The Texas Tax Lawyer

Fall 2014
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Part 1

2014

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PART II- ALL ARTICLES FOLLOWING "HOT TOPICS IN TRANSFER PRICING" WILL APPEAR IN PART II

COMMITTEE ON GOVERNMENT SUBMISSIONS:

Chair's Message

Welcome to the winter edition of the Texas Tax Lawyer! The Tax Section has a lot going on as we pass the half-way mark for this fiscal year. Please note the following Tax Section events on your calendar:

- February 28, 2014 – Tax Law Survey in a Day, Dallas, Texas
- March 24, 2014 – Property Tax Conference, Austin, Texas
- June 26-27, 2014 – Annual Meeting of the State Bar of Texas (including the Tax Section Annual Meeting on June 27th which is discussed in detail below), Austin, Texas; and
- August 28-29, 2014 – Advanced Tax Law Course, Dallas, Texas.

Further details of these upcoming events will be forwarded to you via Section e-blasts and posted on the Tax Section's website at www.texastaxsection.org.

Here's what has been going on with the Tax Section:

Tax Law Survey in a Day

This basics course is new to our Tax Section this year. By the time of this publication, it will have been held at the Citiplace Conference Center in Dallas, Texas on February 28, 2014. The course will have covered the gamut of tax issues from choice of entity, like-kind exchanges, estate and gift tax, charitable organizations, state & local tax issues, how the IRS works, the IRS collections practice, employee benefits, international tax, and partnership and limited liability companies. Many thanks to our speakers, Sam Merrill, Wesley Bowers, Todd Keator, Terri Lynn Helge, Sam Megally, Richard Hunn, Dustin Whittenburg, Rob Fowler, Austin Carlson, and Chester Grudzinski. A especially huge thank you to the Chairs of this new program, Lora Davis and Amanda Traphagan for their tireless work getting this new program off the ground.

Leadership Academy

The newest Leadership Academy class has been chosen! These individuals will have the opportunity to participate in a year-long program consisting of leadership development events throughout the State of Texas. The new class is: Julie Bergkamp, Brandon L. Bloom, John Steven (Steve) Britt, Linda G. Dimachkieh, Kenneth (Kenny) S. Freed, Jason B. Freeman, Tiffany L. Hamil, Amber N. Haque, Justin J. Hepworth, Faye Hoffman Hilpert, Bryan L. Jepson, Stephen Long, Mel E. Myers, Joseph L. Perera, Rachael Rubenstein, Michelle A. Spiegel, Alexander (Alex) Thomas, Meredith VanderWilt, Lauren A. Waite, Lee Wilson and Zhusong Yang.

A huge "THANK YOU" to David Colmenero and Dan Baucum who are serving as the program directors of the Leadership Academy. Their committee did an outstanding job in selecting the candidates from a distinguished pool of applicants and planning the various programs, obtaining presenters, and dealing with the logistics of putting on such a program. Their job was made easier because of the hard work of Susan House who is an indispensable asset to this program.

COGS Projects

We continually seek to improve the substance and administration of state and federal tax laws through our Committee on Government Submissions ("COGS") process. The COGS process also enhances the profile of our members within the tax community and furthers the national reputation of the Texas Tax Bar. Currently, the COGS chairs are Stephanie Schroepfer and Robert ("Bob") Probasco, who to do an incredible job shepherding through our COGS projects. In addition to the COGS projects previously reported to you, we have also submitted the following:

- Comments on the proposed regulations relating to relief from joint and several liability (REG 132251011)
- Comments on the proposed regulations regarding net investment income tax under Section 1411 relating to charitable remainder trusts and their options for determining the distributed amount of NII

Many thanks to Richard Hunn, Chair of the Controversy Committee, David C. Gair and Shawn R. O'Brien for their work on the REG 132251011; and Lora Davis, Chair of Estate and Gift Tax Committee, and Melissa Willms, Wesley Bowers and Celeste Lawton, Vice Chairs of Estate and Gift Tax Committee, for their work on the net investment income tax under Section 1411. There are additional COGS projects in the works which will be reported to you at a later date. If you wish to get involved with an ongoing project, or have ideas for leading one yourself, please contact Stephanie Schroepfer at (713)651-5591 or sschroepfer@fulbright.com or Robert ("Bob") Probasco at (214) 335-7549 or bob.probasco@gmail.com.

Annual Meeting

We have an unbelievable program lined up for our Annual Meeting. The meeting will take place on June 27, 2014, at the Hilton Austin and Austin Convention Center. This year's world-class program will be headlined by the Honorable Judge Juan Vasquez, of the United States Tax Court, giving us an update on the Court. The program will also feature Ken Gideon as our Lunch with a Legend, moderated by Bill Elliott.

New this year will be a collaboration with the LGBT Law Section for a program titled *Taxation and Federal Benefits for Unmarried and Same Sex Couples*. This is a program you will not want to miss!

Conclusion

We have had a number of things going on this year with hard work by a number of people. These are just some of the activities of your Tax Section. Remember that the greatest benefit you can receive as a member is to become involved with one or more of the Section's many activities. It provides you with a great way to meet fellow tax professionals and make a lasting impact on the practice of tax law – both in Texas and nationally. If you are not sure how to get involved, please contact me at (210)

250-6121 or at Elizabeth.Copeland@strasburger.com. I look forward to finishing out an active and strong year with your help.

Thank you and I look forward to working with all of you this year!

Elizabeth Copeland
2013 – 2014 Chair

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

2013 / 2014
CALENDAR

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

19-21	ABA Joint Fall CLE Meeting, San Francisco, CA
23	Pro Bono Committee Calendar Call Assistance (regular and small case) United States Tax Court – Lubbock, Texas
27	Article Deadline – Fall 2013 issue of the *Texas Tax Lawyer*
30	Pro Bono Committee Calendar Call Assistance (small case)\United States Tax Court San Antonio, Texas
October 2013	
7	Pro Bono Committee Calendar Call Assistance (regular case) United States Tax Court – Dallas, Texas
22	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
25	Publishing Deadline – Fall 2013 Issue of the *Texas Tax Lawyer*
November 2013	
7	16th Annual International Tax Symposium – Place to be determined, Houston, Texas
8	16th Annual International Tax Symposium – The Center for American and International Law 5201 Democracy Drive, Plano, Texas 75024
8	**Council Meeting** Hosted by: Strasburger Price Oppenheimer Blend (Elizabeth Copeland) 901 Main Street, Suite 4400, Dallas, Texas 75202 214-651-4300 10:30 a.m. – 12:30 p.m.
19	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
December 2013	
2	Pro Bono Committee Calendar Call Assistance (small case) United States Tax Court Houston, Texas
2 and 9	Pro Bono Committee Calendar Call Assistance (regular case) United States Tax Court Dallas, Texas
17	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
January 2014	
15	Deadline for annual meeting program agenda Nominations due for Outstanding Texas Tax Lawyer (Council vote follows January 17th meeting)
17	Leadership Academy Application deadline
17	**Council and Committee Chairs and Vice Chairs Meeting** Hosted by: Strasburger & Price, LLP 2201 Broadway, San Antonio, Texas 78209 210-224-2000 or 210-250-6121 10:30 am – 12:30 pm
21	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
TBA	ABA Tax Section Midyear Meeting
February 2014	
TBA	Tax Law For the Rest of Us
7	Article Deadline – Winter 2014 issue of the *Texas Tax Lawyer*

14	Tax Court Pro Bono Program Annual Renewal
18	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
March 2014	
3	Nominations due for Chair-Elect, Secretary, Treasurer, and 3 Elected Council Members
3	Publishing Deadline – Winter 2014 Issue of the *Texas Tax Lawyer*
18	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
TBA	**Property Tax Conference**
20-21	**Leadership Academy Meeting** San Antonio, Texas Hosted by: Strasburger Price Oppenheimer Blend (Elizabeth Copeland) 2201 Broadway, San Antonio, Texas 78209 210-224-2000 or 210-250-6121
April 2014	
4	Nominating Committee's Report due to Council
18	Article Deadline – Spring 2014 issue of the *Texas Tax Lawyer*
18	**Council Meeting** Hosted by: Strasburger & Price, LLP 2201 Broadway, San Antonio, Texas 78209 210-224-2000 or 210-250-6121 Election for Chair-Elect, Secretary, and Treasurer 10:30 a.m. – 12:30 p.m.
22	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
May 2014	
8-10	**ABA Section of Taxation 2014 May Meeting** – Grand Hyatt, Washington, DC
20	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
TBA	**Free CPE Day** – Dallas, Texas
June 2014	
TBA	**30th Annual Texas Federal Tax Institute** – Hyatt Regency Hill Country Resort, San Antonio
6	Publishing Deadline – Summer 2014 issue of the *Texas Tax Lawyer*
17	COGS Call Dial In: 866.203.7023 Conference Code: 7136515591# (No security passcode) 9:00 am
18	Leadership Academy Group Evening Event
18	Deadline for appointing Nominating Committee (list in *Texas Tax Lawyer* and on website) – Sept. 19th
18 – 20	**Leadership Academy Meeting – A**ustin, Texas
20	**SBOT 2014 Annual Meeting** – Austin, Texas
July 2014	
August 2014	
27 – 29	**32nd Annual Advanced Tax Law Course and Tax Law 101** Westin Galleria – Dallas, TX
September 2014	
October 2014	
November 2014	

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December 2014	
January 2015	
15	**Leadership Academy Meeting –** Dallas, Texas
September 2015	
25 – 26	**Leadership Academy –** Houston, Texas

2014 Texas State Bar Tax Section Annual Meeting

We have another outstanding line-up for this year's Annual Meeting CLE Program. The Tax Section's 2014 Annual Member Meeting and CLE Program will be held as part of the State Bar of Texas Annual Meeting which runs from June 26-27, 2014, and will be held at the Hilton Austin and the Austin Convention Center, in Austin, Texas. Our Annual Meeting will be held on Friday, June 27, 2014, at 8:00 a.m. followed by the CLE Program which will begin at 8:30 a.m. This year's world-class program is headlined Faris Fink, Former IRS Commissioner; Doug Lindholm, President and Executive Director, Council on State Taxation and Hon. Juan F. Vasquez, U.S. Tax Court Judge. We have a variety of talented presenters joining us from around Texas and the U.S. The topics and presenters are:

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

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

- Presentation of Outstanding Texas Tax Lawyer Award

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

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

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

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

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EMPLOYMENT TAX ON SETTLEMENT AGREEMENTS IN ERISA CASES

by Brian Giovannini[1]

THIS ARTICLE IS FOR EDUCATIONAL PURPOSES ONLY. NOTHING HEREIN CONSTITUTES LEGAL ADVICE BY THE AUTHOR OR THE LAW OFFICES OF HAYNES AND BOONE, LLP. ANY TAX ADVICE CONTAINED IN THIS ARTICLE IS NOT INTENDED OR WRITTEN TO BE USED, AND CANNOT BE USED, FOR THE PURPOSE OF (I) AVOIDING PENALTIES UNDER THE INTERNAL REVENUE CODE OR (II) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY TRANSACTION OR OTHER MATTER ADDRESSED HEREIN. EACH CASE VARIES DEPENDING UPON ITS FACTS AND CIRCUMSTANCES. ANYONE SEEKING TAX ADVICE SHOULD CONSULT WITH HIS OR HER TAX ADVISOR.

Overview of the FICA Tax

In addition to the income tax imposed on an employee's income, the Internal Revenue Code of 1986, as amended (hereinafter, the "***Code***"), also imposes employment taxes equal to a percentage[2] of the portion of an employee's income characterized as wages.[3] These employment taxes are commonly referred to as the FICA tax.[4] The FICA tax is comprised of two parts, the old age, survivors and disability income tax (or OASDI tax), commonly known as the Social Security tax,[5] and the hospital insurance tax (or HI tax), commonly known as the Medicare tax.[6]

Code Section 3101 imposes FICA tax directly on the employee while Code Section 3111 imposes an equal amount of FICA tax on the employer. The employee and employer portion of the Social Security tax are each equal to 6.2% of the employee's wages up to the Social Security taxable wage base ($117,000 for 2014),[7] while the employee and employer portion of the base Medicare tax are each 1.45% of all wages.[8]

For wages over $200,000 (for an a single taxpayer filing an individual return), or $250,000 (for married taxpayers filing a joint return),[9] the Code imposes an additional 0.9% Medicare tax on

[1]I wish to acknowledge the contributions to this article made by my fellow attorneys at Haynes and Boone, LLP, Marilyn Doolittle and Jesse Gelsomini.

[2]*U.S. v. Cleveland Indians Baseball Co.*, 532 U.S. 200, 208 (2001) (*citing* 26 U.S.C. §§ 3111(a), 3111(b), and 3301).

[3]*See* Code Sections 3101 and 3111; *see*, IRS Chief Counsel Memorandum 200017042 (Mar. 3, 2000).

[4]FICA stands for the "Federal Insurance Contributions Act" which is codified in Chapter 21 of the Code.

[5]Code Sections 3101(a), 3111(a).

[6]Code Sections 3101(b), 3111(b).

[7]Code Section 3121(a) establishes an annual ceiling on wages subject to Social Security tax. It does so by defining "wages" to exclude any remuneration "paid to [an] individual by [an] employer during [a] calendar year" that exceeds "remuneration . . . equal to the contribution and benefit base . . . paid to [such] individual by [such] employer during the calendar year with respect to which such contribution and benefit base is effective."

[8]Code Section 3101(b)(1).

[9]Code Section 3101(b)(2); for married employees, the wage threshold for the additional Medicare tax is $125,000 if filing separately.

the employee without imposing a parallel tax on the employer.[10] Withholding is only required on the amount of the employee's wages from the employer that exceed the threshold, disregarding income from external sources or the spouse's income.[11]

In short, if remuneration is considered to be wages, FICA tax must be calculated and withheld, and the remuneration must be reported on Form W-2 not Form 1099-MISC.

FICA Tax Applies to ERISA Settlement Payments

For purposes of calculating the FICA tax, "wages" means all remuneration for employment,[12] unless a specific exception applies.[13] For any remuneration paid in a non-cash medium, wages are the cash value of such remuneration.[14] This definition of wages applies to any payment that is remuneration *for the overall employment relationship*[15] even if there is no longer an employee-employer relationship at the time the remuneration is paid.[16] Consequently, a payment to a former employee could be considered wages for employment tax purposes.

A settlement payment is no different from any other form of remuneration. The settlement payment will be subject to FICA tax if it is properly characterized as wages.[17] Conversely, if the settlement payment is not determined to be wages, it will not be subject to FICA tax.

The IRS[18] position is that a settlement payment made to a former employee in lieu of ERISA[19] plan benefits would be wages for FICA tax purposes[20] because the settlement payment arises from the employment relationship.[21] Furthermore, related attorney's fees may also be includable as wages and thus subject to FICA taxation depending on how those fees are paid.[22]

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[10]Code Section 3101(b)(2). The additional Medicare Tax became effective in 2012 as a result of the 2010 Patient Protection and Affordable Care Act (P.L. 111-148).

[11] Code Section 3102(f)(1).

[12]As "employment" is defined in Code Section 3121(b); any service of whatever nature performed by an employee for the person employing him is employment, unless a specific exemption applies. See, IRS Rev. Rul. 2004-110 citing Code Sections 3121(b) and 3306(c) and Treas. Reg. §§ 31.3121(b)-3(b) and 31.3306(c)-2(b).

[13]Code Sections 3121(a), 3306(b), and 3401(a); Treas. Reg. §§ 31.3121(a)-1(b), 31.3306(b)-1(b), and 31.3401(a)-1(a)(1).

[14]Code Sections 3121(a), 3306(b), and 3401(a); Treas. Reg. §§ 31.3121(a)-1(b), 31.3306(b)-1(b), and 31.3401(a)-1(a)(1).

[15]*See*, *CSX Corp. v. U.S.*, 518 F.3d 1328, 1333 (Fed. Cir. 2008); *see*, *Hemelt v. U.S.*, 122 F.3d 204, 209 (4th Cir. 1997)

[16]Treas. Reg. § 31.3121(a)-1(i); Treas. Reg. § 31.3306(b)-1(i); Treas. Reg. 31.3401(a)-1(a)(5).

[17] *See, e.g.*, *Hemelt v. U.S.*, 122 F.3d 204 (4th Cir. 1997); *Mayberry v. U.S.*, 151 F.3d 855 (8th Cir. 1998).

[18] The U.S. Internal Revenue Service.

[19] Employee Retirement Income Security Act of 1974, as amended.

[20]Internal Revenue Service *Lawsuits, Awards, and Settlement Audit Techniques Guide* May 2011, p. 18 (available online at http://www.irs.gov/pub/irs-utl/lawsuitesawardssettlements.pdf, last accessed July 27, 2013)("***IRS Audit Guide***"), p. 19; *see*, IRS Chief Counsel Memorandum 200017042 (Mar. 3, 2000).

[21] Such settlement payments do not qualify for the exception in Code Section 3121(a)(5)(A) because the payments are not made from the tax-exempt trust of a qualified plan.

[22] *See*, IRS Chief Counsel Memo 20133501F (Aug. 30, 2013) ("When attorney's fees are includable in income in a suit involving an employment-related claim, they may also be wages for employment tax purposes.").

According to the IRS, when attorney's fees are clearly allocated by the court in its judgment, the attorney's fees, although includable in income, are not wages for FICA tax purposes.[23] However, if the court does not allocate attorney's fees, and instead the former employee pays the attorney's fees out of the settlement payment, the entire settlement payment, including the amount paid to the attorney, is considered wages for FICA tax purposes.[24] Similarly, in a settlement agreement that clearly specifies the amount to be allocated as attorney's fees, the attorney's fees would not be considered wages if the amount is reasonable and the claim is otherwise brought under a statute that permits fee-shifting,[25] such as ERISA.[26] It may be helpful to provide in the settlement agreement both the exact amount of the attorney's fees and a provision to the effect that the attorney's fees will be paid directly to the attorney from the employer.

Both an employer and former employee benefit by not characterizing a settlement payment as wages since the result is that no FICA tax would apply. Consequently, to avoid having FICA tax apply, the parties to an ERISA claim may collude to expressly characterize the settlement payment, or a portion thereof, as something other than wages. However, the IRS is aware of this practice and will generally disregard the parties' expressed characterization, and look instead to the economic substance of the settlement payment.[27] As with the IRS, courts also recognize the potential for collusion and agree that the characterization of a settlement payment cannot depend entirely on the intent of the parties.[28]

The FICA Tax Year Is the Year of Payment

If it is determined that all or a portion of a settlement agreement is subject to FICA taxation, the next step is to determine the proper tax year to which to allocate the settlement. For purposes of FICA taxation, a settlement payment is properly allocated to the year in which the settlement payment is made rather than the year in which the wages were earned.[29]

Prior to 2001, there was some confusion on this issue because some federal appellate courts, including the U.S. Court of Appeals for the Fifth Circuit, had held that, for FICA tax purposes, a

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[23] IRS Chief Counsel Memo 20133501F (Aug. 30, 2013) citing IRS Rev. Rul. 80-364 (45 F.R. 74798, Nov. 12, 1980).

[24] *Id.*

[25] IRS Chief Counsel Memo 20133501F ("Although Rev. Rul. 80-364 addresses court awards in the back pay context and not settlements of claims outside of court, the reasoning in the ruling can be extended to settlement payments. When an employment-related claim brought under a fee-shifting statute is settled outside of court and the settlement agreement clearly allocates a reasonable amount of the settlement proceeds as attorney's fees, the amount allocated to attorney's fees, while includable in income, is not wages for employment tax purposes. On the other hand, if the settlement agreement does not clearly allocate an amount for attorney's fees, and/or the claim is brought under a statute that does not provide for fee-shifting, the entire amount paid to the claimant-employee is wages for employment tax purposes.").

[26] ERISA Section 502(g)(1).

[27] IRS Audit Guide, p. 18 (citing Treas. Reg. §§ 31.3121(a)-1(c), 31.3306(b)-1(c), and 31.3401(a)-1(a)(2))("Because both parties generally benefit by classifying payments as non-wage payments, the specific portion of a settlement agreement allocating payments to non-wage payments is generally not based on an arm's length negotiation between adverse parties.").

[28] *See, Dotson v. U.S.*, 87 F.3d 682, 687 (5th Cir. 1996); *see also, Hemelt v. U.S.*, 122 F.3d 204, 208 (4th Cir. 1997).

[29] *U.S. v Cleveland Indians Baseball Co.*, 532 U.S. 200 (2001);

settlement payment is properly allocated to the year in which the wages *should have been paid*,[30] while other federal appellate courts and the IRS held that a settlement payment is allocable to the year in which *the payment is actually made*.[31] However, in 2001, the U.S. Supreme Court resolved the issue with its decision in *U.S. v Cleveland Indians Baseball Co.*, which held that settlement payments are properly allocated to the year in which the settlement payment is made.[32]

FICA Tax Withholding

Once the amount of the FICA tax liability is determined, the employer is responsible for withholding the former employee's portion of the FICA tax from the settlement payment pursuant to Code Section 3102. The employer should draft the settlement agreement to state that any payment to the former employee will be net of amounts withheld for taxes (including FICA tax). Otherwise, the employer could find itself in the unenviable position of having to pay the full settlement amount to the former employee and also being liable for any underwithheld employee portion of the FICA tax.[33]

Reporting of Wages

The portion of the settlement payment that is considered to be wages must be reported on Form W-2 and not on Form 1099-MISC.[34] Any portion that is not considered wages (such as an amount that is clearly and reasonably allocated for attorney's fees) would be reported to the employee on Form 1099-MISC.

The Financial Impact of Using the Current Tax Year for FICA Tax Purposes

Allocating FICA tax to the year of payment could have a substantial impact on the amount of FICA tax that is owed by a former employee, as is shown by the following examples.

***Example*:** An ERISA settlement agreement relates to services performed in 2011. The settlement agreement provides that an unmarried retired former employee will receive $60,000. The settlement payment is made in 2014. Apart from the settlement agreement, the former employee had gross wages of $90,000 in 2011 for which FICA tax was already properly withheld and paid. The former employee has no wages in 2014.

In 2011, the Social Security taxable wage base was $106,800, and the employee portion of the Social Security Tax was 4.2%.[35] In 2014, the Social Security taxable wage base is $117,000, and the employee portion of the Social Security Tax is 6.2%.

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[30] *See, Johnston v. Harris County Flood Control Dist.*, 869 F. 2d 1565 (5th Cir. 1989); *see Bowman v. U.S.*, 824 F.2d 528 (6th Cir. 1987).

[31] *See*, *Hemelt v. U.S.*, 122 F.3d 204 (4th Cir. 1997); *see* IRS Rev. Rul. 89-35 (1989-1 CB 280).

[32] *U.S. v. Cleveland Indians Baseball Co.*, 532 U.S. 200 (2001)

[33] *See*, *Luxemburg v. Texas A&M University System*, 863 F. Supp. 412 (S.D. Tex. Sept. 19, 1994).

[34] *See*, IRS Chief Counsel Memo 20133501F (Aug. 30, 2013)

[35]For 2011 and 2012, the Social Security Tax was reduced to 4.2% for employees due to the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 and subsequent extension.

The following chart shows the impact to a former employee of allocating FICA tax to 2014 rather than 2011.

Example 1	**2011**	**2014**
Amount of Settlement	60,000	60,000
Amount of Other Wages	90,000	0
Total Wages	150,000	60,000
Social Security Wage Base (SSWB)	106,800	117,000
Amount of Other Wages Already Applied to SSWB	90,000	0
Amount of Settlement Subject to Social Security Tax	16,800	60,000
Social Security Tax Rate (Employee Portion)	4.2%	6.2%
Amount of Social Security Tax (Employee Portion)	**705.60**	**3,720.00**
Amount of Settlement Subject to Medicare Tax	60,000	60,000
Medicare Tax Rate (Employee Portion)	1.45%	1.45%
Amount of Medicare Tax (Employee Portion)	**870.00**	**870.00**
Amount of Settlement Subject to Addtl Medicare Tax	0	0
Addtl Medicare Tax Rate (Employee Portion)	N/A	0.9%
Amount of Addtl Medicare Tax	**N/A**	**0**
Total Employee Portion of FICA Tax	**1,575.60**	**4,590.00**

As can be seen, if the settlement payment is allocated to 2011, the former employee's FICA tax bill is only $1,575.60. However, because the settlement payment must be allocated to the 2014 year of payment, the former employee's FICA tax bill almost triples to $4,590.[36]

Conclusion

Generally, payments made to settle an ERISA claim by a former employee will be considered wages subject to FICA tax. Additionally, if attorney's fees are not clearly allocated in the settlement agreement, the attorney's fees will also be considered part of the former employee's wages subject to FICA tax. Any amount of a settlement payment that is considered wages must be reported on an IRS Form W-2 for the year of the payment, and the FICA tax is calculated for the year of the payment. Once the amount of the FICA tax has been calculated, the employee portion must be withheld by the employer.

If attorney's fees under an ERISA claim were clearly allocated in the settlement agreement, those fees may not be considered wages, in which case, the employee would be issued a Form 1099-MISC for that portion of the settlement payment, and no FICA tax would be calculated or withheld on that portion.

[36]This does not include any interest that may be assessed by the IRS for amounts allocated back to 2011.

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PRACTICAL AND TAX CONSIDERATIONS OF DRAFTING ILITS

Michelle Rosenblatt[1]

I. INTRODUCTION

Irrevocable life insurance trusts (ILITs) have become commonplace in our practice. They are often promoted by estate planners, financial advisors, and insurance agents as simple trusts to create, fund, and administer. ILITs, however, require careful drafting and administration if one is to avoid the myriad opportunities to compromise the very planning one is attempting to achieve by putting an ILIT in place.

II. BASIC CONSIDERATIONS

A. Policy Owner and Beneficiaries. Life insurance policies are generally non-probate assets that pass outside of a person's probate estate.[2] As such, the beneficiary designation form controls the disposition of the policy. For clients with existing policies, the prudent planner should request a copy of any policies and the corresponding beneficiary designations currently in place. Clients often believe they have named certain beneficiaries of a policy, only to find out after reviewing the beneficiary designation form with an attorney that their intended disposition will not be accomplished.

For clients who want to avoid the inclusion of the policy proceeds in their estates, the preferred ownership for a new policy is by the trustee of an ILIT. The trustee of the ILIT also should be named as the primary beneficiary in the beneficiary designation form. For example, the designation should read, "___________, as trustee of the ___________Trust."

When representing a married couple, it is first important to consider whether the settlor/insured's spouse will be a beneficiary of the ILIT.[3] If so, it is important to draft the trust agreement so that the settlor/insured is the sole settlor of the trust. Moreover, any contributions to the trust should be the settlor/insured's separate property to preclude an undesirable estate tax consequence to the settlor's spouse.[4]

If the settlor/insured does not own sufficient separate property to fund the trust, it is advisable prior to the trust funding to have the couple enter into a partition agreement commuting the property that will be used to fund the trust into the separate property of the settlor/insured. A partition agreement also should be entered into each time a subsequent contribution is made to the trust by the settlor/insured.[5]

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[2] Insurance proceeds become probate assets and pass under a Will if the policy owner names his or her estate as the policy beneficiary or if the policy provides that the default taker is the estate and the owner neglects to name a beneficiary or fails to name an alternate beneficiary where the first named beneficiary predeceases the owner.

[3] If the ILIT will own only a survivorship policy and benefits only the settlor's descendants (and the settlor's spouse does not have any tax-sensitive interest), the separate or community property distinction of the contributions or policy should not be relevant for estate tax purposes as it relates to the settlor's spouse.

[4] *See* discussion at V.F. herein.

[5] Before representing a married couple, one should consider carefully whether to represent both husband and wife with regard to preparing the partition agreement that changes community property into separate property. If one decides to represent both spouses, the engagement letter should include language setting forth the requirements of a joint representation.

Existing policies may be owned either in trust or in any number of other ways. Existing policies present planning opportunities which are discussed later.

B. Elements of a Typical ILIT. In designing and drafting an ILIT, the planner should consider the following elements: the identities of the settlor(s) and trustee(s); the trust's irrevocability; the beneficiaries; the withdrawal rights of beneficiaries; powers of appointment of beneficiaries; the distribution standard; the powers of the trustee; whether to include provisions for a protector; state law; and the settlor's intended estate planning goals, tax or otherwise.

III. OBJECTIVES FOR CREATING AN ILIT

A. Non-Tax Objectives. There are several reasons why a planner may decide that an ILIT would be a good fit for a client. Examples of non-tax objectives for creating an ILIT include: (1) the client's estate will need liquidity to pay the anticipated estate tax liability; (2) the client wishes to provide a stream of income to a family member at his or her death and life insurance is a good way to leverage the value of his or her gift; (3) the client wishes to equalize gifts going to children not involved in the family business or from a prior marriage; (4) the client wishes to protect the inheritance from the creditors and spendthrift beneficiaries; (5) the client wishes to protect the assets used to fund the ILIT from his or her own creditors; (6) the client wishes to provide a hedge against his or her own premature death; (7) instead of the proceeds being paid outright to beneficiaries, the client wishes to provide that the policy proceeds will be distributed in the discretion of the trustee; and (8) the client wishes to provide professional management of the policy proceeds for future generations.

By way of example, a client may own a family business in which one or more of the client's children is not involved. In such an instance, the client may wish to provide for an inheritance that will equalize the value of the business that the client's other children will inherit. The client can accomplish this by creating and funding an ILIT to benefit the children who are not involved in the business; the trustee of the ILIT then can purchase a policy and name the ILIT as the policy beneficiary. Alternatively, the life insurance policy proceeds may be used as a family bank by not only the children who will not inherit the business, but also by those that will. In today's stringent lending market, an ILIT with a significant deposit of funds available to be lent offers flexibility and opportunity to the family that may not be available in the public market.

B. Tax Objectives. Several tax objectives also may lead to the creation of an ILIT for a client, including the desire to: (1) shelter the life insurance proceeds from estate tax at the client/insured's death; (2) leverage the client's annual gift tax exclusion amount ($14,000 per donor per donee in 2014) and lifetime gift tax and generation-skipping transfer tax exemption amounts (each $5,340,000 in 2014); (3) reduce the client's estate by removing an existing policy from the estate; and (4) protect the policy proceeds from being subject to estate tax at the deaths of the ILIT beneficiaries.

IV. PRACTICAL DRAFTING ISSUES

Four practical drafting considerations (which have tax consequences overlays) are set forth below. Drafting an ILIT, as simple as it may seem, is both an art and a craft that can be filled with minefields of which the careful drafter should be aware.

A. Choice of Trustee. The choice of trustee is often given short shrift by planners, especially in the ILIT context. Clients often are not ready to determine whom they would name to such a position, even if the client comes to the drafter requesting an ILIT. No matter the client's certainty as to choosing a trustee, it is helpful for a client to understand the basic duties and responsibilities imposed on trustees.

The next consideration is whether to name an individual, professional, or corporate trustee. Many clients and planners prefer individual trustees for various reasons (cost, formalities, or the perceived or actual inflexibility of corporate trustees). In each case, however, the choice of trustee should be analyzed carefully.

Texas law permits any individual to serve as trustee of a trust so long as he or she has "legal capacity to take, hold, and transfer the trust property."[6] There are certain advantages to naming an individual the trustee of an ILIT. The individual may have personal knowledge about the settlor's intentions and the beneficiaries' situations and needs. Another advantage is that individuals, especially those with a close relationship to the settlor, often are willing to serve for little or no fee. An astute drafter, therefore, should include a provision that a trustee may waive compensation.[7] Alternatively, some drafters include a provision that no individual will receive compensation for serving as trustee.

