALYSIS AND REVIEW OF CID CRIMINAL REFERRALS.

A. New Organization and Focus for Counsel. Effective no later than October 8, 2000, District Counsel will cease to exist in its present form. Instead, the various legal functions presently being performed by District Counsel will be absorbed by newly-formed, much more specialized organizational units.

1. Line Authority. The criminal tax function of the Chief Counsel's office was reorganized on July 3, 2000, along the lines of the reorganization of CID, with line authority from the national office to the field. (That means that District Counsel offices ceased doing CT work after July 3.) At the field level in each of six areas there is an Area Counsel (CT), who is located close to the CID Director of Field Operations. Carleton Knechtel is the Area Counsel (CT) for the Midstates Area (Area 5) and will supervise eleven attorneys located in or near SAC offices around the area. Six of those attorneys will be located in Texas (three in Dallas, two in Houston and one in Austin). The attorneys will specialize in criminal tax work, a departure from the cross-assignment concept which has been in place within the Chief Counsel's office since the reorganization of 1978. Mr. Knechtel will report directly to Nancy Jardini, Division Counsel/Associate Chief Counsel (CT) and Barry Finkelstein, Deputy Division Counsel/ Associate Chief Counsel (CT), both of whom are in Washington, D.C.

B. Counsel's Role in Investigations. The CID/Counsel reorganization is presently in a transitional stage, partly because of staffing shortages, including that the Midstates Area is presently understaffed by four attorneys. Upon full implementation of reorganization goals, it is envisioned that Counsel will be much more involved in CID investigations from the very beginning. Such involvement would include (1) working closely with CID agents to gain a working knowledge of all CID investigations in progress, particularly tax related investigations and IRS forfeiture investigations, so that areas needing legal advice can be more readily identified; (2) providing advice to CID as early as possible regarding all evidentiary, procedural, and/or technical legal issues in the cases being investigated by CID; (3) providing legal advice with respect to Special Investigative Techniques, such as undercover and obtaining search warrants; and (4) providing legal advice with respect to certain tangential civil matters, such as disclosure issues and enforcement of CID summons. Primary purposes for such early and intense involvement by Counsel in criminal tax investigations include: maximizing use of CID and Counsel resources by minimizing the time spent in "blind alleys" and/or on cases in which there is little likelihood of successful prosecution, and maximizing the probability that, with respect to each criminal tax case being recommended for prosecution by CID, the evidence establishes guilt beyond a reasonable doubt and there is a reasonable probability for conviction.

C. Review Function. Counsel CT attorneys would also still be expected to review the special agent's report and supporting exhibits in each tax case recommended for prosecution by CID. Upon completion of such review, the CT attorney would prepare an evaluation document for the referring CID official. After the reorganization, Counsel will no longer have referral or declination authority with respect to criminal tax cases. In most instances, these authorities will be vested in the Special Agent in Charge ("SAC"), with the Area Manager acting as the adjudicating official for declinations that are appealed by the case agent/group manager. The Area Manager will be the sole concurring/referring official for those cases that are determined to be "sensitive" in nature.

D. Conferences With the SAC and Counsel. Conferences will still be offered, with the conference being attended by the Counsel CT attorney and the SAC, or the SAC's representative.

VIII. DEFENDING A CRIMINAL TAX INVESTIGATION.

A. Basic Issues and Concerns. The handling of a criminal fraud case requires a careful balancing act by the practitioner--containing past problems, handling the current investigation, and satisfactorily complying with any future reporting obligations in a way that will not exacerbate any past problems or incriminate the client.

When defending against fraud charges, or attempting to avoid them altogether, the practitioner should, in most cases, strive to ensure that there is no direct contact or dialogue between the taxpayer and the government agents, thereby containing any problems to actions or activities which occurred in the past. No matter how strong the client's desire to avoid looking "uncooperative," and no matter how natural his or her tendency to want to explain, the client should be advised that direct contact may do nothing more than assist the government with the task of obtaining a conviction. Even in seemingly straightforward situations, where sympathetic facts and reasonable, non-criminal explanations exist, the potential for misunderstandings or misperceptions on the part of the agents is normally too great to warrant any sort of direct contact by the taxpayer--even if this means that the client must invoke the fifth amendment privilege.

Handling the ongoing investigation requires a careful understanding of the facts, which can be achieved by interviewing the client in detail (something which the government usually cannot do) and by monitoring the agents' progress in the case. For example, the practitioner should interview witnesses who have been contacted by the government, and obtain copies of any documents the agents have secured from third parties. In appropriate cases, counsel may need to file suit to block the enforcement of summonses which are too broad or seek irrelevant documents. The practitioner may also need to hire Kovel accountants to assist with legal advice, which is still an important consideration since the new accountant-client privilege does not apply to criminal tax investigations.

The most difficult aspect of handling a criminal fraud case may be the filing of future returns. Careful consideration must be given to exactly what information can or must be provided on the return itself, and whether the fifth amendment should be claimed on the return as to specific items or schedules.

In the midst of balancing these aspects of the case, the practitioner must also be prepared to advise the client about the benefits of early pleas, sentencing guideline considerations and the inevitable "civil aftermath" of a criminal tax investigation. Appropriate handling and consideration of these factors can, in many instances, mean the difference between probation and prison time.

IX. OVERVIEW OF THE DEFENSE OF A CRIMINAL TAX CASE: GOALS AND STRATEGIES.

A. Protecting Privileged Information: Kovel Agreements, Asserting the Fifth and the Filing of Current Returns.

1. Controlling the Flow of Information from the Outset. As indicated previously, no matter how much a taxpayer believes he is in control of his initial meeting with the Special Agents, he should say nothing and answer no questions. If the taxpayer attempts to mislead the agents, lies or tells half-truths, he has committed additional federal crimes. This was recently confirmed by the Supreme Court in Brogan v. United States, 118 S. Ct. 805 (1998), cert. denied, 118 S. Ct. 1033 (1998) (rejecting once and for all the "exculpatory no" doctrine).

2. Kovel Agreements. In most criminal tax cases, it is helpful to retain an accountant (or an investigator) to review the taxpayer's financial records, assist in the building of a defense, and possibly testify at trial as an expert. Even with the advent of I.R.C. Section 7525, which does not apply to federal criminal tax investigations, such an accountant (or investigator) should be engaged by counsel (i.e., not the client), to ensure that the attorney client privilege will extend to his work. See, United States v. Kovel, 296 F.2d 918 (2d Cir. 1961).

B. Filing the Current Year Return.

1. Tax Returns Filed During an Investigation. In a criminal tax investigation, the subject of the investigation faces a host of problems resulting from the requirement that he file current tax returns with the very agency which is

investigating him. The filing of a current year tax return presents problems because it will often require admissions of facts relevant to the criminal investigation. See, e.g., United States v. Dinnell, 428 F. Supp. 205, 208 (D. Ariz. 1977), aff'd without opinion, 568 F.2d 779 (9th Cir. 1978), 176 F.2d 217, 220 (7th Cir. 1949) (Statements made in a tax return constitute "admissions.") In some circuits, however, the taxpayer may use a current year or amended return to his advantage, offering evidence of the filing of amended tax returns and the payment of tax to show lack of willfulness. See, e.g., United States v. Rischard, 471 F.2d 105 (8th Cir. 1973), and Hill v. United States, 363 F.2d 176 (5th Cir. 1966).

2. Extensions. In most circumstances, a taxpayer under investigation should avail himself of all of the filing extensions provided by law. This will, at a minimum, have the effect of requiring the agent to continue his examination without benefit of admissions made in the return and provide the practitioner with additional time to focus on and address problem areas. Recent changes to the regulations allow taxpayers to obtain an automatic extension without payment of their estimated liabilities. Notice 93-22, 1993-1 C.B. 305; T.D. 8651; Treas. Reg. § 1.6081-4T. This is a change from the prior requirement that 90% of the estimated liability be paid in order to secure the extension. In addition, the taxpayer need not sign the automatic extension form. Treas. Reg. § 1.6081-4T.

3. Cash Bonds. A deposit in the nature of a cash bond will stop the running of interest on deficiencies. The procedures for making deposits in the nature of a cash bond are described in Rev. Proc. 84-58, 84-2 C.B. 501. In some cases, the taxpayer will have little to lose in making a deposit in the nature of a cash bond if funds are available to do so. The deposit does not constitute an admission that additional taxes are owed. By the same token, the deposit may be used at some point in the future, either before a judge or a jury, as evidence of the taxpayer's good faith to comply with his responsibilities.

C. Asserting the Fifth Amendment Privilege on Tax Returns.

1. Although a taxpayer may not make a blanket claim of Fifth Amendment privilege on a tax return, it is well established that the taxpayer may make a specific claim of such privilege as to the source of income, at least in circumstances where the source of income is illegal and disclosure on the return would be potentially incriminating. See, e.g., Garner v. United States, 424 U.S. 648 (1976); United States v. Sullivan, 274 U.S. 259 (1927). The question, however, is much more difficult as to whether the privilege may apply, not just to the source, but also to the amount of an item of income. For an excellent discussion of these and other issues relating to the filing of Fifth Amendment returns, see Siffert and Saltzman, "The Fifth Amendment and Tax Returns: The Viability of the Deferred Filing/Current Payment of Tax Approach Pending a Criminal Investigation," 4 White-Collar Crime Reporter 1 (Jan. 1990).

D. Monitoring the Government's Investigation and Case Development: Review and Defense of the Summons.

1. The Administrative Summons. The IRS is empowered by statute and case law to issue an administrative summons for testimony and documents. I.R.C. § 7602 permits the Service to require the production of books, records, and other data relevant to its inquiry and to take testimony under oath. See also, United States v. Morton Salt Co., 338 U.S. 632, 642-3 (1950). The IRS may issue a summons not only for those purposes listed specifically in § 7602(a)(1-3) but also for "the purpose of inquiring into any offense connected with the administration or enforcement of the internal revenue laws." I.R.C. § 7602(b).

2. Limitations On Summons Authority. An administrative summons may not be issued, nor may any enforcement action be commenced, "with respect to such person if a Justice Department referral is in effect with respect to such person." I.R.C. § 7602(c). A "referral" may occur in two instances: (a) pursuant to I.R.C. § 6103(h)(3)(A), to initiate a grand jury investigation or a recommendation from the IRS to the Department, to prosecute or (b) a request for the Department under I.R.C. § 6103(h)(3)(B) for disclosure of tax return or tax return information. United States v. Michaud, 907 F.2d 750, 754 (7th Cir. 1990) (en banc). A referral to the Justice Department remains in effect until the Attorney General notifies the IRS that he will not prosecute the individual for an offense related to the internal revenue laws, that he will not authorize a grand jury investigation of such person with respect to such offense, that he will discontinue a grand jury investigation, or a referral is terminated only by the above actions, when there is a final disposition of a criminal tax matter which has been prosecuted.

3. Procedural Limitations. A duces tecum summons must be issued to the person having "possession, custody or care"of books and records. I.R.C. § 7602(2). Similarly, a person may not be required to give testimony under oath unless the summons contains an ad testificandum clause. United States v. Hugh, 75-1 U.S.T.C. § 9409 (D. N.Dak. 1975). The witness may not be required to appear less than ten days from the date the summons is issued. I.R.C. § 7605(a).

4. Other Issues. Other issues the practitioner should consider when faced with a summons are as follows:

    a. New Notice Provisions Do Not Apply to Criminal Investigations.

       Section 3415 of the RRA extended the current third-party recordkeeper procedures to all third-party summonses. In other words, a taxpayer is entitled to notice of a summons, even though the party who is summoned does not meet the definition of a third-party recordkeeper. The extension of these protections does not, however, apply to summonses issued in connection with a criminal investigation. See Code Section 7609(c)(2), as amended by the RRA.

    b. Handwriting Exemplars.

       A summons seeking a handwriting exemplar is enforceable. United States v. Euge, 444 U.S. 707 (1980), reh'g denied, 446 U.S. 913 (1980).

    c. Presence of Counsel.

A summoned witness is entitled to be accompanied and advised by counsel during his appearance before the IRS and to a transcript, witness fees, and mileage. 5 U.S.C. §§ 555(b), 555(c), 503(b); IRM [9.4]5.11.1 Right to Advice of Counsel (6/30/98). See, also I.R.C. § 7610; IRM [109.1]5.4 Rights and Privileges of Person Summoned (4/30/99); and IRM [109.1]5.4.2 Right to be Represented by Counsel (4/30/99). If the subject about which the witness will be questioned is technical, the witness is also entitled to consult with his accountant during the examination. IRM [109.1]5.4 Rights and Privileges of Person Summoned (4/30/99).

d. Return Preparers.

If the Special Agent attempts to interview the return preparer, the preparer may request that counsel for the taxpayer attend the interview. The taxpayer's counsel would not represent the preparer at the interview, but would be in a position to monitor the interview. Some preparers feel more comfortable by having the taxpayer's counsel present because they want the taxpayer to understand clearly that preparers have no choice but to answer the Agent's questions. The Special Agent may attempt to exclude the taxpayer's representative from the interview, but if the witness insists on having the taxpayer's representative present, the interview must proceed unless the presence of the representative will "impede the development of the case." See, IRM [109.1]5.5.2 Obstruction of Interview (4/30/99). However, the taxpayer has no right to intervene in a third party recordkeeper summons action in order to compel the IRS to allow his representative to attend the preparer's interview. United States v. Taylor, 79-1 U.S.T.C. § 9231 (E.D. Va. 1979).

e. Transcripts.

The witness is entitled to receive a transcript of his testimony, or to bring his own court reporter, provided he allows the IRS to obtain a copy of the transcript at its expense. 5 U.S.C. § 555(c); 26 C.F.R. § 601.107(d)(1) (criminal investigation functions); IRM [9.4]5.8 Right to Record Interview (6/30/98); [109.1]5.4 Rights and Privileges of Person Summoned (4/30/99); and [109.1]5.4.4 Right to Make an Audio Recording of the Proceeding (4/30/99). Agents frequently allow counsel for a witness to bring his own tape recorder, which is something counsel should request because the IRS usually takes a long time to prepare transcripts. However, the IRS requires that it be notified ten days prior to the interview that counsel intends to bring a tape recorder.

f. Second Examinations.

If the summons is in reference to a second examination of the taxpayer, there must be written notice to the taxpayer. I.R.C. § 7605(b). An objection based on the second examination must be timely made or it is waived. United States v. Baker, 451 F.2d 352 (6th Cir. 1971). A valid objection will prevent the IRS from enforcing the summons. United States v. Crespo, 281 F. Supp. 928 (D. MD. 1968).

5. Resisting the Summons: Grounds for Non-Compliance.

a. Requirements for a Valid Summons.

The standard requirements for a valid administrative summons are that (1) the inquiry must be for a legitimate purpose, not for harassment or leverage in settlement, (2) the material must be relevant to that purpose, (3) the information sought must not be in the Commissioner's possession, and (4) the Code's administrative steps must be followed. See, United States v. Powell, 379 U.S. 48 (1964); Reisman v. Caplin, 375 U.S. 440 (1964).

b. Objections to Summons.

A taxpayer who receives a summons may decline to comply if he has a valid objection to the summons. Objections to an administrative summons based on materiality and relevance are difficult grounds on which to prevail given the broadly defined permissible purposes of a summons. The summons, by its own terms, will limit the scope of the inquiry to a particular taxpayer, certain records, and a time period. The taxpayer could argue that the records summoned were irrelevant to the preparation of the return, but the court may require at least an in camera disclosure to ascertain the strength of this contention. There are rare instances where enforcement has been denied on relevance grounds. See, e.g., United States v. Matras, 487 F.2d 1271, 1275 (8th Cir. 1973); United States v. RLC Corp., 80-1 U.S.T.C. ¶ 9400 (D. Del. 1980).

A witness may claim that compliance with a summons would be excessively burdensome because the summons is too broad. A summons must be specific enough that it does not impose an unreasonable burden on the witness. United States v. Wyatt, 637 F.2d 293, 302 n.16 (5th Cir. 1981); United States v. Tratner, 511 F.2d 248 (7th Cir. 1975). In some instances, courts have refused to enforce a summons because of overbreadth or excessive burden. See, e.g., United States v. Northwest Pa. Bank and Trust Co., 355 F. Supp. 607 (W.D. Pa. 1973); United States v. First Nat'l Bank of Fort Smith, Arkansas, 173 F. Supp. 716 (W.D. Ark. 1959).

c. Fifth Amendment Claims.

A taxpayer may claim his Fifth Amendment privilege in response to an IRS summons where he has a reasonable fear that compliance will incriminate him. See, Kastigar v. United States, 406 U.S. 441, 444 (1972); United States v. O'Henry's Film Works, Inc., 598 F.2d 313, 317 (2d Cir. 1979); United States v. Noble, 76-1 U.S.T.C. § 286 (N.D. Ill. 1976). A

taxpayer may always claim his privilege against self-incrimination in response to questions from the Agent, but may not be able to protect his books and records with the privilege. If the summons seeks material protected by the attorney client or the work product privileges, it may be resisted as to those documents. If the IRS excuses a witness' appearance because he is likely to assert a privilege in response to all questions, it may waive its right to enforce the summons. See, e.g., United States v. Malnik, 489 F.2d 682 (5th Cir.), cert. denied, 419 U.S. 826 (1974); United States v. Lipshy, 492 F. Supp. 35 (N.D. Tex. 1979).

6. Summons Enforcement Actions. Sections 7604(a) and 7402(b) grant jurisdiction to the United States District Courts to enforce summonses. When a taxpayer declines to comply with a summons, the IRS will refer the matter to the Department of Justice, which, through the U.S. Attorneys Office or the Tax Division, will bring an ex parte application seeking an order to show cause why the summons should not be enforced. The Court will generally grant the application and issue the order to show cause, which will set a hearing at which time the taxpayer will present his basis for refusing to comply with the summons.

7. Summons Issued to Third Party Recordkeepers. In addition to issuing a summons for the records of the taxpayer, the IRS will typically issue a number of third party recordkeeper summonses under I.R.C. § 7609. Third party recordkeepers include financial institutions, consumer reporting agencies, brokers, entities that extend credit, accountants, and attorneys. I.R.C. § 7609(a)(3). The taxpayer under investigation receives notice of the summons.

   a. Objections.

   A taxpayer who wishes to prevent compliance with a third party summons must bring a proceeding to quash in U.S. District Court no later than 20 days after notice of the summons is given. The twenty-day period begins to run on the date the summons was mailed, not the date it was received. See, e.g., Stringer v. United States, 776 F.2d 274, 275 (11th Cir. 1985); Riggs v. United States, 575 F. Supp. 738 (N.D. Ill. 1983). No examination of the records will be allowed before the close of the 23rd day after notice was given, until the court orders production after a proceeding to quash, or until, during such a proceeding, the taxpayer consents. The taxpayer has standing to raise issues which normally could only be raised by the party having custody or control of records, such as ambiguity, relevancy and overbreadth. S. Rep. No. 938, Part I (Finance Committee), 94th Cong.2d Sess. 370 (1976); reprinted in 1976 U.S. Code, Cong. & Ad. News 3797 The ultimate burden of persuasion with respect to his right to enforce the summons is on the Secretary.

   b. Tolling of Statute of Limitations.

   The civil and criminal statutes of limitation are suspended during the period of any proceeding to quash instituted by a taxpayer regarding a summons served upon a third-party recordkeeper. The statute of limitations is not suspended, however, if the IRS brings an action to enforce a summons issued to the taxpayer with respect to whose liability the summons was issued. Treas. Reg. § 301.7609-5(b) provides that the limitations period is suspended "until all appeals are disposed of, or until the expiration of the period in which an appeal may be taken or a request for rehearing may be made. Full compliance, partial compliance, and noncompliance have no effect on the suspension provisions." As with any third party summons, counsel should ascertain that the taxpayer has received appropriate notice and weigh whether or not to bring a proceeding to quash. I.R.C. § 7609. Counsel can also attempt, when a third party such as an accountant is summoned for an interview merely to monitor it on the ground that the accountant and the taxpayer have had a confidential relationship through the years about which information is sought.

E. Developing and Preserving Defense Evidence.

1. The flip side of monitoring the agents' activities is to ensure that any favorable witnesses and information are identified as soon as possible. The practice of interviewing witnesses and making contemporaneous memoranda of the interviews (just as the special agents do) will enable the defense attorney to obtain and preserve important information from the early stages of the case, which is particularly important when the investigation is likely to drag on for many years. In certain instances, it may prove beneficial to reduce key aspects of a witness' statement to writing, in the form of a sworn affidavit or declaration, which should always be reviewed and/or corrected by the witness before it is signed. Note, however, these statements are subject to Jencks Act production if the witness testifies at trial.