Conversely, there are certain factors that weigh against appointing individual trustees. An individual may not follow the formalities of trust administration as he or she should, if he or she does not fully understand his or her role as a fiduciary. An individual with a close relationship to the settlor may not bring an appropriate level of impartiality to the task of serving as trustee. This may damage the relationship of the trustee and beneficiary, and in extreme cases, may even lead to litigation by the beneficiary against the trustee. The cost savings aspect also may be illusory. For example, a trustee who does not properly carry out his or her fiduciary responsibilities may cause more fees to be incurred with relation to the investment of trust assets or with regard to the legal formalities that should have been followed and now must be remedied. Lastly, individual trustees do not provide continuation of trusteeship in the same way that a professional or corporate trustee does.

Professional trustees may be individuals or corporations. Examples of professional individual trustees include attorneys, CPAs, and financial advisors or money managers. Although it seems to be common practice for attorneys to serve as trustees of trusts in other parts of the country, the author has observed that Texas attorneys rarely accept such an appointment unless they have some non-legal relationship with the trust settlor. In the event a professional accepts trusteeship of a trust, the professional often expects to be compensated at his or her hourly rate, especially if such professional has a depth of knowledge about fiduciary responsibilities. One advantage of an individual professional serving as trustee is the knowledge and experience that the professional brings to the trusteeship. The same issue of continuity of trusteeship arises, however, in the case of the professional individual trustee.

The third option, that of a corporate trustee with trust powers, offers continuity of trusteeship and the probability of greater resources in fulfilling the trustee's investment and other duties and responsibilities. Corporate trustees, however, are often more impersonal (unless they have already have established a relationship with the family, settlor, or

[6] Tex. Trust Code § 112.008.

[7] Once administration has begun, the trustee must be cautious when waiving compensation. Generally, a waiver of compensation will not constitute an assignment of income or a gift so long as it is done early in the administration, and before being allowed as a deduction for income or estate tax purposes. In the instance where a trustee is also a beneficiary of the trust, compensation for serving as a trustee must be included in the trustee's taxable income. However, if the trustee/beneficiary waives compensation, then distributions to the beneficiary will be taxable only to the extent the trust has income (known as distributable net income) which is carried out to the beneficiary with the distribution. Other trustees may decide to waive compensation to ensure fairness to the beneficiaries or to gain the opportunity for greater indemnification against any potential liabilities they may incur during the trust administration (if the trust contains such provisions).

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beneficiaries). There is also the chance that, even if a particular trust officer has a long-standing relationship with the family, such officer may leave the corporate trustee and be replaced by another officer without that relationship. Corporate trustees also tend to be conservative and deliberate in making discretionary distributions, and the process may take place more slowly than if an individual trustee is serving. Further, as corporate trustees tend to follow the prudent person rule of investment, they generally want a well-balanced portfolio of investments that can be readily converted to cash. Therefore, if the plan is for the trust to hold and retain one or more classes of assets that are not traded on a stock exchange (e.g., life insurance, a family ranch, mineral interests, or a family business), the settlor should ensure that the corporate trustee will not sell these assets in order to diversify the trust investments. Additionally, the settlor should ensure the corporate trustee has a division with employees experienced in managing such assets. Some settlors may not want the added expense of the corporate trustee. Because corporate trustees often charge a fee based on the value of assets under management and an annual minimum fee regardless of the value of those assets, a corporate trustee may be prohibitively expensive for an ILIT (especially if the trust owns nothing more than an insurance policy, as the trust administration is perceived to be relatively straightforward and the trust likely lacks liquid assets with which to pay the trustee's fee). A final consideration is whether the corporate trustee willing to manage an unfunded ILIT has an ILIT center where all unfunded ILITs are managed and whether that trust center is in Texas. In short, a corporate or professional trustee may not be as necessary for an ILIT as for other trusts because of the relatively basic trust administration of an ILIT. If an individual trustee (whether a professional or non-professional) is chosen, the drafter must take particular caution in guiding the settlor's choice of trustee and in drafting the trustee provisions to ensure that no unintended tax consequences result.[8] Moreover, the individual trustee (or his or her advisor) should fully understand the mechanics of trust contributions and premium payments, withdrawal notices, and keeping detailed trust records. Some drafters provide the trustee with an introductory trust package transmitting the executed trust, trust administration documents,[9] and a letter explaining the trust and the trustee's duties under the document). Any such letter should clearly state that the drafter does not represent the trustee (unless, of course, he or she has disclosed the potential conflicts of interest in doing so and the trustee and the settlor have waived any such conflicts) and that the trustee should seek independent counsel with regard to any questions relating to trust administration.

B. <u>*Crummey* Withdrawal Rights and Notices</u>.

1. *Withdrawal Rights*. ILITs commonly grant withdrawal rights to the trust beneficiaries to ensure that gifts to the trust qualify for annual exclusion treatment.[10] A drafting consideration is whether the trust will benefit one or more beneficiaries, and if it benefits multiple beneficiaries, whether all beneficiaries will be granted withdrawal rights.

In the event a trust agreement provides for withdrawal rights in favor of several holders, the trust agreement should address the situation. One manner of doing so is limiting the beneficiary's withdrawal right to the lesser of the amount of the gift or the amount of the annual exclusion amount which the donor can utilize in the year of the gift for the gift to the trust. Another manner

[8] This concept is explored further herein at V., *Tax Considerations of Drafting an ILIT*.

[9] Such documents might include the Form SS-4 for the trust, the insurance policy, and the beneficiary designation form.

[10] *See* discussion herein at V.C., *Gift Tax Issues Relating to the Settlor*.

of addressing such a situation is to require apportionment of the demanded funds.[11]

2. *Satisfaction of Withdrawal Right.* The trustee should have available assets during the period of withdrawal to satisfy any demand rights. With ILITs, contributions often are made not far in advance of the date when premiums are due. One drafting technique to protect against this common situation is to permit the trustee to satisfy the withdrawal right from the trust assets other than the most recent gift. For example, the agreement may permit the trustee to distribute the policy, although including such a provision may result in several other issues.[12] Another (and more common) provision is to allow the trustee to borrow against trust assets to satisfy the demand by the beneficiary.

3. *Notice*. Most trust agreements require that written notice of gifts to the trust to the trust beneficiary be given by the trustee within a specified time of the gift by the settlor. The term "*Crummey* notice" arises from *Crummey v. Commissioner,*[13] the seminal case providing guidance as to what constitutes a present interest for purposes of the gift tax annual exclusion rule.[14] Interestingly, in *Crummey*, the court ruled that notice was not required to qualify the gift as a present interest eligible for annual exclusion treatment. Instead, the beneficiaries' mere right to enjoy the transferred property (i.e., their demand right) was sufficient. Several years later, the Service took the opposite position by requiring that a beneficiary must be given notice of his or her right to withdraw trust property in order to qualify the fit as a present interest eligible for annual exclusion treatment.[15] In 2011, however, the Tax Court in *Turner*[16] reaffirmed the position taken in *Crummey*, in which no notice was required to qualify the gift as a present interest. Thus, it seems that notice of the gift is not, in fact, required for annual exclusion treatment.

Out of an abundance of caution, however, most drafters include notice provisions in their trust agreements and continue to advise trustees to issue withdrawal notices whenever a gift is made to the ILIT. Written withdrawal notices also provide the taxpayer with a permanent and readily available record (assuming the trust records are well maintained) of any gifts made.[17] If the drafter includes notice provisions in his or her ILIT agreement, several issues are important to consider.

4. *Timing of Notice*. The Service has ruled that three-day demand period is not sufficient,[18] but otherwise has failed to define what constituted "reasonable" notice.

[11] *See* Rev. Rul. 80-261, 1980-2 C.B. 279.

[12] See *Ryerson v. U.S.,* 405 (1941), holding that if a beneficiary (who is not the only beneficiary) and the trustee jointly own the policy, they must jointly exercise the incidents of ownership over the policy unless the policy is bifurcated. If the policy is not bifurcated, the distribution of an undivided interest in the policy to one beneficiary likely will not qualify for annual exclusion treatment.

[13] *Crummey v. Comm'r*, 397 F.2d 82 (9th Cir. 1968), *aff'g and rev'g* T.C. Memo 1966-144. The Service has *accepted* the viability of *Crummey* demand powers to a great extent. *See* Rev. Rul. 73-405, 1973-2 C.B. 321.

[14] I.R.C. § 2503(b).

[15] Rev. Rul. 81-7, 1981-1 C.B. 474. *See also* Tech. Adv. Memo. 9532001 (Apr. 17. 1995) (holding that the Service will recognize *Crummey* withdrawal rights only in those instances which the donee receives actual, current notice of any gifts to the trust).

[16] *Turner v. Comm'r,* T.C. Memo 2011-209 (Aug. 30, 2011).

[17] For example, in an audit, the taxpayer has the burden of proof to defend the position that gifts to the ILIT qualified for an annual gift tax exclusion of the donor because the gift (as a result of the withdrawal power) was of a present interest to the beneficiary. Documented written notices in the ILIT records will assist with the audit.

[18] Rev. Rul. 81-7, 1981-1 C.B. 474; *see also* Priv. Ltr. Rul.7946007 (Jul. 26, 1979) (involving a Texas ILIT where the trustee did not notify the adult beneficiary that he had a demand power over contributions to the ILIT and did not notify the beneficiary when contributions were received). In *Estate of Cristofani v. Comm'r*, 87 T.C. 74 (1991), the beneficiary's withdrawal right began on the date of contribution and ended 15 days later. The trustee was required to notify the beneficiary when a contribution was received; however, how quickly that notice had to be given was not addressed.

Several private letter rulings ("PLRs") offer guidance, however, and have held that a 30-day demand period is sufficient.[19]

As a result, many drafters tie their withdrawal period to 30 days. Some other drafters include language in their trust agreements that a withdrawal right will lapse upon the earlier of 30 days or December 31 of the year in which the gift was made. Given the Service's position that a three-day demand period is not sufficient, a careful drafter will ensure that the trust agreement does not unintentionally cause a three-day demand period. For example, if the settlor makes a gift to the trust on December 28 and the trust provisions state that the withdrawal right will lapse upon the earlier of 30 days or December 31, the agreement may not be provide a sufficient notice period to qualify the gift as an annual exclusion gift. Alternatively, the trust provision could be drafted to provide that a withdrawal right automatically lapses upon the earlier of 30 days or December 31 of the year in which the gift is made; provided however, that at least 30 days must pass before the withdrawal right lapses. The drafter should be wary of adjusting the lapse period to be too generous, however, to preclude an unintended gift tax situation or estate inclusion.[20]

Also of note is the Service's ruling that if a demand period overlaps two years (e.g., a December 28 gift is subject to a 30-day demand period), and if the trust agreement does not provide that the beneficiary's demand right lapses at year-end, the trustee may give notice of the gift in the following year.[21] Moreover, the annual exclusion may be taken in the year in which the transfer was made, rather than in the year the notice was given.[22]

Some might argue that the Service has held that a "one-time" notice is sufficient when future contributions are expected to be made to the trust,[23] but the more conservative position is to require that the trustee give notice each year and a written acknowledgement of the contribution and corresponding withdrawal right be obtained from all beneficiaries. More importantly, notice of a future right does not qualify as a present interest that would qualify the gift as an annual exclusion gift.

5. *Manner of Notice.* At least one Tax Court has upheld the use of a taxpayer's annual exclusion amount for gifts to a trust when the trust beneficiaries were given verbal notice.[24] No revenue rulings or PLRs

[19] Priv. Ltr. Rul. 199912016 (Dec. 21, 1998) (holding that a father's contribution to two trusts qualified for the annual gift tax exclusion where the trust beneficiary had 30 days after receiving notice to make a demand); *see also* Priv. Ltr. Rul. 8813019 (Dec. 24, 1987); Priv. Ltr. Rul. 8143045 (Jul. 29, 1981); Priv. Ltr. Rul. 8134135 (May 28, 1981); Priv. Ltr. Rul. 8103074 (Oct. 23, 1980); Priv. Ltr. Rul. 8030085 (Apr. 30, 1980); Priv. Ltr. Rul. 8024084 (Mar. 21, 1980); Priv. Ltr. Rul. 8006048 (Nov. 16, 1979); Priv. Ltr. Rul. 8004172 (Nov. 5, 1979); and Priv. Ltr. Rul. 8003033 (Oct. 23, 1979). In the following PLRs, the withdrawal period was 60 days: PLR 7939061 (Jun. 27, 1979), and PLR 8007080 (Nov. 26, 1979). The withdrawal period in the following PLRs was 90 days: PLR 8008040 (Nov. 28, 1979), 8015133 (Jan 21, 1980), PLR 8044080 (Aug. 11, 1980), and PLR 8051128 (Sept 26, 1980).

[20] See discussions herein at V.D., *Gift Tax Issues Relating to the Beneficiary*, IV.G., *Estate Tax Issues Relating to the Beneficiary*, and V.I., *GST Issues Relating to the Beneficiary*.

[21] Rev. Rul. 83-108, 1983-2 C.B. 167.

[22] Rev. Rul. 83-108, 1983-2 C.B. 167 , (in which the beneficiary did not receive notice of a gift made at the end of 1981 and accompanying withdrawal right until the beginning of 1982 and had 45 days to exercise the withdrawal right). Note that in this instance the beneficiary's withdrawal right did not lapse until the following year.

[23] The argument, based at least one commentator's reading of TAM 9532001, is that a notice informing the beneficiary of his or her rights over specific gifts to the trust and detailing the dates and amounts should suffice, unless gifts are made in amounts or on other dates other than those specified. *See* Tech. Adv. Memo. 9532001 (Apr. 12, 1995) (in which the trust beneficiaries signed a statement waiving their right of withdrawal to not only the initial trust contribution, but also to their right to receive notices of future trust contributions).

[24] See *Estate of Carolyn W. Holland v. Comm'r*, T.C. Memo 1997-302, where the Service argued that the lack of written notice as required under the ILIT

have required that a trust agreement require a trustee to give written notice. As a case in point, the beneficiaries in the *Crummey* case received no notice.

The Service has allowed an annual exclusion where a taxpayer's spouse was trustee and had actual notice of the gifts.[25] In another PLR, although the trustee (who was a beneficiary *himself*, the trustee, and the guardian of the other minor beneficiaries) failed to provide written notice of the gifts to himself as guardian of the minor beneficiaries, an annual exclusion was allowed because constructive notice was given.[26] It should be noted that although the Service has approved constructive notice in this one PLR, in a later Technical Advice Memorandum ("TAM"),[27] it required actual notice. Thus, the careful drafter should ensure that his or her trust agreement requires actual notice of any gifts and, to the extent possible, that the trustee gives actual notice of any gifts.

It also is important to note that the taxpayer has the burden of proof to show that notice was given. Thus, the more cautious planners require written notice by the trustee prior to or contemporaneously with the gift to provide (the taxpayer with a permanent and readily available record (assuming the trust records are well maintained) and avoid the need for later-drafted affidavits attesting to the notice given by the trustee to the trust beneficiaries.

should result in the loss of the annual gift tax exclusion, even though the beneficiaries had actual notice. The Tax Court disagreed: "The sufficiency of the notice given the beneficiaries is a factor in the likelihood that the right of withdrawal will be exercised; it is not a factor in the legal right to demand payment from the trustee …. Furthermore, during the years of the transfers, the only minor beneficiaries of the Weinstock Trusts were the children of the trustees. We do not think that the failure of a trustee to give written notice to himself should require a finding that notice was not given."

[25] Priv. Ltr. Rul. 8008040 (Nov. 28, 1979).

[26] Priv. Ltr. Rul. 9030005 (Apr. 19, 1990).

[27] Tech. Adv. Memo. 9532001 (discussed above).

C. Trustee's Duties. Another important drafting consideration is the trustee's fiduciary duties, and specifically, the management of the trust assets. The default standard is contained in Texas Trust Code Chapter 116 *et seq.,* and is otherwise known as the Texas Uniform Principal and Income Act ("TUPIA"). Under the TUPIA, a "trustee must invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust."[28] Moreover, "the trustee shall exercise reasonable care, skill, and caution."[29] Finally, a "trustee's investment and management decisions relating to individual assets must be evaluated not in isolation but in the context of the portfolio as a whole and as part of an overall investment strategy having risk and return objectives reasonably suited to the trust."[30]

The TUPIA provides certain circumstances relevant to the trust or its beneficiaries that a trustee must consider in investing and managing trust assets: "(1) general economic conditions; (2) the possible effect of inflation or deflation; (3) the expected tax consequences of investment decisions or strategies; (4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property; (5) the expected total return from income and the appreciation of capital; (6) other resources of the beneficiaries; (7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and (8) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries."[31]

The other statutes setting forth the TUPIA's standard of care are as follows:

[28] Tex. Trust Code Section 117.004.

[29] Tex. Trust Code Section 117.004.

[30] Tex. Trust Code Section 117.004(b).

[31] Tex. Trust Code Section 117.004(c).

- A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.[32]

- Except as otherwise provided by and subject to this subtitle, a trustee may invest in any kind of property or type of investment consistent with the standards of this chapter.[33]

- A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.[34]

- A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.[35]

- Within a reasonable time after accepting a trusteeship or receiving trust assets, a trustee shall review the trust assets and make and implement decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust, and with the requirements of the TUPIA.

The TUPIA's affirmative duty to diversify may present issues for an uneducated drafter of an ILIT. Unless the trust terms provide otherwise, the trustee of an ILIT can be held to a duty to diversify trust assets, which may present a problem when the intention is for the trust's primary or sole asset to be a life insurance policy. As mentioned, however, the TUPIA is merely the default statutory rule and may be expanded, restricted, eliminated, or otherwise altered by the terms of the trust agreement.[36] The TUPIA provides further protection for the trustee in that a "trustee is not liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the provisions of the trust."[37]

When drafting an ILIT agreement, then, it is prudent to specifically state that the settlor's intent is that the trustee not dispose of all or part of specific assets, or specific types of assets, in order to meet the purposes of the trust and to specifically provide that the trustee may hold a disproportionate amount of one class of asset, namely life insurance. In contrast, if an existing ILIT agreement does not contain a specific provision waiving the duty to diversify under TUPIA, the first thing to look for in the trust provisions is "retention" language. Prior to the adoption of the TUPIA in 2004, the Texas Trust Code specifically addressed the retention of assets as follows: "A trustee may retain, without regard to diversification of investments and without liability for any depreciation or loss resulting from the retention, any property that constitutes the initial trust corpus or that is added to the trust."[38] If the trust agreement at issue contains such language, then the trustee will have an argument that he or she can retain certain assets.[39] It is of note that

[32] Tex. Trust Code Section 117.004(d).
[33] Tex. Trust Code Section 117.004(e).
[34] Tex. Trust Code Section 117.004(f).
[35] Tex. Trust Code Section 117.005.

[36] Tex. Trust Code Section 117.003(b).
[37] Tex. Trust Code Section 117.003(b).
[38] Tex. Trust Code Section 113.003 (effective January 1, 1984 to December 31, 2003).
[39] In Texas, the issue has been addressed in *Shands v. Texas State Bank*, 121 S.W.3d 75 (Tex. App..-San Antonio 2003), *Shands v. Texas State Bank*, 2001 WL 21490 (*not designated for publication*) (Tex. App..-San Antonio), and *Neuhaus v. Richards*, 846 S.W.2d 70, 77-79 (Dec. 31, 1992), *rehr'g overruled* Jan. 14, 1993. In the 2001 *Shands* appeal, the appellate court determined that the agency relationship with Texas State Bank created a fiduciary relationship as a

some corporate trustees require periodic reviews of policies held in trust to ensure that the policies cannot be restructured to better increase the return or fulfill the trust's purpose.

D. Drafting Flexibility in an ILIT. By its very definition, an ILIT is irrevocable. There are certain provisions the drafter may include, however, to provide flexibility.

1. *Settlor's Ability to Adjust or Eliminate Withdrawal Rights.* Some drafters include language permitting the settlor to adjust or eliminate withdrawal rights as to certain beneficiaries and the Service has upheld such language in several instances.[40] The most typical language provides that a settlor may, contemporaneously or prior to the gift, specify in a writing to the trustee that the settlor wishes to adjust the withdrawal rights over the gift as to one or more trust beneficiaries.[41]

There are at least two reasons that a settlor may want to retain this right. First, the settlor may want to retain the ability to determine on an annual basis how he or she will utilize the gift tax annual exclusion as to a particular beneficiary or beneficiaries. Second, the settlor may have some concern that a beneficiary will exercise the withdrawal right, thereby causing the trustee to be unable to make the premium payment due in that year.

2. *Trustee Discretion to Distribute Principal and Amounts Derived from Policy*. The drafter may include a provision to allow the trustee, on a discretionary basis, to distribute trust principal (including amounts derived from the policy) to the trust beneficiaries during the settlor's lifetime. Such a provision provides the trustee the flexibility to make distributions to the trust beneficiaries from what would otherwise be a non-income producing asset. If the drafter chooses to include this power, he or she should consider the interplay with the choice of trustee and the distribution standard (i.e., whether distributions are limited to an ascertainable standard), to ensure no unintended tax consequence results.[42]

3. *Trustee Ability to Terminate the Trust.* The trustee may be given the power to terminate the trust at any time and distribute the trust property to the beneficiaries then entitled to receive the net income of the trust. If the trustee is also a beneficiary or a situation exists in which they may be one in the same or if the trustee is related or subordinate to the settlor, such a power should only be given to an independent trustee.

4. *Trustee Ability to Merge Trust with Another Trust*. The drafter also may include provisions permitting the trustee to merge any trust estate created under the trust agreement with any other trust estate for the benefit of the same beneficiaries. It should be noted that if such a provision is included, the merger should not result in adverse tax consequences (i.e., the trust should not change the trust's inclusion ratio for GST tax purposes). Another aspect that needs to be addressed is the perpetuities period; the merged trusts should have the same perpetuities period or the ILIT should contain provisions limiting the perpetuities period with respect to any merged trusts.

5. *Defining Beneficiaries*. The trust agreement can be drafted to define beneficiaries rather than naming particular beneficiaries. Doing so permits the

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matter of law. In the 2003 *Shands* appeal, based on whether or not damages had been proven where the customer directed investments and kept most of them in mutual bonds, the appellate court affirmed the trial court.

[40] Tech. Adv. Memo. 9532001 (Apr. 12, 1995); Priv. Ltr. Rul. 9030005; Priv. Ltr. Rul. 8103074 (Oct. 23, 1980), and Priv. Ltr. Rul. 8103069 (Oct. 23, 1980).

[41] For another option that addresses this concern, see discussion herein at IV.B.2., *Satisfaction of Withdrawal Right*.

[42] For a more in-depth discussion of the potential tax implications associated with the distribution standard, *see* discussion herein at V.A., *Income Tax Issues Relating to the Settlor*, and V.G., *Estate Tax Issues Relating to the Beneficiary*.

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inclusion of all children of the settlor (which is especially useful when a settlor is in the stage of life in which he or she is expanding his or her family) and can permit the inclusion of the settlor's spouse.[43] The definition of the settlor's spouse can be further utilized to provide marital planning in that the settlor's spouse can be defined as the settlor's spouse at his or her death.[44]

6. *Limited Power of Appointment*. If the ILIT will benefit only one beneficiary or be subdivided into separate trusts at inception or a later date, the drafter may decide to grant a limited power of appointment to the beneficiary (over his or her separate trust) exercisable in favor of the settlor's descendants and one or more charitable organizations in equal or unequal amounts or shares. Such a provision gives the beneficiary flexibility in his or her own estate planning.

Alternatively, the drafter may include a limited power of appointment exercisable by the settlor's spouse during the settlor's lifetime in favor of the settlor and settlor's spouse's common descendants. If the drafter chooses to include such a provision, the settlor's spouse should not be an insured of the policy (to avoid inclusion of the policy proceeds in his or her estate). Additionally, the limited power of appointment would have to be inapplicable during any period in which *Crummey* withdrawal rights are outstanding and unexercised. Given this latter factor, it may be best to avoid such a provision unless the drafter knows that he or she will be assisting with the trust administration to ensure that the trust provisions are strictly followed.[45]

7. *Including a Trust Protector or Independent Trustee.* The most flexibility may be had by adding a trust protector or independent trustee to exercise certain powers (some of which are discussed above). A person in this role must be someone implicitly trusted by the settlor, but neither the settlor nor any trust beneficiary should be permitted to be named as either the trust protector or independent trustee.

Other issues arise, in that although protectors commonly are used in the foreign context, Texas law does not provide specific duties or liabilities as they relate to protectors. Thus, the most prudent course of action is to name such a person an independent trustee so that he or she is subject to the standards of a trustee.[46]

8. *Grantor Trust Provisions*. Including grantor trust provisions in the trust agreement provides flexibility because the Service ignores such trusts for income tax purposes. Such treatment results in transactions between the trust and its grantor being disregarded. By way of example, and as explained later, a grantor trust may purchase a policy from the grantor without the gain on the policy being recognized.[47] Drafting the trust as a grantor trust thus provides flexibility even if it is not

[43] As discussed in this article, caution should be employed when naming a settlor's spouse as beneficiary or trustee.

[44] Some settlors may elect not to constrict the definition of his or her spouse to avoid current marital strife, but the topic should be discussed with the settlor during the drafting process. Planners representing both spouses must consider carefully the ethical implications of the joint representation and the fact that if one of the spouses becomes disenchanted with the planning, the disenchanted spouse may use the joint representation as a wedge in litigation.

[45] Often, the trustee of an ILIT does not retain a CPA or attorney (including the ILIT drafter) for ongoing trust administration.

[46] Some practitioners believe there is a distinct possibility that a court faced with the issue of whether a protector has fiduciary responsibilities will determine that the protector is, in reality, a trustee with limited responsibilities. Thus, calling the protector an independent trustee with limited responsibilities is another way of defining the role of the protector.

[47] Of course, the trust must pay full and adequate consideration for the policy (to avoid a taxable gift argument by the Service) and analysis of the transfer for value rule must be made (as discussed further herein at V.A., *Income Tax Issues Relating to the Settlor*).

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anticipated to be needed), and can be terminated later if desired.[48]

V. TAX CONSIDERATIONS IN DRAFTING AN ILIT[49]

As mentioned, ILITs often are touted as "simple" estate planning tools that offer significant tax advantages because a policy held in an ILIT should not be subject to income tax or estate tax at the settlor/insured's death. This grossly over-simplifies the tax issues that should be considered when drafting and implementing an ILIT. While the proceeds of a life insurance policy are generally received income tax free by the beneficiary upon the death of the insured, there are a number of income, gift, estate, and generation-skipping transfer tax issues that should be considered when planning with life insurance and ILITs.

That is not to say that life insurance does not offer significant tax advantages when utilized by a knowledgeable estate planner. Three such tax advantages are: (1) the accumulation in cash value inside a policy is income tax free to the policy holder;[50] (2) proceeds received at the death of the insured are generally income tax free to the policy beneficiary;[51] and (3) the policy proceeds are generally not includible in the insured's estate for estate tax purposes if (i) the policy beneficiary is someone other than the insured's estate, (ii) the insured possessed no "incidents of ownership," and (ii) the insured did not contribute the policy to the ILIT within three years of death.[52]

A. Income Tax Issues Relating to the Settlor.[53] The ILIT agreement can be drafted to cause the settlor to be the grantor for income tax purposes or so that the settlor is not the grantor for income tax purposes. A grantor ILIT typically proves more flexibility with regard to the settlor's future planning.[54] For example, a grantor ILIT permits: (1) gift tax free contributions to the trust with relation to the grantor's payment of any income taxes due from the ILIT; (2) the grantor to transact business with the ILIT without an income tax consequence (i.e., sales or loans to or from the trust); and (3) tax-efficient ILIT funding (e.g., split-dollar arrangements).[55]

That said, if the ILIT will hold assets other than just an insurance policy, it may have significant income for which the settlor may not want to incur tax responsibility. A non-grantor ILIT also may be beneficial in the situation where the ILIT distributes income

[48] *See* discussion herein at V.A., *Income Tax Issues Relating to the Settlor*.

[49] Most of the tax issues are inextricably interwoven and must be applied in successive overlays, but the author has done her best to discuss each issue under the type of tax to which it most relates.

[50] I.R.C. § 72(e)(4)(B).

[51] I.R.C. § 101. Section 101, however, further provides that if a life insurance policy is transferred for valuable consideration, then the death benefit is taxable to the recipient. The general rule does not apply, however, if such a sale is to the insured, a partner of the insured, or a partner in which the insured is a partner, or a corporation in which the insured is a shareholder or officer. *Id.* § 101(a)(2)(B).

[52] I.R.C. §§ 2035, 2042.

[53] As a general rule, the trustee of the trust must file Form 1041 in each year that the trust income exceeds the reporting threshold. *See* http://www.irs.gov/pub/irs-pdf/f1041es.pdf (last visited Feb. 7, 2014). If the ILIT is structured as a grantor trust, the trust's Form 1041 should show that the trust is a grantor trust and include a Grantor Trust information Letter detailing the grantor's name, address, and social security number, as well as any items of trust income attributable to the grantor. If a person is both the grantor of the trust for income tax purposes and the trustee of the trust for the full taxable year, then Form 1041 is not required, nor is a separate employer identification number (EIN) or taxpayer identification number (TIN) for the trust. Instead, all items shown on the grantor Trust Information Letter are reportable on the grantor's individual Form 1040. If the ILIT is not structured as a grantor trust for income tax purposes, only Form 1041 is required to be filed, and the trust will pay income tax on its income above the reporting threshold. The trustee also must obtain an EIN for the trust.

[54] The flexibilities of grantor trust are well known. As a case in point, President Obama's FY 2014 budget contains limitations on certain sale transactions with grantor trusts.

[55] Split-dollar arrangements are outside the scope of this article.

to beneficiaries who are in a lower tax bracket than the settlor.

To cause the ILIT to be a grantor trust, the drafter should use one or more of the several grantor trust powers delineated in sections 671-679 of the Internal Revenue Code.[56] The most common grantor powers used in the ILIT context are as follows:

- The power, exercisable by the trustee without the approval or consent of an adverse party,[57] to use trust income to pay premiums on the policy insuring the grantor's life.[58]

- The power, exercisable by the trustee without the approval or consent of an adverse party, to distribute trust income to the grantor's spouse (e.g., in the context as a trust beneficiary).[59]

- The power, exercisable by the grantor or a related or subordinate person in a non-fiduciary capacity, to borrow the income or principal of the trust without adequate interest or security (unless the trust agreement otherwise grants the trustee the power to make loans to any person without regard to interest or security).[60]

    - If this power is used, the trust provisions should specify that the trustee's power to lend to other persons must be subject to adequate interest and be secured. The trust agreement also should give the trustee to borrow from the policy.

- The power, exercisable by the grantor or a related or subordinate person in a non-fiduciary capacity, without the approval or consent of any person in a fiduciary capacity, to reacquire trust assets by substituting other property of equal value.[61]

    - If this power is used, the trust agreement should provide that: (1) the trustee is required to satisfy his or her fiduciary obligation to ensure that the substituted assets are of equivalent value and (2) assets will not be deemed to be of equivalent value if the exchange would cause a change in beneficial interests under the trust.[62]

[56] Although not discussed at length in this article, an ILIT may be created as a foreign trust under section 679. In such an arrangement, it is common for the foreign trust to invest in a private placement life insurance policy.

[57] Section 672(a) defines an adverse party as a person who has a substantial beneficial interest in the trust that would be adversely affected by the exercise or non-exercise of the power in question. By way of example, a current trust beneficiary is an adverse party. A person related or subordinate to the grantor (including the grantor's spouse if living with the grantor, and the grantor's parents, issue, or sibling) is not an adverse party. I.R.C. § 672(c).