X. REGULAR PROCEDURES IN CRIMINAL TAX CASES.

A. Power of Attorney (Form 2848).

1. Counsel should request that all future contacts with the client be through his representation, including the service of future summonses or subpoenas. To ensure this, counsel should promptly file a power of attorney, Form 2848. In some case, the Service may attempt to "bypass" the representatives listed on the Form 2848. The client should be informed of this possibility and advised that he should not answer any questions if he is in fact contacted.

B. Freedom of Information Act Requests (FOIA).

1. A request for information under the Freedom of Information Act, 5 U.S.C. § 552, may provide useful information about the Government's theories. While internal IRS documents and investigating records compiled for law enforcement purposes are exempt from production, and may therefore be produced in redacted form, statements made by the taxpayer during the civil examination may be produced. The FOIA request must comply with the IRS Statement of Procedural Rules. 26 C.F.R. § 601.702.

C. Consents.

1. In the course of a civil examination, the taxpayer may have supplied the Revenue Agent with numerous records for use by the Service in the determination of the correct tax liability. These records may have remained in the possession of the Revenue Agent through the time of a referral to CID. Under case law, unless these records were supplied to the Service as the result of legal process, the taxpayer is deemed to have consented to the I.R.S.'s possession and examination of his records only until the consent is withdrawn. Thus, upon learning of the possibility that the Service will conduct a criminal investigation, consideration should be given to requesting an immediate return of all of the taxpayer's records. In this regard, the Special Agent's Handbook states:

> Where possession of records is not obtained by legal process but is only by sufferance, they should be returned upon request, at the earliest practicable time. (See Policy Statement P-4-8). It was held in Mason v. Pulliam, that a taxpayer may withdraw an earlier voluntary consent to a taking of possession by the Service of records for examination and copying, the records being immediately returnable upon the withdrawal of that consent. Thus, the Service is effectively prohibited by this decision from making copies of such records following withdrawal of consent.

IRM [109.1]4.3 Withdrawal of Consent to the Use of Records (4/30/99); and Mason v. Pulliam, 557 F.2d 426 (5th Cir. 1977). Therefore, unless the Service has previously made copies of the taxpayer's records, the withdrawal of the consent may prove to be a substantial problem in further development of a criminal case.

D. Conferences.

1. Multiple Conference Opportunities. In a tax investigation, the taxpayer will generally have one or more conference opportunities at various levels in the review process.

   a. Department of Justice.

   It is sound practice to make a conference request early in the investigation. In fact, a conference request to the Tax Division of the Department of Justice should probably be made as soon as counsel ascertains that possible tax violations are the subject of investigation. See generally, Muller and Katz, "Criminal Conference Rules Improved by Tax Division," 65 The Journal of Taxation 158 (1986).

   b. SAC and Counsel.

   In a grand jury investigation, conference opportunities with the SAC and with Counsel are not available. In administrative investigations, the opportunity for a conference is still available as a joint conference with SAC and counsel. See Part VII.

   c. Assistant United States Attorney (AUSA).

   The taxpayer may request a pre-indictment conference with the Assistant United States Attorney, but this conference (if granted) is not likely to affect the final decision regarding prosecution.

XI. OTHER CRIMINAL TAX ISSUES.

A. Asserting and Protecting Privileges in Light of the New Taxpayer Communications and Expanded Work Product Privileges.

1. I.R.C. § 7525. This statute, also a byproduct of the RRA, extends certain confidentiality privileges to taxpayer communications. It states that, with respect to "tax advice," the "same common law protections of confidentiality which apply to communication between a taxpayer and an attorney shall also apply to communications between a taxpayer and any federally authorized tax practitioner to the extent that the communication would be considered a privileged communication if it were between a taxpayer and an attorney." The term "federally authorized tax practitioner" generally refers to anyone who is authorized to practice before the Internal Revenue Service. This would include, for example, certified public accountants and enrolled agents. The term "tax advice" is defined as "advice given by an individual with respect to a matter which is within the scope of the individual's authority to practice ...."

2. Applying the New Privilege to Different Types of Tax Services. In examining the nature and scope of this new privilege, it is useful to view the work that tax advisers perform as a continuum between tax return preparation and litigation. See Lee A. Sheppard, "What Tax Advice Privilege?", 98 Tax Notes Today, 128-3 (July 6, 1998), for an excellent discussion of the new privilege and potential problems with its application to work falling along this continuum. Return preparation, at one end of the continuum, is not privileged; communications in the course of litigation are, however, protected by the attorney-client privilege and the work product doctrine. Between these two extremes is "tax planning," and questions are certain to arise as to what extent, if any, the new privilege created by I.R.C. § 7525 will apply to that large body of tax work. Since the new privilege will apply to the same extent that present privileges apply to attorneys and clients, the case law will help define the scope of "tax advice" covered by the privilege.

   a. Tax Preparation.

   In the context of tax preparation, the courts have clearly held that the preparation of the tax return is not the rendering of legal advice. See, e.g., United States v. Davis, 636 F.2d 1028 (5th Cir. 1981), reh'g denied, 645 F.2d 71 (5th Cir. 1981), cert. denied, 454 U.S. 862 (1981).

   b. Tax Litigation.

   Tax advice can sometimes be linked to litigation preparation, so that the work product doctrine will apply. Probably the best recent example of the application of this doctrine (and its interplay with the attorney-client privilege) is discussed in United States v. Adlman, 68 F.3d 1495 (2d Cir. 1995), on remand, 1996 WL 84502 (S.D. N.Y. 1996), order vacated, 134

F.3d 1194 (2d Cir. 1998).

c. "Tax Advice."

In between tax preparation and tax litigation, is the grey area of "tax advice." The area is grey because the line between legal advice and business advice can be blurry. This is just one area where the new privilege may be subject to attack. A second area of vulnerability relates to the exception to the privilege for communications regarding tax shelters. In defining "tax shelter," Section 7525(b) refers to Section 6662(d)(2)(C)(iii). Section 6662, in turn, defines a "tax shelter" as "a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of federal income tax." Essentially, the new privilege for accountants does not apply to any written communication with corporate representatives "in connection with the promotion of the direct or indirect participation of such corporation in any tax shelter."

B. The Use of I.R.C. § 7212(a) in Criminal Tax Prosecutions.

1. Background on Section 7212(a). Section 7212(a) was significantly revised in the 1954 Code. Previously, the statute applied only to forcible obstruction or hindrance of tax collectors. See Section 360(c) of the 1939 Internal Revenue Code. In the 1954 Code, it was expanded to cover persons who "corruptly . . . endeavor[] to intimidate or impede any officer or employee of the United States acting in an official capacity under this title, or in any other way corruptly . . . obstruct[] or impede[] or endeavors to obstruct or impede, the due administration of this title . . ." The legislative history to the 1954 Code reflects that Congress had a rather specific concept in mind. The committee reports, thus, first point out that subsection (a) provides for the punishment of threats or threatening acts against any IRS persons or their families, and then goes on to state "this Section will also punish the corrupt solicitation of an Internal Revenue employee." Thus, Section 7212(a) is broader than its predecessors (18 U.S.C. § 111), which relates to assaulting or impeding certain United States employees "in that it covers threats of force . . . or corrupt solicitation." Given that history, it would seem that "corrupt attempts to impede" in Section 7212(a) would be directed at attempts to solicit IRS personnel.

   Over the years, Section 7212(a) has been applied to things such as filing "common law liens" on IRS employees. See United States v. Reeves, 752 F.2d 995 (5th Cir. 1985), reh'g denied, 757 F.2d 284 (5th Cir. 1985), cert. denied, 474 U.S. 834 (1985), appeal after remand, 782 F.2d 1323 (5th Cir. 1986), cert. denied, 479 U.S. 837 (1986). In Reeves, the Fifth Circuit interpreted the word "corrupt." The court held that it does not mean "with improper motive or bad or evil purpose." Rather, it is "directed at efforts to bring about a particular advantage such as impeding the collection of one's taxes, the taxes of another, or the auditing of one's or another's tax records." The court observed that it would be possible for a "disgruntled taxpayer" to "annoy a revenue agent with no attempt to gain any advantage or benefit other than the satisfaction of annoying the agent." Such actions would not be "corrupt" because the acts would not be done with an intent to gain some advantage. The court concluded Section 7212(a) applies to "acts done with the intent to secure an unlawful benefit either for oneself or for another."

2. Overuse of Section 7212(a). The current Criminal Tax Manual of the Justice Department indicates an expansive interpretation of Section 7212(a), citing United States v. Popkin, 943 F.2d 1535 (11th Cir. 1991), cert. denied, 503 U.S. 1004 (1992) (Section 7212(a) applied to an attorney who helped another person launder money by running it through a corporation with phony tax losses); and United States v. Mitchell, 985 F.2d 1275 (4th Cir. 1993) (Section 7212(a) applied to defendant who set up an organization to sponsor big game hunts as a disguised charitable organization and cause the hunters to file fraudulent tax returns claiming hunting payments as tax deductible contributions). However, its policy is more restrictive. In pertinent part, that policy is set out in Tax Division Directive No. 77 as follows:

> In general, the use of the "omnibus" provision of Section 7212(a) should be reserved for conduct occurring after a tax return has been filed -- typically conduct designed to impede or obstruct an audit or criminal tax investigation, when 18 U.S.C. 371 charges are unavailable due to insufficient evidence of conspiracy. However, this charge might also be appropriate when directed at parties who engage in large-scale obstructive conduct involving actual or potential tax returns of third parties. (See Section 3.00, supra). Use of omnibus clause is, nevertheless, not limited to conduct occurring after the return had been filed. "Continually assisting taxpayers in the filing of false tax returns or engaging in other conduct designed to make audits difficult; and other numerous large-scale violations of 26 U.S.C. 7206(2) or 18 U.S.C. 287 . . . are examples of situations when Section 7212(a) charges might be appropriate." Directive 77, p.1.

   Notwithstanding this policy, the widespread use of Section 7212(a) has raised concerns among practitioners. See Fink and Rule, "The Growing Epidemic of Section 7212(a) Prosecutions — Is Congress the Only Cure?", Journal of Taxation, 356 (June 1998).

C. Pleading Guilty in a Tax Case: The Availability and Benefits of Early Pleas, the Simultaneous Plea Program and Rule 11.

1. Simultaneous Plea Program. Internal Revenue Manual section (31)450 sets forth an administrative procedure for an expedited investigation and review of a criminal tax case "prior to the completion of the investigation." From the standpoint of the defense, the benefit of a simultaneous plea is the potential for a reduced sentence stemming from the taxpayer's unusual assistance and the time and cost savings to the government. The first requirement for this expedited procedure is that "Plea discussions must originate with the taxpayer represented by counsel." The procedure contemplates that counsel for the taxpayer will inquire of the Special Agent about the availability of the plea program. The Special

Agent is to then contact District Counsel who in turn will write to counsel explaining the program and the condition of the program. The agent, in turn, will then conducts and investigation with the cooperation of the taxpayer and his counsel. A modified Special Agent's report is then prepared and transmitted to District Counsel for a legal sufficiency review. If approved by District Counsel, the Special Agent's Report and the exhibits are transmitted directly to the United States Attorney. Duplicate copies of the Criminal Reference Letter are simultaneously transmitted to the Tax Division and to the United States Attorney. (Hence the name, "simultaneous plea program.") The standard of review in simultaneous plea cases is found in the U.S. Attorney's Manual, 6-4.310.

2. Rule 11 Plea Discussions. Rule 11 Plea Discussions: Rule 11 of the Federal Rules of Criminal Procedure and Rule 410 of the Federal Rules of Evidence provide for the inadmissability of plea discussions in any civil or criminal proceedings "against the defendant who made the plea or was a participant in the plea discussions." The protected information is: "any statement made in the course of plea discussions with an attorney for the government which do not result in a plea of guilty or which result in a plea of guilty later withdrawn."

D. The Civil Aftermath.

Regardless of the outcome of a trial involving criminal tax offenses, the taxpayer-defendant will normally be confronted with dealing with most of the very same issues, one additional time, in the civil context. This is permissible because of the different standards of proof: an acquittal for evasion under the beyond a reasonable doubt standard does not preclude the IRS from later asserting that the taxpayer is subject to the civil fraud penalty, which must be proven by the less onerous standard of clear and convincing evidence.

E. Conclusion. Boiling the defense of a criminal case down to its core elements is difficult, but the practitioner, as a general matter, would be well advised to do the following in most cases: Avoid actions that will or may make the problem worse. Refrain from the unsolicited, volunteering of documents or information to agents, but when compelled to do so, provide what must be given to the Government under law, but little or nothing else. Finally, prepare and pursue all defenses and develop a strategy for trial, but always look for opportunities to cut the best deal possible.

END NOTE

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Dual Resident Individuals--Interaction of Treaty Tie-Breaker Rules

William H. Newton, III[1]

A dual resident individual is one who though an alien is a resident for purposes of United States income taxation and also a resident of a treaty partner of the United States under its own internal laws. In this event recent treaties patterned after the Organization for Economic Cooperation and Development (OECD) model treaty contain specific tie-breaker rules on the issue of residence.

The Canada-United States income tax treaty which covers not only income taxes but taxes imposed by reason of death provides illustration. It spells out the following ordering rules for individuals deemed residents by both Canada and the United States:

1. The individual is deemed a resident of the jurisdiction in which the individual has a permanent home available;
2. If a permanent home is available in both or neither jurisdiction, the individual is deemed a resident of the jurisdiction with which the individual's personal and economic relations are closer (centre of vital interests);
3. Where the centre of vital interests cannot be determined, residence is deemed to be in the jurisdiction where the individual has an habitual abode;
4. If the individual has an habitual abode in both or neither jurisdiction, the individual is deemed a resident of the jurisdiction of citizenship; and
5. Otherwise, the competent authorities are to settle the issue by mutual agreement.

The United States Treasury Department's Technical Explanation underlying the 1969 United States-Netherlands Estate Tax Convention illustrates the reaction of the United States to these various criteria:

> These concepts are highly uncertain in their application, involving factual determinations in such case which may be extremely difficult to make and very controversial.

Indeed, the uncertain and elusive nature of these criteria can be illustrated by focusing on that of the jurisdiction with which an individual's personal and economic relations are closer (centre of vital interests).

In this regard there would seem to be some analogy between the centre of vital interests concept and the closer connection exception to the substantial presence test for determining residence for United States income taxation. This arises from the requirement that for the exception to apply the alien must have both a closer connection (in terms of personal contacts) to a foreign jurisdiction and a tax home (principal place of business) in that same foreign jurisdiction. Unless both requirements are satisfied with respect to the particular foreign jurisdiction at issue, the exception is inapplicable.

By way of more specific clarification, the OECD Commentary to the 1977 OECD Model Income Tax Treaty provides in part:

> If the individual has a permanent home in both Contracting States, it is necessary to

> look at the facts in order to ascertain with which of the two States his personal and economic relations are closer. Thus, regard will be had to his family and social relations, his occupations, his political, cultural or other activities, his place of business, the place from which he administers his property, etc. The circumstances must be examined as a whole, but it is nevertheless obvious that considerations based on the personal acts of the individual must receive special attention.

The concluding sentence of the Commentary would seem to give more weight to personal interests to economic ones. In any event, the same Commentary then extends further and provides:

> If a person which has a home in one State sets up a second in the other State while retaining the first, the fact that he retains the first in the environment where he has always lived, where he has worked, and where he has his family and possessions, can, together with other elements, go to demonstrate that he has retained his centre of vital interests in the first state.

Take these criteria and apply them to a scenario in which a Canadian citizen and resident, leaving his spouse and children in Canada at the family home, moves to the United States where he is principal decision maker in a construction business. In the process a second house is purchased in the United States where additional personal contacts are developed (such as club memberships, memberships in religious organizations, and local driver's license) along with acquisition of a United States green card. While periodic trips are made back to Canada to visit the spouse and children, no business activities are conducted there.

Under this set of facts the individual is not only a United States resident, due to acquisition of the green card alone, but Revenue Canada to protect the fisc likely will take the same position as well. The problem is that despite absence of business activities in Canada retention of the home there could in accordance with the OECD commentary conceivably demonstrate a retained centre of vital interests. See, e.g., Boidman, A Summary of Recent Developments Respecting Dual-Resident Individuals and Companies, 3 J. Strategy in Int'l. Tax. 36, 56 (1987) (suggesting in discussing Commentary that it can be "dangerous" to rely on this component of tie-breaker rules "where a home is retained in first country of residence").

The net result could well be absence of resolution under the tie-breaker rules until the fourth criterion is reached. Then, with the jurisdiction of citizenship being in Canada, that jurisdiction would be the jurisdiction of residence for purposes of the Treaty. Further, since income tax rates in Canada generally exceed those of the United States, a more substantial overall tax would likely be due.

In conclusion, application of treaty tie-breaker rules should be approached with caution. There is little interpretive guidance and the relevant apparent authorities which do exist may be inconsistent in application. Ultimately, it is the bright line of citizenship which may be controlling.

END NOTE

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TRANSFER OF STOCK OPTIONS PURSUANT TO A DIVORCE DECREE

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I. Introduction

The taxation of nonstatutory options[2] granted to an employee as compensation and transferred pursuant to a divorce decree is an area of tax law rife with confusion. The Internal Revenue Service (the "Service") has previously issued informal rulings on the transfer of options in community property states, but authority concerning transfers in common law property states has, until recently, been nearly nonexistent.

Transfers of compensatory options pursuant to a divorce decree may result in certain unfavorable tax consequences to transferring employees. The tax consequences of an option transfer depend on (i) whether or not the options are community property and (ii) whether or not the transfer pursuant to the divorce decree is an "arm's length" or "non-arm's length" transfer. Recently, in Field Service Advice ("FSA") 200005006 (Feb. 4, 2000), the Service concluded that the transfer of options pursuant to a divorce decree should be taxed as an arm's length transaction. Although the Service's conclusion clears up confusion surrounding such transfers in common law property states, it casts doubt on positions previously held by the Service regarding the transfer of options in community property states. The clear answers it provides to employee transferors of options held as separate property are not favorable to affected taxpayers as such transfers will now be considered taxable events and the amount of income realized by the employee transferor upon such event will be difficult to ascertain.

II. Background

A. Tax Consequences of Option Transfer

Options granted to employees as compensation are taxed pursuant to Treasury Regulations promulgated under Section 83 of the Code. When a nonstatutory option has no readily ascertainable fair

market value upon grant (as is the case with most options), an employee will not be taxed when he receives the option as compensation for services rendered. Instead, the employee will typically be taxed when he exercises or disposes of the option. Upon exercise, the employee will recognize ordinary income in an amount equal to the fair market value of the stock received less the amount paid by the employee to exercise the option (that is, the exercise price). An employee may also be taxed if he transfers the option to a third party.[3]

Options can be transferred in either arm's length or non-arm's length transactions, and the tax consequences for each are different.

1. Arm's Length Transfers

In an arm's length transaction an employee will realize compensation income in an amount equal to the sum of any money or the fair market value of any property received pursuant to the disposition. Upon transfer, the compensation element inherent in the option is said to be "closed." The transferee will receive the options with a basis equal to the income realized by the employee. When the transferee exercises the options he will not realize income, but upon sale of the stock the transferee will realize a capital gain (either long- or short-term, depending upon his holding period) in an amount equal to the excess of the fair market value of the property received over the amount of ordinary income recognized by the employee plus the amount the transferee paid for the stock on his prior exercise of the options. For example:

On January 1, 1998, A is granted an option by *X Corporation* to purchase 100 shares of *X Corporation* stock with an exercise price of $10 per share. On July 1, 1998, *A* transfers his option to B in an arm's length transaction. Upon transfer *A* will realize income in an amount equal to the money or property he received in the transaction. On December 31, 1998, when the stock to which the option relates has a fair market value of $15 per share, *B* exercises the options by paying the $1000 exercise price ($10 x 100 shares). Neither *A* or *B* will recognize income upon this exercise. Then on January 1, 2000 *B* sells all 100 shares of stock at their then fair market value of $20 per share. *B* will recognize a long-term capital gain, assuming the stock is a capital asset in *B*'s hands, on the sale in an amount equal to $2000, less the exercise price paid by *B* of $1000 and the amount of ordinary income realized by A upon transfer of the option.