[58] I.R.C. § 677(a)(3).

[59] I.R.C. § 677(a)(1).

[60] I.R.C. § 675(2).

[61] I.R.C. § 675(4).

[62] Rev. Rul. 2008-22, 2008-16 I.R.B. 796; Rev. Rul. 2011-28, 2011-49 I.R.B. 830. Although one of the most common grantor trust powers used in other contexts, there previously was concern that such a power would cause inclusion of the policy proceeds in the grantor's estate for estate tax purposes. However, the Service in late 2011 ruled that the grantor's retention, in a nonfiduciary capacity, of a power of substitution over trust assets will not be viewed as the retention of an incident of ownership in the policy (causing estate tax inclusion under section 2042) if: (1) the grantor may not serve as trustee; (2) the trustee has a fiduciary obligation to insure that the substituted assets are of equivalent value; and (3) the

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- The power, exercisable by the grantor or a related or subordinate party, without the consent of an adverse party, to control the beneficial enjoyment of the trust income or principal.[63]

- The power, exercisable by the trustee (who is not the spouse of the grantor), to distribute trust income and principal among a class of beneficiaries.[64]

It is important to remember the spousal attribution rule under which a grantor's spouse's power always will be imputed to the grantor. Additionally, under section 677, a grantor is taxable to the extent trust income is used to discharge his or her legal obligation to support the beneficiary to whom a distribution is made.

If the trust agreement is drafted as a grantor trust, provisions allowing the grantor trust provisions to be "toggled off" in the future permits further flexibility if the grantor later decides that the income tax burden of the trust has become or will be too great. For example, the grantor could relinquish all powers that would otherwise trigger grantor trust status, such as any power held in a nonfiduciary capacity.

Great care should be taken when toggling off grantor trust status. First, most trusts are not drafted so that that powers, once toggled off, can be toggled back on. Even if the trust agreement permits the power to be toggled on and off, the Service does not look favorably on the toggling on and off of grantor trust powers.[65] Moreover, the trustee should not be required to consent to the toggling off of the power to avoid the breach of the trustee's fiduciary duty to the beneficiaries. Finally, the income tax consequence of toggling off grantor trust status may actually cause a greater income tax liability to the grantor. Specifically, at the time the status is toggled off, the grantor is treated, for income tax purposes, as if he or she has transferred all of the ILIT's assets and liabilities to the ILIT. This can result in a significant income tax liability to the grantor (equal to the amount of the gain) if the ILIT owns encumbered assets in which the debt exceeds the ILIT's adjusted basis in its assets.[66]

B. <u>Income Tax Issues Relating to the Beneficiary</u>. When an insured dies, and the death benefit of the policy is paid to the beneficiary, those benefits are generally income tax free to the recipient.[67] In this manner, life insurance proceeds are like a most inheritances, which pass income tax free to the beneficiary.[68] As alluded to above and further discussed below,[69] however, if and when a transfer of such policy for valuable consideration occurs, the planner must carefully analyze the transaction so as not to cause a "transfer for value" consequence.[70]

As a general rule, *Crummey* powers make each beneficiary taxable as an owner of both the income and corpus portions of the trust as a result of the beneficiary's power of

substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries.

[63] I.R.C. § 674(a).

[64] I.R.C. § 674(a); Priv. Ltr. Rul. 9543050 (Aug. 3, 1995).

[65] *See* Notice 2007-73, 2007-34 I.R.B. 435; Notice 2009-55, 2009-31 I.R.B. 1. The 2007 Notice identifies a type of transaction involving the toggling on and off of grantor trust status, and substantially similar transactions, as transactions of interest. Specifically, it describes three situations which allow the trust grantor to claim a tax loss greater than his or her actual economic loss, or to avoid the recognition of capital gain. The 2009 Notice includes the toggling on and off of grantor trust status on its list of transactions identified by the Service as transactions of interest.

[66] Treas. Reg. § 1.1001-2(c)(3); Rev. Rul. 85-13, 1985-7 I.R.B. 28.

[67] I.R.C. § 101(a)(1).

[68] I.R.C. § 102(a). Income from such property, however, is includible in the recipient's gross income *Id.* § 101(b). There are assets (like IRAs) which carry out income to the beneficiary when received, because they were income tax free to the decedent until and unless distributed.

[69] *See* discussion herein at V.A., *Income Tax Issues Relating to the Settlor*.

[70] *See* I.R.C. § 101.

withdrawal over such property.[71] An important exception to this rule is that if a grantor holds a power under sections 671 through 679 and the beneficiary holds a section 678 power over the income (i.e., a *Crummey* power), the beneficiary's power is disregarded, and the grantor is taxed as the owner of the trust income.[72] It is of note that there is a disconnect under a strict reading of the rule in that the beneficiary is still deemed the owner for income tax purposes of the trust principal.

Some situations may dictate the use of a trust that is income taxable to the beneficiary. For example, the drafter may want to permit the beneficiary to pay the trust's income tax liability or sell assets to the trust without an income tax consequence. In these instances, the trust agreement may be drafted so that it is income tax defective not as to the grantor, but as to the beneficiary. One way of causing the trust to be a grantor trust with respect to the other person is to not permit the beneficiary's withdrawal power to lapse as to withdrawals for health, education, maintenance and support.[73]

C. <u>Gift Tax Issues Relating to the Settlor</u>. In order to qualify a gift for annual exclusion treatment, the gift must be a gift of a present interest.[74] Gifts to an irrevocable trust, therefore, typically do not constitute annual exclusion gifts because they are gifts of future interests, meaning that the use, possession, and enjoyment of the gifted property is delayed to a future date.[75] As discussed above in relation to *Crummey* notices, however, if a trust agreement grants a beneficiary a withdrawal right over the gifted property, the gift will qualify for the gift tax annual exclusion (in 2014, $14,000 per donor per donee).[76] In essence, the *Crummey* power converts what would otherwise be a future interest gift into a present interest gift.

To ensure that gifts to an ILIT qualify for annual exclusion treatment, then, the trust agreement should grant withdrawal rights to the beneficiaries. The primary case in addressing this issue is *Estate of Cristofani v. Commissioner*,[77] in which the Tax Court ruled that contingent beneficiaries who have no beneficial interest in the trust other than the right to demand the withdrawal of amounts gifted to the trust have a present interest that qualifies any such gift to the trust for annual exclusion treatment. As a matter of practice, many practitioners grant the settlor's grandchildren withdrawal rights as secondary beneficiaries of the ILIT to increase the amount of annual exclusion gifts available to the settlor. In certain instances, however, such as where a grandchild may not understand the purpose of the trust or may be a "black sheep" who will not assist in the tax planning aspects of the trust, it may not be advisable to grant withdrawal rights. It is important to note that the Service has warned that if the facts and circumstances show that there is a prearranged understanding that withdrawal

[71] I.R.C. § 678(a); Rev. Rul. 67-241.

[72] Some commentators believe that section 678(b) merely contains a drafting error, while others contend that if the grantor and beneficiary each hold powers that apparently create conflicting ownership over trust principal, the most logical view would be to treat them as co-owners, with pro rata ownership of the trust income, deduction, gain, and loss allocated to trust principal. *See* Zaritsky & Leimberg, *Tax Planning with Life Insurance: Analysis with Forms* (WG&L, 2ed. 1998); *cf.* Blattmacher, et al., *A Beneficiary as Trust Owner: Decoding Section 678*, ACTEC Journal, Vol. 35, No. 2, pp. 117-119 (Fall 2009), citing Treas. Reg. § 1.671-2(b) to conclude that the word "Income" in section 678(b) seems to mean taxable income (rather than accounting income), and that as such, includes income in a tax sense allocated to trust accounting and corpus. Finally, the Service has ruled that sections 671-677 trump section 678. *See* Priv. Ltr. Rul. 200729005, 200729007, 200729008.

[73] *See e.g.,* Jonathan G. Blattmachr and Diana S. C. Zeydel, *PLR 200949012 - Beneficiary Defective Trust*[SM] *Private Letter Ruling*, Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1559 (Dec. 9, 2010); *see also* Priv. Ltr. Rul. 200949012 (Dec. 4, 2012).

[74] I.R.C. § 2503(b).

[75] Treas. Reg. § 25.2503-3(a).

[76] I.R.C. § 2503(b).

[77] *Estate of Cristofani v. Comm'r*, 97 T.C. 74 (1991).

rights will not be exercised or that the exercise of such rights would result in adverse consequences to the holder, then the gift will not qualify as a bona fide present interest gift.[78] Moreover, the careful drafter will avoid a situation in which a withdrawal right beneficiary is strictly a contingent beneficiary (i.e., he or she will not receive any of the trust assets unless he or she survives other beneficiaries).[79]

Another issue arises when beneficiaries holding withdrawal rights are minors. Although Rev. Rul. 73-405 provides that a gift tax annual exclusion is available when a parent of a minor beneficiary can exercise the right on behalf of the minor,[80] the Service has taken inconsistent positions regarding whether the donor parent may exercise a minor child's withdrawal right.[81] It may be prudent to limit the ability of the settlor or another transferor to the trust to exercise the withdrawal right on behalf of the settlor's or other transferor's minor child (to preclude any adverse estate tax consequences to the grantor or other transferor). Some drafters include language where another person (other than the settlor, the settlor's spouse, or a transferor of the trust) appointed by the trustee may exercise the withdrawal right for the minor beneficiary.

D. Gift Tax Issues Relating to the Beneficiary. If a beneficiary with a withdrawal right power releases or exercises the power, the beneficiary will be treated as making a gift (to the extent the power is exercised in favor or someone other than the beneficiary) and/or treated as a transfer for estate tax purposes (such as where the beneficiary exercises it in further trust from which the beneficiary is entitled to income for life).[82] The mere lapse of a withdrawal power, however, is not treated as a release, and as such, does not constitute a gift of the lapsed amount (i.e., the greater of $5,000 or 5% of the amount from which the demand right may be satisfied) by the beneficiary.[83] In other words, the lapse of the power is not a gift by the beneficiary except to the extent the power lapses in excess of the greater of $5,000 or 5% of the value of the property over which the power is exercisable in a given calendar year.

If the trust agreement provides that the beneficiary's withdrawal power lapses in an amount equal to the greater of $5,000 or 5% of the value of the property over which the power is exercisable in a given calendar year, then the beneficiary only has a potential gift tax (or estate tax, as discussed below) issue with regard to those unlapsed, hanging powers. Over time, these powers should be whittled away, therefore gradually reducing the amount over which the beneficiary may be deemed to have made a gift (although additional gifts made to the trust subject to the withdrawal power may lengthen the time it takes for the reduction).

[78] *See* Action on Decision 1996-010, 1996-29 I.R.B. 4.

[79] *See* Tech. Adv. Memo. 9731004 (Apr. 21, 1997) ruling that beneficiaries who must survive other beneficiaries to receive trust distributions and persons (in this case, spouses) who had no other beneficial interest in the trust other than a withdrawal right didn't convert gifts into present interests. *See cf. Kohlsaat v. Comm'r*, T.C. Memo. 1997-212 (1997), in which the Tax Court failed to find a prearranged agreement where contingent beneficiaries had not exercised any withdrawal rights. *See also cf. Holland v. Comm'r*, T.C. Memo. 1997-302 (1997), in which the Tax Court failed to find a prearranged agreement when no withdrawal rights were exercised, even though family members had discussed the gift in advance and made a deliberate investment decision to not withdraw the gifted funds.

[80] Rev. Rul. 1973-405, 1973 C.B. 321. *But cf. Naumoff v. Comm'r*, 46 T.C. Memo. 852 (1983), which held that a minor's inability to exercise the demand power was problematic. Specifically, the trust must include a provision allowing a guardian to exercise the withdrawal right on behalf of the minor beneficiary.

[81] Tech. Adv. Memo. 8339995 held that a withdrawal right exercisable by the donor or donor's spouse on behalf of their minor child was illusory. In contrast, two PLRs issued subsequently reached the opposite conclusion. Priv. Ltr. Rul. 8712014 (Dec. 18, 1986), Priv. Ltr. Rul. 8825111 (Mar. 30, 1988).

[82] *See* I.R.C. §§ 2514(b), 2041(a)(2).

[83] *See* I.R.C. §§ 2514(e), 2041(b)(2).

E. Estate Tax Issues Relating to the Settlor.

1. *Three-Year Rule - Section 2035.* Even if an insured creates an ILIT and funds it prior to death, the three-year rule of section 2035 of the Internal Revenue Code may cause the inclusion of the policy proceeds in the insured's estate. Specifically, if the grantor gratuitously transfers a policy or any incident of ownership with respect to the policy during the three-year period preceding his or her death, the death benefit will be includible in the transferor's estate for estate tax purposes under section 2035 of the Internal Revenue Code.[84] Section 2035 provides in pertinent part that:

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

If section 2035 does apply, it seems that the character of the initial gift will not be altered and a credit will be given for gift taxes paid.[85]

When analyzing whether an ILIT makes sense, the drafter should look to the life expectancy of the insured to determine whether the insured has a likelihood of surviving at least three years.[86] If the insured is not expected to survive the three-year period, an alternative planning device is to create and fund a family limited partnership to hold the insurance policy.[87] The Tax Court in at least one case has held that the insured partner will not hold any incidents of ownership, and thus, only a percentage share (i.e., the insured's partnership percentage) of the total policy proceeds will be includible in the insured's gross estate; several recent PLRs have

[84] I.R.C. § 2035. As discussed later, the three-year rule does not apply to transfers made for valuable consideration.

[85] Priv. Ltr. Rul. 9533001. Any gift taxes previously paid should be listed on Form 706, Page 1, Line 25, under "Prior Payments."

[86] The Service publishes life expectancy tables that can be used for this analysis. *See* I.R.S. Pub. 590 (Jan. 30, 2013).

[87] Of course, the planner will want to ensure that there is a valid business purpose for the partnership and the purchase of the policy.

applied this same reasoning.[88] Other commentators object to this planning proposition on the grounds that a partnership that will later distribute to the objects of the founding partner's bounty is really a trust subject to the three-year rule under section 2035.

If you have any concern that the grantor may not survive the three-year period required under section 2035, there are several different ways to limit whether a policy owned by the ILIT will be subject to the claw back of section 2035. As a matter of course, always make sure the insured does not possess any incidents of ownership over the policy either in the policy documents or the trust agreement. Also consider using an existing policy on which the three-year period set forth in section 2035 may have run.[89] Another option is to purchase the policy outside of the ILIT, then fund the trust so that the trust may purchase the policy from its owner.[90] Because there is no gratuitous transfer in such scenario, the three-year rule will not apply. It is important to ensure that the sale will be respected as a sale and not as a gift (as discussed below when addressing sales of existing policies to a newly drafted ILIT). Another planning mechanism is to create and fund a partnership (which must have a business purpose other than avoiding the three-year rule) in which the insured is a partner, have the partnership purchase the policy, then have the trust purchase the policy from the partnership.[91]

2. *Retained Powers - Section 2036 and Section 2038*. Section 2036(a) of the Internal Revenue Code requires the inclusion of property transferred by a decedent in the decedent's gross estate when the decedent retained "(1) the possession or enjoyment of, or the "right to the income from, the property, or the right either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."[92] Section 2038(a) similarly requires inclusion in a decedent's gross estate when the decedent has the power, alone or in conjunction with any other person, "to alter, amend, revoke, or terminate" the enjoyment of the trust property.[93] If the distribution standard is not limited to an ascertainable standard, then the trust assets may be includible in the settlor's estate under section 2038. The easiest solution to prevent such inclusion is to include provisions limiting distributions to the beneficiary to an ascertainable standard

[88] *Estate of Knipp*, 25 T.C. 153 (1953), acq. in result, 1959-1 C.B. 4, aff'd on another issue 244 F.2d 436 (4th Cir.), cert. denied, 355 U.S. 827 (1957). *See also* Priv. Ltr. Rul. 200947006 (Nov. 20, 2009); Priv. Ltr. Rul. 200948001 (Nov. 27, 2009); and Priv. Ltr. Rul. 200949004 (Dec. 4, 2009) (ruling that that the proceeds of two whole life insurance policies received by a limited partnership on an insured's death will not be includible in the insured's gross estate under sections 2042 and 2035 of the Internal Revenue Code, even if the individual dies within three years of releasing his powers over one of the policies). *See also* Rev. Rul. 83-147, 1983-2 C.B. 158 (considering whether incidents of ownership in an insurance policy owned by a general partnership would be attributed to the insured general partner and concluding that, where the insurance proceeds are payable to the partnership, the inclusion of the proceeds in the gross estate under section 2042 would result in "unwarranted double taxation" of a substantial portion of the proceeds because the proceeds were reflected in the value of decedent's partnership interest). However, where the proceeds are payable to a third party for a purpose unrelated to the general partnership business, and thus, would not be included in the value of the partnership interest included in the gross estate, the incidents of ownership are treated as held by the insured general partner in conjunction with the other partners.

[89] An existing policy likely will have some value and the planner must consider the transfer tax implications and transfer for value rules when using such a policy to fund the trust or if the trust purchases such a policy from the insured. In the event the existing policy insures an ill or uninsurable settlor, the Service may argue for a greater policy value.

[90] It is essential in this planning to ensure that the ILIT is a grantor trust for income tax purposes as to the insured to avoid any transfer for value argument.

[91] The transaction should be structured to qualify for the exception to the section 101 transfer for value rules.

[92] I.R.C. § 2036(a).

[93] I.R.C. § 2038(a).

(health, education, maintenance, and support). Sections 2036 and 2038 also may become problematic if the insured settlor retains a limited power of appointment over any or all of the trust property.

For instance, some drafters desire to grant a limited power of appointment to the settlor/insured's spouse, child, or other trusted individual to maintain flexibility in the event of changes in the settlor's family, settlor's financial situation, and the tax laws. Although such power alone should not cause inclusion of the trust in the settlor/insured's estate, the drafter must be cautious if he or she includes such a power to ensure it doesn't cause inclusion under sections 2036, 2038, or 2041 (discussed below). One such tripwire (under section 2038) is if the settlor and power holder have any agreement that the power holder will distribute the trust property in accordance with the settlor's desires.

Another example is that if the trust document requires the trustee to reimburse the settlor for the trust's income taxes, the trust assets will be included in the settlor's estate for estate tax purposes under section 2036.[94]

3. *Incidents of Ownership-Section 2042*. Under section 2042(2) of the Internal Revenue Code, life insurance proceeds are includible in the estate of the insured to the extent that the insured possessed, exercisable either alone or in conjunction with any other person "incidents of ownership" in the policy. Read literally, the term "incidents of ownership" would seem to suggest retention of some right associated with ownership of the policy, but the concept is much broader. Section 2042 fails to otherwise define "incidents of ownership" and states only that an incident of ownership includes a reversionary interest (if the value of such interest exceeds 5% of the policy value immediately before the insured's death).[95] The Treasury Regulations offer guidance and provide that the insured's estate may include the policy proceeds even if someone other than the insured is named as the owner. By way of example, incidents of ownership include: (1) the power to change the trust beneficiary or veto a change of beneficiary;[96] (2) the power to surrender or cancel the policy or to prevent a veto or cancellation; (3) the power to assign a policy or revoke an assignment; (4) the power to pledge the policy as collateral for a loan; (5) the power to obtain a loan from the insurer against the cash value of the policy;[97] and (6) the power to change the beneficial ownership, alone or with another; (7) the power to change the time or manner of enjoyment;[98] (8) controlling ownership of the policy;[99] and (9) (possibly) the power to select a settlement option.[100] The Service also takes the position that powers held in a fiduciary capacity are incidents of ownership if the settlor/trustee transferred the policy to the trust, contributed funds used to pay policy premiums, or if the trustee powers can be exercised to benefit the settlor/trustee.[101]

Payment of premiums by the insured (without more), however, will not cause any part of the policy to be includible in the insured's gross estate.[102] Similarly, the insured's right to receive policy dividends (which in turn may be applied against policy premiums) is not, by itself, an incident of

[94] Rev. Rul. 2004-64, 2004-27 I.R.B. 7. If the decision is in the trustee's absolute discretion, the trust assets should not be includible in the settlor's estate in self-settled asset protection states such as Alaska or Delaware.

[95] I.R.C. § 2042(2).

[96] Treas. Reg. § 20.2042-1(c)(2). *Schwager v. Commissioner*, 64 T.C. 781 (1975).

[97] Treas. Reg. § 20.2042-1(c).

[98] The settlor's power to divorce his or her spouse (if such spouse is a beneficiary) is not an incident of ownership. Tech. Adv. Memo. 8819001.

[99] If a corporation or an entity owns the policy or any of its benefits, the insured cannot control the corporation or entity. Treas. Reg. § 2042-1(c)(6).

[100] *Estate of Lumpkin, v. Comm'r,* 474F. 2d 1092 (5th Cir. 1973), *rev'g.* 56 T.C. 815 (finding incident of ownership); *cf. Estate of Connelly, Sr.*, 551 F.2d 545 (3rd Cir. 1977) (holding not an incident of ownership).

[101] Rev. Rul. 84-79, 1984-23 I.R.B. 52.

[102] Rev. Rul. 71-497, 1971-2 C.B. 329.

ownership under section 2042 that would cause inclusion of the policy in the insured's gross estate.[103]

To prevent the inclusion of the policy proceeds in the grantor's estate under section 2042, the trust agreement should provide that the trustee is the sole owner of any life insurance policies transferred to or purchased by the trustee and that only the trustee has to power to exercise any incidents of ownership over the policies. The trust agreement also should provide that the policy cannot be returned to the settlor/insured. If a beneficiary holds a power of appointment, such power necessarily should preclude the settlor/insured as a permissible appointee under the power. The drafter should ensure that the policy documents also reflect the trustee as the owner and agree with the other provisions of the trust agreement.

It is important to note, however, that as long as the ILIT agreement does not contain a requirement that the trustee lend all or part of the proceeds to the insured's estate or to use some or all of the policy proceeds to purchase assets from the insured's estate, the trustee's mere power to do so will not cause inclusion of the policy proceeds in the insured's estate.[104] If under state law, the discretionary reimbursement clause subjects the trust assets to the claims of the settlor's creditors, the assets may be includible in the settlor's estate.[105]

Finally, to avoid the inclusion of the policy proceeds in the estate of the settlor/insured, the trust agreement should provide that the death benefit received by the beneficiaries cannot be used to fulfill any obligation of the decedent (i.e., taxes, debts, or costs of the administration of the insured's estate) unless such funds are lent at an adequate interest rate or used in a fair market value purchase of assets from the estate.[106]

F. <u>Estate Tax Issues Relating to the Settlor's Spouse</u>. In the instance when a Texas (or another community property state) ILIT will own a policy on the settlor's life alone, there are a few traps for the unwary. Specifically, if community property funds are used to fund the ILIT (and make the corresponding premium payments), and the settlor's spouse dies first, one-half of the then current market value of the policy may be includible in the settlor's spouse's estate. Alternatively, if the grantor dies first, the surviving the settlor's spouse may be deemed to have made a gift of one-half of the policy proceeds to the trust at the settlor's death. The drafter thus should include language in the trust agreement prohibiting the contribution of community property and requiring that all contributions to the trust and all policies owned by the trust must be the separate property of the settlor/insured.[107] It also is advisable to have the settlor and the settlor's spouse enter into a partition agreement with respect to any property that will be used to fund the trust. These actions will prevent (1) the inclusion of one-half of the policy proceeds from being included in the settlor's spouse's estate if the settlor's spouse predeceases the settlor; and (2) the settlor's spouse from being deemed to have made a taxable gift to the trust at the settlor's death (when the trust receives the policy proceeds).

[103] Chief Counsel Advice 201328030 (Jul. 2, 2013). *See also Estate of Bowers v. Comm'r*, 23 T.C. 911 (1955), *Estate of Jordahl v. Comm'r*, 65 T.C. 92, 99 (1975). *Cf. Schwager v. Comm'r*, 64 T.C. 781, 792 (1975) (finding that while certain powers may be retained which will not constitute incidents of ownership, such as the right to receive policy dividends, the ability to bar the change of beneficiary to part of the policy does constitute a substantial incident of ownership).

[104] Rev. Rul. 2004-64, 2004-27 I.R.B. 7; *Estate of Wade*, 47 BTA 21 (1942).

[105] Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

[106] Treas. Reg. § 20.2042-1(b)(1).

[107] One must be particularly careful with this issue in split-dollar or group term policies, but an in-depth analysis of this issue is outside of the current scope of discussion. If community property is partitioned into separate property so that only separate property is used, consider advising that one of the spouses have representation by separate counsel.

If the ILIT will own only a survivorship policy, or is a jointly settled trust by the settlor and his or her spouse, and benefits only the settlor's descendants (and the settlor's spouse does not have any tax-sensitive interest), the separate or community property distinction of the contributions or policy should not be relevant for estate tax purposes as it relates to the settlor's spouse.

G. Estate Tax Issues Relating to the Beneficiary. A *Crummey* withdrawal right is, in effect, a general power of appointment.[108] Therefore, the estate of a beneficiary granted withdrawal powers will include any unlapsed and unexercised withdrawal rights because the exercise or release of a power of appointment (in a trust agreement created and funded after October 21, 1942) is deemed a transfer of property to the trust by the power holder.[109] Thus, it is common to include in the trust agreement a provision under which the beneficiary's withdrawal power lapses on an annual basis in an amount equal to the greater of $5,000 or 5% of the aggregate value of the trust property (the "five and five amount"); this is commonly referred to as a "hanging" power.[110] If such a provision is included, then the beneficiary will not be deemed to hold a general power of appointment under 2041 over any such lapsed amounts, and as a result, the beneficiary's estate should only include any unexercised and unlapsed (or hanging) withdrawal amounts. The effect is that each year, any unexercised withdrawal rights are whittled away. Where handing powers are used, especially where there is more than one beneficiary of the ILIT, practitioners often include such a provision in their ILIT agreement to limit and reduce the amount includible in the beneficiary's estate.

When crafting hanging power provisions, one must be cautious, as the Service has issued conflicting PLRs relating to hanging powers.[111] In short, it is best to avoid any use of a formula that references gift tax avoidance, and instead rely on a mathematical formula referencing the five and five amount. Additionally, if an ILIT benefits the settlor's spouse, the trust agreement should be drafted so that hanging powers are created in favor of the spouse in order to avoid the creation of an estate tax inclusion period (ETIP) precluding the allocation of the settlor's GST exemption amount to the trust until the end of the ETIP. One of the easiest ways to do this is to restrict the spouse's withdrawal right to the five and five amount, so that any withdrawal rights lapse each year.

If the beneficiary is granted a power of appointment over the trust assets, this also may cause inclusion of those trust assets subject to the power in the beneficiary's estate. The obvious issue is when a beneficiary is granted a general power of appointment over the trust assets. Additionally, all amounts over which the beneficiary holds unlapsed withdrawal rights (and the pro rata portion of the policy proceeds attributable to same) will be includible in the beneficiary's estate if the beneficiary predeceases the settlor. If the beneficiary survives the settlor but the unlapsed withdrawal rights are not distributed and spent during the beneficiary's lifetime, the amounts similarly will be includible in the beneficiary's estate for estate tax purposes. A third problem, commonly known as the "Delaware Tax Trap," is that if the beneficiary's limited power of appointment creates another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of the appointed trust property or extend the applicable rule against perpetuities, the appointed property will be includible in the

[108] I.R.C. §§ 2514(e); 2041.
[109] I.R.C. §§ 2514(e); 2041(a)(2).
[110] I.R.C. § 2042(b)(2).
[111] Priv. Ltr. Rul. 8701007 (approving hanging power provision); Priv. Ltr. Rul. 8901004 (disapproving hanging power provision).

beneficiary's estate for estate tax purposes.[112]

H. Generation-skipping Transfer Tax Issues Relating to the Settlor. When (and preferably, before) each contribution is made to the trust, generation-skipping transfer ("GST") tax issues should be considered.

An ILIT may be drafted in myriad ways. If an ILIT is drafted so that the (non-skip or child) beneficiary holds any unlapsed withdrawal rights or a general power of appointment, then the trust is a trust in which some portion would be included in the gross estate of a non-skip person if such person died immediately after the transfer.[113] In other words, the trust is not a "GST trust" to which the transferor's GST exemption amount will be automatically allocated.

Other ILITs are drafted as perpetual trusts and so as not to be includible in the estate of a beneficiary (i.e., the beneficiary has no unlapsed withdrawal rights or general power of appointment), and they do not meet the definition of a "GST trust". Thus, gifts to these ILITs are deemed indirect skip gifts to which the transferor's GST tax exemption amount will be automatically allocated unless the transferor opts out of the automatic allocation rules on a timely filed gift tax return.[114]

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[112] I.R.C. §§ 2041(a)(3); 2514(d).

[113] I.R.C. § 2632 provides as follows:

> (A) For purposes of this subsection, the term "indirect skip" means any transfer of property (other than a direct skip) subject to the tax imposed by chapter 12 made to a GST trust.
> (B) GST trust
> The term "GST trust" means a trust that could have a generation-skipping transfer with respect to the transferor unless—
> (i) the trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons—
> (I) before the date that the individual attains age 46,
> (II) on or before one or more dates specified in the trust instrument that will occur before the date that such individual attains age 46, or
> (III) upon the occurrence of an event that, in accordance with regulations prescribed by the Secretary, may reasonably be expected to occur before the date that such individual attains age 46,
> (ii) the trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons and who are living on the date of death of another person identified in the instrument (by name or by class) who is more than 10 years older than such individuals,
> (iii) the trust instrument provides that, if one or more individuals who are non-skip persons die on or before a date or event described in clause (i) or (ii), more than 25 percent of the trust corpus either must be distributed to the estate or estates of one or more of such individuals or is subject to a general power of appointment exercisable by one or more of such individuals,
> (iv) the trust is a trust any portion of which would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer,
> (v) the trust is a charitable lead annuity trust (within the meaning of section 2642(e)(3)(A)) or a charitable remainder annuity trust or a charitable remainder unitrust (within the meaning of section 664(d)), or
> (vi) the trust is a trust with respect to which a deduction was allowed under section 2522 for the amount of an interest in the form of the right to receive annual payments of a fixed percentage of the net fair market value of the trust property (determined yearly) and which is required to pay principal to a non-skip person if such person is alive when the yearly payments for which the deduction was allowed terminate.

[114] Although not the primary subject of this article, it is important to consider whether it makes sense to opt out of the automatic allocation rules on a timely filed gift tax return. In situations where the trust is not likely

I. <u>GST Issues Relating to the Beneficiary</u>. As discussed earlier (in *Gift Tax Issues Relating to the Beneficiary*), when a beneficiary chooses not to exercise his or her withdrawal right, he or she is deemed to have made a gift to the other beneficiaries equal in amount to the gift over which the beneficiary could exercise the withdrawal right. Accordingly, to the extent other beneficiaries are skip persons in relation to the beneficiary the beneficiary becomes a transferor for GST tax purposes. If the ILIT will benefit downstream descendants of the settlor, there are several ways of addressing this issue.

First, the trust agreement can limit the beneficiary's withdrawal right to the greater of the five and five amount. One must be cautious when using such a provision, however, as the inclusion of the five and five amount in this context in effect limits the amount of annual exclusion available to any gift by the settlor(s) to $5,000 or 5% of the trust value (which for ILITs holding term policies is often very low). For example, in a jointly settled trust, $28,000 in annual exclusion amounts presumably is available for a gift to the trust if the five and five amount is not used. Conversely, if the five and five amount is included with relation to withdrawal rights, then the annual exclusion amount available to the settlors is $5,000 (assuming the trust value is equal to or less than $100,000).

A further solution to this issue is to fund the ILIT with assets so that 5% of the trust value will be equal to the annual exclusion amount (e.g., in 2014, a single grantor would need to gift $280,000 to the trust to accomplish such funding). Doing so will necessarily use some of the settlor's lifetime exemption amount, which may not be available or advisable.

Another solution is to create and fund an ILIT for each individual beneficiary so that the full annual gift tax exclusion amount can be used for each beneficiary (subject, of course to other gifts by the donor). If the ILIT has any property in it upon the beneficiary's death, then a portion of the ILIT will be includible in that beneficiary's estate. For those clients whose primary purpose is to benefit their children, rather than multiple generations, this technique works well.

A related method of addressing the GST issue is to draft the agreement so that the withdrawal rights do not lapse, but remain "hanging." This can be achieved by granting the beneficiary a limited or general power of appointment over any unlapsed withdrawal rights (which causes such amounts not to be completed gifts). The inclusion of this kind of provision, too, requires careful consideration, as discussed above in *Estate Tax Issues Relating to the Beneficiary.*

Another option is to create separate subtrusts for the various beneficiaries in the trust agreement to avoid any potential gift by the beneficiary to other beneficiaries when withdrawal rights go unexercised. This can be problematic if the settlor's intent is for the trust proceeds to first benefit a spouse for life, then children, as the spouse's share will necessarily be limited on a pro rata basis. Including such provisions also can be problematic from a GST standpoint, as the settlor will not be able to effectively allocate his or her GST exemption amount to the trust. This result occurs because the beneficiary becomes the transferor of any amounts in excess of the five and five amount, and thus, to allocate the settlor's GST exemption amount to the full contribution would be wasteful. That is not to say that separate subtrusts are not ever desirable. If all of the

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to lead to a taxable distribution or a taxable termination in favor of a skip person, the taxpayer may want to elect out of the automatic allocation rules. Similarly, if the grantor makes a contribution to the trust in the year of his death to pay premiums on a term policy, and the grantor dies before the gift tax return is filed, then an allocation of GST tax exemption amount equal to the last premium due should protect all of the policy proceeds from the GST tax. The practitioner must take all such factors into consideration.

trust beneficiaries are skip persons, and the settlor has already used his or her GST exemption amount, creating separate subtrusts for each skip person beneficiary allows the settlor to apply the GST annual exclusion to all gifts to the trust.

V. HOW TO ADDRESS A BROKEN ILIT

A. Sale of Policy to New Trust. In the situation where a trust agreement has not been drafted properly, but the existing policy is to be retained, the existing ILIT may sell the policy to a new trust.[115] This solution makes the most sense if the ILIT owns a policy with cash value or if the settlor/insured is still insurable. The new ILIT should be structured as a grantor trust and have the same grantor as the existing ILIT so as avoid any portion of the policy death benefit being included in and taxed as ordinary income.[116] Specifically, the "transfer for value" rule states that if a transferee of a policy received the policy for valuable consideration, the policy proceeds will be subject to income tax when received by the named beneficiary (to the extent that the proceeds exceed the amount of valuable consideration plus any premiums paid by the transferee recipient).[117] There are three exceptions to the rule, but the most important one to consider when selling an existing policy to a new trust is that the transfer for value rules do not apply if the policy is transferred to the insured.[118] The Service has held that, for purposes of the transfer for value rule, a grantor who is treated as the owner of a trust for income tax purposes also is treated as the owner of any life insurance policy on the grantor's life owned by the trust.[119] As such, a transfer from a non-grantor trust to a grantor trust, a transfer from the grantor/insured to a grantor trust, or a transfer between two grantor trusts are not transfers for valuable consideration under the transfer for value rule. Moreover, any sale should be properly documented and adequate consideration should be paid for the policy by the new trust to avoid any argument by the Service that any or all of the sale was actually a gift. Doing so will also place the sale outside of the three-year rule of section 2035 of the Internal Revenue Code, as section 2035 is limited to gratuitous transfers.

The trustee entering into the sale should be certain that the sale does not violate his or her fiduciary duty to the beneficiaries of the existing ILIT. Thus, the policy should be sold for fair market value, and it is best if the beneficiaries of the new trust are the same as those under the existing ILIT.[120]

B. Allow Existing Policy to Expire. In the situation where a trust owns term life insurance where the insured grantor would qualify for a new policy without much added cost (i.e., he or she is still insurable at preferred rates), one of the easiest solutions is to allow the existing policy owned by the ILIT to lapse and purchase a new policy within the trust. If both the trust agreement and the policy are problematic, then the trustee can allow the existing policy to lapse and a new policy can be purchased by the trustee of a new trust.

C. Non-Judicial Modification. There are several methods for non-judicial modification. The first is to look to the trust agreement terms to see if the document permits modification or the termination of a small trust or a trust for tax purposes, allows for the merger or division of the trust, or permits termination by distribution. Texas

[115] The grantor can fund the new ILIT with sufficient funds for the policy purchase or may lend funds to the new ILIT. Of course, the new ILIT should be initially funded with "seed" money and any loan should be made at the applicable federal rate then in effect.
[116] *See* I.R.C. § 101.
[117] I.R.C. § 101(a)(2).
[118] I.R.C. § 101(a)(2)(A). The rule also does not apply if the policy is transferred to a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder. *Id.* The exception does not apply, however, to transfers between shareholders. *Id.*
[119] Rev. Rul. 2007-13, 2007-11 I.R.B. 684.
[120] Some trustees may want to request the beneficiaries to approve the sale.

law also permits non-judicial modification in certain situations. For instance, section 112.057 of the Texas Trust Code provides a statutory power to combine and divide trusts and also operates as a power to change the terms of a trust non-judicially.

In essence, non-judicial modification permits a trust amendment without the time and expense of a court proceeding. It may not offer the certainty of a judicial modification, however.

D. Judicial Modification. This option is the most time consuming and costly, but can be desirable to ensure absolute certainty and to limit the liability of those involved (attorneys included). Section 112.054 of the Texas Trust Code permits judicial modification if: (i) because of circumstances not known to or anticipated by the settlor, such order of the court will further the purposes of the trust; (ii) modification of administrative, nondispositive terms of the trust is necessary or appropriate to prevent waste or avoid impairment of the trust's administration; (iii) the order is necessary or appropriate to achieve the settlor's tax objectives and is not contrary to the settlor's intentions; or (iv) the order is not inconsistent with the material purpose of the trust and all beneficiaries of the trust have consented or are deemed to have consented to the order.[121] Texas provides for virtual representation of downstream beneficiaries in formal proceedings, meaning that a parent can represent a minor or unborn child who is a beneficiary if the parent has a substantially identical interest.[122]

[121] Tex. Trust Code § 112.054.
[122] Tex. Prop. Code Ann. § 115.013(c)(2).

Refund Suits, Divisible Taxes and *Flora*: When is a Representative Payment "Representative" Enough?

Rachael Rubenstein[1]

The author is the attorney who represented Mr. Kaplan in his tax refund suit. All facts in this article are part of the public record.

On January 27, 2014, in *Kaplan v. United States,*[2] Judge Wheeler of the United States Court of Federal Claims made a significant jurisdictional decision in favor of a plaintiff taxpayer in a refund suit. The issue decided was whether Mr. Kaplan's three $100 payments towards the Trust Fund Recovery Penalties (TFRPs) assessed against him under section 6672 were sufficient amounts to confer jurisdiction on the court to determine Kaplan's ultimate liability for the penalties. The court ultimately accepted the three $100 payments as sufficient to establish subject matter jurisdiction, but the final decision on the matter required the court to vacate its earlier opinion published last fall. In August of 2013, the government filed a motion to dismiss Mr. Kaplan's complaint, arguing that his $100 payments did not satisfy the jurisdictional requirement that he "pay the entire assessment for at least one employee per quarter."[3] The government cited to *Flora*[4] as authority while also acknowledging that "a number of courts have held that the full-payment rule is a divisible tax, and requires a taxpayer to pay only the amount of the penalty attributable to one employee before bringing a refund suit."[5]

Before jumping to the specifics of the jurisdictional challenge in the case, a bit of background on section 6672[6] and the development of the *Flora* divisible tax exception are helpful. Congress designed section 6672 to impose civil penalties against persons whom the Service determines have failed as employers to perform their employment tax (FICA and Federal income tax) withholding and/or remitting obligations. Section 6672 allows the Service to pierce through the entity veil and asses the tax penalty directly against individuals responsible for the entity's failure to pay. The amount is equal to one hundred percent of all employee portions of unpaid FICA and Federal income taxes not provided to the government as required by sections §§ 3102, 3402(a). In order to be found personally liable for a company's failure to pay employment taxes under section 6672, a party must be found 1) responsible, and 2) willful. Questions of responsibility and willfulness are fact intensive investigations with many factors developed through decades of case law to consider, such as: day-to-day management authority, check signing authority, and responsibility for hiring employees, and control over disbursement of payroll.[7] Many taxpayers and their representatives believe that section 6672 penalties are over assessed at the agency level because examiners don't have adequate time and training to really conduct an intensive fact and law analysis of a potentially liable taxpayer. Additionally, courts vary a great deal in their interpretations of how the factors apply to any given set of facts in the cases before them. Arguably, recognition of the complexity involved in assessing and challenging section 6672 penalties played a role in shaping the exception to the *Flora* full-payment rule, along with the uniform characterization of section 6672 assessments as divisible taxes.

In the past several decades, the government seldom contested modest representative payments, such as Kaplan's, because of the development of the divisible tax exception in tax refund suits. The first major cases that carved out this exception to *Flora* were *Steele v. United States*[8] and *Boynton v. United States*.[9] *Steele*, a case from the Eighth Circuit, was decided in 1960, the same year as *Flora;* it held that "the full-payment rule is not applicable to an assessment of divisible taxes."[10] The court determined that the plaintiff was entitled to make a payment applicable to the withholding of any individual employee to make a claim for a refund.[11] In 1977, the Ninth Circuit ruled in *Boynton* that a taxpayer's refund suit is proper when the plaintiff pays the assessment fully or pays a properly divisible portion of the assessment.[12] The *Boynton* court reasoned that a section 6672 assessment represents a cumulation of separate employee assessments. Thus, a plaintiff may pay a portion of the withholding taxes attributed to a single employee to form the basis of a refund suit.[13] Since these cases, the majority of appellate circuits have followed suit. Indeed, a shorthand practice of paying a representative figure such as $100–$200 towards the penalty assessment along with an administrative claim for refund developed as a means to get taxpayers into court expeditiously in order to challenge their liability under section 6672.[14]

Mr. Kaplan was assessed the penalties due to his involvement in a San Antonio, Texas restaurant. The restaurant opened in 2007, just as the great recession hit. The IRS never received any employment tax payments on behalf of the entity that owned the restaurant. Kaplan was an investor in the restaurant and owned a minority ownership interest in the limited liability company that operated the restaurant. As such, he did not have access to employee records, except for one wage report from the state that detailed each restaurant employee's cumulative wages for the last quarter in 2008; a quarter which was not part of his assessment. In order to contest his ultimate liability for the penalties, he decided to utilize the common practice of paying a modest representative amount along with an administrative claim for refund.

Based on the records he had, and his knowledge of the generally low wages paid in the industry, $100 payments seemed reasonable and appropriate to cover the withholding taxes for, at least, one employee for each of the three quarters. Nonetheless, Kaplan diligently tried to obtain additional employee records, even after filing the suit for refund. These attempts yielded very little new evidence, except payroll records for one week in the third quarter of 2008.

Over a year after Kaplan's complaint was brought, and less than two months before trial was set, the government challenged the sufficiency of the payments in a motion to dismiss for lack of subject matter jurisdiction. This motion was initially successful. Judge Wheeler's first opinion in the case, on October 9, 2013, dismissed Kaplan's case for lack of jurisdiction.[15] In that opinion, the court ruled that Kaplan could not carry his burden of showing, by a preponderance of the evidence, that his payments equaled a sufficient amount of divisible tax attributable to one employee for each of the assessed quarters.[16] Kaplan filed a motion for reconsideration, which was granted. The court vacated its first opinion and held that denial of jurisdiction in the case was *manifestly unjust*.[17]

The reason for the change lies in the "competing evidentiary burdens imposed by the jurisdictional and liability standards in this type of divisible tax refund suit."[18] Kaplan, like most plaintiffs in 6672 cases, contests the Service's determination that he was a "responsible person" who had a legal duty to withhold/remit employee payroll taxes for the company. However, in order to establish subject matter jurisdiction for the refund suit, Kaplan must prove by a preponderance of the evidence that he has paid the assessed tax for at least one employee. Kaplan's central argument in his motion for reconsideration was that the court's dismissal of his case effectively concluded that he was a "responsible person" with a duty to maintain employee tax records *before* he had the opportunity to present the merits of his case. In granting the motion, the court acknowledged the "evidentiary Catch-22" Kaplan was caught in, assuming he was truly not responsible under section 6672.[19]

In his motion for reconsideration, Kaplan offered further support for the sufficiency of his $100 payments by citing IRM section 8.25.1.7.4.2, which states that "[i]f the amount required cannot be accurately determined, the Service may accept a representative amount."[20] The last paragraph of the court's revised opinion concluded, "[i]n the end, the merits of this case will turn on whether Mr. Kaplan is liable for the full [amount of the assessed] penalt[ies], and the divisible amount at issue is merely representative of that full amount . . . Under the circumstances of this case, the Court is not inclined to prevent Mr. Kaplan from challenging that full assessment in this forum simply because the representative amount he paid might not be representative enough."[21]

Rather than eagerly announce that there is now a new jurisdictional rule in section 6672 cases, it's important to note that there were some unique circumstances in this case that, perhaps, prevent broad application of the decision. First, Kaplan was able to recount for the court in detail (along with evidentiary exhibits), his diligent (but futile) search made for employee records. Second, the government was unable to produce *any records* to show what minimum payments would be sufficient. Third, the government had already tried, unsuccessfully, to deprive Kaplan of his choice of forum by filing its own suit in the Western District of Texas to litigate the issue of liability under section 6672.[22]

That said, this case is important because, as Professor Jack Townsend observed in his updated blog post about the case, "it is a further holding in a line of cases [involving the question of section 6672] responsibly, [which] mitigate[s] the full bore and inequitable application of the *Flora* rule."[23] After all, the United States Tax Court does not have jurisdiction over these types of assessments, so the deficiency procedures that allow taxpayers to challenge first and pay later are unavailable. Thus, the real purpose of the refund suit in section 6672 cases is not for taxpayers to get back their divisible tax payment(s), but rather to permit them a "day in court" to challenge their underlying liability for the Trust Fund Recover Penalty assessments. When viewed in this context, Judge Wheeler's decision is a huge victory, not only for Mr. Kaplan, but also other taxpayers who may lack employee records but still want the opportunity to contest the penalty assessments without the harshness of the *Flora* rule standing in their way.

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[1] Rachael Rubenstein supervises the Tax Clinic Program at St. Mary's University School of Law. The Clinic receives partial funding from the Internal Revenue Service (IRS) under a Low Income Taxpayer Clinic (LITC) Grant. She had significant help throughout litigation of this case from several clinical

students. Two students, Andre Anziani and Matt Pottu, deserve special recognition for their contributions to briefing the motion for reconsideration in this case.

[2] *Kaplan v. United States*, No. 11-456T, 2014 WL 292527 (Fed. Cl. January 27, 2014).

[3.] Motion of the United States to Dismiss the Complaint for Lack of Jurisdiction at 4–5, *Kaplan v. United States*, No. 11-456T, 2014 WL 292527 (Fed. Cl. January 27, 2014).

[4] *Flora v. United States,* 362 U.S. 145 (1960).

[5] Mot. of U.S. to Dis. the Com. for Lack of Jurisdiction at 4–5, *Kaplan v. United States*, 2014 WL 292527.

[6] All references to statute sections in this article refer to current sections of the Internal Revenue Code.

[7] *See, e.g., Salzillo v. United States*, 66 Fed. Cl. 23 (2005).

[8] *Steele v. United States*, 280 F.2d 89 (8th Cir. 1960).

[9] *Boynton v. United States*, 566 F.2d 50, 56–57 (9th Cir. 1977)

[10] *Steele,* 280 F.2d at 90.

[11] *Id.*

[12] *Boynton,* 566 F.2d at 56-57.

[13] *Id.* at 52.

[14] *See generally* EFFECTIVELY REPRESENTING YOUR CLIENT BEFORE THE IRS, at 921 (4th ed. 2009); Jack Townsend, TFRP Refund Suits – How Much Must Be Paid, Federal Tax Procedure (Jan. 18, 2013), http://www.federaltaxprocedure.blogspot.com/2013/01/tfrp-refund-suits-how-much-must-be-paid.html.

[15] *Kaplan v. United States*, 113 Fed. Cl. 84 (2013), *vacated by*, *Kaplan v. United States*, No. 11-456T, 2014 WL 292527 (Fed. Cl. January 27, 2014).

[16] *Id.* at 86.

[17] *Kaplan*, 2014 WL 292527 at *2.

[18] *Id.*

[19] *Id.*

[20] IRS IRM 8.25.1.7.4.2 (12-07-2012). The author attributes this citation in Kaplan's motion for reconsideration to Larry Jones and Jack Townsend, as it was found on Townsend's blog during research for the motion. Jack Townsend, Litigating Trust Fund Recovery Penalties -- the Flora Rule, Divisible Taxes and Unfairness, Federal Tax Procedure (October 11, 2013), http://federaltaxprocedure.blogspot.com/2013/10/litigating-trust-fund-recovery.html.

[21] *Kaplan*, 2014 WL 292527 at *2.

[22] Before the government filed an answer to Kaplan's complaint, it moved to suspend the proceedings in the Court of Federal Claims and simultaneously filed a separate lawsuit against Kaplan and another defendant in the Western District of Texas to reduce their TFRP assessments to judgments. Kaplan sought an injunction against the government's suit in Texas under section 6331(i). This venue dispute was briefed and the case was temporarily stayed in both federal courts pending the outcome of *Beard v. United States*— a 6331(i) case that the government appealed to the Federal Circuit after the Court of Federal Claims enjoined the government from maintaining its later filed suit. *Beard v. United States*, 99

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Fed. Cl. 147 (Fed. Cl. 2011). The Federal Circuit never ruled on the 6331(i) issue because the *Beard* case settled after oral argument but before a decision was rendered. In *Kaplan*, the government ultimately conceded the issue and agreed to dismiss the case in Texas and permit the Court of Federal Claims suit to move forward.

[23] Jack Townsend, Revised Opinion in TFRP Case Involving Flora Full Payment Requirement, Federal Tax Procedure (January 29, 2014), http://federaltaxprocedure.blogspot.com/2014/01/i-recently-blogged-on-court-of-federal.html.

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I. SUCCESSOR LIABILITY

A. Successor Tax Liability Upon Transfers Of Businesses.

1. Successor liability provisions – in general. Most states have some variation of the requirement that a purchaser has a responsibility and/or potential liability for unpaid tax liability on the part of the selling entity if certain steps are not taken to satisfy that liability. Some provisions apply only to sales tax liability; others pertain to other taxes as well.

a. The taxing authority typically requires that there be some notification that the transfer of the business is (or has) occurred. This reporting requirement is usually within a short period of time of the transfer.

b. The acquiror is often required to either get some evidence of no tax due by the selling entity, or withhold and/or pay over to the taxing authority those amounts if an assurance of no tax due is not received.

c. If the acquiror has not followed the prescribed requirements, and there is some tax amount due, the acquiror is usually made liable for unpaid taxes owed by the seller (up to the amount of the purchase price) as a successor in interest. Often times the successor cannot even challenge the underlying propriety of the tax liability.

d. It is not unusual for an acquiror not to request tax clearance information from the taxing authorities in connection with an acquisition. This usually happens either because (i) there is insufficient time before closing to obtain the necessary information from the taxing authority, or (ii) there is a (valid) fear that an audit will be triggered by such a notification or request.

e. **CAVEAT**: If an acquiror does not receive the necessary clearance from the taxing authorities, the purchaser should obtain an indemnification from the seller with respect to any tax, penalty and/or interest that is ultimately asserted against the acquiror pertaining to such prior liabilities. Further, the acquiror should have a high comfort level that the seller/indemnitor is capable of, and will perform on the indemnification if necessary. Failure to protect itself can easily result in the acquiror being liable for a debt that does not properly belong to the acquiror.

B. Tax Collection on Termination of Business - Successor Liability in Texas State Taxes.

1. There is a potential withholding requirement on the part of successor in interest to the owner of a business (per TEX. TAX CODE ("Tax Code") § 111.020) unless and until the seller provides a receipt from the Texas Comptroller of Public Accounts ("Comptroller") showing either that tax amounts have been paid or no tax is due.

2. In general, a purchaser of a business or stock of goods who (or which) fails to withhold an amount of purchase price is liable for the amount required to be withheld to the extent of the value of the purchase price. Tax Code § 111.020(b). In situations involving fraud, however, the successor can be held liable for tax in excess of the purchase price. See Tax Code § 111.024.

3. There must be consideration transferred in order for there to be a purchase price. Unless there is consideration in a transaction, there should be no successor liability. See Comptroller Decision No. 32,202 (1995) where a repossession of inventory by the prior seller of a business was not deemed to be consideration for successor liability purposes.

4. When determining if a "business" has been sold, the Comptroller will examine the transaction to determine what the parties to the transaction intended to buy and sell. 34 TEX. ADMIN. CODE ("Rule") § 3.7(d).

5. A purchaser may request that the Comptroller issue a certificate stating that no tax is due or issue a statement of the amount required to be paid before a certificate may be issued.

a. The Comptroller is required to issue a certificate or statement within 60 days after receiving the request or within 60 days after the day on which records of former owner made available for audit (whichever date is later), but in no event more than 90 days after receiving the request. Tax Code § 111.020(c).

b. If the Comptroller fails to mail the certificate or statement within the applicable period, the purchaser is released from the obligation to withhold the purchase price. Tax Code § 111.020(c).

> Where purchaser of business requested a certificate of no tax due and Comptroller provided results of audit more than 90 days after request was received, Comptroller was

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barred from collecting tax from purchaser. Comptroller Decision Nos. 14,609, 16,093 (1985).

c. The seller is required to inform the Comptroller in writing of the name and address of purchaser and must file a final report immediately after the sale of the business. Rule 3.7(f).

d. Provisions in a sale contract between seller and buyer as to which party has resulting tax obligations have no binding effect on the Comptroller. Consequently, where the parties to a sale transaction agreed that the buyer of that business would not be liable for the debts of the seller, the buyer was still subject to successor liability provisions with respect to the seller's unpaid taxes. Comptroller Decision No. 10,316 (1979).

6. Per Comptroller Rule, a seller may be deemed to have sold a business even when few assets are transferred. *E.g.*, the following may be deemed "business" sales (a non-exclusive listing) if the owner sells:

a. A building, land, furniture, fixtures, inventory and the right to use the seller's trade name, or

b. All the capital assets of a business, or

c. The name and goodwill of a business, or

d. All the inventory of a business, or

e. Fixed assets and realty necessary to operate a similar business as the seller at the same location. Rule 3.7(d).

7. Successor Liability Considerations – Foreclosure and Bankruptcy. Tax Code § 111.020

a. Exception for sale by bankruptcy trustee or estate - not a sale by a vendor or former owner for purposes of Tax Code § 111.020 successor liability provisions and the purchaser will not incur liability thereunder.

b. The conclusion in several Comptroller decisions is that successor liability per Tax Code § 111.020 should not flow through a mortgagee to a purchaser with respect to foreclosures because the mortgagee was not itself a purchaser of the property. See Comptroller Decision Nos. 22,978; 24,563-24,569 (1989).

c. For contrary results with respect to a similar statute (Tax Code §§ 351.0041 and 351.002(a)) dealing with the Texas municipal hotel occupancy tax, see *City of Amarillo v. Ray Berney Enterprises, Inc.*, 764 S.W.2d 861 (Tex. App. – Amarillo 1989, no writ).

d. The language of Tax Code § 111.020 describes the responsible party (i.e., the successor) as a "purchaser;" and not (for example) as one who acquires a business in any manner – such as through repossession resulting from a failed transaction. Case law holds that any doubt as to legal authority for the reach or application of the tax is to be resolved in favor of the taxpayer. It is a so-called "imposition" tax.

e. If a foreclosure is not conducted with the proper formalities, a purchaser may still have tax liability as a successor. That was the result in a hearing where the Comptroller tax division argued that the transaction at issue was a failed foreclosure, the result of which would have been successor liability for the purchaser. The administrative law judge ("ALJ") concluded there was not sufficient proof that the foreclosure was improper, or in fact, that a foreclosure had actually occurred. Furthermore, the Tax Division had not proved up consideration passed from buyer to seller. The result was buyer was not deemed to have purchased assets from the seller whose property was (allegedly) foreclosed – and there was no successor liability. Comptroller Decision No. 29,568 (1994).

f. A taxpayer who bought a restaurant that was in financial difficulty and had been subject to a Small Business Administration ("SBA") lien was liable for sales tax owed by preceding owner. Taxpayer argued this type of sale was analogous to a foreclosure sale, in which case the exception to successor liability provision applied. A review of the facts revealed the sale did not formally involve the SBA – and the foreclosure exception to successor liability did not apply. Comptroller Decision No. 25,559 (1994).

8. Fraudulent Transfer Successor Liability Considerations. Tax Code Statutory Provisions § 111.024.

a. A person who acquires a business or the assets of a business from a taxpayer through a fraudulent transfer or a sham transaction is liable for any tax, penalty and interest owed by the taxpayer. Tax Code § 111.024(a). A fraudulent transferee can therefore be liable for a tax amount that exceeds the purchase price paid.

b. A transfer of a business or the assets of a business is considered to be a fraudulent transfer or a sham transaction if the taxpayer made the transfer or undertook the transaction:

i) With intent to evade, hinder, delay or prevent the collection of any tax, penalty or interest owed under this title; or

ii) Without receiving a reasonably equivalent value in exchange for the business or business assets subject to the transfer or transaction.

(Tax Code § 111.024(b))

c. In determining intent of the taxpayer (as to evade, hinder or delay payment of tax) consideration may be given, among other factors, to whether:

i) The transfer was to a current or former business insider, associate or employee of the taxpayer or to a person related to the taxpayer within the third degree of consanguinity by blood or marriage;

ii) The transfer was to a third party who subsequently transferred the business or assets of the business to a current or former business insider, associate, or employee of the taxpayer or to a person related to the taxpayer within the third degree of consanguinity by blood or marriage;

iii) The taxpayer retained possession or control of the business or the assets of the business after the transfer or transaction;

iv) The taxpayer's business and the transferee's business are essentially operated as a single business entity at the same location;

v) Before the transfer or the transaction occurred, the taxpayer had either been subjected to or apprised of impending collection action by the Comptroller or by the attorney general;

vi) The transfer or transaction was concealed

vii) The taxpayer was insolvent at the time of the transfer or became insolvent not later than the 31st day after the date the transfer or transaction occurred; or

viii) The transfer or transaction involved all or substantially all of the taxpayer's assets.

(Tax Code § 111.024(c))

d. The fraudulent conveyance provisions do not apply to a transfer of a business or the assets of a business:

i) Through a court order on dissolution or a marriage; or

ii) By descent and distribution or testate succession on the death of a taxpayer.

(Tax Code § 111.024(d))

e. The interplay of the successor liability provisions of Tax Code § 111.020 and the fraudulent conveyance liability provisions of Tax Code § 111.024 serve to keep a taxpayer who owns one business from shutting down or abandoning that enterprise and subsequently starting up a new business with some or all of the old business assets. Doing so will very likely result in successor liability from the old business attaching to the newly established enterprise.

f. A convenience store company assessed liability for unreported taxable sales was also deemed to have successor liability for taxes owed by the former owner of the convenience store. The owner of the predecessor entity was the brother of an officer of the new entity which acquired the assets of the prior entity. Those facts, coupled with non-disclosures on the sales tax application, were deemed prima facie that the fraudulent transfer provisions of the Tex Code § 111.024 applied. Comptroller Decision No. 104,533 (2012).

g. Fraudulent transfer / sham transaction provisions of Tax Code § 111.024 were also applicable in the following hearings:

i) During the course of a mixed beverage gross receipts tax audit of a night club business the company sold assets of the business to a third party. The acquiring entity was assessed tax pursuant to the fraudulent transfer provisions of Tax Code § 111.024. The successor argued for insolvency relief. The insolvency claim was denied with the notation that insolvency relief is denied in cases involving fraudulent transfers. Comptroller Decision No. 47,837 (2012).

ii) A refrigerator and repair business that acquired the assets of a predecessor entity was subject to fraudulent transfer provisions. The acquirer had previously operated under five different taxpayer ID numbers, but was determined to be essentially the same business. Several factors deemed to be indicators of a sham transaction / fraudulent transfer pursuant to Tax Code § 111.024 were deemed present, including: transfer to a current or former business insider ((c)(1)); taxpayer retained possession of the business ((c)(3));

taxpayer's business was essentially operated as a single business entity at the same location ((c)(4)); taxpayer was subject to or knew about pending collection action at the time of the transfer ((c)(5)); and the transferor was insolvent (or became insolvent) at a time within 31 days of the transfer ((c)(7)). Comptroller Decision No. 101,355 (2013).

iii) The sole proprietor of a computer consulting and repair business who transferred the assets of the business to a newly formed sole member LLC at a time when the individual was insolvent and when tax collection actions were impending was deemed to be prima facie evidence that fraudulent transfer / sham transaction had occurred. Comptroller Decision No. 106,447 (2012).

h. Taxpayer deemed not to be a fraudulent transferee. Merely establishing that tax was collected but not remitted does not, by itself, establish a prima facie case that the fraudulent transfer provisions of Tax Code § 111.024 apply. Nor does merely operating the same business at the same location before or after the transfer without further factors present indicate intent to evade taxes. There needed to be some pending or threatened collection action the transferor knew about before the fraudulent transfer provisions applied. The Tax Division failed to carry its burden of proof and the case claiming a fraudulent transfer was dismissed. Comptroller Decision No. 104,681 (2012).

9. Successor liability provisions apply to all taxes in Chapter 2 of the Texas Tax Code (*i.e.* all taxes except for property tax). Rule 3.7(a). As discussed in more detail below, however, there are also property tax successor liability provisions that can be applicable. See Tax Code § 31.081.