2. Non-Arm's Length Transfers

In a non-arm's length transaction the compensation element inherent in the options remains "open." Therefore, upon transfer the employee transferor will not realize income. However, when the transferee exercises the options the employee transferor will realize ordinary income in an amount equal to excess of the fair market value of the stock received pursuant to the exercise of the options over the exercise price paid by the transferee. In other words, the employee transferor will recognize ordinary income on the entire "spread" not upon transfer of the option, but upon exercise by the transferee. This is the case even if the "spread" was very small or nonexistent at the time of transfer and significant appreciation occurred while the option was held by the transferee. The transferee will hold the stock with a basis equal to the exercise price paid plus the amount of income realized by the employee transferor. For example:

On the same facts as the above example, upon transfer *A* will not realize any income. However, on December 31,1998 when *B* pays $1000 to exercise the option *A* will realize income in an amount equal to $500 ([$15 - $10] x 100). *B* will hold the stock with a basis of $1500, recognizing $500 of long-term capital gain upon sale on January 1, 2000 ([$20 – $10 + $5] x 100).

B. Davis Decision

In a 1962 Supreme Court decision the Supreme Court determined that property transfers pursuant to a divorce decree are arm's length taxable transfers. In *United States v. Davis*, 370 U.S. 65 (1962), the Court held that transfers of martial property pursuant to divorce are exchanged for the release of other marital rights or property. Therefore such transactions occur at arm's length.

Typically transfers among family members are considered non-arm's length transfers. However, the Court in *Davis* reasoned that transfers pursuant to a divorce decree are negotiated settlements very unlike gifts. Although it is difficult to imagine a less likely context for gift-giving than divorce, the unfortunate result of the Court's reasoning is that transfers of property pursuant to divorce would become taxable events. Consequently, marital assets containing unrealized appreciation would become large tax liabilities upon divorce. To rectify this perceived problem, Congress enacted Section 1041 of the Code.

C. Internal Revenue Code Section 1041

Under Section 1041 of the Code no gain or loss will be recognized on a transfer of property from an individual to a former spouse, if the transfer is incident to divorce. Section 1041 of the Code effectively nullifies the holding of *Davis* and postpones the tax event on transferred property. Under Section 1041 of the Code, the transfer by an individual of property containing unrealized appreciation to a former spouse is no longer a taxable event. The transfer is treated as a gift and the former spouse will hold the property with the transferor's adjusted basis.

D. Post Encactment of Code Section 1041

In the case of a community property state, a question arises as to whether a division of property pur-

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suant to a divorce amounts to a transfer. This is because the property being divided is usually owned by both spouses jointly. However, Section 1041 of the Code does not distinguish between a divorce that occurs in a community property state and one that occurs in a common law state. Likewise, Section 1041 of the Code does not specifically address the transfer of options pursuant to a divorce.

1. Private Letter Rulings Regarding Common Law States

Following the passage of Section 1041 of the Code there is a paucity of authority concerning the transfer of options pursuant to a divorce decree in common law property states. Although Section 1041 of the Code appears to nullify the results of a *Davis* analysis in most cases of property transfer pursuant to divorce in a common law state, its plain language is not readily applicable to income realized under Section 83 of the Code upon the transfer of options. The income realized upon the transfer of options is not "gain" as contemplated by Section 1041(a) but is instead compensation income. On the other hand, Section 1041(b) of the Code provides that transfers incident to divorce will be treated as gifts, indicating that such transfers are non-arm's length and should be taxed accordingly. However, as discussed below, in FSA 200005006 the Service comes to a different conclusion.

2. Private Letter Rulings Regarding Community Property States

Following the passage of Section 1041 of the Code the Service has informally ruled on the tax consequences of option transfers pursuant to a divorce decree in community property states on three separate occasions.[4] In all three letter rulings the Service concluded that a disposition of community property upon divorce is not a "transfer" within the meaning of Section 83. Instead, the disposition is merely a division of the community estate owned by both spouses. As the non-employee spouse is owner of one-half of the options, upon disposition such spouse merely receives her previously owned share of the property rather than property transferred from the employee spouse. Consequently there is no tax event to the employee spouse upon disposition. Instead, the employee will recognize ordinary income when he exercises his one-half of the options in an amount equal to the excess of the fair market value of the stock received over the exercise price paid AND the non-employee spouse will recognize ordinary income when she exercises her one-half of the options in an amount equal to the excess of the fair market value of the stock received over the exercise price paid. This is the case even though the non-employee spouse did not personally participate in the labors for which the options were granted. Even though the spouse is not an employee, she will still realize income when she exercises her one-half of the options.

III. **FSA 200005006**

A. The Rule

On February 4, 2000 the Service released FSA 200005006. The Service concluded in this FSA that, although Section 1041 of the Code does nullify *Davis* in many respects, the rule presented by *Davis* regarding transfers incident to divorce as occurring not at arm's length remains good law. Furthermore, the Service concluded that Section 1041 of the Code does not act as a shield regarding the compensation income event resulting from such a taxable transfer because, by it's plain language, FSA 200005006 only prevents the recognition of "gain," not income realized under Section 83 of the Code.

Therefore, the Service determined that an employee is taxed under Section 83 of the Code when stock options are transferred to his former spouse pursuant to a divorce decree. Specifically, the employee is taxed on the amount of income realized in the transfer, which is deemed to be the fair market value of the options transferred. Upon exercise by the non employee spouse neither party will recognize income. The non-employee spouse will hold the stock received pursuant to such exercise as a capital asset with a basis equal to the amount she paid to exercise the option plus the amount of income realized by the employee spouse upon transfer.

B. Effect of FSA 200005006 on Common Law Property States

FSA 200005006 provides much needed authority concerning the transfer of options not owned by the community incident to divorce. Although arguably Section 1041(b) of the Code nullifies the holding under *Davis* that transfers incident to divorce occur at arm's length[5], the Service considered the effect of Section 1041 of the Code in the recent FSA and held that *Davis* is still good law on this issue. Accordingly, the Service will treat transfers of options owned as separate property pursuant to a divorce decree as a taxable event. The amount of income the employee will realize upon transfer equals the fair market value of the options transferred. No income will be recognized by either party upon exercise by the non-employee spouse, and the non-employee spouse will hold the stock received pursuant to exercise with a basis equal to the exercise price she paid plus the amount of income recognized by the employee upon transfer.

C. Effect of FSA 200005006 on Community Property States

The effect of FSA 200005006 upon community property states is unclear. Prior informal Service rulings on the transfer of options owned by the community did not depend upon whether or not the transfer is at arm's length. Those rulings held that no transfer, as contemplated by Section 83 of the Code, occurs upon divorce. This is because, in a community property state, the non-employee spouse already owns all of the options being transferred to her pursuant to the divorce. Therefore,

FSA 200005006 should arguably have no effect upon the transfer of options in community property states. This is especially true when one considers the rule in *Davis* concerned the division of separate property in a common law property state. However, it should be noted that the plain language of FSA 200005006 is not limited to common law property states and consequently could apply.[6] If this were the case it would significantly alter the heretofore presumed tax consequences of option transfers owned by the community pursuant to a divorce decree.

D. Valuation Concerns

Section 83 of the Code, as applied by FSA 200005006, provides that the amount realized by an employee upon the transfer of options pursuant to a divorce decree equals the "fair market value" of the options transferred. Generally, options do not have a readily ascertainable fair market value. For this reason alone FSA 200005006 will create significant problems to employee transferors of options in common law states.

The regulations issued under Section 83 of the Code provide some guidance regarding the valuation of options. Specifically, an option will have a readily ascertainable fair market value if it is either (a) actively traded on an established market or (b) not actively traded on an established market but its value can be measured with reasonable accuracy. The regulations clarify that if an option is not traded on established market, it will not have a readily ascertainable fair market value unless the taxpayer can show that **all** of the following conditions exist (1) the option is transferable by the optionee; (2) the option is exercisable immediately in full by the optionee;[7] (3) the option or the property subject to the option is not subject to any restriction or condition (other than a lien or other condition to secure the payment of the purchase price) which has a significant effect upon the fair market value of the option and (4) the fair market value of the option privilege is readily ascertainable in accordance with the regulations issued under Section 83 of the Code.[8]

But even if an option's fair market value is not readily ascertainable under Code Section 83, the value of the option privilege must still be determined for purposes of non-arm's length transfers.

The regulations clarify that the option privilege in the case of an option to buy stock is the opportunity to benefit during the option's exercise period from any increase in the value of the stock and is not merely the difference between the fair market value of the stock and the exercise price to be paid for the option (that is, the option privilege is not merely the "spread"). Therefore, the value of an option privilege is affected by (i) the probability of any increase or decrease in the stock to which the option relates and (ii) the length of period in which the option can be exercised.[9] Consequently, a Black-Scholes, or similar method, valuation of the options must be made to determine the amount a transferor employee must realize upon the transfer of an option pursuant to a divorce. Performing such a valuation will complicate the division of options pursuant to a divorce and will result in additional costs to the parties to the divorce. In addition, it is not clear what impact, if any, the use of a valuation method not specifically approved by the Service will have. Hopefully, the Service will issue additional guidance regarding the valuation of options in this context.

IV. **Conclusion**

FSA 200005006 clarifies the Service position regarding the transfer of compensatory stock options pursuant to a divorce decree which were held as separate property. Unfortunately, under the Service position, the transfer of such options by an employee will be a taxable event to the employee. Also, the Service position creates difficult valuation problems, including additional costs, for taxpayers. Arguably FSA 200005006 does not apply to the transfer of options held as community property and the tax consequences of such transfers should, therefore, remain unchanged. However, we will have to wait for official Service guidance on this issue to speak with any degree of certainty.

END NOTE

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2. Nonstatutory options are options other than incentive stock options or qualified stock options granted pursuant to Section 422 of the Internal Revenue Code of 1986, as amended (the "Code"). "Options" herein will only refer to nonstatutory options.

3. Although the regulations under Section 83 which govern the tax consequences of transfers do not, by their plain language, apply to transfers of options, the general interpretation of the regulations is that the transfer of options should be treated in a like manner. FSA 200005006 endorses this interpretation of the regulations.

4. Priv. Ltr. Rul. 84-51-031 (Sept. 14, 1984); Priv. Ltr. Rul. 87-51-029 (Sept. 22, 1987); Priv. Ltr. Rul. 94-33-010 (May 11, 1994).

5. An unlikely argument for an employee taxpayer to make as it would result in an employee recognizing ordinary income when the non-employee spouse exercises her options.

6. Editors of "The Corporate Executive" report the Service has indicated that the particular facts which gave rise to FSA 200005006 involved a common law state; however, they report the Service would give no indication as to their current position regarding the transfer of options in a community property state. See *Divorce Transfer of Options*, The Corporate Executive, May-June, 2000, at 9-10. Although private letter rulings may be relied upon only by the taxpayer(s) requesting them, such rulings typically provide insight as to the Service's views on a particular issue. Thus, it is probable that the result in FSA2000005006 will apply to transfers of options pursuant to a divorce in a common law state, but it is less clear whether such result will apply in community property states.

7. This condition would not be satisfied to the extent that unvested options are transferred pursuant to a divorce.

8. See Treas. Reg. § 1.83.7(b)(2).

9. See Treas. Reg. § 1.83.7(b)(3).

Hot Topics and Recent developments in The IRA /Qualified Plan Distribution arena From the Sublime to the Ridiculous

Marital Deduction Issues
Spousal Rollovers
Community Property
The Separate Account Rule At Death
Disclaimers
Trusts As Beneficiaries, Etc.

Noel C. Ice•

1999 and 2000 (so far) have been fertile years for IRS rulings and pronouncements in the area of IRA and qualified plan minimum required distribution (MRD) rules. The purpose of this article is to acquaint the reader with a number of the rulings and pronouncements, some of them informal and unofficial, and occasionally really weird.

The source for much of what we think we know in this area has been gleaned from two ALI-ABA Programs, Estate Planning for Distributions from Qualified Plans and IRAs (1999/Q284; 2000/VLR997), held in May of 1999 and 2000, in which Marjorie Hoffman (herein "MH"), Senior Technician Reviewer, Employee Benefits and Exempt Organizations Branch - Internal Revenue Service, and principal author of the proposed regulations under §401(a)(9), gave her personal opinions of what the rules are. In 2000, Marjorie Hoffman was joined by her colleague at the IRS, George Masnik (herein "GM"), Chief, Branch 4, Office of the Assistant Chief Counsel, responsible for the development and issuance of rulings, both public and private, in the estate, gift, and GSTT areas.

In order to keep this article as brief as possible, I am going to assume that the reader is familiar with the basic minimum required distribution (MRD) rules. Those rules need to be mastered before the practitioner should even dream of injecting into the equation the subject of trusts, disclaimers and community property. An introduction to the general distribution rules can be found in my article "The Minimum Distribution Rules Affecting IRAs and Qualified Plans in a Nutshell, A Guide for the Perplexed." This article, and my 900 page treatise *Estate Planning for Distributions From Qualified Plans and IRAs*, can be found on my website: http://www.trustsandestates.net/ (go to the "Guides and Articles" page). The subject of trusts as beneficiaries is treated in excruciating detail, far beyond the treatment given in this paper, in Article VIII, "Excise Taxes on Distributions."

MARITAL DEDUCTION ISSUES

Revenue Ruling 2000-2[1]

1.1 <u>If A QTIP Trust Is The Beneficiary Of An IRA Or Qualified Plan (QP), Must All Of The Income From The Plan Or IRA Be Distributed To The QTIP Trust In Order To Qualify The Plan Or IRA For The Estate Tax Marital Deduction, Or Is It Sufficient That The Surviving Spouse Has The Right To Demand Distribution?</u> *The latter.* **The answer is that it is sufficient that the surviving spouse has the right to demand distribution.** There never was any doubt that this is the law with respect to other forms of property, because, under the IRC, the spouse need only be "entitled" to the income, and further, Treas. Reg. §20.2056-7(d)(2) explicitly provides—

> **(2) Entitled for life to all income.** The principles of **20.2056(b)-5(f)**, relating to whether the spouse is entitled for life to all of the income from the entire interest, or a specific portion of the entire interest, apply in determining whether the surviving spouse is entitled for life to all of the income from the property regardless of whether the interest passing to the spouse is in trust.[2]

And, Treas. Reg. §20.2056(b)-5(f)(8) explicit provides—

> (**8**) In the case of an interest passing in trust, the terms "entitled for life" and "payable annually or at more frequent intervals," as used in the conditions set forth in paragraph (a)(1) and (2) of this section, require that under the terms of the trust the income referred to must be currently (at least annually; see paragraph (e) of this section) distributable to the spouse or that she must have such command over the income that it is virtually hers. Thus, **the conditions in paragraph (a)(1) and (2) of this section are satisfied in this respect if, under the terms of the trust instrument, the spouse has the right exercisable annually (or more frequently) to require distribution to herself of the trust income**, and otherwise the trust income is to be accumulated and added to corpus. . .[3]

Rev. Rul. 2000-2[4] now tells us that the regulation just quoted does indeed apply to IRAs and QPs, as in the case of any other asset; and, more importantly, that it applies where the beneficiary of the IRA or QP is a QTIP trust, provided that the trustee acts as a conduit for the income from the IRA or QP that the spouse demands be distributed to the trust, and provided the trust is required to distribute the income to the spouse. This ruling will come as no surprise to sedulous readers of ACTEC Notes, since the subject has previously been addressed in depth in an article that anticipated the holding of Rev. Rul. 2000-2 and which expressed no doubt that Treas. Reg. §20.2056(b)-5(f)(8) applies to a Spouse's beneficial interest in an IRA and to a QP or IRA named as beneficiary.[5] It is nevertheless reassuring to have a Revenue Ruling on point.

Specifically, Rev. Rul. 2000-2 addressed the following question:

> May an executor elect under section 2056(b)(7) of the Internal Revenue Code to treat an individual retirement account (IRA) and a trust as qualified terminable interest property (QTIP) if the trustee of the trust is the named beneficiary of decedent's IRA and the surviving spouse can compel the trustee to withdraw from the IRA an amount equal

to all the income earned on the IRA assets at least annually and to distribute that amount to the spouse?[6]

The following facts were recited in the Ruling:

> A died in 1999 at the age of 55, survived by spouse, B, who was 50 years old. Prior to death, A established an IRA described in section 408(a). The IRA is invested only in productive assets. A named the trustee of a testamentary trust established under A's will as the beneficiary of all amounts payable from the IRA after A's death. A copy of the testamentary trust and a list of the trust beneficiaries were provided to the custodian of A's IRA within nine months after A's death. As of the date of A's death, the testamentary trust was irrevocable and was a valid trust under the laws of the state of A's domicile. **The IRA was includible in A's gross estate under section 2039.**
>
> Under the terms of the testamentary trust, all trust income is payable annually to B, and no one has the power to appoint trust principal to any person other than B. A's children, who are all younger than B, are the sole remainder beneficiaries of the trust. No other person has a beneficial interest in the trust. Under the terms of the trust, B has the power, exercisable annually, to compel the trustee to withdraw from the IRA an amount equal to the income earned on the assets held by the IRA during the year and to distribute that amount through the trust to B. The IRA document contains no prohibition on withdrawal from the IRA of amounts in excess of the annual minimum required distributions under section 408(a)(6). [The life expectancy exception under the look-through rule for trusts was elected, and distributions were begun in the year following death.]
>
> * * * *
>
> Under the terms of the testamentary trust,[7] B is given the power, exercisable annually, to compel the trustee to withdraw from the IRA an amount equal to all the income earned on the assets held in the IRA and pay that amount to B. If B exercises this power, the trustee must withdraw from the IRA the greater of the amount of income earned on the IRA assets during the year or the annual minimum required distribution. Nothing in the IRA instrument prohibits the trustee from withdrawing such amount from the IRA. If B does not exercise this power, the trustee must withdraw from the IRA only the annual minimum required distribution.[8] [Emphasis added.]

The precise holding was—

> An executor may elect under section 2056(b)(7) to treat an IRA **and** a trust as QTIP when the trustee of the trust is the named beneficiary of the decedent's IRA, the surviving spouse can compel the trustee to withdraw from the IRA an amount equal to all the income earned on the IRA assets at least annually and to distribute that amount to the spouse, and no person has a power to appoint any part of the trust property to any person other than the spouse.[9]

Rev. Rul. 2000-2 gave the death knell to Revenue Ruling 89-89[10] by declaring it obsolete. We are all familiar with the fact that Revenue Ruling 89-89 approved a cumbrous process whereby the IRA was required to distribute all of its fiduciary accounting income (computed how?) to the QTIP trust, and the trust, in turn, would distribute the income to the spouse. Despite being rendered technically obsolete, 89-89 is still a valid approach,[11] but it has the disadvantage of requiring income in excess of the minimum required distribution (MRD) to be distributed and taxed earlier than 401(a)(9) would otherwise require. How big a disadvantage this is depends on the nature of the investment. If capital growth constitutes most of the increase in the IRA each year, and fiduciary accounting income (computed how?) is minimal (say, 3.82%[12]), then the MRD is usually going to exceed fiduciary accounting income anyway —but not always.

One advantage that the 2000-2 approach has over 89-89 is that the burden of determining fiduciary accounting income, while still there, is not so pressing. If the spouse does not make an issue out of it, then the fact that all of the true fiduciary accounting income was not distributed is not quite so critical as it might have been under 89-89.

Rev. Rul. 2000-2 is explicit that "[b]ecause the trust is a conduit for payments equal to income from the IRA to B, **A's executor needs to make the QTIP election under section 2056(b)(7) for <u>both</u> the IRA and the testamentary trust."**[13] This is consistent with the odd notion, articulated in some of the private letter rulings, that a trusteed IRA (or QP or custodial IRA?) is itself a trust, and as such cannot be an asset of another trust, and that a 2056(b)(7)(B)(v) election must therefore be made for both the IRA interest and for the QTIP trust itself.

It seems to me that a more appropriate (if slightly less technical) approach would be simply to treat the QTIP trust as owning "the right to receive" distributions from the IRA or QP (which is undoubtedly true), and treating this "distribution right" as a property interest and asset of the QTIP trust (also undoubtedly true), the same as if the QTIP owned the right to receive insurance commissions or a royalty interest. (Query, is a separate election required for other wasting assets?) I fail to see why it is the least bit relevant where the distributions (the right to receive which is owned by the QTIP trust) come from.