10. Successor liability provisions vary by state. Consult the applicable successor tax liability provisions for the specific state(s) at issue. CAVEAT: When in doubt, be sure to get assistance of local counsel to assure compliance with the provisions, or to assure an understanding of what liability for failure to so comply will be. **DO NOT ASSUME THE SUCCESSOR LIABILITY PROVISIONS ARE THE SAME FROM STATE TO STATE. CONSULT LOCAL COUNSEL FOR FURTHER ADVICE.**

11. Successor Liability Rulings and other Determinations

a. Successor not liable even though taxpayer began business at same location of previous owner, where there was no evidence of any purchases by or transfers to taxpayer, nor evidence of consideration given by taxpayer for purchase. Comptroller Decision No. 30,262 (1994).

b. The purchase of the name of the prior business and use of an existing telephone number at the same location of the selling entity was not deemed to be the purchase of an existing business. The buyer entered into a new lease with the landlord, provided new inventory, and basically started a new business. Consequently there was no successor liability resulting from the acquisition of the name and telephone number. Comptroller Decision No. 33,110 (1995).

c. Provision in sales contract that buyer of business was not responsible for seller's debts did not alter buyer's liability as successor for seller's delinquent taxes. Comptroller Decision No. 10,316 (1979).

d. The Comptroller considers whether there was intent to sell a business in determining whether there has been such a transfer. In a transaction where the purchase agreement provided the acquiring taxpayer was conveyed the right, title and interest in a business, and the items purchased included the leasehold, furniture and fixtures, inventory, the business name and a clientele list, the Comptroller ruled there was a business transfer. Successor liability was incurred. Comptroller Decision No. 35,441 (1997).

e. The purchaser of a going concern was deemed liable for the unpaid sales tax of its predecessor where a change in the method used to generate business was held to not change the nature of the business purchased. The purchaser (an outside sales office supply business) acquired a retail office supply business at the same location as the selling entity. The purchaser was still held to be operating a continuing office supply business – and successor liability attached. Comptroller Decision No. 24,762 (1989).

f. Shutting down an operating business in one type of entity and reopening essentially the same business in another legal entity will typically not avoid successor liability for any taxes owed by the transferor. Thus, for example, incorporating a sole proprietorship with tax liabilities will result in the corporate entity incurring transferee liability with those unpaid. See Comptroller Decision No. 35,696 (1998). The same result is likely to occur if corporate entity A ceases operations and newco Corporation B starts a "new" business in a new corporate (or LLC or partnership or…) entity.

C. Property tax successor liability – withholding required on purchase of a business or inventory.

1. Persons who make such a purchase are required to make withholding payments on business personal property, or face personal liability. Tax Code § 31.081(a).

2. Purchaser is required to hold from purchase price an amount sufficient to pay all taxes imposed on personal property of a business (plus penalty and interest) until seller provides purchaser with:

a. A receipt from appropriate tax collector showing taxes, penalty or interest have been paid, or

b. A tax certificate from the collector from each taxing unit stating no taxes, penalty or interest is due the taxing unit. Tax Code §§ 31.08; 31.081(b). The tax certificate may be requested by the purchaser. Tax Code § 31.081(d).

3. A purchaser who (or which) fails to withhold or obtain a required tax certificate is liable to the taxing unit to the extent of the purchase price. Tax Code § 31.081(c).

> Successor liability for property taxes occurs upon the acquisition of a business. Thus a taxpayer that purchased business after the first of the year was liable for entire year's ad valorem tax rather than only having liability for a pro rata share of the acquisition year's tax. Tax Code § 31.081. *Dan's Big & Tall Shop, Inc. v. County of Dallas,* 160 S.W.3d 307 (Tex. App. – Dallas 2005, pet. denied).

4. An action under Tax Code § 31.081(a) does not release the seller of the business or inventory taxes imposed. Tax Code § 31.081(f).

5. For purposes of Tax Code § 31.081, a person is considered to have purchased:

a. A business, if the person purchases the name or goodwill of the business, and

b. The inventory of the business, if the person purchases inventory of a business which is at least 50% of the value of the total inventory of the business on the date of the purchase. Tax Code § 31.081(g).

> Comptroller held that taxpayer neither 1) purchased "the business", since he did not acquire the name, business location, or any goodwill associated therewith, or 2) its "stock of goods", since he only purchased 20% of inventory. See Comptroller Decision No. 12,822 (1983).

D. Successor liability – Hotel Occupancy Tax Considerations

1. A hotel tax is imposed on persons on use or possession of hotel type business (when stay is less than 30 days). See Tax Code Chapter 156.

2. A successor/acquiror of hotel is required to withhold an amount of the purchase price sufficient to pay any tax amount due state unless a certificate of no tax due is obtained from Comptroller. Tax Code § 156.204(a).

a. A taxpayer that purchased real property at a foreclosure sale that was subject to hotel occupancy tax incurred successor liability for taxes owed by the mortgagor foreclosed upon. In this transaction title never vested in the creditor – it passed directly from mortgagor to the purchaser at the foreclosure sale. Comptroller Hearing No. 22,292 (1989). A purchaser of property in a properly conducted foreclosure would not be liable as a successor because the purchaser would not be buying the property directly from the seller. As evidenced by the result in Comptroller Hearing No. 22,292, that does not mean, however, that the seller and/or a third party in a foreclosure could not still have a successor tax liability resulting from the transaction.

b. City was entitled to pursue collection of unpaid hotel occupancy taxes from prior owner of hotel, who was required to collect this tax in the first place, as well as from lender who purchased hotel at foreclosure sale and failed to withhold amount of occupancy taxes due from purchase price. Obligation of prior owner to pay occupancy tax is not extinguished by foreclosure. *Calstar Properties, L.L.C. v. City of Fort Worth,* 139 S.W.3d 433 (Tex. App. – Fort Worth 2004, no pet.).

3. The procedure for requesting and obtaining a certificate of no tax due for state hotel tax purposes and consequences for failure to do so are similar to analogous provisions pertaining to general Comptroller successor liability. See Tax Code § 156.204(b)-(e).

4. Successor liability for hotel purchases – local taxing authorities.

a. Similar to state taxing authority successor liability provision, but at local level.

b. Requests for no tax due/clearance certificate are to be directed to person designated by municipality in which hotel located (including extra territorial jurisdiction). See Tax Code §§ 351.001, 351.002, et seq.

E. Employment Tax – Business Transfer Considerations

1. Texas unemployment compensation provisions administered by Texas Work Force Commission ("TWC"). TEX. LABOR CODE ("Labor Code") § 202 et seq.

2. Texas Unemployment Compensation. Texas imposes a payroll/ unemployment tax on employees based upon an experience rating of unemployment claims that have been filed and sustained against employees in the state. Labor Code § 201.001, et seq.

3. Under the Texas Unemployment Compensation Act, an employing unit that acquires all of the business of an employer and continues that business of an employer and continues that business also acquires the predecessor's compensation experience if there is a connection between the acquiror and acquiree, *e.g.*, a common shareholder, officer or other owner of a legal or equitable interest. Labor Code § 204.083.

4. Conversely, the acquiror can be a new employer, without the predecessor's experience, where there are not related shareholders, directors or officers of the acquiring or selling business. Labor Code § 204.081 et. seq.

5. There may be situations where only a part of the business is sold, and the acquiror wants to retain the experience rating of the predecessor business that would otherwise not occur. In such a case, the successor and predecessor employers may apply to the Texas Workforce Commission to transfer the attributable compensation experience, which may be approved upon a showing of the following factors: Labor Code § 204.084.

a. Immediately after the acquisition, the successor employer continues operation of substantially the same business or the part of the business or organization acquired;

b. The predecessor employer waives, in writing, all rights to an experience rating computed on the compensation experience attributable to the part of the business acquired by the successor employer, unless the acquisition results from the predecessor's death;

c. A definitely identifiable and segregable part of the predecessor's compensation experience is attributable to the part of the business acquired; and

d. The successor employer was not an employer within the terms of the Act at the time of the acquisition, but elects to become such an employer on the date of the acquisition or otherwise becomes an employer during the year in which the acquisition occurs.

e. There are limitations on the ability to utilize the compensation experience rating of a predecessor employee if TWC determines that the transfer of the experience rating was accomplished solely for the purpose of obtaining a lower contribution rate. See, e.g., Labor Code §§ 204.083(d), 204.0861.

II. PERSONAL LIABILITY FOR TEXAS TAXES

A. State Of Texas Imposes A Trust Fund Liability on Responsible Persons. The State of Texas imposes a trust fund liability tax on responsible persons pursuant to the dictates of Tax Code § 111.016. It is similar in scope and purpose to Internal Revenue Code § 6672 responsible person provisions (the 100% penalty tax). Specific requirements of the trust fund tax are as follows:

1. Tax Held in Trust. Any person who receives or collects a tax or any money represented to be a tax from another person is deemed to hold the amount so collected in trust for the benefit of the state and is liable to the state for the full amount collected plus any accrued penalties and interest. Tax Code § 111.016(a).

2. Who is a "responsible individual" for purposes of the trust fund tax? An individual who controls or supervises the collection of tax or money from another person, or an individual who controls or supervises the accounting or paying over of the tax or money, and who willfully fails to pay or cause to be paid the tax or money is considered to be a responsible individual. Tax Code § 111.016(b).

3. By statute, a "responsible individual" includes (but is not limited to) an officer, manager, director, or employee of a corporation, association, or limited liability company or a member of a partnership who (in such capacity) is under a duty to perform an act with respect to the collection, accounting, or payment of a tax or money subject to the provisions of Tax Code § 111.016(a). Tax Code § 111.016(d).

4. "Tax" is defined to include penalty and interest responsible person purposes. Tax Code § 111.016(d)(2). The essence of Tax Code § 111.016 is discussed later in this outline.

5. Responsible person – selected Tax Code § 111.016 statutory provisions.

a. Any person who receives or collects a tax or any money represented to be a tax from another person holds the amount so collected in trust for the benefit of the state and is liable to the state of the full amount collected plus any accrued penalties and interest on the amount collected. Tax Code § 111.016(a).

b. A person is presumed to have received or collected a tax or money represented to be a tax for the purpose of this section if the person files, or causes to be filed, a tax return or report with the Comptroller showing tax due. A person may rebut this presumption by providing satisfactory documentation to the Comptroller that the tax on a transaction or series of transactions was not collected. Tax Code § 111.016(a-1).

c. An individual who controls or supervises the collection of tax or money from another person, or an individual who controls or supervises the accounting for and paying over the tax or money, and who willfully fails to pay or cause to be paid the tax or money is liable as a responsible individual for an amount equal to the tax or money not paid or caused to be paid. The dissolution of a corporation, association, limited liability company, or partnership does not affect a responsible individual's liability. Furthermore, an individual may be help personally liable for a trust fund tax even if not affiliated with the business entity to which the tax relates. Tax Code § 111.016(b).

6. If the tax liability of the legal entity with which the responsible individual was employed or associated has either not become final, is subject to tolling of limitations or is the subject of a federal bankruptcy proceeding, the statute of limitations relating to the period during which the individual may be personally assessed by the Comptroller is stayed until the first anniversary of the date the liability becomes final or the date the bankruptcy proceedings is closed or dismissed. Tax Code § 111.016(b-1).

7. The district courts of Travis County have exclusive, original jurisdiction of a suit dealing with responsible person litigation. Tax Code § 111.016(c).

8. For purposes of § 111.016 providing that a "responsible" person can be held liable for a company's collected but unremitted state sales tax if he "willfully" fails to pay the tax, "willfully" encompasses both actual knowledge and a responsible individual's reckless disregard of the risk that taxes may not be remitted.

> Where a corporation performed jobs that were both subject to and not subject to sales tax, the corporation's bookkeeper incorrectly marked the jobs at issue as non-taxable in the corporation's monthly sales tax returns and payments. Upon audit, the taxable transactions were treated as taxes collected and not remitted. Evidence brought forward was sufficient to establish that corporation's officers did not "knowingly" fail to remit the collected taxes, for purposes of determining whether officer's acted "willfully." The officers were therefore not personally liable for unremitted taxes. *State v Crawford,* 262 S.W.3d 532 (Tex. App. – Austin 2008, no pet.).

9. Responsible Person Determinations

a. Corporate president and director could be held jointly and severally liable with corporation for conversion of gasoline and diesel fuel taxes collected by corporation on State's behalf, given his actions in instigating, aiding or abetting corporation in spending of State's tax money for corporate purposes. The corporate president/director argued he could not be held liable for spending fuel tax amounts collected from customers on corporate expenses. He was unclear on the concept – and did not prevail in his argument. Those who have the ability to direct payment of trust fund taxes and do not make sure the state is paid are at risk. See *Dixon v. State*, 808 S.W.2d 721 (Tex. App. – Austin 1991, no writ).

b. A liquidation trustee appointed under debtor's confirmed bankruptcy plan who "willfully" failed to remit state sales taxes from debtor's restaurants to the Texas Comptroller was held personally responsible for his professional conduct. Trustee admitted that he knew that the sales taxes were due to the Comptroller but used the money to pay other creditors, including suppliers and staff. This was the result notwithstanding the trustee's "good intentions" of maximizing the estate's value. Tax Code § 111.016 (b). *In Re Texas Pig Stands, Inc.*, 610 F.3d 937 (5th Cir. 2010).

c. By definition, responsible individual includes an officer, manager, director, or employee of corporation, association, or limited liability company, or a member of the partnership who, as an officer, manager, director, employee or member, is under a duty to perform an act with respect to the collection, accounting, or payment of a tax money subject to the provisions of Tax Code § 111.016(a).

> For one to be held individually liable under § 111.016, the State must 1) prove the actual amount he received or collected, and 2) prove his liability is limited to the "amount collected." Proof, by means of comptroller's certifications, of the full amount of corporate tax liability is insufficient. The State failed to carry its burden – taxpayer prevailed. See *N.S. Sportswear, Inc. v. State*, 819 S.W.2d 230 (Tex. App. – Austin 1991, no writ).

d. In order to recover a corporation's delinquent sales tax from an individual, the State must show: 1) that the tax is due; 2) that the individual was responsible for the delinquency; and 3) the amount of tax actually collected by the individual. The State must affirmatively prove the specific amount of tax actually collected by the individual. The Comptroller's certificate does not meet this burden. *Herrera v. State*, 03-01-00101-CV, 2002 WL 185476 (Tex. App. – Austin February 7, 2002, no pet.) (unpublished opinion).

e. Where there are no facts establishing an individual's liability and the only documentation provided by the Tax Division in the administrative process was a certification of tax liability from the Comptroller, the State was unable to meet its evidentiary burden of proving the amount of money actually collected by the target individual and not remitted. This was the result even though the individual in question admitted he had collected some amount of tax and failed to remit same to the Comptroller. The State's failure to prove up the amount of tax collected and not remitted resulted in a decision that no amount was due from the asserted responsible person. *Herrera v. State*, 2002 WL 185476. See also *Parker v. State*, 36 S.W.3d 616 (Tex. App. – Austin 2000, no pet.).

f. When the reason for the Comptroller's inability to present documentation in support of the asserted tax liability is due to taxpayer's lack (or inadequacy) of records, the taxing authority is given more leeway to press its claim that responsible person liability applies.

> Where the Comptroller's auditors asserted liability based on only two categories of items sold at a convenience store (beer and cigarettes) and relied on cash register tapes and vendor records of beer sales to support their claim of taxes collected and not remitted, the court agreed that such an approach was reasonable and sufficient. The two audited items were selected because of the presumption (accepted by the court) that all sales of those items were subject to sales tax. The result was responsible person liability for the person who was in charge of the operations. See *Khan v. State*, 03-09-00708-CV, 2011 WL 3890394 (Tex. App. – Austin, August 31, 2011, no pet.). To the same affect is Comptroller Decision No. 404,689 (2013).

g. If corporate taxpayer's officer and director can be held individually liable under provision of Tax Code imposing individual liability on any person who receives or collects a tax, State must still prove actual amount officer received or collected. The individual liability is limited to amount collected absent a showing of a fraudulent transfer. See Tax Code § 111.016(a).

B. Forfeiture of Corporate Privileges, Charter or Certificate of Authority.

1. Forfeiture of Corporate Privileges. Pursuant to Tax Code § 171.251, a corporation's corporate privileges are required to be forfeited by the Comptroller if the corporation:

a. Does not file within 45 days after the date notice of forfeiture is mailed a required franchise tax report.

b. Does not pay, within 45 days after the date of notice of forfeiture is filed, tax or penalty under the franchise statute.

c. Does not permit the Comptroller to examine the corporation's records.

2. Result of Forfeiture of Corporate Privileges. If corporate privileges are forfeited, the corporation is not entitled to the use of the state's courts to sue or defend. Further, each director or officer of the corporation is liable for debts of the corporation from the date of the forfeiture. Tax Code §§ 171.252, 171.255. If the corporate privileges are so forfeited, each director or officer of the corporation is liable for each debt of the corporation that is created after the date such report,

tax or penalty is due (including any taxes that become due).

a. An individual defendant could be held liable for corporation's unpaid franchise taxes and penalties only if they became due and payable after corporate privileges were forfeited. When the franchise tax due date occurred before corporate privileges were forfeited, the subsequent jeopardy determination could not be retroactively applied to create director or officer liability where it did not otherwise exist. See *Davis v. State*, 846 S.W.2d 564 (Tex. App. – Austin 1993, no writ).

b. Officers and directors are not required to have personally participated in transactions resulting in corporate debt to have liability exposure; rather, it is the director's or officer's consent to and approval of corporate debts that leads to their personal liability. Tax Code § 171.255. See *Trammell*, 246 S.W.3d 815 (2008).

3. Exceptions that Preclude Forfeiture. A director or officer will not be personally liable for the corporation's debts if it can be shown that the debt was created or incurred over the director's objections, or without the director's knowledge and that the exercise of reasonable diligence to become acquainted with the affairs of the corporation would not have revealed the intention to create the debt. Tax Code § 171.255(c).

a. A plaintiff who was injured on condominium premises sued builder's corporate offices seeking to hold them personally liable. The Court of Appeals held that Tax Code § 171.255, holding directors and officers liable for debts of a corporation whose corporate privileges are forfeited for failure to pay its franchise taxes, did not apply to debts arising out of tort judgments predicated on negligence liability. Tort judgments are deemed to have arisen involuntarily, and are therefore not within the scope of Tax Code § 171.255. See *Williams v. Adams*, 74 S.W.3d 437 (Tex. App. – Corpus Christi 2002, pet. denied).

b. Former directors were not liable for debts corporation allegedly owed to financial corporation that had hired accounting corporation to collect certain delinquent accounts. It is the act of creating or incurring a debt when the franchise report is delinquent that triggers personal liability once the corporate privileges are forfeited; if no debts are created or incurred after delinquency there is no liability. Tax Code § 171.255(a). In addition, officers and directors that resigned their positions prior to the time the debt was incurred are not liable pursuant to the provisions of Tax Code § 171.255. See *Paccar Financial Corp v. Potter*, 239 S.W.3d 879 (Tex. App. – Dallas 2007, pet. denied).

4. Window of Liability. Even if corporate privileges are ultimately revived, the personal liability of the officers and directors who are liable by reason of the forfeiture is not affected by the revival of the charter or certificate of authority. That exposure remains in place. Tax Code § 171.255(d).

5. Forfeiture of Corporate Charter or Certificate of Authority. If the corporation does not pay the amount of taxes and penalties it owes within 120 days from the forfeiture of corporate privileges, the Comptroller can request the Attorney General to bring suit to cause the forfeiture of the charter or certificate of authority. Tax Code §§ 171.301-303. Alternatively, the Comptroller can certify the name of the defaulting corporation to the Secretary of State, who has the power to forfeit the charter or certificate of authority without court proceedings. Tax Code § 171.301.

6. Applicability of Forfeiture Provisions. Substantial case law exists interpreting the applicability of the forfeiture of corporate privileges/charter provisions, including the following authority:

a. Officers or employees of a corporation whose corporate privileges have been forfeited need not take a specific action creating corporate debt after corporate privileges have been forfeited for the officer to be liable for the corporate debt. If the determination of liability occurred after forfeiture, even though the binding agreement arose prior to forfeiture, the tax/penalty amounts did not "relate back" to the initiation of the contract. *Serna v. State*, 877 S.W.2d 516 (Tex. App. – Austin 1994, writ denied).

b. An officer of a corporation whose charter had been revoked for nonpayment of franchise tax was individually liable to pay for stock which had been ordered through the corporation by an individual who was not an employee; the court concluded the officer could have discovered the debt with reasonable diligence. *Skrepnek v. Shearson Lehman Bros., Inc.*, 889 S.W.2d 578 (Tex. App. – Houston [14th Dist] 1994, no writ).

c. Forfeiture of corporate privileges exposes officers and directors to liability that extends beyond just deficiencies. Taxpayer argued that the personal liability provisions only applied to such tax deficiencies, and that a successor liability tax obligation that existed prior to the forefeiture date would not be a personal liability of the successor. The Court disagreed, stating the plain language of Tax Code § 171.255(d) specified that officer and directors are liable for "each debt" incurred after the forfeiture date – not just tax debts arising after forfeiture. *Bosch v. Cirro Group, Inc.*, 05–11–01625–CV, 2012 WL 5949481 (Tex. App.—Dallas Nov. 28, 2012, pet. denied).

d. While debts incurred pursuant to Tax Code § 171.255(a) by a corporate entity after forfeiture of corporate privileges extend beyond just tax obligations, courts have ruled that such liability does not extend to tort judgment predicated on negligence liability. *Suntide Sandpit, Inc. v. H & H Sand & Gravel, Inc.*, 13-11-00323-CV, 2012 WL 2929605 (Tex. App.—Corpus Christi July 19, 2012, pet. denied) (citing *Williams v. Adams*, 74 S.W.3d 437, 442 (Tex. App.—Corpus Christi 2012, pet. denied)).

e. Officer's and director's statutory liability for corporate "debt" upon the corporation's forfeiture of its corporate privileges for failing to pay franchise taxes, encompassed the corporation's obligation to pay contributions to the Unemployment Compensation Fund. *Wilburn v. State*, 824 S.W.2d 755 (Tex. App. – Austin, 1992, no writ).

f. Tax Code § 171.255 must be strictly and narrowly construed to protect individuals against whom liability is sought because the resulting personal obligation is penal in nature. Tax Code § 171.255 does not create a basis for asserting personal jurisdiction (as opposed to liability) over a nonresident officer or director of an entity that has (or had) corporate privileges in Texas. *ACS Partners, LLC v. Allen Gross*, No. 01-11-00245-CV, 2012 WL 1655547 (Tex. App. – Houston [1st Dist] May 4, 2012, no pet.).

g. The relation back doctrine did not apply to preclude imposition of personal liability on automobile dealership corporation's director and officer for a corporation's breach of dealership agreement in which the corporation's privileges were revoked for failure to file a required franchise tax report after entry into dealership agreement but before breach of the agreement. The debt was deemed to be "created or incurred" at the time of the breach. See *Taylor v. First Community Credit Union*, 316 S.W.3d 863 (Tex. App. – Houston [14th Dist] 2010, no pet.).

h. When an order from the Texas Railroad Commission assessing penalty for failing to plug abandoned oil wells was issued after the date the corporation's franchise taxes were due, but not paid, officers and directors of the corporation were individually liable for penalty. The debt was deemed to be "created or incurred" on the date the Texas Railroad Commission entered an order directing the corporation to pay – not four years earlier when the violations actually occurred. *Jonnet v. State*, 877 S.W.2d 520 (Tex. App. – Austin 1994, writ denied).

i. Where taxpayer's tax delinquency amount is a portion of the sales tax delinquency amount that was at issue in an administrative redetermination, the tolling of three-year statute of limitations of Tax Code § 111.207 applies only to the "issues that were contested" in that administrative redetermination. The question in the case was whether the three year statute of limitations period to bring an action to collect a tax (per Tax Code § 111.202) was tolled by an administrative proceeding relating to the corporate entity – as opposed to the individual from whom the Comptroller was asserting to be a responsible person. Taxpayer argued that a prior Comptroller hearing decision supported his position – which it did. The court declined to follow the prior Comptroller decision, however, stating that the plain language of the statute authorized tolling of the limitations period. Consequently, the statute of limitations was extended as to the individual as a result of the pendency of the corporate administrative hearing. The taxpayer was consequently determined to be a responsible person per Tax Code § 171.255. See *Wilson v. State*, 272 S.W.3d 686 (Tex. App. – Austin 2008, pet. denied).

7. Comptroller may use the same procedure and rationale of forfeiture of corporate authority or certificate of authority for forfeiture of certificate or registration of any taxable entity (e.g., partnership, LLCs, etc.). Tax Code § 171.302.

C. Personal Liability for Actions Considered to be Fraudulent Tax Evasion – Additional 50% Fraud Penalty.

1. Any officer, manager or director of a corporation, association or LLC, partner of a general partnership or managing general partner of a limited partnership or LLP who in such capacity engaged in fraudulent tax evasion activities is personally liable for the tax. Tax Code § 111.0611(a). This is distinct from the 50% fraud penalty that can be asserted against a "person" engages in fraudulent activity per Tax Code § 111.061(a) (failure to pay tax or alteration of records). For purposes of Tax Code § 111.061(a), a "person" could be a legal entity such as a corporation or LLC. By contrast, Tax Code § 111.0611(a) applies specifically to individuals.

2. An additional 50% is penalty added to tax due to an individual engaged in fraudulent activity. Tax Code § 111.0611(a).

3. Per statute, actions indicating of fraudulent tax evasion include:

a. filing or causing to be filed a fraudulent business tax return or report;

b. intentional failure to file required tax return, report or document on behalf of business entity;

c. filing or causing to be filed a tax return or report containing an intentionally false statement resulting in understating tax by 25% or more;

d. altering, destroying or concealing any record, document or thing presented to the Comptroller or other conduct utilized with the intent to fraudulently affect the outcome of a Comptroller investigation, audit, hearing or other such matter.

(Tax Code § 111.0611(b))

4. Personal liability limited to an amount by which excess otherwise personal liability obligation exceeds unencumbered assets of the corporation. Tax Code § 111.0611(c).

5. Comptroller administrative hearing decisions dealing with the personal liability for fraudulent tax evasion including the following pursuant to Tax Code § 111.0611(a):

a. Personal liability for fraudulent tax evasion was assessed against a taxpayer associated with a limited liability company (LLC) that has an unpaid tax liability dismissed when Comptroller representatives failed to present a *prima facie* case for personal liability. No public records were used to confirm the target individual's role with the company. The only relevant evidentiary documentation was the references to the taxpayer as president in the audit documents. No facts were established regarding the identity of the person who was involved in the day-to-day operation of business, who completed the returns and what records were used. As liability for the penalty pursuant to Tax Code § 111.0611 hinges on the target individual being an officer, manager or director of the entity, failure to prove that link resulted in a ruling for the taxpayer and against the Comptroller. See Comptroller Decision No. 103,918 (2011).

b. Whether the president of a corporate entity reporting greatly understated taxable transaction amounts in filing returns or causing them to be filed, constitutes grounds for personal liability was the focus of Comptroller hearing dealing with applicability (or lack thereof) of Tax Code § 111.0611. Petitioner's involvement in the day-to-day operations of corporate activity plus the gross underreporting of tax (46.57% error rate), was considered sufficient by a clear and convincing evidence standard to warrant imposition of the 50% fraud penalty against the corporation. The consequent conclusion was that the corporate president filed the sales and use tax returns as part of a fraudulent scheme or plan to evade payment of taxes, and was personally liable for the 50% fraud penalty. See Comptroller Decision No. 104,433 (2011).

6. In a redetermination proceeding the taxing authority's representatives bear the burden of proving clear and convincing evidence that the assessment of personal liability is warranted under Tax Code § 111.0611.

> Factual assertions in Staff's pleadings about audit findings and the Petitioner's actions in its pleadings do not qualify as evidence. Such evidence must be clear and convincing to establish that Petitioner took an action or participated in a fraudulent scheme or fraudulent plan to evade the payment of taxes due under § 111.0611. The ALJ was clear in opining that audit findings are not "evidence." The conclusion was the taxpayer was not liable for the 50% fraud penalty due, even though it was apparent there had been under reporting of tax. The unanswered question was who was responsible for such under reporting. See Comptroller Decision No. 104,430 (2011).

7. Once Comptroller representatives have presented facts indicating a *prima facie case* supporting a finding of fraud or evasion, the burden of proof shifts to the taxpayer to prove by a preponderance of the evidence that liability should not be imposed and that the assessment should be dismissed. Tax Code § 111.0611.

> Where Comptroller representatives submitted copies of receipts for delivery of liquor to bar which taxpayer had signed, the taxpayer was determined to have been involved in the day-to-day operations of the bar. The gross underreporting of tax (at a rate of 82.67%), sufficed as clear and convincing evidence so

as to establish personal liability for the fraud penalty. The Comptroller had established *prima facie* evidence that taxpayer acted in a fraudulent manner, and that assertion was not rebutted by the taxpayer. See Comptroller Decision No. 105,113 (2011). Note: This is one of several decisions dealing with convenience stores resulting in similar outcomes.

8. Additional instances where the taxpayer was found to have acted in a fraudulent manner such that the 50% fraud penalty of Tax Code § 111.0611 include:

a. The under reporting of taxable transactions by 36% plus the involvement of a key employee, the lack of records and no explanation as to the reason for the under reported tax amounts was sufficient for the Comptroller to determine the 50% fraud penalty was warranted. Comptroller Decision No. 103,683 (2011). Note: The ALJ's proposed decision was changed to a substantial degree by the Comptroller. The Comptroller rejected that finding of fact (as well as several findings of law) in determining the penalty was proper.

b. Filing, or causing to be filed, fraudulent tax returns or reports. Comptroller Decision No. 103,204 (2012).

c. Taxpayer president of company signed all tax returns, audits of which showed receipts underreported by more than 25%. Taxpayer did not specifically contest the 50% penalty and provided no evidence showing why the 50% fraud penalty should not be imposed. Comptroller Decision Nos. 105,282 (2012), 105,289 (2012). Once a prima facie case has been made, the burden is on the taxpayer to show why the fraud penalty should be abated. The fraud penalty was upheld. See also Comptroller Decision Nos. 104,617 (2012) and 106,244 (2012) for similar results.

d. Taxpayer was president of the general partner of a company that failed to report 87% of taxes found to be due on audit. Taxpayer managed the company's store, ordered its inventory and oversaw day to day operations. The liability could not be contested by a successor entity. Comptroller Decision No. 107,234 (2013).

e. While not involved in day to day operations of three convenience stores, reviewing a store's activities and records thoroughly and being aware of purchases of taxable inventory and receipts indicates the individual was aware or should have been aware of significant underreporting. The 50% fraud penalty was upheld. Comptroller Decision No. 104,445 (2012).

Applicable Large Employer Status under the Affordable Care Act

Even though Notice 2013-45 has delayed employer penalties under the Affordable Care Act until 2015, employers, and their advisers, should be planning for the law now because employment decisions in 2014 will determine if the employer is an applicable large employer subject to penalties in 2015.

Employers could be subject to a penalty under section Code section 4980H in 2015 if at least one of their employees receives a tax credit or cost-sharing subsidy for purchasing health insurance through a health insurance exchange. However, the penalty is only imposed on "applicable large employers." The Code defines an applicable large employer as an employer who employed an average of at least 50 full-time employees including full-time equivalents during the preceding calendar year.

It is important to note that the applicable large employer status is determined by the employer's prior year employment. Employment in 2014 will determine whether an employer is an applicable large employer in 2015. Employers with 100 or more full-time employees could be subject to penalties in 2015, and employers with 50 or full-time employees could be subject to penalties in 2016.

The applicable large employer determination is a five step process

From Code Section 4980H, Treas. Reg. Section 54.4980H-1, -2, and -3, a five step process can be developed for determining if an employer is an applicable large employer. First, determine if the employer is a member of a group of employers that must be consider as a single employer. Second, determine which employees are included in the calculation of the average number of employees. Third, determine the hours of service for each employee. Fourth, calculate the average number of employees, and finally determine if the employer is an exempted seasonal employer.

Step 1: Determine if the employer is a member of a group of employers that is considered a single employer

The employer is a member of a group that must be considered a single employer for purposes of determining applicable large employer status if the group would be a single employer under sections 414(b), (c), (m) & (o) of the Code (the employer is a member of a controlled group of corporations, a member of a group of businesses under common control, or a member of an affiliated group). All employees of all members of the group of employers are included in a single calculation of average number of employees to determine if the group is an applicable large employer.

Step 2: Determine which employees are included in the calculation of the average number of employees

For purposes of determining applicable large employer status, the common law definition of an employee, as defined in Reg. § 31.3121(d)-1(c), is used to determine employees. The primary factor indicating an employer—employee relationship being the employer's right to direct the work to be performed and the method in which it is to be accomplished. All full-time and part-time employees employed during the prior calendar year are included in the calculation including those who are no longer employed by the employer. Independent contractors and leased employees are not included in the calculation. In addition, sole proprietors, two percent or more shareholders in an S corporation, and partners in a partnership are not employees for purposes of determining an employer's status as an applicable large employer.

Step 3: Determine the number of hours of service for each employee during each calendar month of the preceding year

An hour of service is defined as each hour for which an employee is paid or entitled to payment for the performance of duties, vacation, holiday, illness, incapacity, layoff, jury duty or leave of absence. For hourly employees, the employer must determine actual hours of service from their employment records. For employees who are not paid on an hourly basis, the proposed regulations allow an

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employer to use a days-worked or weeks-worked equivalency as an alternative to the actual hours of service. The days-worked equivalency credits the employee with eight hours of service for each day that the employee had at least one hour of service. The weeks-worked equivalency credits the employee with 40 hours of service for each week in which the employee has at least one hour of service. However, the employer cannot use the days-worked or weeks-worked equivalency if it substantially understates an employee's hours of service. Work performed outside the U.S. is not included in an employee's hours of service.

Example of an employer not permitted to use the days worked equivalency: Employer has salaried employees who work 3 12-hour days per week. Employer must use actual hours of service to determine employment status because the employees would be part-time employees with 24 hours of service per week using the days-worked equivalency which substantially understates the actual 36 hours worked per week.

Step 4: Calculate the average number of employees

First determine the employer's number of full-time employees during each calendar month of the previous calendar year. Employees are full-time if they averaged at least 30 hours of service per week during the month, and 130 hours of service in a calendar month is treated as the equivalent of 30 hours of service per week.

Then, determine the number of full-time-equivalent employees during each calendar month of the previous calendar year. Full-time-equivalent employees for a calendar month are determined by dividing the total hours of service of all part-time employees during the month (but not more than 120 hours for any one employee) by 120. If the resulting number is a fractional number, the number is not rounded to the nearest whole number at this step. The number of full-time-equivalent employees for each month is added to the number of full-time employees for each month to determine the total number of employees for each month.

Determine the average number of employees for the preceding year by dividing the sum of the total number of employees for all 12 months in the calendar year by 12. If the resulting number is a fractional number it is rounded down to the nearest whole number. If the number is 50 or more the employer is an applicable large employer.

Step 5: Determine if the employer is an exempted seasonal employer

There is an exemption for employers who exceed the 50 employee threshold due to seasonal employees. An employer is not considered an applicable large employer if the employer's workforce exceeds 50 full-time and full-time-equivalent employees for 120 days (or four calendar months) or less and the excess employees during the 120-day period were seasonal workers. The 120 days or 4 calendar months need not be consecutive. In addition, the seasonal employees can work more than 120 days so long as the employer does not exceed 50 employees for more than 120 days or 4 calendar months.

Example of the number of employees calculation:

Hours worked:

	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.
Manager	160 hrs	160 hrs	163 hrs	180 hrs	160 hrs	160 hrs	160 hrs	130 hrs	120 hrs	129 hrs	220 hrs	110 hrs
Employee 1	130 hrs	150 hrs	129 hrs	180 hrs	160 hrs	140 hrs	130 hrs	130 hrs	120 hrs	129 hrs	110 hrs	220 hrs
Employee 2	130 hrs	120 hrs	129 hrs	180 hrs	160 hrs	140 hrs	125 hrs	130 hrs	120 hrs	129 hrs	110 hrs	220 hrs
Employee 3	130 hrs	120 hrs	129 hrs	10 hrs	70 hrs	110 hrs	125 hrs	130 hrs	120 hrs	129 hrs	110 hrs	0 hrs
Employee 4	0 hrs	0 hrs	0 hrs	0 hrs	0 hrs	0 hrs	10 hrs	30 hrs	70 hrs	34 hrs	0 hrs	0 hrs

Calculation of total employees per month:

	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sep.	Oct.	Nov.	Dec.
Full-time	4	2	1	3	3	3	2	4	0	0	1	2
Full-time Equiv	0	2	3	0.083	0.583	0.917	2.083	0.25	4.583	4.283	2.75	0.917
Total	4	4	4	3.083	3.583	3.917	4.083	4.25	4.583	4.283	3.75	2.917

(Note: in each month the employees had a total of 550 hours of service, but the calculation of the total number of employees ranged from 2.971 to 4.583. Also, each highlighted cell exceeds the 120 hour cap for calculation of full-time equivalents but does not meet the 130 threshold for full-time employee; thus, 120 hours is used in the calculation of full-time equivalents.)

Calculate average for preceding year:

(4+4+4+3.083+3.583+3.917+4.083+4.25+4.583+4.283+3.75+2.917)/12=3.871=3 full-time employees for purposes of determining if the employer is an applicable large employer. (Note: use the decimal number determined each month in calculating the average for the year, but always round the average for the year down.)

Example 1: The impact of full-time versus part-time employees on the calculation of total employees

Employer has 19 full-time employees working 130 hours per month and 60 part-time employees working 65 hours per month for every month in 2014. The employer would be an applicable large employer in 2015 (19 full-time employees each month and 32.5 full-time equivalents per month=51 full-time employees). As an alternative, the employer could employee 30 full-time employees working 130 hours per month rather than the 60 part-time employees. The employer would not be an applicable large employer in 2015 because the employer did not have 50 or more employees on average in the preceding year.

Example 2: The impact of increasing hours worked per full-time employee versus additional employees

Employer has 60 full-time employees working 130 per month during every month in 2014. The employer would be an applicable large employer in 2015. As an alternative, the employer could employee 49 full-time employees working 160 hours per month during every month in 2014. The employer would not be an applicable large employer in 2015 because the employer does not have 50 or more employees on average in the preceding year.

Example 3: Seasonal employer with 50 full-time employees

Employer operates a chain of water parks. Employer has 50 full-time employees during every month of 2014. In addition from May 15th until September 10th of 2014 Employer has an additional 200 full-time seasonal employees and 1500 part-time seasonal employees working an average of 100 hours per month. The employer is within the exemption for seasonal employers and is not an applicable large employer for 2015.

Example 4: Seasonal employer with seasonal employees that work more than 120 days

Employer operates a ski resort. Employer has 5 full-time employees during every month of 2014. In addition, employer has 120 seasonal employees from November 1st through April 30 of each year. In 2014, the 120 seasonal employees were full-time during the months of January, February, March and December. During the months of November and April the seasonal employees were part-time and had a total of 4800 hours of service in November and 5400 hours in April. The employer is within the exemption for seasonal employers and is not an applicable large employer for 2015.

Planning opportunities to avoiding applicable large employer status

As illustrated by the five-step process and the above examples, employers near the 50-employee cut-off can make adjustments in 2014 to avoid being an applicable large employer in future years. As seen in the first and second example, employers can increase the allocation of hours of service to full-time employees to reduce the number of total employees for purposes of making the applicable large employer determination. As seen in examples 3 and 4, an employer can utilize seasonal employee to significantly exceed the 50-employee threshold so long as it does not do so for more than 120 days. In addition, employers should consider outsourcing some functions to independent contractors, or adding additional S corporation shareholders or partnership partners if either of those strategies is appropriate for their situation.

Offering health insurance coverage as an alternative to avoiding applicable large employer status

Employers can also avoid penalties by offering health insurance that is affordable and provides minimum essential coverage to at least 95 percent of full-time employees. Even if the employer is an applicable large employer and the employer has an employee who receives a tax credit or cost-sharing subsidy, the employer will not be subject to the penalty under section 4980H of the Code if the employer offered the employee and his or her dependents the opportunity to enroll in coverage that provided minimum essential coverage and was either affordable or meets one of the affordability safe harbors in Prop. Treas. Reg. § 54.4980H-5. The coverage is affordable if the employee's cost for the lowest cost employee-only coverage does not exceed 9.5 percent of the employee's household income. The coverage provides essential minimum coverage if it covers 60 percent of the covered expenses as determined by actuarial standards. Thus, an employer, as an alternative to avoiding applicable large employer status, can avoid penalties by offering employees and their dependents the opportunity to enroll in affordable coverage that provides minimum essential coverage.

An applicable large employer can avoid penalties by not exceeding 30 full-time employees in any calendar month in the calendar year

If an employer cannot, or does not, avoid applicable large employer status and chooses not to offer its full-time employees the opportunity to enroll in minimum essential coverage, it can also avoid penalties by employing 30 or less full-time employees in each calendar month of the calendar year. The penalty imposed on applicable large employers is calculated basis on full-time employees and does not include full-time-equivalent employees, and Code Section 4980H(c)(2)(D)(i) excludes the first 30 full-time employees from the calculation of the penalty. Thus, the employer in Example 1 above would not be liable for a penalty, even though it is an applicable large employer, so long as it does not employee more than 30 full-time employees in any calendar month.

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Current Issues Related to Estate Planning with Qualified Plans and IRAs

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Estate Planning Goals relating to Qualified Plans and IRAs

- Want to make sure that qualified plan/IRA passes to the correct beneficiaries at death
- Want to avoid having qualified plan/IRA pass directly to a minor or incapacitated person (or a spendthrift)
- Usually (but not always) best to have plan/IRA pass in a way that is consistent with the client's overall estate plan

Estate Planning Goals, continued

- Avoid "fraud on the spouse" with respect to the surviving spouse's community interest in the decedent's plan/IRA (e.g., 100% passes to someone other than spouse)
- As a general rule, include a specific bequest of the non-participant spouse's community interest in the surviving spouse's IRA to the surviving spouse (i.e., "anti-*Allard* clause")

Estate Planning Goals, continued

- Structure beneficiary designation to preserve designated beneficiary treatment (e.g., do not name the "estate" or say "per Will" in beneficiary designation form)
- If a qualified plan/IRA will be passing to a trust, make sure the trust is a "qualified see-through trust" (so that income taxes aren't accelerated): special drafting required

Estate Planning Goals, continued

Consider how qualified plan/IRA fits into overall estate plan, which may have one or more of these objectives:

- Defer, reduce and/or eliminate estate taxes
- Protect inherited assets from divorce/creditors' claims
- Maximize income tax options for beneficiaries
- Provide asset management for the beneficiaries
- Split benefits between current and future beneficiaries
- Control the ultimate disposition of the assets
- Provide benefits to charity at death

Premise:

To achieve Estate Planning Goals with respect to Qualified Plans and IRAs, must consider the basic rules regarding post-death distributions from inherited Plans and IRAs

(**It's been almost 12 years since the final Treasury Regulations were published**)

Participant (“P”)

- Participant: the employee or retiree who is participating in an employer-sponsored qualified retirement plan
- Participant: the “named owner” of an IRA
- Participant must begin taking minimum required distributions from his plan/IRA upon reaching his “required beginning date”

“Required Beginning Date” (“RBD”)

- For IRA owners and 5% or more owners of employer sponsoring qualified plan: P’s RBD is April 1 of year after year P attains age 70½
- For less than 5% owners (if plan so provides): P’s RBD is April 1 of later of year after

  (i) P attains age 70½ or

  (ii) P retires

Community Property Issues

- Both qualified plans and IRAs can be community property (and usually are in TX)
- Participant's spouse (NPS) has no right to dispose of her community interest in P's <u>qualified retirement plan</u> upon her death if she dies before P: *Boggs v Boggs*
- NPS *can* dispose of her community interest in P's IRA if she dies before P (*Boggs* not applicable to IRAs: *Allard v. Frech* applies)

Designated Beneficiary (“DB”)

- A“defined term”: desirable in most cases
- Only human beings can be DBs
- Special “look through” rule for qualifying trusts
- If multiple DBs of single plan/account (and no timely separation into separate shares), use oldest DB as measuring life for all DBs
- If any *entity* (other than a qualifying trust) included as a beneficiary of single plan/account, no DB (unless entity cashed out before DB Determination Date or unless separate shares created before DB Determination Date)

“DB Determination Date”

- DB determined on September 30 of year following year of P’s death
- Post-death rules recognize effect of qualified disclaimers (relation back to d. o. d.)
- Post-death rules allow “bad” beneficiaries to be “cashed out” before DB determination date (and thus ignored)
- Certain post-death actions involving “bad” trusts (or “bad” b.d. forms) *may* allow DB treatment

Post-death "bad beneficiary fixes" *other than* Qualified Disclaimers

- Successful:
  - PLR 201203033 (release of "bad" powers)
  - PLR 200620025 (transfer to a post-death created SNT--discussed later)
  - PLR 200616039 (court reformation of defective b.d. form)
- Not Successful:
  - PLR 201021038 (post-death modification of "bad" trust ignored)
  - PLR 200846028 (court construction of b.d. wording: "as stated in wills" ignored)
  - PLR 200742026 (court reformed b.d. form w/no contingent benef.-ignored)

Minimum Required Distributions (MRDs) After Death of Participant

- Depend on whether P died before or after RBD
- Depend on whether P is deemed to have a DB as of the DB determination date
- Depend on who the DB is

Participant Dies *Before* RBD: Commencement Date

- No DB: "5 Year Rule" (see next slide)
- Non-Spouse beneficiary (spouse *not* sole DB): Commence post-death MRDs by December 31 of year following year of P's death
- Spouse is *sole* DB: Spouse must commence post-death MRDs by December 31 of year when P would have reached age 70½ (assumes no spousal IRA rollover)

Participant Dies *Before* RBD: <u>Distribution Period</u>

- <u>No DB</u>: "5 year Rule" - Beneficiary must withdraw 100% from P's plan/IRA by December 31 of year containing 5^{th} anniversary of P's death
- <u>Non-spouse Beneficiary (spouse not *sole* DB)</u>: Take MRDs over *non-recalculated* life expectancy of (oldest) DB, starting with divisor* for DB's age as of birthday in year following year of P's death; reduce divisor by 1 each year thereafter
- <u>Spouse is *sole* DB</u>: Take MRDs over spouse's *recalculated* life expectancy, using divisor* for spouse's age as of birthday <u>in</u> <u>each</u> <u>distribution</u> <u>year</u> (assumes no spousal IRA rollover)

Participant Dies *On or After* RBD: Commencement Date

- If not already distributed before P's death, pay final MRD due P to P's beneficiary/ies by December 31 of year of P's death
- Commencement Date for post-death MRDs to P's beneficiary/ies is December 31 of year following year of P's death

Participant Dies *On or After* RBD: Distribution Period

- No DB: Take MRDs over P's remaining, *non-recalculated* life expectancy, starting with divisor* for P's age in year of death; reduce divisor by 1 each year thereafter
- Non-spouse Beneficiary (spouse *not* sole DB): Take MRDs over (oldest) beneficiary's *non-recalculated* life expectancy, starting with divisor* for DB's age as of birthday in year following year of P's death; reduce divisor by 1 each year thereafter; *OR*, can use "No DB" method, if desired
- Spouse is *sole* DB: Take MRDs over spouse's *recalculated* life expectancy, using divisor* for spouse's age in each distribution year (assumes no spousal IRA rollover); *OR*, can use "No DB" method, if desired

Spouse as P's Beneficiary

- Spouse as P's beneficiary can either:
  - Remain in position of being <u>P's beneficiary</u> (post-death distribution rules and Single Life Table apply), *OR*
  - Do (spousal) IRA rollover and <u>become new P</u> (lifetime distribution rules and Uniform Lifetime Table apply)
- Spouse who does spousal IRA rollover becomes Participant herself (and is no longer P's beneficiary)
- Spouse who does not do spousal IRA rollover, remains as P's beneficiary, but can still name successor beneficiary/ies to take amounts remaining in P's plan/IRA upon her death (and can do rollover later)

Marital Property Rules/Considerations

- Per REACT, all <u>defined benefit plans</u> must provide surviving spouse of P with either a QPSA or QJSA (unless waived)
- Per REACT, P's spouse must be primary beneficiary of <u>qualified contribution plans</u> (unless waived)
- Per *Boggs v. Boggs*, non-participant spouse (NPS) has no right to dispose of her community property ½ interest in P's <u>qualified plan</u> upon her death if she dies before P
- *Boggs* does not apply to IRAs, even an IRA that was derived from a qualified plan (i.e., P's IRA rollover)

Allocating IRAs and Qualified Plans to Trusts used in Estate Planning

Consider **conflict** between post-death minimum distribution rules (income tax rules) applicable to qualified plans and IRAs and client's estate planning goals (reduce, defer or avoid future estates taxes, provide divorce/creditor protection for beneficiaries, provide for multiple beneficiaries [e.g., spouse for life, then to children on spouse's death or charity and individuals], control the ultimate disposition of the assets, reduce post-death fees and expenses, keep estate plan simple to administer, etc.)

Trusts as Beneficiaries of Qualified Plans/IRAs

Requirements for **trust** named as beneficiary **to obtain DB treatment** (i.e., to be a “qualified see-through trust”):

– Must be a valid trust under state law

– Trust is (or becomes) irrevocable on P’s death

– All trust beneficiaries who will (or could) receive P’s IRA/Plan benefits are identifiable from trust instrument

– All beneficiaries of P’s benefits are human beings (or other qualifying trusts)

– Required trust documentation has been timely provided to plan administrator/IRA custodian

Trusts as Beneficiaries of Plans/IRAs: **Special Drafting Required**

If client plans to name a trust as the beneficiary of all or part of his qualified plan or IRA, the standard trusts used in estate planning have to be *modified* in view of the MRD rules, otherwise, the trust named as beneficiary may not qualify for DB treatment (and *acceleration of income taxes* will result)

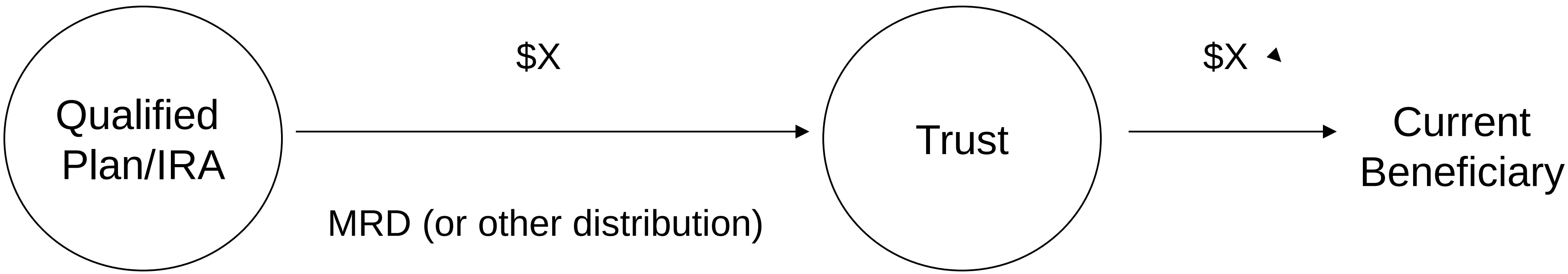
Types of Trusts in Terms of MRD Rules

- Conduit Trust: All distributions from the plan/IRA to the trust must be distributed currently out of the trust to the current beneficiary/beneficiaries
- Grantor Trust: Trust beneficiary who is treated as "grantor" has a withdrawal right over the trust assets
- Accumulation Trust: Distributions from plan/IRA to the trust can be distributed currently to current beneficiaries or accumulated (if accumulated, can be distributed later during term of trust to one or more current beneficiaries or distributed to remainder beneficiaries upon termination of the trust; may also be distributed to p.o.a. appointees)

Types of Trusts in Terms of MRD Rules, continued

- Conduit Trust: Current beneficiary is DB; remainder beneficiaries can be ignored
- Grantor Trust: Person treated as "grantor" of trust is DB; remainder beneficiaries can be ignored
- Accumulation Trust: All potential beneficiaries of plan/IRA distributions made during DB's life must be determined "up front" to determine DB qualification and identity of DB (circular—drafting must fix)

CONDUIT TRUST

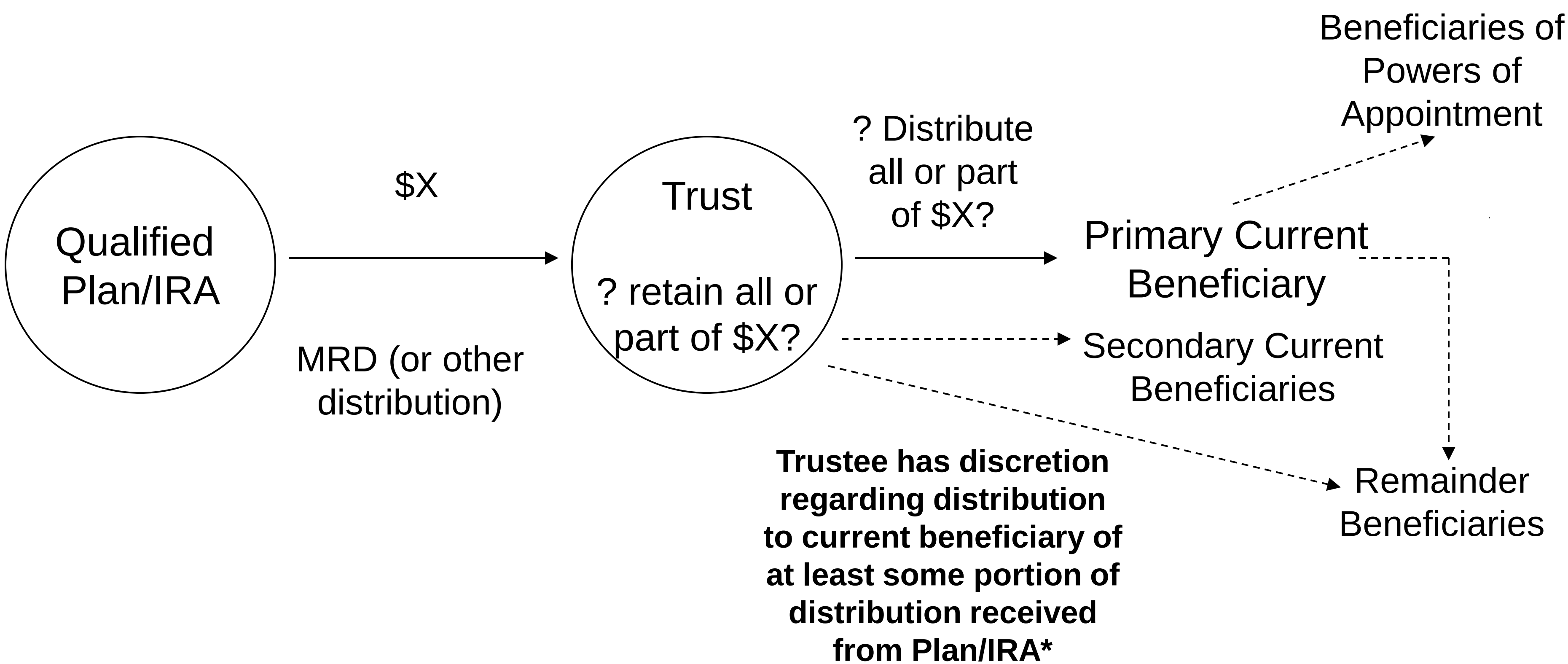


Per Trust instrument,
Trustee has no discretion:
Trustee must distribute 100% of
plan/IRA distribution ($X) out
of Trust to Current Beneficiary

Current Beneficiary = DB

(All remainder/other beneficiaries can be ignored)

ACCUMULATION TRUST



All beneficiaries who might end up with any part of distribution ($X) made during DB's life must be taken into account in determining qualification for DB treatment and who is DB

***Distribution from Plan/IRA ($X) might be all income or part income/part principal or all principal for trust accounting purposes

Identifying All Trust Beneficiaries: Conduit Trust

Since all distributions made from P's plan/IRA after P's death to conduit trust must be distributed by Trustee of conduit trust to current beneficiary of trust, current beneficiary is sole DB and remainder beneficiaries of trust can be ignored (they are "mere successor potential beneficiaries")

Identifying All Trust Beneficiaries: Grantor Trust

- No specific authority in Treasury Regulations for grantor trust as recipient of plan/IRA, but many PLRs
- If beneficiary of trust has power to withdraw trust assets=grantor trust
- Because grantor can withdraw all trust assets, grantor is sole beneficiary of P's plan/IRA allocated to the grantor trust

Tricky Requirement for Accumulation Trusts: Identify all beneficiaries who have a potential interest in P’s plan/IRA

- All trusts have at least 2 beneficiaries: a current beneficiary and a remainder beneficiary
- Many trusts have multiple current beneficiaries and multiple remainder beneficiaries
- Some trusts also have potential beneficiaries of powers of appointment
- Must identify all potential beneficiaries of any distributions made from the plan/IRA during the life of the “measuring beneficiary” (i.e., *the* DB)
- But, who is the DB? (circular)

Identifying All Trust Beneficiaries: Accumulation Trust

When an <u>Accumulation Trust</u> receives a distribution from P's plan/IRA, since the full amount received by the Trustee does not have to be currently distributed out of the trust to the current beneficiary, all potential recipients of those *accumulated* plan/IRA benefits must be taken into account to determine (i) if all possible beneficiaries of the accumulated benefits qualify as DBs, and (ii) if so, which one out of all of those multiple DBs is the oldest (since the oldest DB is the particular DB whose life expectancy must be used to calculate MRDs to the trust each year)

Powers of Appointment

- General Powers of Appointment: No beneficiary of intended DB trust should have a general power of appointment because the potential appointees of the power are not identifiable up front and some may be entities
- Limited Powers of Appointment: Can be used if carefully drafted--should be exercisable only in favor of identifiable human beings (no charities or other entities) who are younger than the intended DB

Powers of Appointment, cont.

Q: What if the donee of the power of appointment can appoint “in further trust”?

1. Would that *further trust* be considered irrevocable as of P’s date of death?

2. What type of trust documentation for that *future* appointed trust can be delivered to the Plan Administrator by October 31 of the year following the year of P’s death?

Idea: Perhaps the power to appoint in further trust should be limited to other trusts already created in the same instrument creating the intended DB trust

Special Drafting of Recipient Trust

- For any trust that is intended to receive all or part of P’s plan/IRA upon P’s death, **special drafting** is required
- Conduit trust is easier to draft than accumulation trust, but has some disadvantages
- Accumulation trust drafting can be difficult and “circular” (also: conflict between income tax rules and desired disposition)

Separate Account Treatment

- Separate Accounts/Segregated Shares must be created by December 31 of year following year of P’s death
- Not just an accounting concept—need actual separation into separate accounts by due date
- Must be done **pro rata**
- Post-death gains, losses, distributions, etc. must be taken into account
- Wording used on beneficiary designation form can **preclude** separate account treatment

Separate Account Treatment, cont.

- Separate account treatment means that MRDs to **the** DB will be based on **the** DB's life expectancy (and not on another possible DB's life expectancy)
- IRS rule: To obtain separate account treatment, the separation into shares *must occur in the beneficiary designation form itself*, and not due to provisions in the Will or Trust or due to decisions made by the Trustee

Separate Account Treatment, cont.

- If beneficiary designation form says: “To the Trustee in P’s Will”, the separation of P’s plan benefits among the beneficiaries in P’s Will is NOT occurring in the beneficiary designation form itself (it is occurring in the Will)—therefore, no separate account treatment
- But, if the beneficiary designation form says: 50% to Trust A and 50% to Trust B, whether true separate account treatment is available depends on the terms of trust and actual facts

Separate Account Treatment, cont.

- If plan/IRA beneficiary designation form itself names multiple **conduit** trusts, each receiving a specified percentage, and separate accounts are timely created, MRDs to each conduit trust will be based on the life expectancy of **the** DB of the particular conduit trust
- If the beneficiaries are multiple **accumulation** trusts, even if the separation of shares occurs in the beneficiary designation form itself, true separate account treatment may not be available, depending on trust terms and facts*

Separate Account Treatment, cont.

- When multiple *lifetime accumulation trusts for children and issue* are beneficiaries, those trusts will usually be drafted to include the siblings of the primary trust beneficiary as remainder beneficiaries if the primary beneficiary dies without issue
- If a trust beneficiary has no issue on the DB Determination Date, then it doesn't matter if the separation of shares occurs in the beneficiary designation form itself because the beneficiary's siblings are "countable" beneficiaries of his trust
- Thus, oldest child is the DB for all children's trusts in a case like this (see examples on next slides)

Separate Account Problem with Trusts: Example 1: Accumulation Contingent Trust

- Beneficiary Designation Form itself says: equal shares to P’s 3 children, subject to an age 35 Contingent Trust created in P’s Will
- At time of P’s death, Child A is 37, Child B is 36 and Child C is 34—Child C has no children as of DB Determ. Date
- Per numerous PLRs, Child A and Child B, as remainder beneficiaries of Child C’s Contingent Trust, are “countable” beneficiaries because plan/IRA distributions can be *accumulated* in Child C’s trust and, thus, may end up being distributed to Child A and Child B if Child C dies before reaching age 35 without issue
- **Result**: Child A is the DB of Child C’s Contingent Trust

Separate Account Problem with Trusts

Example 2: Lifetime Accumulation Trusts for Descendants

See next slide

Beneficiary Designation Form:

1/3 to Child's Trust for Ann

1/3 to Child's Trust for Ben

1/3 to Child's Trust for Carl

(Note: same result if form had named "Trustee in Will" as beneficiary)

Terms of Each Child's Trust:

- Accumulation Trust
- Child is primary beneficiary for life (Child's descendants, if any, are secondary beneficiaries)
- On Child's death, remainder to Child's descendants, per stirpes, if any, otherwise to Child's then living siblings, in equal shares (etc.), *with all distributions subject to same lifetime trust provisions*

Result: each child is a "countable" beneficiary of each other Child's Trust and, therefore, oldest child who survives P is the DB for all*

Natalie Choate’s Accumulation Trust “Testing Rule”

When testing an accumulation trust to determine if all trust beneficiaries are human beings and, if so, which trust beneficiary (or potential trust beneficiary) is the oldest, you can stop at the point where the trust assets will definitely be distributed outright and free of trust to a human being. All beneficiaries after that are “mere successor beneficiaries.” Please note: the “life expectancy theory” is dead!