Treating the right to the distributions simply as a part of the corpus of the QTIP trust has the added benefit of meaning that the trustee of the QTIP trust can credit the income account with any income from the IRA (determined under applicable state law), and can distribute an equivalent amount from the QTIP trust rather than from the IRA, in those cases where the spouse needs the money and

where the income exceeds the MRD. This alternative will likely result in less income taxes being owed than if the income is forced to be disgorged by the IRA. I believe that such an alternative to 2000-2 is viable, but why rely on it exclusively when Rev. Rul. 2000-2 gives us a ready alternative? I believe that it is possible to combine both approaches.[14]

As is pointed out later in this article, a proposed regulation has no more weight in court than that of a brief filed by the Commissioner.[15] A Revenue Ruling is no different, but, like a proposed regulation, a Revenue Ruling can be used by the taxpayer as a shield against the IRS, even if it cannot be used by the IRS as a sword. Revenue Ruling 89-89 was utterly useless, in my opinion, because under the facts given, there was absolutely no way that the arrangement did not qualify for the marital deduction, and so the ruling was of zero benefit to the taxpayer. Nevertheless, the ruling was used by most of us as a roadmap for qualifying IRA/QTIP trust combinations for the marital deduction. As a roadmap, 89-89 was very poor indeed, even after considering the cartographer. Now, eleven years later, we have a new, much improved map, one that I predict will entirely supplant the 89-89 approach.

Possible Pitfalls. In 2000-2, it is not clear whether the failure of the spouse to take a distribution during the year resulted in the lapse of the right to the income. A lapse in this situation, is, however, expressly sanctioned by Treas. Reg. §20.2056(b)-5(f)(8). If the intent is to dissuade the spouse from taking a distribution which the spouse doesn't need, thereby incurring an income tax earlier than otherwise, consider making the withdrawal right non-lapsing. That way the spouse will not be as likely to take a distribution which the spouse does not presently need, but which the spouse might want to take later. Moreover, there are tax advantages to making the right non-lapsing.

If the right actually lapses, what are the transfer tax consequences, if any? The estate tax consequences are nil, since the QTIP will be included in the estate in any event. Are there any gift tax consequences? There might be if the gift were complete. **Is a gift of a remainder interest complete if the donor retains the right to the income, and there is no power over the remainder retained?** Possibly.

Recall that the whole basis for the common law GRIT[16] as an estate planning tool was that when a grantor transferred property to a trust, retaining the right to the income, there was a completed gift of the remainder even though an income interest was retained. However, since the present value of the remainder was much less than the future value of the remainder (and, much more importantly, the income was expected to be less than the applicable federal rate), the GRIT had definite transfer tax savings features. And what was the Congressional response to the common law GRIT? §2702, which makes matters considerably worse. If it applies, §2702 would presumably operate to provide that if the spouse eschewed the right to say, $50,000, then upon the lapse there would be a gift, a gift not just of the value of the remainder interest in the $50,000, but of the $50,000 itself. This is certainly how §2702 would operate in the case of a common law GRIT.

Are the 5&5 rules helpful? Probably not in the case of a common law GRIT because §2036 applies to actual transfers, and there is no 5&5 exception for actual transfers. The exercise or release of a power of appointment is only "deemed" to be a transfer. It is not a real transfer. That is why the Treasury needs §§2041 and 2514, because §§2036 and 2501 were thought to be insufficient. (If you think about it, you will realize that if §2036 applied to lapsed powers, then Crummey Trusts would be ineffective.) In the case of the lapse of a QTIP income right, however, I believe that §2514 would ameliorate the situation somewhat, to the extent the lapse was within the 5&5 harbor. Further, as is the case in any transaction under §2702, the taxpayer is only penalized if a gift tax is incurred (after application of the applicable exclusion), either immediately or in the future. If a gift tax is incurred, the estate tax adjustments are helpful, but never fully ameliorate the loss of the time value use of the money used to pay the tax.

Can the gift issue be avoided by giving the spouse a nongeneral power of appointment? Presumably yes, but then giving the beneficiary of a trust a power of appointment over IRA or QP proceeds creates other problems, discussed latter on in this paper.

What about §2519? If applicable, §2519 could be a huge problem. According to the Ruling[17] under discussion, "B has a qualifying income interest for life in the IRA and the testamentary trust for purposes of sections **2519** and 2044."[18] §2519 provides:

> "**Any** <u>**disposition**</u> **of all** or <u>**part of**</u> **a qualifying income interest** for life in any property to which this section applies **shall be treated as a transfer** <u>**of all**</u> **interests in such property other than the qualifying income interest**."

Is a lapse with a retained income right a "disposition"? Perhaps not. Recall the tortured nomenclature of §§2041 and 2514, where a release is taxed as a transfer and a lapse is treated as a release, unless within the 5&5 exception. Transfers, releases and lapses, I know, but "dispositions"? Treas. Reg. §25.2519-1 provides that a disposition of any part of the income interest is treated as a transfer of the value of the remainder interest in QTIP property. Is the reverse true? Is a transfer of a part of the income interest a disposition of that interest? Arguably, yes, but the real question is whether a transfer of income that has already accrued is a disposition of a part of the income interest for purposes of §2519, taking the purposes of the statute into account.

The regulation is helpful in otherwise elucidating how the statute operates in practice, but it does not define the term "disposition." I think that **once the income has actually accrued, any subsequent transfer of that income is not a disposition of the *income interest* (presumably the right to receive income in the future), but is, at worst, a disposition/transfer of the income itself**, after the functional equivalent of receipt. This is because the right to the income matured prior to the lapse. To illustrate, if one were asked to value the income interest as of the date of lapse, would one

include the income that had already accrued and was subject to demand, or only the right to future income? The latter strikes me as more correct. Well, that, at least is my litigation position. (For what it is worth, the spouse has not "disposed" of the income on the eschewed income.)

It bears noting that if a transfer for gift tax purposes is a "disposition" under §2519 (a doubtful proposition for the reasons indicated), the value of the interest *actually transferred* is irrelevant. §2519 taxes the value of the remainder, not the transferred income interest. **What is relevant under §2519 is the value of the remainder; which, incidentally, the spouse never owned and is not empowered to transfer.** It is this value that §2519 taxes. The interest that is actually being transferred is never taxed under §2519; but, instead, is taxed under §§2501/2511, arguably after application of §2702; which, as noted, may be but a minor concern after application of the 5&5 exception and the use of any available unified credit.

> At the May 2000 ALI-ABA Seminar, George Masnik opined that §2519 was probably **not** a problem here; rather, the transaction would be viewed as a withdrawal followed by a recontribution, and not a disposition of the income interest.

I believe that §2702 is possibly applicable to the transfer of the lapsed right to income for the year of the lapse, to the extent exceeding the 5&5 harbor, and that §2519 might technically cause the spouse to be treated as having made a gift of the entire non-income interest. Not a pretty picture at first blush. The reality, however, may be that the impact of §2702 will in most cases be mitigated by the 5&5 exception, and that the courts and the IRS will be reasonable in applying §2519 (which is to say they will not apply it); but it is really too early to tell. **Until these issues are resolved, I advise making the right to the income non-lapsing!** That should cure the problem.

SPOUSAL ROLLOVERS

A spouse who is a beneficiary of a participant's interest in a QP, tax sheltered annuity or IRA, may rollover the inherited interest; or, in the case of an IRA, treat it as his or her own[19] (which amounts to the same thing), even where death was after the participant's RBD. For purposes of this portion of the material, I will use the word spousal rollover to include the situation where the spouse elects to treat an IRA as his or her own. The proposed regulations on the subject are worth reviewing:

Q-. May an individual's beneficiary elect to treat such beneficiary's entire interest in the trust upon the death of the individual (or the remaining part of such interest if distribution to the beneficiary has commenced) as the beneficiary's own account?

A-. (a) In the case of an individual who died before January 1, 1984, the provisions of §1.408-2(b)(7)(ii) (as in effect on December 31, 1983) continue to apply to the distribution of such individual's account. Thus, any beneficiary (whether or not the beneficiary is the individual's surviving spouse) may treat his interest in such individual's account as the beneficiary's own account in accordance with §1.408-2(b)(7)(ii), regardless of whether or not distribution to the beneficiary has commenced.

(b) In the case of an individual dying after December 31, 1983, **the only beneficiary of the individual who may elect to treat the beneficiary's entire interest in the trust** (or the remaining part of such interest if distribution thereof has commenced to the beneficiary) as the beneficiary's own account **is the individual's surviving spouse**. If the surviving spouse makes such an election, the spouse's interest in the account would then be subject to the distribution requirements of section 401(a)(9)(A), rather than those of section 401(a)(9)(B). **An election will be considered to have been made by the surviving spouse if either of the following occurs: (1)** any required amounts in the account (including any amounts that have been rolled over or transferred, in accordance with the requirements of section 408(d)(3)(A)(i), into an individual retirement account or individual retirement annuity for the benefit of such surviving spouse) have not been distributed within the appropriate time period applicable to the decedent under section 401(a)(9)(B), **or (2)** any additional amounts are contributed to the account (or to the account or annuity to which the surviving spouse has rolled such amounts over, as described in (1) above) **which are subject, or deemed to be subject, to the distribution requirements of section 401(a)(9)(A)**. The result of such an election is that the surviving spouse shall then be considered the individual for whose benefit the trust is maintained.[20] [Emphasis added.]

2.1 <u>Is a Minimum Required Distribution (MRD) Due in the Year of a Participant's Death, if Death is After the RBD?</u> *Yes.*

The fact that the Participant dies during the year will ordinarily have no effect on the obligation to make the MRD for the year. Once the RBD has been reached, distributions under the rule are to continue "at least as rapidly as under the method of distributions being used under subparagraph (A)(ii)[21] as of the date of his death."[22] This would ordinarily require a distribution no later than December 31 of the calendar year of death, if death is after the RBD. If a participant, who intended taking the MRD at year end, dies on December 30, it is unlikely that anyone will be in the proper state of mind, or even have the authority, to make a timely distribution the next day. However, this could be true of any one of a number of other tax deadlines as well (including personal income tax), so there is no presumptive reason to doubt the conclusion suggested, even if the result may be draconian in operation.

> MH confirmed that a MRD is due by December 31 of the year of death after the RBD (if not made during life), but noted that the IRS does have authority to waive the 4974(a) excise tax if it finds reasonable cause for the shortfall.[23]

One solution, to corrupt an old Chicago voting adage, would be to take your MRD's early and often.

2.2 <u>If the Participant Has Passed the RBD, But the</u>

Participant's MRD Was Not Made in the Year of Death, While the Participant Was Alive, Can a Spouse Beneficiary Rollover the Participant's Entire Account Balance Including the Amount That Should Have Been Distributed Had the Participant Lived? ***Technically no, but the Service apparently thinks it is okay.***

It is not entirely clear to me whether the spouse must deduct from the amount rolled over in the year of death of the participant the amount that would have been due had the participant lived until December 31. On balance, I believe that a deduction is technically required.

Treas. Reg. §1.402(c)-2 Q&A 7(a) provides in part:

> A-7. **(a) General rule**. Except as provided in paragraphs (b) and (c) of this Q&A, if a minimum distribution is required for a calendar year, the amounts distributed during that calendar year are treated as required minimum distributions under section 401(a)(9), to the extent that the total required minimum distribution under section 401(a)(9) for the calendar year has not been satisfied. Accordingly, these amounts are not eligible rollover distributions. . . .[24] [Emphasis added.]

Treas. Reg. §1.402(c)-2 Q&A 7(a), quoted above, suggests to me that to the extent an amount is required to be distributed by December 31 of the year of the participant's death, after the participant's required beginning date (RBD), as a result of the minimum distribution rules, this amount cannot be rolled over by the surviving spouse, even if the rollover takes place prior to December 31 of the year of death, and even though the minimum distribution would not otherwise have been required prior to December 31, had the participant lived so long. In reiteration of this notion, it is worth noting in this context that the Roth regulations prevent a Roth rollover in the year prior to the RBD unless the participant deducts from the rollover, and pays tax on, the MRD for the first distribution calendar year (which isn't even due to be paid until the following year!).[25]

Arguably, Treas. Reg. §1.402(c)-2 Q&A 7(a) conflicts with the first sentence of Treas. Reg. §1.408-8, Q&A A-4(b):

> "(b) In the case of an individual dying after December 31, 1983, the only beneficiary of the individual who may elect to treat the beneficiary's **entire interest** in the trust (or the remaining part of such interest if distribution thereof has commenced to the beneficiary)[26] as the beneficiary's own account is the individual's surviving spouse. . . . "[27] [Emphasis added.]

Unfortunately, this regulation antedates the MRD rules.

> It is important to note that (1) if the participant's life is being recalculated, and (2) if the rollover takes place in the year after death, and (3) if a minimum required distribution (MRD) is required to be made based on the status of the account prior to the rollover, then **a very large minimum distribution may be required before the account can be rolled over**.

Requiring a MRD prior to the rollover appears to me to fit the letter and spirit of the law, even if the result is not taxpayer friendly. However, the informal unofficial position appears to be that since the legislative history favors spousal rollovers, the spouse can rollover the participant's last MRD.

> In summary, if a participant dies after the RBD, then a MRD will ordinarily be due by December 31 of the year of death. Although as a technical matter MRDs cannot be rolled over, **MH clearly indicated that the entire account, including the MRD in the year of death, can be rolled over**. (In fact, it may be deemed to have been rolled over if not taken. See below.)

2.3 Assuming That A Spouse Beneficiary Is Allowed To Rollover The Participant's Final MRD, And The Spouse Does Nothing, And The MRD Is Not Made, Is The Spouse Deemed To Have Elected Rollover Treatment? ***Yes, if the premise is correct.***

The Deemed Election Rule. If an MRD for the year would have been due if a *spousal rollover had **not** been elected*, but that MRD was not made, the proposed regulations save the day (?) by providing that an election by the spouse to treat the IRA as his or her own will be deemed to have been made,[28] the effect of which is that no MRD is due after all.

Prior to the RBD, a minimum distribution will never be required before at least five years have expired[29]; and, if the designated beneficiary is the Participant's spouse, distributions need not begin any earlier than the end of the calendar year in which the participant would have attained 70 1/2 (or the end of the calendar year following the year of death, if later).[30] So, it may be awhile before the deemed election rule applies. But what if the participant has passed the RBD, dies on December 31 on the way to the bank to withdraw the MRD for the year, and the bank closes before the spouse can make the withdrawal? The concern here is not the IRC §4974(a) excise tax; rather, the concern is that the spouse may have just innocently elected to treat the IRA as his or her own.

Having the IRA treated as the spouse's own is usually a desirable result, but not always. For example, if both spouses were over 70 1/2, but the decedent was much younger, a deemed rollover might not be the best course. Likewise, if the spouse were younger than 59 1/2 and needed to take a distribution, a deemed rollover, followed by a distribution would result in the imposition of the 10% premature distribution tax. Finally, and perhaps most important, a spouse who has rolled over a distribution would be precluded from making a qualified disclaimer under IRC §2518, if the "deemed" rollover were considered the exercise of dominion and control or the acceptance of benefits under the IRA. However, as will be discussed later, we have reason to believe that the IRS is not presently disposed to press this issue too hard.

Under my analysis, the spouse could not have rolled over the MRD anyway, so there could be no deemed election, but if MH is right then I am wrong about this. If so, it follows that the spouse has fallen under the deemed rollover rule. MH suggests that the spouse might take some action, such as paying the excise tax and applying for the waiver, in order to counter the application of the deemed rollover rule. At the 2000 ALI-ABA Seminar, MH suggested that a waiver application would be a prerequisite for escaping deemed rollover treatment.

The planning point is to take the MRD early each year.

2.4 <u>Can A Spouse Make A Rollover If The Spouse Has Previously Taken Distributions Prior To Age 59 1/2 But Did Not Pay The Premature Distribution Tax?</u> ***The PLRs are divided, but the IRS apparently now thinks the answer is yes. If the situation is reversed, however, and the spouse fails to take a distribution that was required in the absence of a rollover, the spouse cannot claim that there was no rollover.***

Can a spouse elect by his or her actions to be treated as a beneficiary, thereby precluding a rollover? MH implied that she thinks the election is one way only: that if the spouse takes action that is **inconsistent with beneficiary treatment** (and is consistent with rollover treatment) that the spouse cannot backtrack and be treated as a beneficiary. On the other hand, she clearly implied that **the spouse can take action that is consistent with beneficiary treatment, without waiving the right to subsequently make a rollover**. This is one time I agree with MH. Unfortunately, her interpretation of the rules is contrary to the position taken in two PLRs discussed below.[31]

There are two private letter rulings holding that if a spouse who is under 591/2 takes a distribution from an IRA without paying the §72(t) 10% early withdrawal penalty tax (which would not be applicable if the spouse were a beneficiary), the spouse is deemed to have elected beneficiary status.[32] Despite this, I understood MH to say that this is an evolving area, and that she does not think that an election to never rollover has been made, which implies to me that she is not in full agreement with the cited PLRs. Rather, the election is made when the spouse takes some affirmative act that would be inconsistent with the MRD rules unless rollover treatment had been elected. My clear impression was that MH did not see much that could prevent a spouse from making an election, deemed or otherwise, to treat the IRA as his or her own; and that the problem was the other way around: if the spouse takes action that indicates that a rollover election has been made, the spouse cannot go back and claim that no rollover took place.

To recapitulate the above, MH made it clear that the spouse could take the MRD for the participant in the year of death, and then rollover the next year, even if both spouse and participant are passed 70 1/2. At the ALI-ABA 2000 Seminar, MH reconfirmed the IRS ruling position on this point was now favorable to the taxpayer. MH sees the problem as being where a spouse fails to take a distribution that is required in the absence of a rollover, and then later tries to treat the IRA as if no rollover took place. As indicated above, she is of the opinion that the reverse of this fact pattern is not where the problem lies.

2.5 <u>How Long May a Spouse Wait Before Making a Spousal Rollover?</u> ***There is no known published time limit, but that does not mean that there is none, and the IRS is now suggesting that if the spouse if over 70 1/2 the spouse must rollover within a year if the spouse wishes to begin a new life expectancy period!***
How long may a spouse wait to rollover? We don't know. Perhaps there is no limit. This question is somewhat related to the question of whether or not a spouse who has taken a pre-59 1/2 distribution without paying a premature distribution penalty tax may subsequently rollover.

Of all of the pronouncements that issued from MH at the 2000 ALI-ABA Seminar, perhaps the most startling and disturbing was an opinion, given out of the blue, that although a spouse may have an unlimited time to rollover, the spouse has a limited time to rollover if the spouse wishes to use the joint life expectancy method. This pronouncement is not supported by anything written. If the spouse elects to treat the IRA as his or her own, then it would seem that the MRD rules would be applied without regard to the source of the IRA, and I can see no logical reason why the joint life expectancy method would not be available, but **I very clearly heard MH say that if the rollover was more than a year after the year of death, and if the spouse was over 70 1/2, the joint life expectancy payout method is unavailable!** Merv Wilf says that MH's position is the correct one, but no one, including Merv, has cited any authority whatsoever for the conclusion. And indeed there is none.

2.6 <u>What is the Required Beginning Date For a Spouse Who is Over 70 1/2 at the Time a Spousal Rollover is Made, If The MRD For The Participant Was Made In The Year Of The Rollover?</u> ***December 31, of the year following the rollover.***
The proposed regulations do not address the question of what the rollover RBD is for a spouse who makes a rollover after the spouse's normal RBD has passed. This question is relevant because its answer directly affects the solution to the next three questions: (1) When is the first MRD required to be made? (2) When does the spouse have to have a designated beneficiary in order to qualify for a joint life expectancy MRD payout? When is the spouse's life expectancy to be first determined, assuming no recalculation: the calendar year before the spouse's regular RBD, or the calendar year of the rollover RBD?

These issues were treated in PLR 9534027. Both the decedent, A, and his wife, B, were past the normal RBD, when A died in 1994. A had already taken the MRD for 1994 prior to his death. B was A's beneficiary. B planned to roll over A's IRA in 1995 into three separate IRAs, simultaneously designating a different child as the beneficiary of each. Prior to the rollover, B would take the MRD using the method of distribution in effect at A's

deaths. The PLR said that the first distribution was due in 1996, and would be based on the joint life expectancy of B and whichever child was the beneficiary of the particular IRA. (This makes sense because the distribution can be made based on the December 31, 1995 balance, consistent with the general rule for valuation.)

> The entire balance credited to Individual A's IRA is to be transferred in 1995 from Individual A's IRA to Individual B's IRAs. Accordingly, with respect to ruling request three, for purposes of section 408(a)(6) of the Code and the income tax regulations thereunder, **Individual B's required beginning date for her IRAs will be December 31, 1996**.
>
> . . . [I]t is a reasonable interpretation of the minimum distribution requirements . . . that Individual B's three children may be treated as designated beneficiaries for purposes of section 408(a)(6) of the Code, since they will have been designated before Individual **B's first required distribution date of December 31, 1996**.[33]

In PLR 9311037, both A and his spouse, B, were passed the normal RBD. A died in 1991, designating B as his sole beneficiary. B rolled over A's IRA in 1991, after the MRD for A had been made for that year. B designated new beneficiaries. The ruling held that the first MRD for the rollover account was December 31, 1992, and that if B had a designated beneficiary by that date, the MRD could be computed using the joint life expectancy method.

> With respect to ruling request four, once you are treated as the individual for whose benefit the IRA is maintained, there is no longer an IRA maintained for the benefit of Individual A. As stated above, section 1.401(a)(9)-1, Q&A G-2 of the proposed regulations provides that **the 1991 amount rolled over to your IRA does not affect any required minimum distribution from your IRA for 1991**. Because your account balance in the preceding calendar year (as of December 31, 1990) was $0.00, no distribution was required from your IRA in 1991, and no excise tax under section 4974 of the Code will be imposed with respect to your IRA, for a failure to make distributions for any calendar year prior to 1992.[34]

So, if PLRs 9534027 and 9311037 reflect the law, then the spousal RBD is December 31 of the calendar year following the rollover, the MRD must be made by that date, and if the MRD is to be determined under the joint life expectancy method, there must be a designated beneficiary by that date. Presumably, the spouse's age for MRD purposes is the spouse's age as of his or her birthday in the year following the rollover, although this issue was not directly addressed in PLR 9534027. (The alternative would be to take the spouse's age on her normal RBD, and to subtract one for each intervening year, in the absence of recalculation.)

2.7 <u>What is the Required Beginning Date For a Spouse Who is Over 70 1/2 at the Time a Spousal Rollover is Made If The MRD For The Participant Was Not Made In The Year Of The Rollover?</u> ***December 31 of the year of death, according to MH.***

As noted elsewhere in this article, by not taking out the decedent's MRD for the year of death, the spouse is deemed to have elected to treat the IRA as his or her own. By virtue of this rule, the Service, in effect, permits a spouse to rollover the MRD for the year of death of a participant who was past the RBD. If the spouse is not yet 70 1/2, then it follows that no MRD is paid in that year, which is certainly a boon. But what if the spouse is over 70 1/2 at the time of the deemed rollover? The PLRs suggest that the spouse's RBD for rollover purposes is December 31 of the calendar year following the rollover, as above explained. And if so, there would be no MRD for the year of death, even if the participant was passed the RBD. However, in PLRs 9534027 and 9311037 the MRD for the participant was in fact made in the year of death, prior to the rollover, and thus, these rulings did not address what would happen if the MRD for the participant was rolled over.

I am skeptical about the notion that the spouse can rollover the MRD otherwise due for the year of the rollover, because the result is contrary to the regulation that prohibits rollovers of MRDs. I of course welcome the IRS liberal interpretation of the spousal rollover rule as allowing a rollover of the participant's MRD. But there are implications to any theory which supports the IRS position, and one implication that is inescapable is that there is no MRD at all in the year of the rollover because the rollover account had a zero value in the preceding valuation calendar year.

> Lest we be too hopeful that logic will prevail, MH, at the 2000 ALI-ABA Seminar, said that if both spouses were over 70 1/2, the spouse would have to take out a MRD based on the spouse's life expectancy for the year of death!

This corrects one anomaly and creates another, but at the expense of logic and theory -a practice that unfortunately is all too common in this particular area of IRS pronouncements. Shall I explain? Logical would be to withdraw the decedent's MRD for the year -in effect not rolling it over. Less logical, but only slightly, would be to allow the rollover, require that an MRD be made the first year, but base the MRD on the method in effect at the participant's death. Least logical of all would be to base the MRD in the year of rollover on the spouse's choice of beneficiary. And there is more to logic at issue.

It is one thing to expect the decedent to take MRDs early and often, and to have the good sense not to die late in the year without first satisfying 401(a)(9), but if death is on December 31, and the MRD was not previously satisfied, the poor bereaved spouse will be deemed to have rolled over the account. And what is worse, the spouse will probably be stuck with the single life expectancy payout method, unless the spouse completes a beneficiary designation form before the end of the year of death, which in the example probably means before the funeral, before the decedent has even been properly planted.

The final planning point, if planning under present circumstances can possibly be considered a serious option, would be to determine who will be the spousal rollover designated beneficiary, compare it to the method in effect at the decedent's death, and take the MRD before or after the rollover, depending on which is most advantageous.

COMMUNITY PROPERTY ISSUES

3.1 Does IRC §408(g) Compel an IRA Owner to Ignore the State Law Ownership Interest of a Spouse or Former Spouse For Federal Income Tax Purposes? ***Yes(?).***

In PLR 8040101 a taxpayer asked the IRS to rule on the following issues:

"1. For purposes of section 408 of the Internal Revenue Code, should the two individual retirement accounts in the name of Taxpayer B be classified as community property in which the decedent had an individual one-half interest?

"2. When the judgment of possession in the succession is rendered recognizing the decedent's eight brothers and sisters and one niece as her testamentary legatees and as such entitled to ownership of an undivided one-half interest in the subject individual retirement accounts, **can Bank C, as the custodian of said accounts, distribute one-half of the funds contained herein to the legatees?**

"3. Upon receipt of these funds by said legatees, are these funds considered ordinary income to the recipients?

"4. Does this transfer of funds to the legatees of the decedent constitute a taxable distribution to Taxpayer B?"

The IRS ruled as follows:

> "It follows, in the instant case, that the classification of the two IRAs as community property is clearly a matter to be determined under the laws of State D. Therefore, in response to ruling request 1, we accept your determination that the two IRAs constitute community property under the laws of State D in which Taxpayer A had an undivided one-half interest.
>
> "With regard to ruling request 2, **we conclude that Bank C, as trustee of the IRAs, may properly distribute one-half of the funds in the IRAs to Taxpayer A's legatees** pursuant to the judgment of possession in Succession S recognizing the decedent's eight brothers and sisters and one niece as her testamentary legatees and as such entitled to ownership of an undivided one-half interest in the IRAs.
>
> "With reference to ruling requests 3 and 4, section 408(d)(1) of the Code provides that any amount paid out of an individual retirement account or under an individual retirement annuity shall be included in gross income by payee or distributee, as the case may be, for the taxable year in which the payment or distribution is received.
>
> "Therefore, in respect to ruling request 3, we conclude that upon payment of these funds by Bank C to Taxpayer A's legatees pursuant to the judgment of possession in Succession S, these amounts will be includible in the gross income of the recipients as required by section 408(d)(1).
>
> "Accordingly, in response to ruling request 4, we conclude that the distribution of these amounts to Taxpayer A's legatees does not constitute a taxable distribution to Taxpayer B because he is not the payee or distributee of these amounts under section 408(d)(1)."

In *Bunney v. Commissioner*, 114 TC 17 (2000), the trial court ordered the taxpayer's IRA "to be divided equally between the parties." Does anyone other than President Clinton (what does "is" mean) really believe that such an order fails to comply with §408(d)(6), which provides:

> "(6) **Transfer of account incident to divorce.** The transfer of an individual's interest in an individual retirement account or an individual retirement annuity to his former spouse under a divorce decree or under a written instrument incident to such divorce is not to be considered a taxable transfer made by such individual notwithstanding any other provision of this subtitle, and such interest at the time of the transfer is to be treated as an individual retirement account of such spouse, and not of such individual. Thereafter such account or annuity for purposes of this subtitle is to be treated as maintained for the benefit of such spouse."

The taxpayer is husband withdrew the interest belonging to his former spouse and conveyed it to her himself. The Tax Court held that the withdrawn proceeds were taxable to the husband.

Would the result have been different if the taxpayer had instead directed the IRA custodian (husband's agent!) to transfer the spouse's interest to the spouse? If so, the case was wrongly decided, because it is a fundamental tax principal (assignment of income) that the parties should not be able to decide, after the divorce, who will be taxed on the IRA.

Of course, the real reason the case is of interest to estate planners of community property is because of the court's statements that 408(g) is to be given literal application. The court is free to interpret 408(g) however it chooses, and since the statute says that community property laws are to be disregarded for income tax purposes, a strict constructionist approach is certainly legitimate, even if not compelled. My quarrel is with the interpretation that "to be divided" is to be distinguished from "is hereby divided."

The issue was framed by the Tax Court as follows:

> We pass for the first time on the question of whether one-half of community funds contributed to an IRA account established by an IRA participant are, upon distribution, taxable to the participant's former spouse by virtue of the fact that the former spouse has a 50-percent ownership interest in the IRA under applicable community property law. Section 408(g), as discussed below, provides explicitly that section 408 (the statutory provision governing IRA requirements and the taxability of IRA distributions) "shall be applied without regard to any community property laws". Thus, at first blush, it appears that the answer to our question is that the husband is taxable on 100-percent of the distribution notwithstanding the fact that his former wife owned and was entitled to receive 50 percent of the distributed proceeds. As petitioner observes, however, **the Commissioner administratively has recognized that section 408(g) does not**

> **preclude taking community property rights into account in allocating the tax consequences of IRA distributions. See Priv. Ltr. Rul. 80- 401-01 (Jul. 15, 1980) (distribution of decedent's community property interest in surviving spouse's IRA is taxable to decedent's legatees)**. But see Priv. Ltr. Rul. 93- 440-27 (Aug. 9, 1993) (distribution of wife's community property interest in husband's IRA under a separation agreement is taxable to husband).[35] Additionally, the courts of at least two community property States have concluded that section 408(g) does not preempt recognition of community property rights in an IRA for State law purposes.[36] See In re Mundell, 857 P.2d 631, 633 (Idaho 1993) (community property interest in wife's IRA is includable in husband's estate); Succession of McVay v. McVay, 476 So. 2d 1070, 1073- 1074 (La. Ct. App. 1985) (IRA to be accounted for in division of community property at divorce).[37] [Emphasis added.]

* * * *

The theory for the holding was articulated in straightforward fashion:

> Recognition of community property interests in an IRA for Federal income tax purposes would conflict with the application of section 408 in several ways. As an initial matter, an account imbued with a community property characterization would have difficulty meeting the IRA qualifications. Section 408(a) defines an IRA as a trust created or organized "for the exclusive benefit of an individual or his beneficiaries". (Emphasis added.) An account maintained jointly for a husband and wife would be created for the benefit of two individuals and would not meet this definition. See Rodoni v. Commissioner, 105 T.C. 29, 33 (1995) ("as its name suggests, the essence of an IRA is that it is a retirement account created to provide retirement benefits to "an individual").
>
> Secondly, recognition of community property interests would jeopardize the participant's ability to roll over the IRA funds into a new IRA. Section 408(d)(3)(A)(i) provides that distributions out of an IRA "to the individual for whose benefit the account *** is maintained" are not taxable under section 408(d)(1) if the entire amount received is paid into an IRA "for the benefit of such individual" within 60 days. (Emphasis added.) The rollover of a community-owned IRA would doubly fail because both the distribution and contribution would involve two persons.
>
> Thirdly, recognition of community property interests would affect the minimum distribution requirements for IRA's. Section 408(a)(6) requires that distributions from an IRA account meet the requirements of section 401(a)(9). Among those requirements is that the individual for whom an IRA is maintained withdraw the balance in the IRA or start receiving distributions from the IRA by April 1 of the year following the year in which such individual reaches 70 1/2. See sec. 401(a)(9)(c). Recognition of a nonparticipant spouse's community property interest in the IRA might require the age of the nonparticipant spouse to be taken into account in determining the commencement date for the required distributions.
>
> In addition, treating a nonparticipant spouse as a 50-percent distributee would create an asymmetry. Section 219(f)(2) provides that the deductibility of a contribution to an IRA is to be determined without regard to any community property laws. See Medlock v. Commissioner, T.C. Memo. 1978-464 [¶78,464 PH Memo TC]. Section 408(g) appropriately balances that provision by disregarding community property laws when the IRA funds are later distributed. These sections work in tandem to insure that an IRA participant who lives in a community property State is treated as both the sole contributor and the sole distributee of IRA funds.
>
> In Powell v. Commissioner, 101 T.C. 489, 496 (1993), we indicated that the distribution of a community property interest in a retirement plan is taxed one-half to each spouse except where Congress has specified otherwise; e.g., in sections 219(f)(2), 402(e)(4)(G), and 408(g). In Karem v. Commissioner, 100 T.C. 521, 529 (1993), we held that a pension distribution subject to section 402(e)(4)(G) was taxable entirely to the participant even though his former spouse was considered a one- half owner under State community property law. Unlike the taxpayer in Powell, the taxpayer in Karem had elected the multi- year averaging method then available under former section 402(e) for computing the tax due [pg. 158] on lump-sum distributions. As a result, the distributions were subject to former section 402(e)(4)(G), which provided that "the provisions of this subsection *** shall be applied without regard to community property laws." Consistent with these opinions, we hold that section 402(g) precludes taxation of petitioner's former spouse as a distributee in recognition of her State community property interest in petitioner's IRA's. Accordingly, the distributions from petitioner's IRA's are wholly taxable to petitioner.

* * * *

The part of the case that most troubled me was the finding that 408(d)(6) was inapplicable. Recall the facts:

> Petitioner was formerly married. He and his former spouse were granted a Judgment of Dissolution of Marriage (dissolution judgment) on August 17, 1992. The dissolution judgment stated: "IT IS FOUND that all of MICHAEL BUNNEY'S retirement valued at approximately $120,000 was accumulated by the parties prior to their separation **and ordered to be divided equally** between the parties."
>
> Petitioner's retirement savings consisted of several IRA accounts. The money used to fund petitioner's IRA's had been community property. During 1993, petitioner withdrew $125,000 from his IRA's and deposited the proceeds in his money market savings account. During the same year, petitioner transferred $111,600 to his former spouse in a transaction in which he acquired her interest in the family residence. Petitioner reported only the remaining [pg. 156] $13,400 of the distributions on his 1993 Federal income tax returns.[38] [Emphasis added.]

These facts did not result in a good 408(d)(6) order, however:

> Petitioner alternatively contends that the distribution and transfer of his IRA proceeds pursuant to the dissolution judgment was a nonrecognition event for him under section 408(d)(6).[39] We disagree.
>
> There are two requirements that must be met for the exception of section 408(d)(6) to apply: (1) There must be a transfer of the IRA participant's "interest" in the IRA to his spouse or former spouse, and (2) such transfer must have been made under a section 71(b)(2) divorce or separation instrument.
>
> The transaction at issue does not meet the first requirement. Petitioner did not transfer any of his interest in his IRA's to his former spouse. Rather, he cashed out his IRA's and paid her some of the proceeds.[40] The distribution itself was a taxable event for petitioner that was not covered by section 408(d)(6).[41] See Czepiel v. Commissioner, T.C. Memo. 1999-289 [1999 RIA TC Memo ¶99,289].

The Tax Court held that the taxpayer was not liable for the negligence penalty because the issue was one of first impression. The language used strongly suggests that the Tax Court will disagree with the IRS administrative position as applied to other situations, for example where the heirs of a predeceased spouse of an IRA owner take a distribution of the decedent's community property interest in the surviving spouse's IRA.

> As to the contested adjustment, this Court has not previously addressed the issue of whether section 408(g) precludes recognition of a spouse's community property interest in allocating the taxability of an IRA distribution. While **we find the text of section 408(g) to be clear and unambiguous on its face**, we bear in mind that **the Commissioner has interpreted section 408(g) administratively in a manner that is inconsistent with our holding herein**. Under these circumstances, we conclude that petitioner had a reasonable basis for his return position that one-half of his IRA distributions were allocable to his former spouse.[42] Accordingly, we hold the negligence accuracy-related penalty is inapplicable to the taxes and penalties imposed on one-half of petitioner's 1993 IRA distributions.[43] [Emphasis added.]

* * * *

3.2 <u>If the Beneficiary is Not the Spouse, But the Spouse's Heirs (or Estate!) Will Have an Interest in the IRA at the IRA Owner's Death Under the Community Property Laws, Must the Heirs (or Estate!) be Treated as Beneficiaries?</u> *I have no idea, but it is possible.*

Query, to what extent are the beneficiaries of the nonparticipant spouse (under the community property laws) treated as beneficiaries for MRD purposes? It seems to me reasonable for the participant's beneficiary designation to track state law, so that when the participant dies, the plan proceeds will pass in accordance with the designation, and not just partially in accordance with it. The IRS has not even remotely begun to contemplate this issue, nor have any of the commentators of whom I am aware; but I think it is time that we give thought to this issue.

If the nonparticipant spouse dies prior to the RBD, and someone other than the surviving spouse is entitled to the decedent's community interest (e.g., the "estate," worst case), then, on the participant's RBD, is it time to trot out §408(g)? My own opinion is that the separate account rules will operate *de facto* to solve even this pre-RBD problem, since we know that some beneficiaries can choose the 5-year method, and others may choose the life expectancy method.[44]

The analysis post-RBD slightly more involved. If the beneficiary of the participant's IRA is the spouse, and the spouse dies after the RBD, the MRD problem is cured:

> If the designated beneficiary whose life expectancy is being used to calculate the distribution period dies on or after the applicable date, such beneficiary's remaining life expectancy will be used to determine the distribution period **whether or not a [new] beneficiary with a shorter life expectancy receives the benefits**.[45]

But what if the participant cleverly names a child as beneficiary, post RBD. Can we ignore the spouse's interest, or the fact that on the spouse's death the spouse's estate will be the beneficiary? First of all, we note that if the spouse outlives the participant we may have a different situation, and perhaps we should treat that as a contingency. **If the nonparticipant spouse (who is not the participant's beneficiary) predeceases the participant, then perhaps we have the equivalent of a change of beneficiary, with the spouse's estate being the beneficiary of a part of the account, destroying for all time the right of the participant to ever use the joint life expectancy method (because of the multiple beneficiary rule).** Think about it.

Eventually someone besides me is going to carry the logic forward. It would be nice if the IRS would simply issue a regulation giving us a pass on this one, but I don't see it happening. More likely, the issue will just be ignored, and that's okay with me, but it doesn't mean that the issue is not out there lurking. Recall that before *Allard v. Frech*[46] most practitioners simply ignored the nonparticipant's interest altogether. Well, so far as I know, you heard it first here.

3.3 <u>Is a Nonprorata Partition of a Community Property IRA Following the Death of a Spouse Treated as a Taxable Sale or Exchange for Income Tax Purposes?</u> *No.*

Two recent private letter rulings address VERY favorably the issue of whether a nonprorata partition of a community property IRA following the death of a spouse is treated as a taxable sale or exchange for income tax purposes.[47] Moreover, in each case the surviving spouse was not only permitted to allocate the entire IRA to herself tax free, but was then permitted to rollover the proceeds following the allocation. Significantly, neither ruling addressed MRD issues, such as whether the power to freely allocate the IRA proceeds among various potential beneficiaries would have caused the beneficiaries to have been unascertainable or otherwise ineligible for the life expectancy method of payout.

In **PLR 199912040** the decedent died after his RBD. He left his IRA to his revocable living trust. All of his property was community property. The trust provided for a pecuniary gift to children, followed by a division into a survivor's share and a decedent's share. The decedent's

share remaining after satisfaction of the pecuniary gifts was to be used to fund a credit shelter trust, with the remainder going to the survivor's share. The wife (the survivor) was the trustee of all of the trusts. The trustee had the power to revoke or amend the survivor's trust. State law and the trust instrument permitted nonprorata allocations among the trusts. The ruling was favorable on all points. The nonprorata division of the IRA was not a taxable event because it was authorized by state law; and, moreover, the spouse was free to rollover amounts she elected (as trustee) to allocate to the survivor's share.

PLR 199925033 is an even more important ruling. A died. He was survived by his wife B. A named a revocable living trust as beneficiary of his IRA. All the property in the IRA was community property. A and B were co settlors of the trust. At A's death, B became the sole trustee. At A's death, the trust was to be divided into a survivor's trust and a credit shelter trust. B was given the power to make nonprorata allocations among the shares and subtrusts. B had the power to revoke or amend the survivor's trust. The ruling held that the nonprorata allocation of the right to receive the IRA benefits to the survivor's trust was a nontaxable event; and that, further, B could rollover the proceeds thus allocated to her own IRA tax free.

> These rulings send a very strong signal that the IRS is not predisposed to invoke §691 income tax recognition when the right to receive IRA or qualified plan distributions is subject to discretionary apportionment, even though the ultimate recipient is not entitled to the proceeds as a "matter or right."