Income Tax Problems/Issues

- If trust does not qualify for DB treatment, result is acceleration of MRDs: 5 year rule if P dies before RBD *or* P's remaining single life expectancy (not recalculated) if P dies after RBD
- If transfer an inherited plan/IRA to a different (maybe "better") beneficiary than the named beneficiary, risk immediate acceleration of *all* income taxes due to IRC Section 691(a)(2)

Income Tax-Estate Tax Tradeoff

If allocate plan/IRA to a Bypass Trust to avoid estate taxes when surviving spouse dies on amounts remaining in plan/IRA (and, if trust is an accumulation trust, on MRD accumulations in trust), even if trust qualifies as a see-through trust, MRDs after surviving spouse's death must continue based on spouse's single life expectancy—**no "stretch IRA" for children***

Two Options for dealing with Estate Tax-Income Tax Tradeoff

- Portability: now permanent per American Taxpayer Relief Act of 2012 (passed in January 2013)
- Non pro rata distribution with funded joint revocable trust to which plan/IRA passes at death due to spouse's disclaimer

Use of Joint Revocable Trust to Facilitate Non Pro Rata Distribution

Assets of Jack and Helen Johnson (all community property)

Home (no mortgage)	$500,000
Joint Money Market Act	$50,000
Joint Investment Acct	$2,000,000
IRA in Husband's name	$2,000,000
Household furnishings, Personal effects, etc.	$100,000
TOTAL	$4,650,000

Assumptions and Pre-Death Planning

- No prior marriages (i.e., mutual children)
- All assets, including husband's IRA rollover, are community property
- Joint revocable trust creates a Bypass Trust on death of first spouse
- Joint investment account (at least) is titled in name of joint revocable trust before death of first spouse (this is better way to do this versus waiting until first spouse’s death)

Assumptions and Pre-Death Planning, continued

- Trust instrument specifically gives Trustee power to make non pro rata distributions*
- IRA beneficiary designation is set up with wife as primary beneficiary and, if she disclaims husband’s community interest in IRA, that interest will pass to Trustee of the joint revocable trust due to disclaimer/contingent beneficiary wording in beneficiary designation form

Assume Husband Dies First: Post-Death Steps—1st Case

If joint revocable trust *is* 100% primary beneficiary of husband's IRA, Trustee "distributes" (i.e., allocates) *all* of IRA to wife and distributes *all* of investment account to Bypass Trust in a non pro rata distribution (in this example, husband's CP ½ interest in IRA is equal to wife's CP ½ interest in investment account)

Assume Husband Dies First: Post-Death Steps—2nd Case

- If joint revocable trust is *not* primary beneficiary of husband’s IRA, then wife disclaims husband's CP ½ interest in IRA, with result that disclaimed IRA interest “passes to” Trustee of joint revocable trust per beneficiary designation form (retaining its character as husband’s CP ½ interest in IRA)
- Per specific authority in trust instrument, Trustee distributes husband’s CP ½ interest in IRA to wife (wife already owns her ½ of IRA) and distributes wife’s CP ½ interest in investment account to Bypass Trust (Bypass Trust already entitled to husband’s ½ of investment account)*

Assume Husband Dies First: Post-Death Steps, continued

- Wife does spousal IRA rollover of *entire* IRA
  - Better income tax result for wife during life
  - Much better income tax result for children on wife’s death (“stretch IRA”)
- Bypass Trust is funded with after-tax assets that just got a step up in basis
- More assets, overall, are protected from creditors’ claims
- Trustee should not do this if wife objects (even if Trustee has the power to do it)

Assume Husband Dies First: Post-Death Steps, continued

- Trustee should <u>document</u> the non pro rata distribution—i.e., prepare a written document summarizing the transaction (it's part of post-death trust funding)
- Income Tax Issues:
  - Is this a taxable sale or exchange for federal income tax purposes?
  - Does this accelerate the income taxes with respect to the IRA per Section 691(a)(2)?

Supportive Rulings: No Adverse Income Tax Consequences

- PLR 8037124 (June 23, 1980)
- PLR 8016050 (January 23, 1980)
- PLR 9422052 (March 9, 1994)
- PLR 199912040 (March 29, 1999)
- PLR 199925033 (June 28, 1999)
- PLR 200621020 (May 26, 2006)
- PLR 200950053 (December 11, 2009)
- PLR 200935045 (August 28, 2009)

Non-Trust Option: Portability

Per ATRA, portability is now permanent: instead of allocating plan/IRA to a qualified see-through Bypass Trust (or making a non pro rata distribution), consider using portability and having spouse do spousal IRA rollover

- Preserves decedent's estate tax exemption for interest in plan/IRA
- Better income tax result for spouse during life
- Preserves "stretch IRA" for children when spouse dies

Portability Issues

- Expires at midnight on December 31, 2012
- Additional post-death expense to prepare and file a Form 706 for estate with a value under the filing requirement (many clients don't want to do it*)
- If surviving spouse remarries, estate tax exemption amount transported to surviving spouse can be lost if new spouse also predeceases P's surviving spouse
- No remarriage protection for P's IRA

Minor Beneficiaries

- At minimum: name a custodian for minor child under TUTMA
- Better: name testamentary trust for minor child as beneficiary (but trust for child must be a "qualified see-through trust")
- Recurring problem: People name someone "as Trustee for" minor child when there is no actual trust (e.g., "Mary Smith as Trustee for Ann Jones, a minor")

867 Trusts

- If minor is named as beneficiary of plan/IRA, legal guardian appointed for minor can take MRDs based on minor's life expectancy (DB treatment is clear)
- Can a Section 867 Trust be created to be recipient of plan/IRA where minor child is named as beneficiary of plan/IRA? If so, is that a transfer that accelerates the income taxes? No cases involving 867 Trusts, per se, but *see* PLR 200826008 (good SNT ruling)

867 Trusts, continued

Issues:

- Does the “deemed transfer” from the minor beneficiary to the Trustee of the 867 Trust cause income tax acceleration per Section 691(a)(2)?
- Should the 867 Trust be custom drafted in order to be a “qualified see-through trust”?
- If the inherited plan/IRA passes to a *standard* 867 Trust, can MRDs be taken based on the minor child’s life expectancy?

PLR 200620025
(SNT created for disabled child after P’s death)

- P died before RBD, naming his 4 sons as equal beneficiaries of his IRA
- One son, “B”, was disabled and receiving government benefits
- Guardian of disabled son petitioned state court for creation of standard SNT for B
- Court created standard SNT for B, with guardian as trustee

PLR 200620025, continued

- On B's death, amounts remaining in SNT up to total benefits received by B during life payable to state Medicaid department and balance payable to B's "heirs"
- Guardian disclaimed any interest in trust as an heir of B under state law
- Guardian wants to transfer B's ¼ of P's IRA to SNT created by court for B

PLR 200620025, continued

Tax Issues:

- Will “transfer” of B’s share of P’s IRA to SNT be a transfer under Code Section 691(a)(2) (which would accelerate <u>all</u> the income taxes)?
- Will the transaction be a deemed *distribution* of the entire IRA to B, followed by B contributing the IRA proceeds to the SNT, which would make the entire amount taxable income to B in one year?
- Can MRDs from the IRA payable to B’s SNT be calculated using B’s life expectancy instead of the 5 year rule (since standard SNT created by court is not a qualified see-through trust per Regs)?

PLR 200620025, continued

Favorable rulings:

- SNT is a grantor trust and ∴ no sale or disposition under Section 691(a)(2) when B's share of P's IRA transferred to inherited IRA fbo B's SNT
- (Not treated as a distribution to B of entire IRA)
- In this case, B was named as beneficiary as of P's date of death and separate accounts were created, so distributions from inherited IRA to SNT (a grantor trust as to B) can be based on B's life expectancy

What does PLR 200620025 mean?

- Does it mean that it's not necessary to draft an SNT that will receive a plan/IRA as a "qualified see-through trust"?
- Does this ruling answer the question about 867 Trusts? What about PLR 200826008?
- A PLR can only be relied on by the taxpayer who obtained it
- Better practice: All trusts that will be beneficiaries of plans/IRAs should be drafted as "qualified see-through trusts"

Special Needs Trusts

- SNT that will receive a share of P’s plan/IRA should not be a “standard” SNT
- SNT should usually *not* be in the form of a Conduit Trust (because MRDs have to be distributed out of a conduit SNT to the special needs beneficiary)—better to use an SNT that is an Accumulation Trust
- Consider Using a Roth IRA SNT Accumulation Trust for disabled beneficiary

Charitable Planning Issues

- Qualified Plans and IRAs: great assets to leave to charity at death (no income taxes and no estate taxes)
- But, charity is not a “designated beneficiary”
- If *entire* plan/IRA passes to charity, so what?
- If only a portion of plan/IRA to charity, draft beneficiary designation so that charity can easily be cashed out in full by “DB Determination date,” leaving human beings*

Charitable Planning Issues, continued

- Do not name "estate" as beneficiary and then make charitable gifts in Will—name charities directly in beneficiary designation form
- In some cases like that, a few PLRs allow Estate to *assign* IRAs to charities that are residuary Will beneficiaries, without accelerating income taxes per Section 691(c)(2) (this won't work if charity is receiving a specific bequest in Will)

Creditor Protection Issues

- Qualified plans are protected from attachment by ERISA
- IRAs are protected from attachment per Texas Property Code Section 42.0021*
- <u>Issue</u>: Is there a difference between a participant-owned IRA and an inherited IRA for federal bankruptcy purposes?
- If there is, IRA can be left to a spendthrift trust for beneficiary (designed as a "qualified see-through trust")

Bankruptcy Rulings: Inherited IRAs

Exempt

- Nessa (MN)
- McClelland (ID)
- Kutcha (OH)
- Tabor (PA)
- Thiem (AZ)
- Weilhammer (SD)
- Stephenson (MI)
- Chilton (TX)

Not Exempt

- Navarre (AL)
- Sims (OK)
- Jarboe (TX)
- Greenfield (CA)
- Ard (FL)
- Clark (WI)
- Klipsch (IN)

Ex-Spouse is Still Beneficiary Post-Divorce: **“Plan Documents Rule”**

- *Kennedy* case (US S Ct 2009)
- Divorce—no QDRO
- State law waiver of retirement benefits
- P dies with ex-wife still named as beneficiary of plan
- Plan administrator MUST pay plan benefits to ex-wife as named beneficiary

- *Kensinger* case (3rd Circuit 2012)--same facts as Kennedy
- Per **Plan Documents Rule**, on P’s death, administrator MUST pay P’s benefits to ex-wife as named beneficiary
- **BUT** P’s estate may sue ex-wife in state court to enforce waiver and recover benefits *after* distributed out of plan

Post-Divorce Cases: Conflict between Texas law and Federal law: Federal law wins

Assume no QDRO and no post-divorce change of beneficiary:

- Texas Family Code Sections 9.301 and 9.302, attempting to negate pre-divorce beneficiary designation in favor of ex-spouse and imposing liability on company for paying death benefits to ex-spouse, **not valid** as to federally qualified benefits per *Kennedy* case (US Supreme Court case that established the "plan documents rule")
- *After* the qualified benefits are paid to ex-spouse, decedent's estate may sue ex-spouse to recover benefits based on written waiver in divorce and/or Family Code provisions *if* theory in *Kensinger* case held to apply in Texas (likely b/c of Fam. Code)

Pension Protection Act

- Problem before PPA: Many qualified plans *require* a lump sum distribution to P's non-spouse beneficiary on P's death (or require a more rapid distribution than allowed under the federal minimum distribution rules)
- PPA Fix: By creating an "inherited IRA" via a direct rollover (i.e., trustee to trustee transfer) from P's qualified plan, P's DB will be able to use a life expectancy distribution under the MRD rules

Trust or Estate named as Beneficiary But Surviving Spouse Desires Spousal IRA Rollover

There are numerous rulings that allow the spouse to make a spousal IRA rollover in the case where the Plan or IRA is payable to a trust or the estate—usually, spouse must be sole fiduciary and beneficiary and must have power to allocate plan/IRA to herself

Roth IRA Conversion

- As of 1/1/2010, no longer a modified AGI limit to convert a traditional IRA (and certain qualified plans) to a Roth IRA
- This may be a good year to do a Roth conversion because of 35% top income tax rate (rates likely to go up in the future)
- Have a long time to "recharacterize" (undo) a Roth conversion if it doesn't work out (October 15th of the year following the year of the conversion)—i.e., can use hindsight

Roth IRAs

- Neither P nor P's spouse have to take MRDs from Roth IRA during life
- A Roth IRA in which decedent owned an interest at death (whether P or NPS) is included in decedent's estate for federal estate tax purposes (but has a lower value compared to traditional IRA)
- Easier to do estate planning with Roth IRA versus traditional IRA

Roth IRAs, continued

- “Qualified Distributions” from a Roth IRA are income tax free
- To be a “Qualified Distribution,” Two Tests must be met:
  - 5 Year Test
  - Type of Distribution Test
- For more info, see Exhibit 18 attached to outline

THE END

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THE IRS: A FORMER INSIDER'S VIEW OF HOW IT IS ORGANIZED AND HOW IT WORKS

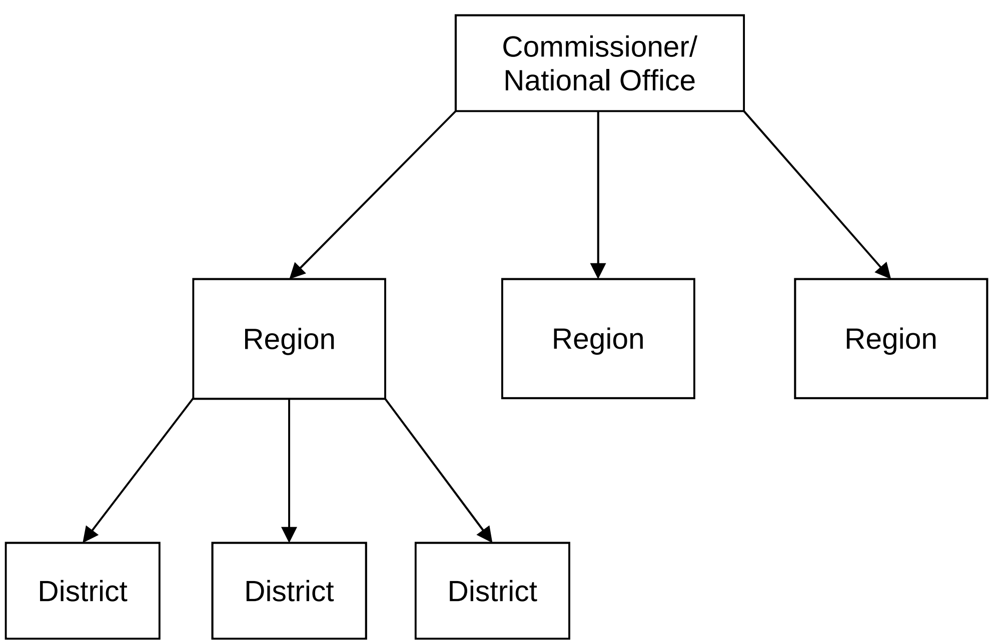
Richard L. Hunn

February 28, 2014

Organization

A. **Historical Organization:**

1. IRS was historically organized on a 3-tier, geographic structure:



See attached organization map.

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2. Historically organized on a functional basis within National Office, Regions and Districts (National Office has additional functions):

Examination Division (“Exam”)	Collection Division (“Collection”)	Criminal Investigation Division (“CID”)

3. **IRS Chief Counsel**: Followed the same geographic model, but Counsel attorneys provided advice and services across the three major functions.

4. **IRS Appeals**: The IRS Office of Appeals has at times been part of IRS Chief Counsel and at other times has been part of the Commissioner’s organization. Appeals also was historically organized on a geographic model. Typically, Appeals’ mission was focused on resolving non-docketed examinations and cases docketed in United States Tax Court.

5. **Service Centers**: Historically, there was a Service Center for each Region. Within the Service Center, in addition to tax return processing functions (the “pipeline”), there was an Examination, Collection and Criminal Investigation function.

6. **Disclosure**: Historically, there was a Disclosure Office in the IRS National Office, and a District Disclosure Officer for each district.

7. **Taxpayer Ombudsman/Problem Resolution**: A national Taxpayer Ombudsman had the authority to issue a Taxpayer Assistance Order if a taxpayer was suffering or about to suffer a significant hardship (which was not defined by statute). The Taxpayer Ombudsman was not independent of the Commissioner and did not have line authority over Problem Resolution Officers in the region and district offices. Local Problem Resolution Officers did not have authority to issue Taxpayer Assistance Orders.

B. **IRS Restructuring and Reform Act of 1998**

1. **Section 1001:**

“The Commissioner of Internal Revenue shall develop and implement a plan to reorganize the Internal Revenue Service. The plan shall . . .

. . . eliminate or substantially modify the existing organization of the Internal Revenue Service which is based on a national, regional, and district structure;

. . . establish organizational units serving particular groups of taxpayers with similar needs:

. . . ensure an independent appeals function . . .”

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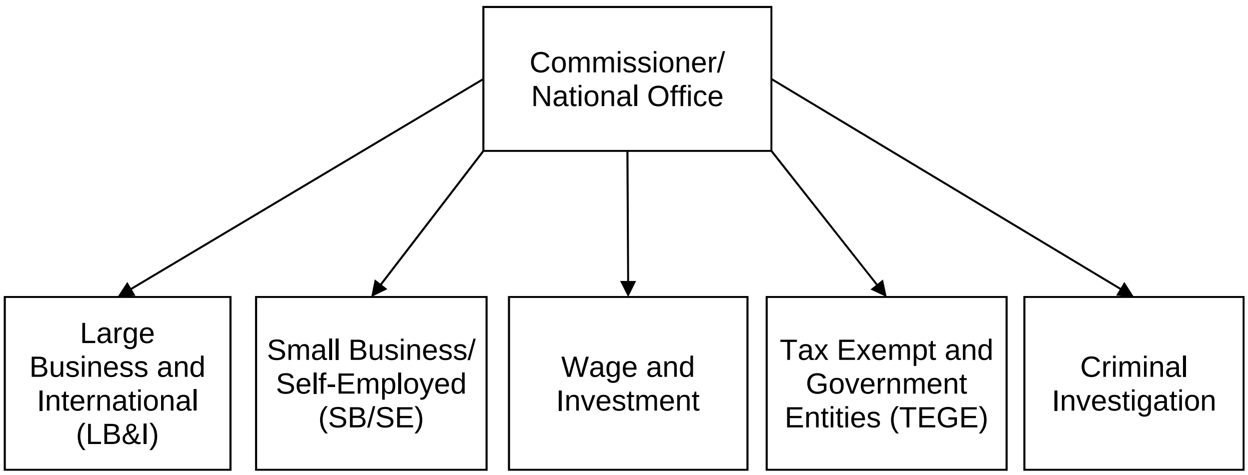
2. **Section 1102 (and Code Sections 7803 and 7811)**: Established a National Taxpayer Advocate, with direct line authority over Local Taxpayer Advocates. The National Taxpayer Advocate can issue a Taxpayer Assistance Order. Provided expanded definition of significant hardship (justifying a Taxpayer Assistance Order) to include an immediate threat of an adverse action; a delay of more than 30 days in resolving a problem; incurring of significant costs if relief is not granted; and irreparable injury, or long-term adverse impact, if relief is not granted.

C. **Current Organization:** Commissioner/National Office & Divisions:



See attached organization chart for more detail.

1. **IRS Chief Counsel**: Generally reorganized along the same functional lines as the Commissioner. Chief Counsel attorneys are no longer multi-functional. Attorneys are assigned to (a) LB&I; (b) SB/SE/Wage and Investment; or (c) Criminal Investigation. LB&I is essentially large-case and examination-function oriented. Collection-related matters are handled by Counsel attorneys in SB/SE/Wage and Investment, as are tax litigation cases involving wage earners, self-employed individuals and small businesses.

2. **IRS Appeals**: The Restructuring and Reform Act added appeal rights for taxpayers with respect to collection-related matters. Taxpayers may now file a Request for a Collection Due Process Hearing in response to (a) an IRS notice of filing of a notice of federal tax lien, or (b) an IRS notice of final intent to levy. Taxpayers have the right to appeal an Appeals Officer's determination to the U.S. Tax Court. Additionally, if a taxpayer misses the opportunity for a formal Collection Due Process Appeal, he or she may request Appeals consideration of collection actions via a request for an Equivalent Hearing, or, for certain collection matters, under the Collection Appeals Program ("CAP"). In those two instances, there is no right of appeal to a court. Appeals also retains its authority to consider appeals of non-docketed examinations and docketed Tax Court cases.

3. **Functions**: Criminal Investigation continues as a separate function. While Examination and Collection were theoretically to merge, that has not occurred in practice. Collection continues to function separately within separate groups within SB/SE.

4. **Service Centers**: Service Centers are now generally part of the Wage and Investment Division, except for some compliance functions that are within SB/SE. Processing of returns is no longer divided on a strictly territorial basis, but some Service Centers process returns based on the type of taxpayer. The IRS in the last few years has started calling the Service Centers "Campuses."

5. **Disclosure**: There is still a Disclosure Office in the IRS National Office, and there are still Disclosure Officers in each of the former districts. However, FOIA requests generally are now filed in one of several centralized locations (pursuant to IRS instructions in regulations and instructions), and then sent out to a Disclosure Officer, generally in or near the city where most or all of the records in question are located, for handling.

6. **Taxpayer Advocate**: National Taxpayer Advocate can issue Taxpayer Assistance Orders and has direct line authority over Local Taxpayer Advocates. A Taxpayer Assistance Order can require the relevant IRS function to release a levy, to refrain from taking actions, to take actions, or to require that review or reconsideration be taken at a higher level within the IRS. The Taxpayer Advocate cannot use the Taxpayer Assistance Order to make substantive determinations in place of the IRS, but it can make recommendations.

The Cast of Characters

A. **Examination:**

1. **The Office Auditor**: Low-grade Exam employee; handles office audits. May not have completed a college degree.

2. **The Revenue Agent**: Higher-grade Exam employee with accounting degree; conducts field audits. Examinations in larger corporate cases are often on-site at the corporation's offices; examinations for the largest corporations are continuous, in two- or three-year audit cycles (historically known as the Coordinated Examination Program, now known as the Coordinated Industry Case program).

3. **The International Examiner**: The "IE" is a revenue agent with training and experience in international issues; IE's are assigned to IE groups, but often work on examination teams in conjunction with revenue agents, and sometime also engineers and economists.

4. **The Engineer**: IRS engineers are assigned to engineer groups, and then obtain work assignments to assist revenue agents or Chief Counsel attorneys on engineering/valuation issues in their cases. Typically IRS engineers are lateral

hires from industry, often the petroleum industry. Most have petroleum engineering degrees, but some have mechanical or other engineering degrees.

5. **The Economist**: Exam employee with economics degree. Typically are assigned to economist groups and then obtain work assignments to assist revenue agents or Chief Counsel attorneys on cases.

6. **The Attorney Examiner**: This is an attorney who conducts estate and gift tax examinations. They are not in Chief Counsel, but instead are in the SB/SE Division.

7. All of the above can issue Information Document Requests to obtain information; summonses are typically issued by revenue agents and IEs.

B. **Collection: The Revenue Officer:** Assigned to revenue officer groups and handle collection of outstanding assessed, unpaid accounts; can issue summonses to obtain financial and other information in aid of collection. Typically has a college degree, but not necessarily an accounting degree.

C. **Criminal Investigation: The Special Agent:** Assigned to special agent groups within the Criminal Investigation Division. Investigates tax crimes under Title 26, as well as related criminal violations under Title 18 for such things as conspiracy (18 U.S.C. § 371), money laundering (18 U.S.C. §§ 1956, 1957), false claims (18 U.S.C. §§ 286, 287), and false statements (18 U.S.C. § 1001); includes authority to seize property involved in money laundering and effectuate civil forfeiture. Minimum number of college hours, including accounting hours, required. Undergoes rigorous, extensive training, including in firearms. Can investigate cases administratively; can issue summonses if no referral to Department of Justice for criminal prosecution has occurred; can prepare and execute search warrants for evidence of criminal violations. Can also initiate or participate in grand jury investigations.

D. **The Chief Counsel Attorneys:**

1. **The Attorney** (General Attorney or Docket Attorney): These are Grade 11 to 14 attorneys in IRS field offices who are now assigned to either LB&I, SB/SE or Criminal Divisions. Attorneys in LB&I and SB/SE typically provide advice to Exam on their examinations, but much more so in LB&I. Counsel review is normally required on proposed notices of deficiency in larger cases or cases involving the civil fraud penalty. Counsel attorneys only litigate cases in the U.S. Tax Court. Refund litigation is handled by Department of Justice attorneys, but typically at the outset of the case, a Counsel attorney is assigned and writes a defense letter to DOJ outlining Counsel's views, and Counsel review and input is normally required on any proposed settlements.

2. **The Special Trial Attorney**: These senior, Grade 15 attorneys are assigned to LB&I and are assigned to litigate large cases, typically involving $10 million or more. The "STA" typically supervises a team of docket attorneys, revenue agents, and other IRS personnel (engineers, economists, etc.) who are assigned to assist him or her on a particular case.

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3. **The Senior Counsel**: These Counsel attorneys are the same grade-level as Special Trial Attorneys. They are historically derived from Special Litigation Assistants, who were senior IRS attorneys focused on advising Exam on nondocketed, large cases. However, the IRS has begun awarding Senior Counsel positions to senior IRS attorneys within the SB/SE Division.

4. **The Special Assistant United States Attorney**: The "SAUSA" is an IRS Counsel attorney that has been deputized by the U.S. Attorney's Office to handle bankruptcy cases in federal bankruptcy courts. The SAUSA plan originated in Houston and is often called the "Houston Plan." Post-reorganization, the SAUSAs ended up in SB/SE, as most of the IRS's cases that end up in bankruptcy involve individuals or small businesses.

E. **Appeals:**

1. **The Appeals Officer**: Typically an experienced, former revenue agent; the Appeals Officer's job is to settle cases. They typically handle Protests from 30-day letters that are issued at the end of an examination. They also typically handle cases that are docketed in U.S. Tax Court. They also handle appeals of other matters, such as appeals from denials of penalty relief and appeals from denials of refund claims.

2. **The Settlement Officer**: The 1998 IRS Restructuring and Reform Act provided taxpayers with administrative appeal rights in collection-related matters. This resulted in a significant increase in Appeals' caseload. Collection Due Process (see I.R.C. §§ 6320 & 6330) and Collection Appeals Program cases are usually handled by a special kind of Appeals Officer called a "Settlement Officer." The Settlement Officer is typically a former revenue officer.

F. **Disclosure: The Disclosure Officer** handles disclosure matters. Before an IRS employee can disclose information in response to a taxpayer request, he or she will typically consult with a Disclosure Officer. Before an IRS employee can testify in court, he or she must obtain an authorization from a Disclosure Officer.

G. **Office of the Taxpayer Advocate** (sometimes called the Taxpayer Advocate Service): A **Local Taxpayer Advocate** is assigned to a case when a taxpayer files a Form 911, Request for Taxpayer Advocate Service Assistance (And Application for Taxpayer Assistance Order). That person "jawbones" the local IRS function to do its job and resolve a problem. Sometimes that is ineffective, but a good **Local Taxpayer Advocate**, with good jawboning skills and the threat of elevation to the **National Taxpayer Advocate**, can sometimes get problems resolved.

Ethical Considerations in Dealing with Various IRS Personnel and Functions

A. **IRS Circular 230:** IRS Circular 230 (31 C.F.R., Subtitle A, Part 10) governs practice before the IRS. Circular 230, as well as various sections of the Internal Revenue Code and Treasury Regulations that establish penalties, set forth standards of conduct that apply to persons who practice before the IRS. The easiest way to obtain a copy of Circular 230 is on the IRS website.

B. **Practice Before the IRS:** Generally, all dealings with the IRS on behalf of a client are considered by the IRS to constitute practice before the IRS, including preparing and submitting tax returns and claims for refund. Circular 230, §§ 10.2(a)(4) & (5), 10.3. There is currently a court case pending in the D.C. Circuit regarding whether the IRS can impose the requirements of Circular 230, including continuing education requirements, on persons who prepare returns or claims for refund who are not attorneys, CPAs or enrolled agents. *Loving v. Internal Revenue Service*, ___ F. Supp. 2d ___, 111 A.F.T.R. 2d 589, 2013-1 U.S.T.C. ¶ 50,156 (D.D.C. 2013); ___ F. Supp. 2d ___, 111 A.F.T.R. 2d 702, 2013-1 U.S.T.C. ¶ 50,171 (D.D.C. 2013); 111 A.F.T.R. 2d 1384 (D.C. Cir. 2013).

C. **Form 2848:** In order to represent a client before the IRS personnel and functions described above, one generally must file with the IRS a Form 2848, Power of Attorney and Declaration of Representative. Once on file with the IRS, data from Forms 2848 are maintained on a computer database known as the Centralized Authorization File or "CAF." There is a unit at certain IRS Service Centers called the "CAF Unit" that enters and maintains the data.

D. **Preparer Tax Identification Number:** In order to prepare and file tax returns and claims for refund, one must register with the IRS and obtain a Preparer Tax Identification Number or "PTIN." Circular 230 § 10.8(a). The PTIN must be renewed annually.

E. **Continuing Education Requirements:** The IRS attempted to impose continuing education requirements on all tax return preparers. Whether it can do so with respect to return preparers who are not attorneys, CPAs or enrolled agents is in litigation in the *Loving* case. Attorneys and CPAs are exempted by the IRS from continuing education requirements, because each are already subject to continuing education requirements in connection with having their professional licenses.

F. **Standards of Conduct:** Circular 230 (including by cross-reference to certain sections of the Internal Revenue Code and Treasury Regulations) provides standards of conduct for representing taxpayers before the IRS, including standards for different types of written advice, for preparation of tax returns and claims for refund, for conflicts of interest, and for due diligence and conduct before the IRS. *See* Circular 230, Subpart B. Failure to comply with these standards can result in the imposition of sanctions and penalties. *See* Circular 230, Subpart C. Before representing clients on federal tax matters, it is important to review Circular 230.

The IRS's "Internal" Sources of Guidance/Information

A. **The Internal Revenue Manual:** Oft-consulted parts include:

1. Part 4, Examining Process

2. Part 5, Collecting Process

3. Part 8, Appeals

4. Part 9, Criminal Investigation

5. Parts 30 through 39, which have commonly been referred to as the "Chief Counsel Directives Manual" or "CCDM."

B. **Integrated Data Retrieval System ("IDRS"):** IDRS consists of the IRS's multi-faceted, linked computer system. IDRS operates on a two-week cycle – i.e., every two weeks the system is updated to capture and reflect new entries that have been input onto the system by IRS personnel. Various reports and printouts can be generated from IDRS, most of which are internal to the IRS.

1. **IRS Processing Codes and Information (formerly titled "ADP and IDRS Information," commonly called the "ADP Code Book")**: This is an IRS-published reference book that contains definitions for the various transaction codes, status codes, and other codes that are utilized in IDRS. It is published annually, with few revisions from year to year. It is intended for internal use, but redacted editions have been made available to the public. The 2011, 2012 and 2013 editions now appear in the Electronic Reading Room on the IRS website at http://www.irs.gov/uac/Document-6209---ADP-and-IDRS-Information.

2. **Major Files on IDRS**:

   a. Individual Master File ("IMF")

   b. Business Master File ("BMF")

3. **Within IMF and BMF** are entity modules containing information on each taxpayer, and tax modules, each containing information on a particular tax return/tax period with respect to a particular taxpayer**.**

4. **IDRS Transcripts**: Various types of transcripts can be generated and printed off of IDRS. Three major ones are:

   a. **Account Transcript:** This is a plain-English transcript that can be ordered from the IRS Practitioner Priority Service at the toll-free number (866) 860-4259. It reflects information on the account for a particular taxpayer for a particular taxable period, such as the account balance, the date of return filing, assessments of tax, penalties and interest, payments and credits, and amounts abated or refunded.

   b. **TXMOD:** This is an internal-use IRS transcript reflecting information for a particular taxpayer for a particular taxable period. It is not in plain English, and is full of transaction, status and other codes. You need the ADP Code Book to be able to read a TXMOD; especially useful is Chapter 8 of the ADP Code Book, defining the various transaction codes. A TXMOD typically contains more information than a plain-English account transcript. It is useful if you are looking for pending transactions that have not yet posted to the system, or for certain codes, such as freeze codes, that the IRS deems too sensitive to reveal on plain-English account transcripts. You may or may not be able to obtain a TXMOD

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from the Practitioner Priority Service, depending on who you reach when you call.