3.4 **<u>If a Pecuniary Bequest is Funded With the Right to Receive Distributions From an IRA or Qualified Plan, Will Income Tax be Accelerated?</u>** ***No.***

Most estate planners have been brought up to recognize and fear sale or exchange treatment in the funding of pecuniary bequests, particularly where zero basis IRD is involved. This fear is in part because of authorities like *Kenan v. Commissioner*, 114 F.2d 217 (2nd Cir. 1940); *Suisman v. Eaton*, 15 F. Supp. 113 (D. C. Conn. 1935), aff'd per cur., 83 F.2d 1019 (2nd Cir. 1936); Rev. Rul. 55-117, 1955-1 C.B. 233; Rev. Rul. 60-87, 1960-1 C.B. 286; Rev. Rul. 56-270, 1956-1 C.B. 325; Rev. Rul. 66-207, 1966-2 C.B. 243; Rev. Rul. 82-4, 1982-1 C.B. 99. Cf. Rev. Rul. 67-74, 1967 1 C.B. 194; Rev. Rul. 72-295, 1972-1 C.B. 197; Rev. Rul. 90-3, 1990-1 C.B. 174 and **Treas. Reg. §1.661(a)-2(f)(1)**, which all strongly suggest that if a pecuniary bequest *or other debt or obligation of the estate* is satisfied by distributing (funding with) the right to receive an item of income in respect or a decent, or any other item of appreciated property, gain will be recognized, as if there had been a taxable sale or exchange of the item in exchange for the extinguishment of the obligation. **In light of PLRs 199912040 and 199925033, (neither of which involved funding pecuniary request, admittedly) discussed above, should we "get over it"?**

Although Rev. Rul. 69-486, 1969-2 C.B. 159 gives us a pass on gain recognition where the fiduciary is authorized to pick-and-choose for the purpose of funding ordinary residuary assets (as confirmed by PLRs 8119040 and 8029054), I worry that 691 could cause acceleration of income tax whenever there is an allocation of an IRD item that is not allocated as a "matter of right." Treas. Reg. §1.661(a)-2(f)(1) is, after all, fairly explicit about the matter.

> **Nevertheless**, the IRS believes that §§402 and 408 trump §691 here, and so perhaps we have been overly concerned with this issue. MH confirmed at the 2000 ALI-ABA seminar that there was no constructive receipt rule applicable to IRAs and qualified plans (constructive receipt isn't really the issue, but never mind that), and that therefore **there is no tax until the amount is actually distributed,[49] even if the right to receive the benefits is transferred in satisfaction of a pecuniary gift.[50]**

> At the 2000 Seminar, Merv Wilf was adamant and categorical that there is absolutely no recognition of income when a pecuniary bequest is funded with the right to receive IRD from an IRA, because §§402(a) and 408(d)(1) provide the basis for the tax, and they do not apply prior to distribution. Of course, IRC §691 provides for the recognition of tax when IRD items are sold or exchanged, and IRA and QP benefits are clearly IRD, so the question is really whether §§402(a) and 408(d)(1) are exclusive, and in effect override §691. Apparently, the answer is that they are exclusive, which is very welcome news indeed.

THE SEPARATE ACCOUNT RULE

4.1 **<u>If A Participant Dies Prior To The RBD, Naming Children A, B & C As Beneficiaries, Do We Have To Use The Life Expectancy Of The Oldest Child For Purposes Of The MRD Rules?</u>** ***No, assuming each child has a separate share for accounting purposes.***

> **The IRS has virtually conceded that where death is prior to the RBD, and where the beneficiary designation names more than one beneficiary, the separate account rule will operate and each beneficiary will be able to use his or her own life expectancy.[51]** MH agrees with this as well, at least where a trust is not involved.

4.2 **<u>If A Participant Has an IRA With a Designated Beneficiary, and the Participant Transfers (Rollsover) a Part of that IRA After The RBD, and Names a Charity (for example) as Beneficiary of the Transferred IRA, Is the Original IRA Tainted?</u>** ***No.***

> The IRS confirmed at the 2000 ALI-ABA Seminar that an IRA owner could, after the RBD, (1) make a rollover or other transfer *of a part of an IRA* and (2) designate a nonqualifying beneficiary (a charity for example) of the new IRA, without tainting the old IRA's beneficiary designation. Of course, the new IRA would lack a designated beneficiary, and it would be tainted.

DISCLAIMERS

5.1 **<u>Can a Spouse Disclaim After a Deemed Rollover?</u>** ***Perhaps.***

GM indicated at the 2000 ALI-ABA seminar that affirmative action on the part of the spouse would be "accepting benefits," precluding a rollover, but an inadvertant deemed rollover alone would not necessarily preclude a subsequent disclaimer, depending on the facts.

5.2 <u>**Can a Disclaimer Take Place After a MRD Has Been Made?**</u> ***Yes.***

At the 2000 Seminar, GM indicated that a disclaimer could be made after a MRD had been made. His authority by analogy was Treas. Reg. §25.2518 3(c) and §25.2518-3(d) Ex. 17, which allows for a pecuniary disclaimer following the withdrawal from an account. Care must be taken, however, that one does not disclaim the income on what was withdrawn; or, viewed from a different perspective, one cannot accept the income from what was disclaimed.

5.3 <u>**Is A Disclaimer Treated As If The Disclaimant Predeceased The Participant, Or As If The Participant Changed The Beneficiary Immediately Prior To Death?**</u> ***The latter.***

I see only two possible approaches: (1) A disclaimant is treated as having predeceased the decedent, either before or after the RBD, depending on whether the decedent survived the RBD.[52] (2) The participant will be treated as having changed beneficiaries in favor of the beneficiary of the disclaimed interest, immediately prior to the participant's death.[53] I have written on this subject extensively before, and will not repeat my earlier comments here, other than to say that I favor, and the PLRs for the most part suggest, the second alternative. (The first alternative could be bad, if recalculation was in effect; but it could also be good, if recalculation was not in effect and if one is entitled to ignore the new beneficiary, which is the way the rule would operate if a primary beneficiary actually died after the applicable date.)

> At the ALI-ABA seminar, MH stated that she (MH) views a disclaimer as a change of beneficiary. However, after applying this concept to the facts, MH made it apparent that what she has in mind is some sort of hybrid idea, that represents a third alternative in practice. See below.

Worse, the IRS continues to hint that the state law disclaimer scheme may affect the outcome. Most state law disclaimer statutes provide that in the absence of a contrary provision in the governing instrument, the disclaimant will be treated as having predeceased the decedent, for whatever difference that makes.

5.4 <u>**If a Spouse Disclaims Prior To The RBD In Favor Of Child, Do Distributions To The Child Have To Be Made Over the Spouse's Life Expectancy, Or Over a Child's Life Expectancy?**</u> ***Probably the latter, but . . .***

> If participant P dies prior to the RBD, naming spouse S as the primary beneficiary and child C as the contingent beneficiary, what payout period applies if S disclaims in favor of C. MH told us clearly that she favors treating the disclaimer as a change of beneficiary by P. If P had changed his beneficiary from S to C prior to death, whose life expectancy would apply under the exception to the 5-year rule? C's, of course. Nevertheless, MH said that in the example just posed, C would take using S as the measuring life!(?)
>
> How can such an outcome be explained? The answer is that it can't.[54] In order to reach the unfavorable tax result, the Treasury has to abandon any theoretical basis for the outcome, and for that reason, I doubt that the attempt will succeed. The correct answer is that under both state and **federal** law, C, as a result of the disclaimer, is the beneficiary for all purposes, and, therefore, **where death is prior to the RBD, C is the measuring life** (not MH's 1999 view).

If death is after the RBD the analysis should be different, admittedly. The reason is that the RBD fixed the ceiling on the payout period, but not the floor. A change of beneficiary after the RBD can shorten the payout period but not lengthen it. The life expectancy of a secondary or contingent beneficiary, following the death of the primary beneficiary after the RBD, is irrelevant. In fact, it is also irrelevant that the contingent beneficiary is not a human being. If a post-RBD disclaimer is treated as if P changed the beneficiary from S to C and then died, then S, being older, would serve as the measuring life, with recalculation applying or not, depending on what the rule would have been if P had changed beneficiaries during life. If the situation were treated as if S died after the RBD, and C takes by default, then if recalculation were in effect, we have a disaster. **But MH, consistent with the few rulings we have on the subject,[55] was clear that a disclaimer is not going to be treated as if the disclaimant predeceased the person who takes as a result of the disclaimer.** If that is correct, and I believe it is, then if the beneficiary of the disclaimer is an estate or a nonqualifying trust, there will be no designated beneficiary, and this will be true whether the disclaimer is before or after the RBD. However, it also follows that we ignore the life expectancy of the disclaimant if death is prior to the RBD, and we consider it after the RBD, but then, only insofar as it sets the outer limit for the payout period.

If, in the example given, P lives to the RBD, then what I believe happens is that the payout to C is measured by S's life expectancy, if shorter (which we presume to be the case only if S is C's parent), taking into effect the benefits or detriments of recalculation, if recalculation is in effect. MH would probably agree, but would apply the same rule to pre-RBD disclaimers, and that position cannot be correct.

At the 2000 Seminar, it was noted by one of the panelist, without comment from the IRS, that in PLR 200013041 a disclaimer was made by a surviving Husband pre-RBD, in favor of the children, the eldest of whom served as the measuring life, the Husband's life expectancy being irrelevant.

TRUSTS AS BENEFICIARIES

This is a subject that we wished would go away, but it won't. There are simply too many instances where an estate planner is forced to use a trust as a beneficiary of an IRA or QP, or where a trust is simply the best alternative, despite some serious unresolved issues.

As a general rule, in order to use the joint life expectancy method during life after the RBD, or the life expectancy method (instead of the five year rule) after death prior to the RBD, each beneficiary must, using the phraseology of the IRC, be a "designated beneficiary," which basically means that each beneficiary must be a human being. Thus, an estate is not a "designated beneficiary," nor is a charity or other legal entity. Nevertheless, the beneficiaries of a trust can be treated as designated beneficiaries if the trust meets certain requirements set forth in the proposed regulations.[56]

The proposed regulations allow the beneficiaries of a trust to be treated as "designated beneficiaries" under rules that appear simple. That appearance is deceptive, however. To paraphrase the proposed regulations: "[A] trust itself may not be the designated beneficiary even though the trust is named as a beneficiary."[57] Nevertheless, if the trust is named as the beneficiary, the beneficiaries of the trust will be treated as designated beneficiaries under certain conditions:

(1) The trust must be valid under state law, or would be but for the fact that there is no corpus.

(2) The trust is irrevocable or will, by its terms, become irrevocable upon the death of the employee.

(3) The beneficiaries of the employee's interest under the trust must be identifiable from the trust instrument.

(4) Certain **documentation** (e.g., a copy of the trust itself or a certification of the terms and beneficiaries) **must be provided** to the plan administrator.[58]

(5) If death is after the RBD, then, depending on whether the trust agreement itself is delivered or whether a certification of the beneficiaries is delivered, **the employee must "agree"** that if the trust instrument is amended at any time in the future, the employee will, within a reasonable time, provide a copy of each such amendment, or provide a corrected certification, as the case may be.[59]

I am not too concerned with the D-5 proposed regulations. The real concern is applying the look-through rule to trusts to determine whether the beneficiaries of the trust are designated beneficiaries. And for that purpose, the E-5 Proposed Regulation is the problem.[60] (On the other hand, the H-7 Proposed Regulation suggests that the look-through rule is not to be construed to require conduit treatment after the distribution to the trust is made, H-7 being explicit that an "estate or trust which receives a payment from a plan after the death of an employee need not distribute the amount of such payment to the beneficiaries of the estate or trust in accordance with section 401(a)(9)(B)."[61])

Most of the questions discussed below simply cannot be answered by reference to the proposed regulations. In many cases the PLRs are no help either. The answers, such as there are, are gleaned from private conversations with Treasury officials, who are speaking informally and unofficially. Some of the opinions are astonishing, contrary to any reasonable public policy respecting the collection of income taxes, and devoid of any common sense. This means, among other things, that you are not likely to figure out these rules on your own, because they are in some cases unfathomable. In virtually every case, if any leeway or choice is available, the IRS will consistently take the position most hostile to the taxpayer. The PLRs are very troubling too. They reflect a poor grasp of both the law and the issues, and this has led inevitably to greater and greater confusion.

* * * *

6.1 <u>Do We Need Regulations To Authorize Us to Treat the Beneficiaries of a Trust as Designated Beneficiaries?</u> ***Maybe not, prior to the RBD; probably so, after the RBD.***

A proposed regulation has no more weight in court than that of a brief filed by the Commissioner:[62] Although a proposed regulation cannot be used by the IRS as a sword against a taxpayer, it can be used by the taxpayer as a shield against the IRS. The question here is whether we need regulations to treat the beneficiaries of a trust as designated beneficiaries. Does a reasonable interpretation of the statute allow us to treat the beneficiaries of a trust as designated beneficiaries?

Under 401(a)(9)(B)(iii)(I), the exception to the five year rule is explicitly made applicable if "any portion of the employee's interest is payable . . . **for the benefit of** . . . **a designated beneficiary**.[63] So, it seems clear to me that at least in the case of distributions on account of death prior to the RBD, a distribution to a trust *for the benefit of* a human being ought to qualify, even in the absence of regulations.

This "for the benefit of" language is not found in the IRC in the case of a distribution after the RBD; so perhaps in that case regulations might (arguably) be necessary. Moreover, in the case of distributions after the RBD, IRC §401(a)(9)(A)(ii) provides that a trust is not qualified unless the plan provides that the entire interest of the employee "will be distributed, beginning not later than

the required beginning date, **in accordance with regulations**, over the life of such employee or over the lives of such employee and a designated beneficiary."[64] (Emphasis added.)

If one concludes that the beneficiaries of a trust can be treated as designated beneficiaries under a reasonable interpretation of the statute, IRC §401(a)(9), then the proposed regulations can be ignored, but the risk is there that final regulations will be issued someday that cannot be ignored, and by that time it might be too late to undo what has already been done, depending upon the effective dates involved. If one is relying on the proposed regulations, one can ignore all of the informal, unofficial IRS comments being made that have little or no support in the proposed regulations (and that includes most of what is discussed below). The same can be said of the PLRs, which are not binding in any event. Here too, the main concern is in anticipating what final regulations will say and when they will be effective; but that is anybody's guess.

6.2 <u>If a Spouse is Treated as a Beneficiary Under the Trust "Look-Through" Rule, Can MRDs From the Trust Be Postponed Until the Participant Would Have Been 70 1/2, as Would Have Been the Case If No Trust Were Involved?</u> ***No, if there are other beneficiaries.***

Under the IRC, if death is prior to the RBD, and the designated beneficiary of a participant's interest in an IRA or QP is the participant's spouse, then distributions need not begin any earlier than the end of the calendar year in which the participant would have attained 70 1/2[65] (or, under the proposed regulations, the end of the calendar year following the year of death, if later[66]). The position of the IRS, as previously articulated in private letter rulings (not always with consistency), has been that this rule is inapplicable if a trust with multiple beneficiaries is involved. This position was reiterated in Rev. Rul. 2000-2:

> Because B is not the sole beneficiary of the testamentary trust's interest in the IRA, the trustee elected to have the annual minimum required distributions from the IRA to the testamentary trust begin no later than December 31 of the year immediately following the year of A's death.[67]

Of course, the right of the other beneficiaries is "contingent" on the death of the spouse, but . . .

6.3 <u>Can The Beneficiaries of a Testamentary Trust Qualify As Designated Beneficiaries?</u> ***Yes, probably, despite technical issues.***

The fact that the re-proposed regulations were not explicit on this subject is unfortunate, since a testamentary trust is not really a trust under state law until the decedent's death.

> According to MH, the IRS intended that the beneficiaries of a testamentary trust that is otherwise qualified would qualify as designated beneficiaries under the re-proposed regulations.

6.4 <u>Who Is The Employee And Who Is The Plan Administrator Of An IRA, For Purposes Of The Notice And Delivery Requirements?</u> ***Arguably the IRA owner is both, but the IRS thinks the employer is the trustee.***

Although the preamble to the re-proposed regulations states that the regulations apply to IRAs, the body of the regulations refers only to employees and plan administrators, terms that are obviously inapplicable to an IRA. It is important to know who the plan administrator is because, before the beneficiaries of a trust will be treated as designated beneficiaries, certain notices must be given to and an agreement must be made with the plan administrator. If the IRA owner could notify him or herself, and also agree to notify him or her if the trust is amended, a lot more IRA beneficiary designations naming trusts will be qualified than otherwise.

Support for the notion that the IRA owner ought to be treated as the administrator can be found in a couple of PLRs, which, unfortunately, weren't dealing with this exact issue. The notion makes sense, because the IRA owner is the person primarily responsible for complying with the MRD rules. After having had 15 years to think about deep issues such as these, the fact that the re-proposed regulations overlook so fundamental a question speaks volumes. However, in keeping with our rule of thumb, if there is a more onerous interpretation, the IRS is predisposed to favor it, and it has done so here as elsewhere.

> According to MH, the IRA owner is treated as the employee and the IRA custodian/trustee is treated as the plan administrator.

6.5 <u>Who Is A "Contingent Beneficiary" Of A Trust For Purposes Of The Proposed Regulation That Permits Us To Disregard Contingent Beneficiaries, And Why Should We Care?</u> ***The answer is not clear or obvious, but whatever it is, it is not what one would expect from only reading the proposed regulations.***

This is the most complex subject in this paper. I will try to highlight my summations for you, but I am also going to give you the background necessary to analyze the summaries. Please forgive and bear with me as I lay the groundwork. Please also excuse my occasional fulminations. I have reason to be frustrated and you do too.

One of the most basic of the MRD rules is that if all of the beneficiaries are human beings then we must use the life expectancy of the oldest beneficiary as our measuring life (absent a separate account), but that if one of the beneficiaries is not human, we may not use the life expectancy of any beneficiary. The proposed regulations formulate the rule in the form of a question, followed by an answer and then an exception. First the question:

> "**E-5.** Q. If an employee has more than one designated beneficiary or if a designated beneficiary is added or replaces another designated beneficiary after the date for determining the designated beneficiary [i.e., after the RBD or date of death if sooner], which designated beneficiary's life expectancy will be used to determine the distribution period?"[68]

Then the answer:

> "**A. (a) General rule. (1)** Except as otherwise provided in paragraph (f) [designations by beneficia-

ries], if more than one individual is designated as a beneficiary with respect to an employee as of the applicable date for determining the designated beneficiary, **the designated beneficiary with the shortest life expectancy will be the designated beneficiary** for purposes of determining the distribution period."[69] (Emphasis added.)

And finally the exception: If one of the beneficiaries is not an individual (or a qualifying trust), then the participant will be treated as not having any designated beneficiaries.

"However, except as otherwise provided in D-5, D-6 [trusts as beneficiaries], *and paragraph (e)(1)* of this E-5 [death contingency], **if [anyone who is not] an individual is designated as a beneficiary**, the employee will be treated as **not** having any designated beneficiaries for purposes of section 401(a)(9) even if there are also individuals designated as beneficiaries."[70] (Emphasis added.)

The Death Contingency Exception to the Multiple Beneficiary Rule

The treatment of so-called contingent beneficiaries under the proposed regulations is the source of much confusion. For me, this subject is far and away the most complex, uncertain and difficult to understand of all that is covered in this paper. I find the "dash 1" E-5(b) and E-5(e)(1) proposed regulations to be prolix at best, and all but unfathomable. I readily confess that my limited intelligence may be the reason that I have such difficulty in the area; alternatively, the regulation may really be as unintelligible as it appears to me. You be the judge. The source of part of the confusion is the elaborate use of cross-references in the proposed regulations, as aptly illustrated by comparing E-5(b) with E-5(e)(1), which must almost be viewed side by side to unscramble.

E-5(b) Contingent Beneficiary **is** a Designated Beneficiary	E-5(e)(1) Contingent Beneficiary **is NOT** a Designated Beneficiary
(b) **Contingent beneficiary**. *Except as otherwise provided in paragraph (e)(1)*, if a beneficiary's *entitlement* to an employee's benefit is *contingent* on an event *other than the* ***employee's*** *death* (**e.g., death of another beneficiary**), such contingent beneficiary **is** considered to be **a designated beneficiary** for purposes of determining which designated beneficiary has the shortest life expectancy under paragraph (a).[71] [Emphasis added.]	**(e)** ***Death contingency.*** **(1)** If a beneficiary's *entitlement* to an employee's benefit is **contingent on the death of a prior beneficiary**, such contingent beneficiary will **not** be considered **a beneficiary** [at all, designated or otherwise] for purposes of determining who is the designated beneficiary with the shortest life expectancy under paragraph (a) *or whether a beneficiary who is not an individual is a beneficiary*. **This rule does not apply if the death** [of the beneficiary] **occurs prior to the applicable date** for determining the designated beneficiary.[72] [Emphasis added.]

A more awkward cross reference scheme is difficult to imagine. If the meaning is clear to you at first reading, your MENSA dues will be waived. Here is what I think the quoted regulations mean, but be advised that I am not smart enough to confidently say I am correctly interpreting them.

Reading E-5(b) and E-5(e)(1) Together. The E-5(e)(1) exception referred to within E-5(b) reads almost identically to E-5(b), except that the result is reversed. E-5(b) is expressly subject to the exception in E-5(e)(1). But E 5(e)(1) does not apply (i) if the death of the beneficiary is prior to the applicable date, or (ii) the beneficiary's entitlement does not depend on the death of a prior beneficiary, which means (apparently) that E-5(b) applies without exception in those cases.[73]

If a beneficiary dies before the applicable date, then I believe the beneficiary is ignored, although you really cannot get there from reading these two regulations.

E-5(b): If, after the applicable date, a beneficiary's (including a secondary beneficiary's) entitlement to the benefit is contingent on some event other than the death of a prior beneficiary, then the E-5(b) regulation applies, and the beneficiary or beneficiaries are treated as designated beneficiary(ies).

E-5(e)(1): If, after the applicable date, a secondary beneficiary's entitlement to the benefit is contingent on the death of a prior beneficiary who survived the applicable date, then the E-5(e)(1) regulation applies and the secondary beneficiary is NOT treated as a beneficiary; i.e., the secondary beneficiary is ignored.

What I think the E-5(b) regulation is saying, in the most abstruse manner imaginable, is that if participant P designates A as his primary beneficiary, but provides that if A does not survive P then P's benefits go to B; then, if A

is not living on P's RBD or prior death, B will be the designated beneficiary, not A. The E-5(e)(1) regulation on the other hand would apply under the same circumstances except that we are to posit that A is living on P's RBD or prior death, in which case, A would be the designated beneficiary, not B. If, however, B takes P's benefits if A is unmarried at P's death —to give but one example of a contingency other than (or more properly in addition to) the employee's death— then both A and B are considered beneficiaries and the multiple beneficiary rule therefore applies.[74]

6.6 How Does The Death Contingency Rule Apply In The Case Of Trust Beneficiaries?

One well known commentator, who has now been thoroughly discredited on the subject,[75] suggested at one time that the only reasonable approach to the regulations as written was that the phrase "contingent beneficiary" should be given the common legal meaning that we all learned in law school under the topic of estates and future interests. That was never an easy subject, as every student of the law of future interests knows. **However, it appears that MH ascribes a meaning to the term contingent beneficiary that is independent of the common legal usage, and instead means something like the following:**

> **You are entitled to disregard a contingent beneficiary of a trust who takes on death of a prior beneficiary only if the prior beneficiary would take all benefits if the prior beneficiary lived out his or her life expectancy.**

As thus formulated, the rule isn't remotely implied by the proposed regulations, but it appears to be the unwritten rule nonetheless. The application of this rule would disqualify a QTIP trust with a charitable remainder, for example. But it has nothing to do with whether the beneficiary is contingent or not, and it is inconsistent with the example at E-5(e)(3).

Again, Treasury officials are intimating that in the trust context, and contrary to the proposed regulations, the real issue is not "contingency" at all, but what will happen if a prior beneficiary lives out his or her life expectancy. Is it possible that there will be any benefits in the trust at the end of that period? If so, whoever might succeed to the interest (apparently whether contingent or not) cannot be disregarded.

> **Why do we care whether the E-5(e)(1) death contingency exception to the multiple beneficiary rule applies?** We care because if somewhere in the universe of possible outcomes, a trust could benefit someone who is not a human being —a charity or an estate, for example— and if that "beneficiary's entitlement to [the] employee's benefit is [NOT] contingent on the death of a prior beneficiary," then one of our multiple beneficiaries is not a human being, and the life expectancy method does not apply. On the other hand, if E-5(e)(1) applies we can ignore the contingent beneficiary altogether.

6.7 Can The Beneficiaries Of A Dynasty Trust Ever Be Treated As Designated Beneficiaries? ***No, according to informal statements by the IRS, but this conclusion cannot be drawn from the proposed regulations.***

By the term dynasty trust, I mean a typical trust, perhaps with spray powers, perhaps not, that will continue "to benefit" after-born beneficiaries indefinitely, so long as permitted by law.

> **"D-2. Q.** May an individual who is **not** designated as a beneficiary under the plan be considered a designated beneficiary for purposes of determining the minimum distribution required under section 401(a)(9)?
>
> > **"A. (a)(1)** Except to the extent provided in E-5 [see discussion above, under the heading "The Death Contingency Exception to the Multiple Beneficiary Rule"] with respect to former beneficiaries, designated beneficiaries are only individuals who are designated as beneficiaries under the plan. An individual may be designated as a beneficiary under the plan either by the terms of the plan or, if the plan provides, by an affirmative election by the employee (**or the employee's surviving spouse**) specifying the beneficiary. A beneficiary designated as such under the plan is an individual **who is entitled to a portion of an employee's benefit, contingent on the employee's death *or another specified event*** [like what?]. For example, if a distribution is in the form of a joint and survivor annuity over the life of the employee and another individual, the plan does not satisfy section 401(a)(9) unless such other individual is a designated beneficiary under the plan. **A designated beneficiary need not be specified by name in the plan or by the employee to the plan in order to be a designated beneficiary so long as the individual who is to be the beneficiary is identifiable under the plan <u>as of the employee's required beginning date</u>, or as of the date of the employee's death** (in the case of distributions governed by section 401(a)(9)(B)(iii) and (iv)), and at all subsequent times. **The members of a class of beneficiaries capable of expansion or contraction will be treated as being identifiable <u>if it is possible at the applicable time to identify the class member with the shortest life expectancy</u>.** The fact that an employee's interest under the plan passes to a certain individual under applicable state law does not make such individual a designated beneficiary unless such individual is designated as a beneficiary under the plan.
> >
> > **"(2)** This paragraph (a) is illustrated by the following example.
> >
> > - **"Example.** Employee X attains age 70 1/2 in calendar year 1990. As of April 1, 1991, X designates as his beneficiaries under the plan his spouse and his children. X does not specify them by name. Even though X did not specify his spouse and his children by name, **they are identifiable** based on their relationship to X **as of**

his required beginning date. Further, it is irrelevant that additional children of X may be born after his required beginning date and thus that the class of beneficiaries is capable of expansion.

"(b) See E-5 for the rules which apply if there is a change in beneficiaries under the plan with respect to an employee."[76]

Does a dynasty trust violate this rule? Clearly not, "if it is possible at the applicable time to identify the class member with the shortest life expectancy."

Does a dynasty trust violate the unwritten rule that one is entitled to disregard a contingent beneficiary who takes on death only if the prior beneficiary would take all benefits if the prior beneficiary lived out his or her life expectancy? Perhaps, but so what? As long as all of the beneficiaries are human beings who are members of a class subject to expansion or contraction, D-2 tells us that we ought to have no problem so long as we can identify with certainty the oldest member, and we can. The situation is simply no different here than if the beneficiaries were named individuals.

Remember, the death contingency rule is basically an exception to the multiple beneficiary rule. It is pro-taxpayer. We only need it if a remote beneficiary is (a) older than the primary beneficiary or (b) is not a human being. If the beneficiaries of the trust are the participant's descendants *per stirpes*, then clearly we can identify the individual with the shortest life expectancy, and that is all that is required under D-2. We don't need to avail ourselves of the contingent beneficiary rule, do we?

> The 1999 ALI-ABA seminar strongly suggests that there is a problem with dynasty trusts, and all I want to know is, granted that there is a problem, just exactly what is it? Is it that everyone might die and the benefits would be payable to someone's estate (God forbid)? This is **always possible**, whether or not a so-called dynasty trust is involved. So what could possibly be wrong with naming a dynasty trust as a beneficiary? I have no idea, but I do know that at the ALI-ABA seminar we were told that the beneficiaries of a dynasty trust (e.g., a trust designed to last for the period of the rule against perpetuities) will not be treated as designated beneficiaries for purposes of the MRD rules. At the 2000 Seminar, the IRS backed off a little, but MH still refused to articulate a rule or theory that can be generally applied.

Any logic to this pronouncement cannot be found in the proposed regulations, and is in direct contradiction to the D-2 regulation just quoted. So, just exactly what is the rule? We don't know. I gather that the Treasury, having fulfilled its obligation to collect taxes —which were paid when the distribution was made to the trust— feels that some other nonstatutory, nontax related social policy is at issue here, a policy against long term trusts I guess. That is the best I can do, and I have been studying this issue closely now for many years.

> We think that the rule is something like the following: **All plan benefits paid to the trust must be paid out to members of the D-2 class of beneficiaries within a period of time measured by the life expectancy of the youngest member of the class who is alive on the applicable date.** If all of the members of the class die prior to the expiration of the life expectancy of the youngest member who was alive on the applicable date, then it makes no difference where the benefits go, because the death contingency exception to the multiple beneficiary rule (E-5(e) to which so much attention was devoted above) applies.
>
> I hasten to add that I am not positive that this is supposed to be the rule, but it is my best guess, based upon the comments that I have heard that Treasury officials are making.

Is this rule found in the proposed regulations? No. It actually contradicts D-2, D-5(b) and H-7. Are any of us bound by whatever it is the rule turns out to be? Not until the rule is published as a final regulation. In the meantime, we are entitled to rely on a reasonable reading of the statute and a reasonable reading of the proposed regulation, neither of which contain anything remotely resembling the gloss being put upon them informally by Treasury officials.

The PLRs are clear that there is no requirement that the trust distribute IRA or QP proceeds to the beneficiary whose life expectancy is being used as the measuring life. More to the point, however, Prop. Treas. Reg. §1.401(a)(9)-1, Q&A D-5(b) provides, in part:

> . . . [I]f the requirements in paragraph (a) are met, for purposes of section 401(a)(9), distributions made to the trust ***will be treated as paid*** to the beneficiaries of the trust with respect to the trust's interest in the employee's benefit.[77]

Prop. Treas. Reg. §1.401(a)(9)-1, Q&A H-7 is equally explicit that a trust which receives a payment from a plan after the death of the participant need not distribute the amount to the beneficiaries under the MRD rules:

> H-7. Will a payment by a plan after the death of an employee fail to be treated as a distribution for purposes of section 401(a)(9) solely because it is made to an estate or a trust?
>
> A. A payment by a plan after the death of an employee will not fail to be treated as a distribution for purposes of section 401(a)(9) solely because it is made to an estate or a trust. As a result, **[an] estate or trust which receives a payment from a plan after the death of an employee need not distribute the amount of such payment to the beneficiaries of the estate or trust in accordance with section 401(a)(9)(B)**. . . . See D-5 and D-6 for provisions under which beneficiaries of a trust with respect to the trust's interest in an employee's benefit are treated as having been designated as beneficiaries of the employee under the plan.[78]

If a trust is named as beneficiary on the applicable date, and if on that date the trust was in compliance with a reasonable reading of the proposed regulations, but final regulations are issued thereafter that would have caused the trust to fail had those rules been in effect on the applicable date, will the trust cease to be a designated beneficiary after the fact? Experience tells us that this is unlikely, but not impossible.

When do we want to use a dynasty trust as the recipient of IRA or QP benefits? The only time we really care is where the estate is not large enough to otherwise shelter the GSTT exemption. This is not a problem for the wealthy. They have $1 million in other, more appropriate assets. It is the estates that don't have $1 million lying around to fund a GSTT dynasty trust where we are forced to resort to retirement assets. Once again, the IRS targets the middle class as its victim; for the rich, all this uncertainty the IRS has been creating in the dynasty trust area is of no concern.

6.8 Under What Circumstances Will The Fact That The Trust May Be Liable For Estate Taxes Or Debts Of The Participant Disqualify The Trust As A Designated Beneficiary? ***This is another murky area. At one time, the informal IRS opinion was that if the issue was addressed, the life expectancy payout method would not be available. More recently, the IRS even indicated that it intends to be more flexible than previously indicated.***

> It is very possible that both state[79] and federal law will provide that a person's IRA can be reached after death to satisfy the debts and personal income tax obligations of the IRA owner as well as of the beneficiary, and it almost certainly can be reached to satisfy the estate tax owed by the IRA owner's estate, and possibly by the creditors of the estate tax owner, even if the decedent dies without a will. Does that mean that it is impossible to name a designated beneficiary? Apparently not. But according to MH, in 1999, if the beneficiary is a trust, and if any provision at all is made for the payment of estate taxes out of the IRA, *even if the provision tracks state law word for word*, then the trust does not qualify as a designated beneficiary.
>
> In 2000, MH expressed the more sensible position that if the trust merely provided for the payment of a prorata share of taxes (even at the margin, as federal law sometimes requires) in the same manner that would otherwise be required under state and federal law, then this power would not disqualify the trust after all.

6.9 Can A Designated Trust Beneficiary Have A Testamentary Power Of Appointment? ***Apparently yes, if the beneficiary fails to survive his or her life expectancy; otherwise, the answer is no. Again, the proposed regulations give no clue that this is the rule.***

You may have heard that the answer to the question of whether or not a trust beneficiary can have a testamentary power of appointment and still be considered a designated beneficiary is no. Since the beneficiary is the one who makes this decision, it is patently ridiculous to consider this as some form of clandestine attempt to violate the ascertainable beneficiary rule, but that is what is being suggested, at least where a trust is involved. However, I have been led to understand that it is permissible for a beneficiary to have a testamentary power of appointment if that power is only exercisable if the beneficiary fails to survive some life expectancy. Just whose life expectancy is involved here is the subject of the following discourse.

Apparently, the rule against giving the beneficiary of a trust a testamentary power of appointment (assuming there is such a rule) would only be violated if the power were exercisable *after* the expiration of the life expectancy of some relevant measuring life. If a beneficiary died before the expiration of that period, then under the E-5(e)(1) death contingency exception to the multiple beneficiary rule, belabored above, it would make no difference where the benefit went, and so, **presumably, a testamentary power of appointment could be exercisable during the life expectancy of the beneficiary, but not afterwards.**

Recall the discussion above to the effect that the IRS is suggesting informally that a trust that is the beneficiary of a QP or IRA must itself distribute the proceeds of the QP or IRA during the life expectancy of someone: either the youngest member of the class of beneficiaries who was alive on the applicable date or perhaps a sibling of such person. Apparently, a version of the contingent beneficiary rule would actually operate to provide that if some relevant beneficiary dies prior to his or her life expectancy, then the trust payout rule no longer applies because it is no longer relevant where the proceeds go.

This rule, since it is not written anywhere, is therefore not subject to close scrutiny, and is difficult to ascertain with anything approaching certainty, much less to intelligently discuss. Assuming that my understanding is at least close to the mark, then there are certain consequences that flow from it. Before going too far down that road, however, it would be nice to know whose life expectancy we are talking about. We know of two that we have to measure **(a)** the oldest beneficiary, necessary to determine the MRD, **(b)** the youngest beneficiary, or a sibling of the youngest beneficiary, necessary to determine the trust payout, and, now, **(c) the beneficiary whose life expectancy can be used to invoke the version of the contingent beneficiary rule that would allow us to ignore what happens if this person fails to survive that life expectancy.**

Consider a trust for spouse and descendants that roughly follows the pattern of the D-2(a)(2) proposed regulation:

> Employee X attains age 701/2 in calendar year 1990. As of April 1, 1991, X designates as his beneficiaries under the plan his spouse and his children. X does not specify them by name. Even though X did not specify his spouse and his children by name, they are identifiable based on their relationship to X as of his required beginning date. Further, it is irrelevant that additional children of X may be born after his required beginning date and thus that the class of beneficiaries is capable of expansion.[80]

Let us stipulate that we have provided that all benefits from this trust will be distributed during the life expectan-

cy of the youngest beneficiary, or a sibling of the youngest beneficiary, who is alive on the applicable date.

What happens if the youngest beneficiary (or some other person?) fails to survive his or her life expectancy? Can he or she be given a testamentary power of appointment? Can we say that if that beneficiary fails to survive life expectancy that the remainder of the trust will pass to charity? I have been assured by those who should know that the answer to both questions is yes, and that the reason is derived from the application of some form of the contingent beneficiary rule, the idea being that if the youngest beneficiary lived out his or her life expectancy the IRA or QP proceeds would no longer be in trust, but if the beneficiary failed to live out that period the subsequent taker would be a contingent beneficiary who can be ignored. Needless to say, this is not a straightforward application of the proposed regulations, but it has some modicum of logic.

Proceeding with the understanding that there are contingencies under which someone in the class of descendants can be given a testamentary power of appointment, and that the contingency under which the power may be exercised is the failure of some person to survive that person's life expectancy, we must next pin down precisely just who this person is. My initial presumption is that the life expectancy to be used for this purpose is that of the person who is acting as the measuring life for trust termination purposes; but since that person may not be a beneficiary of the trust after the death of the spouse, due to a *per stirpes* division, I am not sure.

Typically, the trust will be divided *per stirpes* on the death of the spouse, and will be continued in separate per stirpital shares. At that point do we change the measuring life for purposes of applying the contingent beneficiary rule? Recall that we are clear that the measuring life for MRD purposes was the spouse, and that the measuring life for termination of the trust is the youngest beneficiary living on the applicable date (or a sibling). What I am asking is who is the measuring life for application of the contingent beneficiary rule?

After the trust is divided (or perhaps before), is the life expectancy that is to be used to apply the contingent beneficiary rule (i) the child who happens to be the oldest beneficiary of that trust (who may not even have been alive on the applicable date and who may or may not be a sibling of someone who was), (ii) a grandchild who happens to be the oldest beneficiary of that trust (who may or may not have been alive on the applicable date and who may or may not have been a sibling of someone who was), (iii) the youngest beneficiary living on the applicable date (or a sibling), whether or not that person is a beneficiary of this trust following the death of the spouse, or (iv) the spouse?

Note that if we cannot give a beneficiary a general power of appointment, and cannot pay benefits to the beneficiary's estate (which amounts to the same thing) we might have a generation skipping transfer tax problem.

In summary, one would like to know for sure whether the life expectancy during which the power is exercisable is (a) the life expectancy of the youngest beneficiary whose life is being used to measure the ultimate trust payout period, (b) the life expectancy of the RBD measuring life, or (c) the life expectancy of the beneficiary exercising the power. The distinction is fairly important, for obvious reasons.

Although some well respected commentators insist that the rules under discussion can be ascertained from a close reading of the proposes regulations, I am firmly not in that camp. The rule, if it resembles anything approaching the above, is certainly not implied by Prop. Treas. Reg. §§1.401(a)(9)-1, Q&A D-2, D-5(b) or H-7 (Proposed 7/27/87 and amended 12/30/97), which, if anything, suggest that there is no trust payout rule at all.

> At the ALI-ABA 2000 Seminar MH indicated that she might not have a problem if the power of appointment were limited to a class that was more or less ascertainable (e.g. descendants?), but would be very concerned about a power to appoint to charity or to others beneficiaries that were not so readily ascertainable.

6.10 <u>Since We Don't Know What The Rules Are Right Now, Much Less What They Will Be Under The Final Regulations, What Are We Supposed To Do In The Meantime?</u> ***I have provided suggested language in a separate article, which can be viewed or down loaded from www.trustsandestates.net.***

MISCELLANEOUS

7.1 Can a Beneficiary Designate a Beneficiary? ***Yes, at death, despite the literal wording of Prop. Treas. Reg. §1.401(a)(9)-1, Q&A E-5(f).***

May a beneficiary designate a beneficiary? The proposed regulations provide:

> "(f) *Designations by beneficiaries*. If the plan provides (or allows the employee to specify) that, after the employee's death, any person or persons have the discretion to change the beneficiaries of the employee, then, for purposes of determining the distribution period for both distributions before and after the employee's death, the employee will be treated as not having designated a beneficiary."[81]

> **Does this proposed regulation preclude a beneficiary from designating where any remaining undistributed benefits will go at the beneficiary's death? MH confirmed at the 2000 Seminar that a beneficiary may designated a death beneficiary without affecting the MRD rules.** Note that a different rule may apply in the trust context where the designation is by power of appointment.

END NOTE

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1. Rev. Rul. 2000-2, 2000-3 IRB.

2. Treas. Reg. §20.2056-7(d)(2).

3. Treas. Reg. §20.2056(b)-5(f)(8).

4. Rev. Rul. 2000-2, 2000-3 IRB.

5. See Ice, "Beneficiary Designations For Qualified Plans and IRAs," ACTEC Notes, Summer 1995, Vol. 21, No.1, p.53 at 61-62.

6. Rev. Rul. 2000-2, 2000-3 IRB.

7. We have all wondered whether a testamentary trust may qualify as a designated beneficiary under the look-through rules? The fact that the re proposed regulations were not explicit on this point is unfortunate, since a testamentary trust is not really a trust under state law until the decedent's death. However, the IRS has unofficially several times indicated that the beneficiaries of a testamentary trust that is otherwise qualified will qualify as designated beneficiaries under the re-proposed regulations.

   Is there any significance in the fact that the trust in 2000-2 was a testamentary trust? If the testator had been past his RBD on date of death, then the ruling would have been authority on this point. But since the testator was 55 when he died, the fact that the trust named as beneficiary was a testamentary trust is not as significant as it would have been if the RBD had been the applicable date. At date of death, here the applicable date, the trust would likely be a valid trust under state law, even though receipt of a conventional corpus might be delayed.

8. Rev. Rul. 2000-2, 2000-3 IRB.

9. Rev. Rul. 2000-2, 2000-3 IRB.

10. Rev. Rul. 89-89, 1989-2 C.B. 231.

11. At the May 2000 ALI-ABA Seminar, George Masnik made it clear that the 89-89 technique still works.

12. See Natalie Choate.

13. Rev. Rul. 89-89, 1989-2 C.B. 231.

14. See Ice, "Annotated Form Designation of Beneficiary and Election of Form of Benefits Under IRC §401(a)(9).

15. "First, we note that although final regulations command our respect (*Commissioner v. Portland Cement Co. of Utah*), 450 U.S. 156, 169 (1981), **proposed regulations carry no more weight than a position advanced on brief by respondent.** *Freesen v. Commissioner*, 84 T.C. 920, 939 (1985), revd. on other grounds 798 F.2d 195 (7th Cir. 1986), quoting *F. W. Woolworth Co. v. Commissioner*, 54 T.C. 1233, 1265-1266 (1970). Cf. *Mearkle v. Commissioner*, 87 T.C. 527, 531 (1986). See also *Tamarisk Country Club v. Commissioner*, 84 T.C. 756, 761 (1985); *Scott v. Commissioner*, 84 T.C. 683 (1985); and *Miller v. Commissioner*, 70 T.C. 448, [pg. 898] 460 (1978). [fn] We therefore decide this case by considering the evidence under the standards of the statute, not those of the proposed regulation." *Laglia V. Commissioner*, 88 TC 894 (1987).

16. Grantor Retained Income Trust.

17. IRC §2519(a).

18. Rev. Rul. 2000-2, 2000-3 IRB.

19. IRC §§ 402(c)(9), 403(b)(8)(B) and 408(d)(3)(C). Treas. Reg. 1.408 2(b)(7)(ii). Prop. Treas. Reg. 1.408-8, Q&A A-5 (Proposed 7/27/87).

20. Prop. Treas. Reg. §1.408-8, Q&A A-5 (Proposed 7/27/87).

21. I.e., the distribution method applicable for distributions on and after the RBD.

22. IRC §401(a)(9)(B)(i)(II).

23. IRC §4974(d). Prop. Treas. Regs. §54.4974-2, Q&A A-8.

24. Treas. Reg. §1.402(c)-2 Q&A 7(a).

25. Treas. Reg. §1.408A-4 Q&A 6.

26. Does the parenthetical language suggest that the MRD should be deducted first? Doesn't this regulation antedate §401(a)(9) in its present form?

27. Treas. Reg. §1.408-8, Q&A A-5(b), first sentence.

28. Prop. Treas. Reg. §1.408-8, Q&A A-5 (Proposed 7/27/87).

29. IRC §401(a)(9)(B)(iii)(II).

30. IRC §401(a)(9)(B)(iv)(I). Prop. Treas. Reg. §1.401(a)(9)-1, Q&A C-3(b). (Proposed 7/27/87).

31. PLR 9418034 and PLR 9608042.

32. PLR 9418034 and PLR 9608042.

33. PLR 9534027.

34. PLR 9311037.

35. We recognize that private letter rulings have no precedential value but merely represent the Commissioner's position as to a specific set of facts. See sec. 6110(j)(3) (redesignated sec. 6110(k)(3) under the IRS Restructuring and Reform Act of 1998, Pub. L. 105-206, sec. 3509(b), 112 Stat. 743, 772); Lucky Stores, Inc. v. Commissioner, 153 F.3d 964, 966 n.5 [82 AFTR 2d 98-5815] (9th Cir. 1998), affg. 107 T.C. 1 (1996); Fowler v. Commissioner, 98 T.C. 503, 506 n.5 (1992); Estate of Jalkut v. Commissioner, 96 T.C. 675, 684 (1991); First Chicago Corp. v. Commissioner, 96 T.C. 421, 443 (1991), affd. 135 F.3d 457 [81 AFTR 2d 98-545] (7th Cir. 1998). We mention these rulings merely to set forth the Commissioner's administrative practice as to sec. 408(g). See Rowan Cos. v. United States, 452 U.S. 247, 261 n.17 [48 AFTR 2d 81-5115] (1981); First Chicago Corp. v. Commissioner, 96 T.C. 421, 443 (1991).

36. We address a somewhat narrower issue, i.e., whether for Federal income tax purposes petitioner is the sole "distributee" and thus taxable on the distributions he received from his IRA's. We do not address, as did these State cases, whether sec. 408(g) preempts community property interests in IRA's altogether.

37. *Michael G. Bunney v. Commissioner*, 114 T.C. No. 17 at 155 (2000).

38. *Michael G. Bunney v. Commissioner*, 114 T.C. No. 17 at 155-156 (2000).

39. Sec. 408(d)(6) provides: Transfer of account incident to divorce. – The transfer of an individual's interest in an individual retirement account or an individual retirement annuity to his spouse or former spouse under a divorce or separation instrument described in subparagraph (A) of section 71(b)(2) is not to be considered a taxable transfer made by such individual notwithstanding any other provision of this subtitle, and such interest at the time of the transfer is to be treated as an individual retire-

ment account of such spouse, and not of such individual. Thereafter such account or annuity for purposes of this subtitle is to be treated as maintained for the benefit of such spouse.

40. IRS Publication 590 describes two commonly used methods of transferring an interest in an IRA: (1) Changing the name on the IRA to that of the nonparticipant spouse or (2) directing the trustee of the IRA to transfer the IRA assets to the trustee of an IRA owned by the nonparticipant spouse.

41. Sec. 408(d)(6) governs the transfer of an “individual's interest” in an IRA. It does not address distributions. In contrast, distributions from a qualified pension plan pursuant to a qualified domestic relations order may be reallocated to a spouse (designated as the “alternate payee” and considered a plan “beneficiary”). See sec. 402(e)(1)(A); 29 U.S.C. sec. 1056(d)(3)(J) (1993).

42. We note that for returns filed on or after Dec. 2, 1998, respondent's view is that a return position “reasonably based on one or more of the authorities set forth in section 1.6662- 4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments)” will generally satisfy the reasonable basis standard. Sec. 1.6662-3(b)(3), Income Tax Regs., as amended by T.D. 8790, 1998-50 I.R.B. 4. Among the authorities set forth in sec. 1.6662-4(d)(3)(iii), Income Tax Regs., are private letter rulings issued after Oct. 31, 1976.

43. *Michael G. Bunney v. Commissioner*, 114 T.C. No. 17 at 159 (2000).

44. Prop. Treas. Reg. §1.401(a)(9)-1, Q&A H-2(b), last sentence. (Proposed 7/27/87).

45. Prop. Treas. Reg. §1.401(a)(9)-1, Q&A E-5(e)(2). (Proposed 7/27/87).

46. *Allard v Frech*, 754 S.W.2d (Tex. 1988).

47. PLR 199912040 and PLR 199925033.

48. Treas. Reg. §1.661(a)-2(f)(1) reads “(1) No gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of the distribution, **unless the distribution is in satisfaction of a right to receive a distribution in a specific dollar amount or in specific property other than that distributed.**” IRC §691(a)(2) provides:
    (2) Income in case of sale, etc. If a right, described in paragraph (1), to receive an amount is transferred by the estate of the decedent or a person who received such right by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent, there shall be included in the gross income of the estate or such person, as the case may be, for the taxable period in which the transfer occurs, the fair market value of such right at the time of such transfer plus the amount by which any consideration for the transfer exceeds such fair market value. For purposes of this paragraph, the term "transfer" includes sale, exchange, or other disposition, or the satisfaction of an installment obligation at other than face value, but does not include transmission at death to the estate of the decedent or a transfer to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent.

49. Of course, the right to receive the IRD is being actually distributed in satisfaction of the pecuniary obligation, but it is being distributed from an estate or trust, and not from the IRA or qualified plan.

50. *Cf*. the very confusing PLRs 199918065 as modified by 200008048, where there was both a funding and a distribution.

51. PLR 199903050.

52. See Prop. Treas. Reg. §1.401(a)(9)-1, Q&A E-5(e)(2) (Proposed 7/27/87).:
    If the designated beneficiary whose life expectancy is being used to calculate the distribution period dies on or after the applicable date, such beneficiary's remaining life expectancy will be used to determine the distribution period **whether or not a [new] beneficiary with a shorter life expectancy receives the benefits.**

53. See Prop. Treas. Reg. §1.401(a)(9)-1, Q&A E-5(c). (Proposed 7/27/87).

54. It is perhaps worth noting here that IRC §2518 merely provides that f*or gift tax purposes* a disclaimer will not be treated as a transfer. Therefore, arguably, §2518 does not affect other tax principles, assignment of income being the first to come to mind where income in respect of a decedent (IRD) is the subject of a disclaimer. Nevertheless, in practice, the federal (gift tax) disclaimer statute has been applied generally. Perhaps this is technically not justified, but this practice has at least kept the worms in the can up until now. In the example with which we are concerned, it is probably state law that we should look to tin order to see if the disclaimer is to be given effect, and state law disclaimer statutes, as a rule, merely declare that a disclaimer is not a transfer, and the application of state law disclaimer statutes are generally not limited to transfer tax purposes.

55. PLRs 9037048, 9442032, 9450040, and 9537005.

56. Prop. Treas. Reg. §1.401(a)(9)-1, Q&A D-5 and 6. (Proposed 7/27/87 and amended 12/30/97).

57. Prop. Treas. Reg. §1.401(a)(9)-1, Q&A D-5(b), second sentence. (Proposed 7/27/87).

58. Prop. Treas. Reg. §1.401(a)(9)-1, Q&A D-5(a). (Proposed 7/27/87).

59. Prop. Treas. Reg. §1.401(a)(9)-1, Q&A D-7A(a). (Proposed 7/27/87 and amended 12/30/97).

60. **E-5.** Q. If an employee has more than one designated beneficiary or if a designated beneficiary is added or replaces another designated beneficiary after the date for determining the designated beneficiary, which designated beneficiary's life expectancy will be used to determine the distribution period?

    A. (a) General rule.

    (1) Except as otherwise provided in paragraph (f), if more than one individual is designated as a beneficiary with respect to an employee as of the applicable date for determining the designated beneficiary, the designated beneficiary with the shortest life expectancy will be the designated beneficiary for purposes of determining the distribution period. However, except as otherwise provided in D-5, D-6, and paragraph (e)(1) of this E-5, if a person other than an individual is designated as a beneficiary, the employee will be treated as not having any designated beneficiaries for purposes of section 401(a)(9) even if there are also individuals designated as beneficiaries. The date for determining the designated beneficiary (under D-3 or D-4, whichever is applicable) is the applicable date. The period described in section 401(a)(9)(A)(ii)

(for distributions commencing before the employee's death) or section 401(a)(9)(B)(iii) (for distributions over a life expectancy commencing after the employee's death), whichever is applicable, is the distribution period.

(2) See H-2 for special rules which apply if an employee's benefit under a plan is divided into separate accounts (or segregated shares in the case of a defined benefit plan) and the beneficiaries with respect to a separate account differ from the beneficiaries of another separate account.

(b) Contingent beneficiary. ***Except as provided in paragraph (e)(1)***, if a beneficiary's entitlement to an employee's benefit is contingent on an event other than the employee's death (**e.g., death of another beneficiary**), such contingent beneficiary is considered to be a designated beneficiary for purposes of determining which designated beneficiary has the shortest life expectancy under paragraph (a).

(c) New beneficiary.

(1) Except as provided in paragraph (e)(2) (in the case of the death of a beneficiary), if, after the applicable date for determining the designated beneficiary, a new designated beneficiary with a life expectancy shorter than the life expectancy of the designated beneficiary whose life expectancy is being used to determined the distribution period is added or replaces a designated beneficiary, **the new designated beneficiary is treated as the designated beneficiary for purposes of determining the distribution period**. In such case, the new beneficiary's life expectancy will be used to calculate the distribution period in subsequent calendar years. In determining the beneficiary with the shorter life expectancy, the life expectancies will be calculated as of the applicable birthdays in the calendar year specified in and in the manner provided in E-1 through E-4. Consequently, the old distribution period must be replaced by a new distribution period. The new distribution period equals the period which would have been the remaining joint life and last survivor expectancy of the employee and the designated beneficiary if the new designated beneficiary had been designated as of the applicable date. If, instead, the new designated beneficiary has a life expectancy longer than the life expectancy of the designated beneficiary whose life expectancy is being used to determine the distribution period, the life expectancy of the old designated beneficiary will continue to be used for purposes of determining the distribution period even though such old designated beneficiary is no longer a beneficiary under the plan.

(2) If a new beneficiary who is not an individual is added or replaces a designated beneficiary after the applicable date, unless otherwise provided in D-5 and D-6, the employee will be treated as not having designated a beneficiary. Further, except as provided in paragraph (e)(2) in the case of the death of a designated beneficiary, if at any point in time after the applicable date there is no beneficiary designated with respect to the employee, the employee will also be treated as not having a designated beneficiary. In either case, the new distribution period described in subparagraph (1) will equal the period which would have been the employee's remaining life expectancy if no beneficiary had been designated as of the applicable date.

(3) Any adjustment described in this paragraph will only affect distributions for calendar years after the calendar year in which the new designated beneficiary is added or replaces the prior beneficiary, or there is no beneficiary designated with respect to the employee.

(d) Recalculation for spouse. For purposes of determining the distribution period in accordance with paragraph (a) or (c)(1), if any designated beneficiary involved is the employee's spouse and the life expectancy of the spouse is being recalculated, the life expectancy of the spouse as recalculated will be compared in each calendar year to the remaining life expectancy of the other applicable designated beneficiary or beneficiaries, not recalculated, and the shortest life expectancy will be used for determining the minimum distribution required for that calendar year.

(e) Death contingency.

(1) If a beneficiary's entitlement to an employee's benefit is **contingent** on the death of a prior beneficiary, such contingent beneficiary will not be considered a beneficiary for purposes of determining who is the designated beneficiary with the shortest life expectancy under paragraph (a) or whether a beneficiary who is not an individual is a beneficiary. **This rule does not apply if the death occurs prior to the applicable date for determining the designated beneficiary.**

(2) If the designated beneficiary whose life expectancy is being used to calculate the distribution period dies on or after the applicable date, such beneficiary's remaining life expectancy will be used to determine the distribution period whether or not a beneficiary with a shorter life expectancy receives the benefits. However, in accordance with E-8, if the designated beneficiary is the employee's spouse, the spouse's life expectancy is being recalculated, and the spouse dies, the spouse does not have any remaining life expectancy; therefore, **in the calendar year following the spouse's death**, the spouse's life expectancy will be reduced to zero.

(3) This paragraph is illustrated by the following example:

Example. The designated beneficiary of an unmarried participant (X) **as of X's required beginning date** on April 1, 1988, is X's sister (A), but X has specified that, in the event of A's death, **X's brother (B) will become the beneficiary**. A's life expectancy as of A's birthday in calendar year 1987 is 25 years. B's life expectancy as of B's birthday in calendar year 1987 is 10 years. On X's required beginning date, A is the designated beneficiary because B's entitlement to benefits is contingent on A's death. A dies on May 1, 1988. A's remaining life expectancy will continue to be used to determine the distribution period with respect to X for purposes of determining the minimum distribution for the 1988 distribution calendar year and each succeeding distribution calendar year. This is true even though, upon A's death, B will become X's beneficiary and B's life expectancy as of B's birthday in calendar year 1987 is shorter than A's life expectancy as of A's birthday in that calendar year. However, if B's entitlement was not contingent on A's death but was contingent for another reason, B would be the designated beneficiary for purposes of determining the period described in section 401(a)(9)(A)(ii), even during the period in which his entitlement is contingent, because B's life expectancy, as of B's birthday in calendar year 1987, is shorter than

A's life expectancy, as of A's birthday in that calendar year.

(f) Designations by beneficiaries. If the plan provides (or allows the employee to specify) that, after the employee's death, any person or persons have the discretion to change the beneficiaries of the employee, then, for purposes of determining the distribution period for both distributions before and after the employee's death, the employee will be treated as not having designated a beneficiary. However, such discretion will not be found to exist merely because the employee's surviving spouse may designate a beneficiary for distributions pursuant to section 401(a)(9)(B)(iv)(II).

61. Prop. Treas. Reg. §1.401(a)(9)-1, Q&A H-7. (Proposed 7/27/87). Emphasis added.

62. "First, we note that although final regulations command our respect (*Commissioner v. Portland Cement Co. of Utah*), 450 U.S. 156, 169 (1981), **proposed regulations carry no more weight than a position advanced on brief by respondent**. *Freesen v. Commissioner*, 84 T.C. 920, 939 (1985), revd. on other grounds 798 F.2d 195 (7th Cir. 1986), quoting *F. W. Woolworth Co. v. Commissioner*, 54 T.C. 1233, 1265-1266 (1970). Cf. *Mearkle v. Commissioner*, 87 T.C. 527, 531 (1986). See also *Tamarisk Country Club v. Commissioner*, 84 T.C. 756, 761 (1985); *Scott v. Commissioner*, 84 T.C. 683 (1985); and *Miller v. Commissioner*, 70 T.C. 448, [pg. 898] 460 (1978). [fn] We therefore decide this case by considering the evidence under the standards of the statute, not those of the proposed regulation." *Laglia V. Commissioner*, 88 TC 894 (1987).

63. IRC §401(a)(9)(B)(iii)(I).

64. IRC §401(a)(9)(A)(ii).

65. §401(a)(9)(B)(iv).

66. IRC §401(a)(9)(B)(iv)(I). Prop. Treas. Reg. §1.401(a)(9)-1, Q&A C-3(b). (Proposed 7/27/87).

67. Rev. Rul. 2000-2, 2000-3 IRB.

68. Prop. Treas. Reg. §1.401(a)(9)-1, Q&A E-5(a)(1), the question. (Proposed 7/27/87).

69. Prop. Treas. Reg. §1.401(a)(9)-1, Q&A E-5(a)(1), first sentence to the answer (the general rule). (Proposed 7/27/87).

70. Prop. Treas. Reg. §1.401(a)(9)-1, Q&A E-5(a)(1), second sentence to the answer (the exception). (Proposed 7/27/87).

71. Prop. Treas. Reg. §1.401(a)(9)-1, Q&A E-5(b). (Proposed 7/27/87).

72. Prop. Treas. Reg. §1.401(a)(9)-1, Q&A E-5(e)(1). (Proposed 7/27/87).

73. §401(a)(9) and the proposed regulations often tend to frame the usual case as an exception to the rule, rather than the other way around. The primary example is treating a designation of an individual as a beneficiary as an exception to the 5-year rule. This can be disconcerting at a first reading.

74. If you have another interpretation, I would be delighted to here it. My phone number is 817/877-2885.

75. See Ice, "Estate Planning For Distributions From Qualified Plans and IRAs."

76. Prop. Treas. Reg. §1.401(a)(9)-1, Q&A D-2. (Proposed 7/27/87). Emphasis added.

77. Treas. Reg. §1.401(a)(9)-1, Q&A D-5(b). (Proposed 7/27/87).

78. Prop. Treas. Reg. §1.401(a)(9)-1, Q&A H-7. (Proposed 7/27/87). Emphasis added.

79. A state may or may not have a law shielding IRAs from creditor claims.

80. Treas. Reg. §1.401(a)(9)-1, Q&A D-2(a). (Proposed 7/27/87).

81. Prop. Treas. Reg. §1.401(a)(9)-1, Q&A E-5(f) first sentence. (Proposed 7/27/87).

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