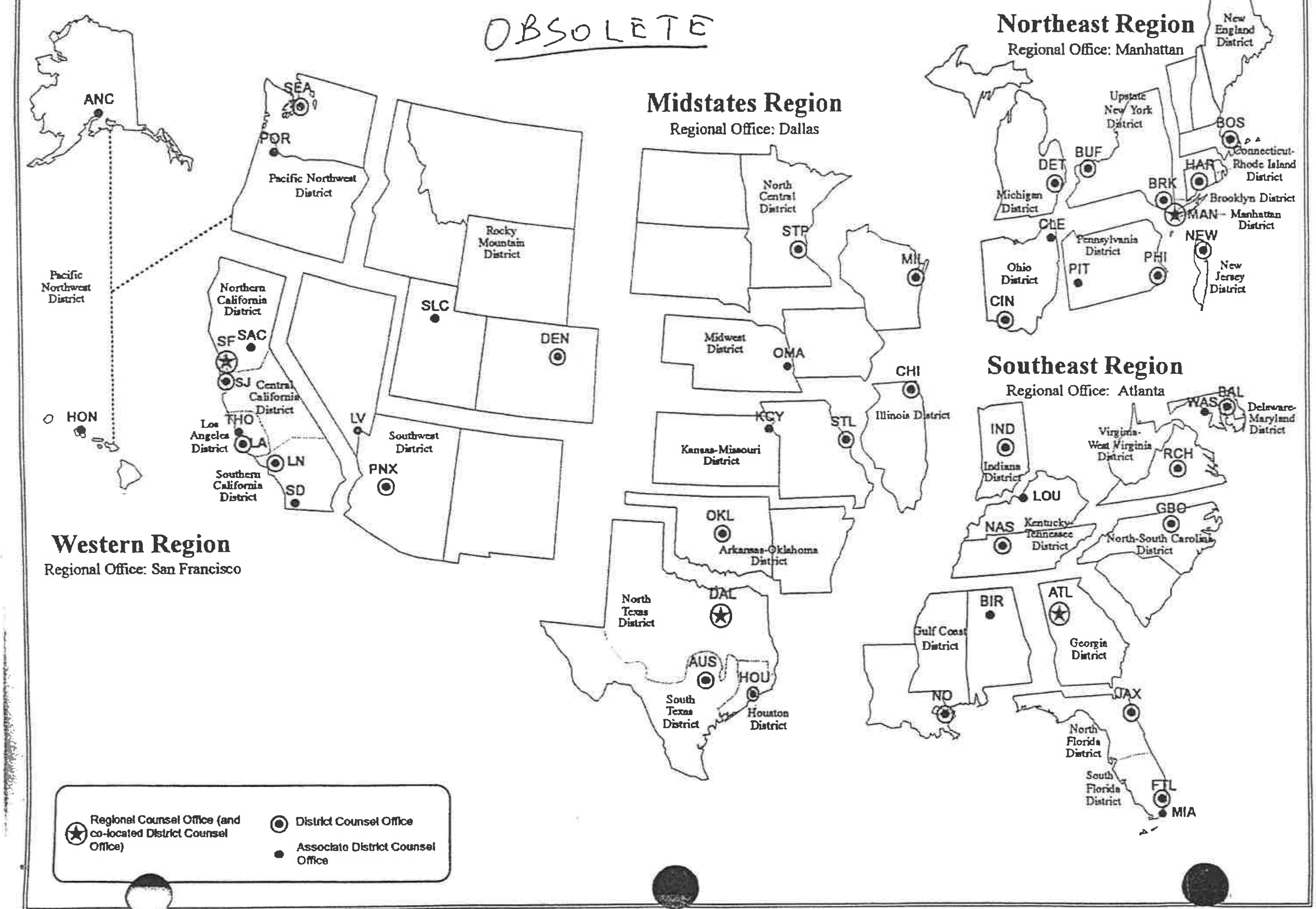
c. **ENMOD:** Reflects identifying information for the taxpayer – e.g., name, taxpayer identification number (SSN or EIN), address.

C. **TLCATS**: IRS Chief Counsel has a computerized case-tracking system called TLCATS that tracks tax litigation cases throughout the country.

D. **Chief Counsel Advice**: This is advice provided by Chief Counsel to attorneys, agents, Service Centers, etc. under a variety of different names. By statute, Chief Counsel is supposed to redact taxpayer information and privileged information and release copies of Chief Counsel Advice; when released, it typically is published by the various commercial tax law databases.

Office of Chief Counsel Field Organization

OBSOLETE



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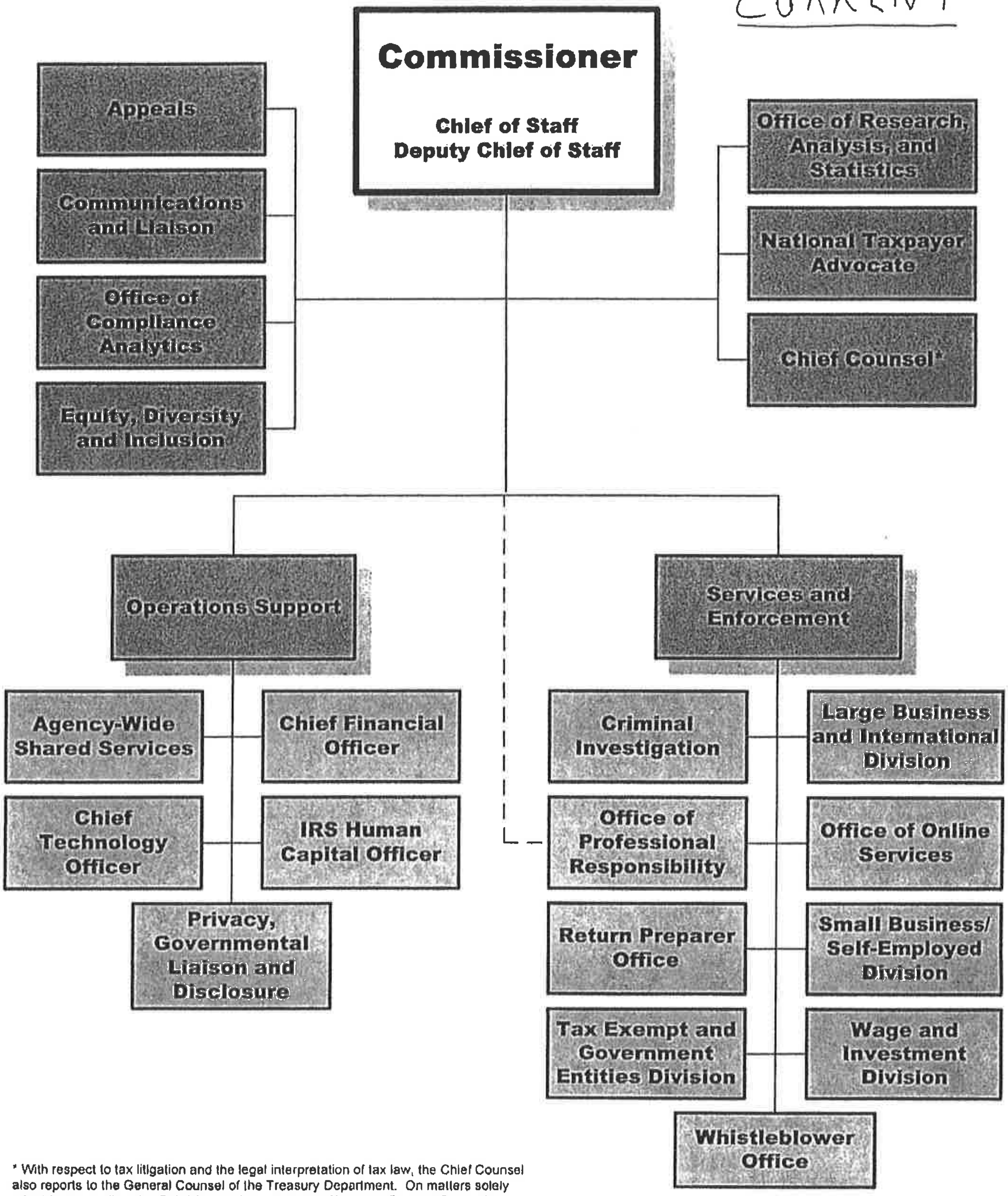
U.S. DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

CURRENT



* With respect to tax litigation and the legal interpretation of tax law, the Chief Counsel also reports to the General Counsel of the Treasury Department. On matters solely related to tax policy, the Chief Counsel reports to the Treasury General Counsel.

Baker & McKenzie

Tax Issues In International Joint Ventures

16th ANNUAL INTERNATIONAL TAX SYMPOSIUM
NOVEMBER 7, 2013
Houston, Texas

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Agenda

- Selection of a joint venture structure and jurisdiction
- Qualification for treaty benefits
- Permanent establishment risks
- Transfer pricing
- Indirect transfer taxes
- Creditability of foreign taxes

Joint Venture Structure

Entity Classification

– There are numerous ways to structure an international joint venture ("JV")
  - Purely contractual (e.g., joint venture agreement, revenue sharing agreement, etc.)
  - Jointly owned entity (e.g., corporation, partnership, etc.)
  - Jointly owned hybrid entity (e.g., partnership for US purposes, corporation for foreign purposes)

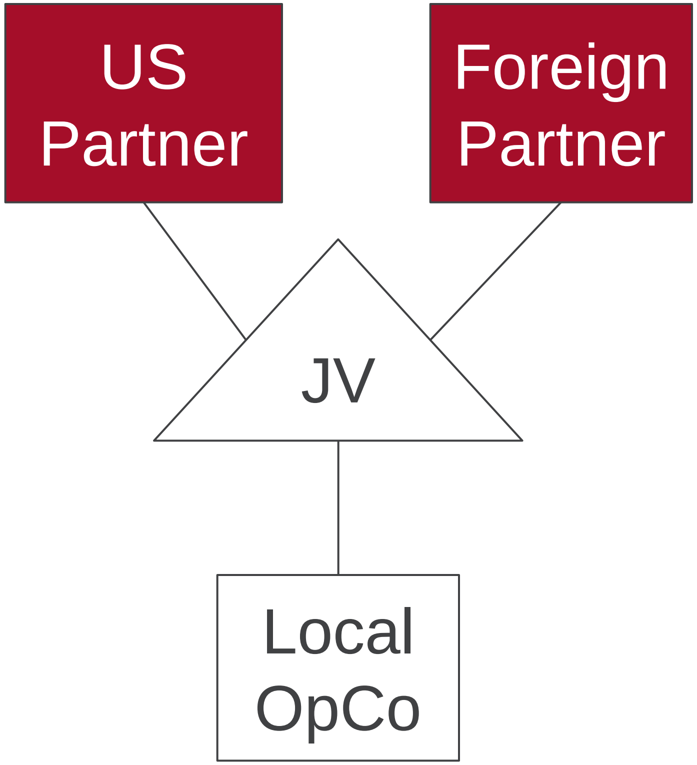
– Even if the JV is purely contractual, it may still be classified as a partnership for US tax purposes
  - Treas. Reg. § 301.7701-1(a)(2) - "A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom"
  - Code § 704(e)(1)
  - *Culbertson* Factors

Selecting an Entity Type

– Factors to consider when choosing an entity type include:
  - Types of entities available in the local jurisdiction to conduct the business of the JV
  - Liability of the JV owners
  - Applicable tax rate on income derived by the local JV entity
  - Taxes applicable to the non-local JV partners (e.g., withholding or other taxes on dividends, royalties, or payments for products or services)
  - Availability of tax treaties to reduce taxes on non-local JV partner
  - Creditability of foreign taxes paid by the local JV entity and/or JV partner
  - Ability to transfer an interest in the JV
  - Direct and indirect taxes applicable to the transfer of an interest in the JV
  - Administrative burdens (e.g., filing and reporting obligations)

Tiered Structure

– It may be desirable for the parties to form one or more joint venture entities outside of the jurisdiction in which the joint venture operates and have the local joint venture operating company be owned through those entities
  - May be corporate governance reasons and benefits
  - May limit exposure to local country taxes



US or Foreign Joint Venture

Definitions of Domestic & Foreign

Code § 7701(a)(4) - “Domestic” when applied to a partnership means created or organized in the United States or under the law of the United States or of any State unless, in the case of a partnership, the Secretary provides otherwise by regulations

Code § 7701(a)(5) - “Foreign” means a partnership which is not domestic

Treas. Reg. § 301.7701-5(a) - A partnership created or organized in both the United States and a foreign jurisdiction is a domestic partnership

Why do we care?

- Domestic partnerships file Form 1065s and foreign partnerships file Form 8865s
- Code § 6038B reporting requirements and penalties apply to transfers to foreign partnerships. The penalties include:
  - Monetary penalty equal to the lesser of:
    - 10% of the FMV of the transferred property or
    - $100,000, and
  - The transferor must recognize gain on the contribution
  - Exception for reasonable cause and no willful neglect
- Code § 1446 withholding applies to both foreign and domestic partnerships

What about unincorporated partnerships?

State Law on Partnership Formation

- Uniform Partnership Act (1997)
  - The association of two or more persons to carry on as co-owners a business for profit forms a partnership

- Texas Business Organizations Code
  - An association of two or more persons to carry on a business for profit as owners creates a partnership, unless certain exceptions apply
  - If an entity is not formed by filing a certificate of formation with the SOS or a foreign governmental authority, the law governing the entity's formation and internal affairs is the law of the entity's jurisdiction of formation
  - Jurisdiction of formation is:
    - Generally, the governing jurisdiction in the entity's governing documents or
    - The jurisdiction in which the entity has its chief executive office

Do you qualify for treaty benefits

Tax Treaty Benefits

- Several tax treaties may potentially be applicable due to the various ways transactions may occur between parties in an international JV
- Tax treaty benefits generally include, among other things:
  - Avoidance of double-taxation
  - Lower rates of withholding tax on dividends, interest, and royalties
  - Limitations on a company's taxable presence under the permanent establishment rules
- Consider whether an income tax treaty is necessary to obtain these types of benefits (e.g., does the country have a territorial tax system?)
- Availability of tax treaty benefits
  - Most US tax treaties contain a limitation on benefits article that limits the ability of third-country residents to treaty shop
  - Some countries require the company claiming treaty benefits to have substance in the company's country of residence
    - For example, a Hong Kong company must generally have substance to qualify for certain benefits under the China-HK treaty

US Model Treaty – Qualification Requirements

- Residency: a person must be a tax resident of one of the treaty countries
  - Tax resident of the US if subject to tax in the US by reason of domicile, residence, citizenship, place of management, place of incorporation, or any other similar criteria, excluding a person that is only subject to tax in the US on US source income
- Limitation on Benefits: a person must satisfy one of the LOB requirements
  - *Qualified Person*: (i) individual, (ii) publicly traded company, (iii) company owned by a publicly traded company that is resident in the same country, or (iv) company that satisfies a base erosion test and is at least 50% owned by certain qualified persons
  - *Active Trade or Business*: company is engaged in an active trade or business in its country of tax residence and the income derived from the other treaty country is derived in connection with, or is incidental to, that trade or business
- Watch out for private companies with private equity owners

Permanent Establishment Risks

Permanent Establishment Risks

- A company with a permanent establishment (“PE”) in a country will be subject to tax in that country on the profits attributable to the PE
- US Model Treaty: a company may have a PE in a country if
  - It has a fixed place of business, including an office or branch, in the country
  - It has a building site or construction or installation project in the country that lasts for more than twelve months
  - It has dependent agents in the country who act on its behalf and habitually exercise authority in the country to conclude contracts that are binding on the company
- Length of time that results in a place of business being “fixed”
  - General rule of thumb is place of business is not fixed if maintained for less than 6 months in the aggregate

Permanent Establishment Risks

- A partner in an international JV may have a PE in the country where the joint venture entity is established / operating if the partner's employees travel to and provide services in that country
- Certain steps can help limit the risk of having a PE
  - Do not have a designated office space available for, or at the disposal of, these employees for business activities
  - Limit the amount of time spent by these employees in the foreign country to less than six months in the aggregate
  - Do not give these employees the authority to bind the company
- Using a special purpose entity to employ persons working in the foreign country may help limit the JV partner's PE exposure

Do you have to worry about transfer pricing

Transfer Pricing

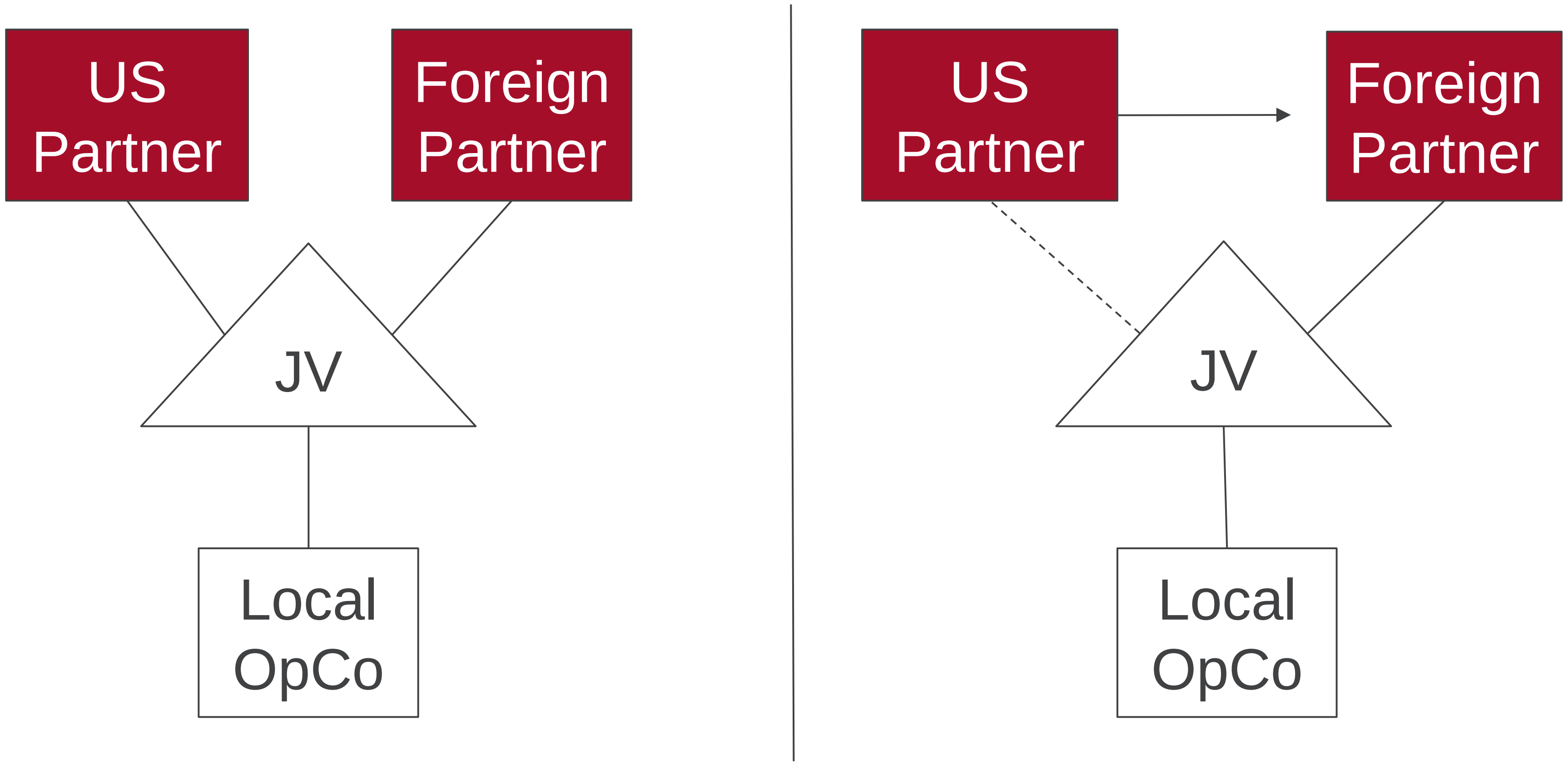
- Section 482: applies to transactions between parties that are owned or controlled, directly or indirectly, by the same interests or by each other
  - Common fact patterns include contributions of services and IP (e.g., trademarks) without compensation
  - Allows the IRS to make allocations of income, deductions, credits, allowances, basis, or any other item affecting taxable income between or among the members of a controlled group to ensure that taxpayers clearly reflect income attributable to controlled transactions and prevent the avoidance of taxes
  - Arm’s length standard is used to determine whether a section 482 allocation is needed
- Tax Treaties: often include an article that incorporates the arm’s-length principle of section 482 and permits allocations between related (e.g., via control) companies to reflect the income (or loss) that the companies would have had in the absence of such a relationship

Section 482 Applies to Joint Ventures

- Transactions between a joint venture and JV partner may be subject to section 482 even if neither party has effective voting control of the joint venture
  - Treas. Reg. § 1.482-1(i)(4) - "Controlled includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose"
  - *Forman Co. v. Comm'r*, 453 F.2d 1144 (2d Cir. 1972) (finding the section 482 control requirement satisfied where unrelated 50/50 owners acted in concert and had identical interests / were not competitors with respect to their dealings with the subsidiary corporation)
  - PLR 8045071 (indicating that the *Forman* acting in concert principle also applies to partnerships)
- Presence of adverse interests may be sufficient to ensure the arm's-length character of a transaction - *R.T. French Co. v. Comm'r*, 60 T.C. 836 (1973)

Taxing Indirect Transfers

Indirect Transfers – What are They?



Indirect Transfer Taxes

- **China**: Notice 698 & Bulletin 24 provide the legal basis for challenging the abusive use of offshore SPVs to avoid capital gains tax in China
  - <u>Reporting</u>: A non-Chinese person is obliged to report an indirect transfer of an interest in a Chinese company to the Chinese tax authorities if the tax on capital gains in the jurisdiction of the intermediary holding company whose shares are transferred is less than 12.5% or if that jurisdiction does not tax its residents on foreign-sourced capital gain
  - <u>Recharacterization</u>: If a non-Chinese person indirectly transfers its ownership interest in a Chinese company through an arrangement that is found to lack a reasonable commercial purpose, the Chinese tax authorities may, after receiving approval from China's State Administration of Taxation, disregard any intermediate holding companies and impose tax on the capital gain derived by the transferor

Indirect Transfer Taxes

- **India**
  - *Vodafone*: Supreme Court of India ruled that an offshore transfer of shares between companies incorporated outside of India is not taxable in India, even if the share transfer indirectly transfers assets in India
  - Legislative Response: Finance Act of 2012 amended the law to permit taxation of a transfer of a share or interest that derives, directly or indirectly, its value substantially from assets located in India
- **Peru**: indirect share transfers are subject to Peruvian tax when:
  - At least 10% of the shares of a non-Peruvian company that owns, directly or indirectly, an interest in a Peruvian entity are transferred, and the FMV of the interest in the Peruvian company is equal to 50% or more of the market value of all of the shares / ownership interests of the non-Peruvian company for the 12 months prior to the transfer
  - The non-Peruvian company is resident in a tax haven or low tax jurisdiction, subject to certain exceptions

Indirect Transfer Taxes

- **Chile**: indirect share or ownership interest transfers are subject to Chilean tax when:
  - The fair value of the share or ownership interest transferred is derived 20% or more from: (i) an interest in a Chilean company, (ii) a Chilean branch or PE, or (iii) movable or immovable property located in Chile or a right with respect to such property when owned by a non-Chilean entity
  - The FMV of the underlying assets in any of the above situations in corresponding proportion is, at the time of transfer (or within the previous 12 months), $200 million or more
  - The non-Chilean company being transferred is domiciled or incorporated in a “tax haven” jurisdiction, subject to certain exceptions
- Are the indirect transfer taxes creditable?
  - Realization requirement
  - Net income requirement

Are Taxes Incurred by a JV Partner Creditable

Foreign Tax Credit

- A taxpayer is generally entitled to a credit in the US for foreign income taxes paid or accrued to a foreign country
  - Designed to eliminate or reduce double taxation
  - Provides a dollar-for-dollar offset against US tax liability, subject to Code § 904 limitation
- Direct Credit: for foreign taxes imposed directly on a US taxpayer
  - Foreign withholding taxes on dividend from foreign corporation
  - Foreign taxes on income from foreign activities of US person
  - Foreign taxes imposed on a partnership entitles a partner to a credit
- Deemed Paid Credit: for foreign taxes imposed on a foreign corporation
  - May only be claimed by a US corporation that owns 10% or more of the voting stock of the foreign corporation
  - Stock owned, directly or indirectly, by or for a partnership is considered as being owned proportionately by its partners
  - Available when earnings are repatriated as dividends or subpart F inclusions

Taxes Imposed on the Foreign Partner

The Technical Taxpayer Rules

- In general, the “technical taxpayer” entitled to claim the credit is the person on whom foreign law imposes legal liability for such tax, even if another person (e.g., a withholding agent) remits such tax
  - A contractual obligation to pay a tax is not sufficient to alter who is considered to be the technical taxpayer with respect to such tax
  - In an agency (or nominee) relationship, the regulations indicate that where legal liability for a tax is imposed on the recipient of income, the technical taxpayer is the principal that is the beneficial owner of the income, rather than the agent that received the income on the principal’s behalf
  - If foreign tax is imposed on the combined income of two or more persons, foreign law is considered to impose legal liability on each such person for the amount of the tax that is attributable to such person's portion of the base of the tax

The Technical Taxpayer Rules

- Technical Taxpayer rules applicable to hybrid entities that are flow thru entities for US tax purposes, but not foreign tax purposes
  - If foreign law imposes tax at the entity level on the income of a partnership, the partnership is the technical taxpayer
  - If foreign law imposes tax at the entity level on the income of a disregarded entity, the person who is treated as owning the assets of the disregarded entity for US tax purposes is the technical taxpayer

- Code § 905(b): a partner in a partnership is entitled to a credit for its proportionate share of the taxes of the partnership paid or accrued to a foreign country

Pursuant to requirements relating to practice before the Internal Revenue Service, any tax advice in this communication (including any attachments) is not intended to be used, and cannot be used, for the purpose of (i) avoiding penalties imposed under the United States Internal Revenue Code, or (ii) promoting, marketing or recommending to another person any tax related matter.

State Bar of Texas International Tax Conference

Hot Topics in Transfer Pricing

Plano, TX

November 8, 2013

Melinda Phelan, Houston

melinda.phelan@bakermckenzie.com, (214) 244-1424

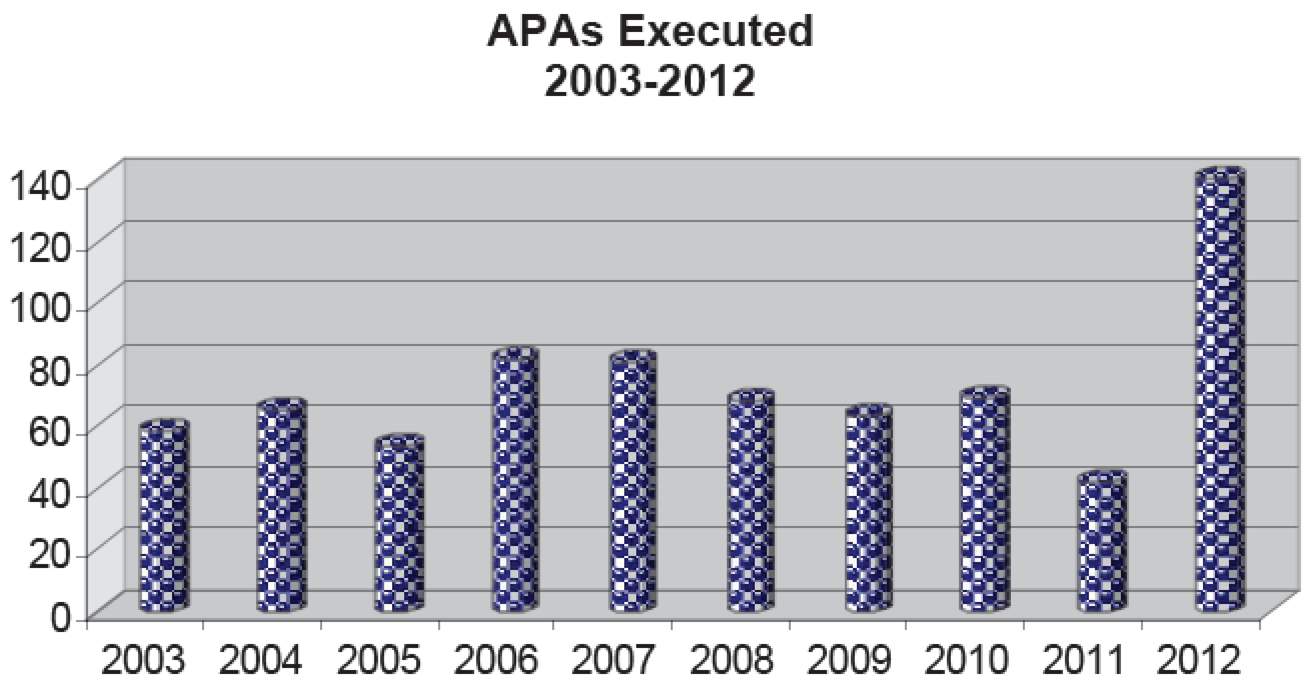
Agenda

- Advance Pricing Agreement Update
- Transfer Pricing Audits and TPO
- Global Developments

Advance Pricing Agreements

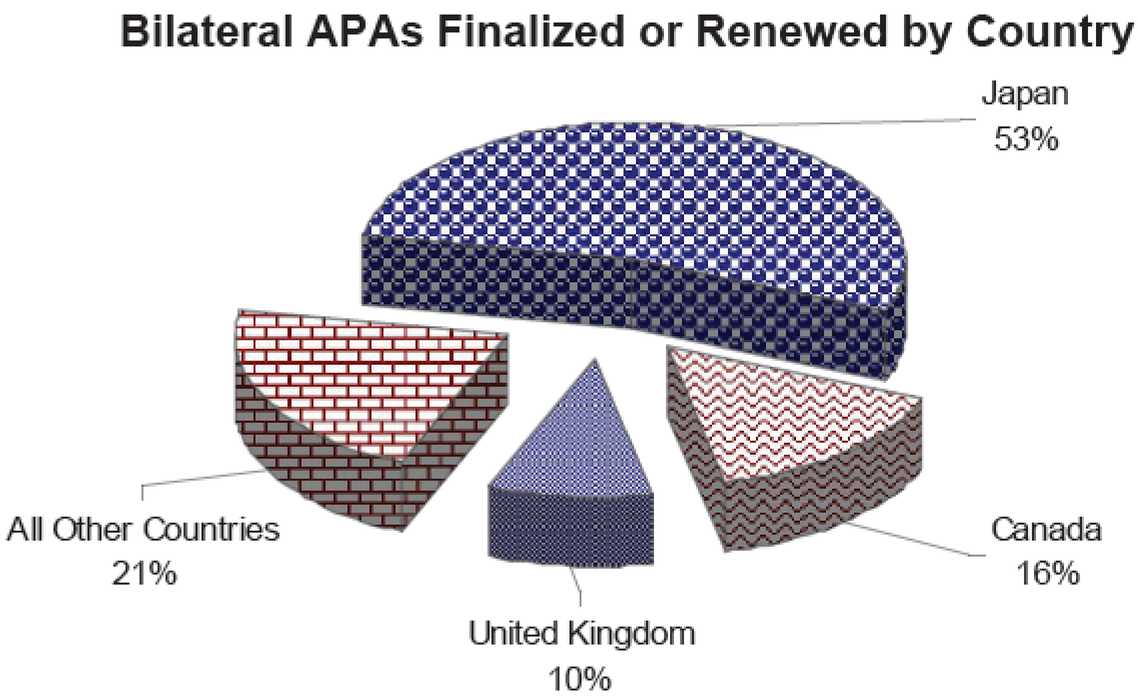
- Update on APMA
- New Rev. Procs.
- Trends and things to watch out for

Significant Increase in Finalized APAs



What about 2013? We anticipate another big year – APMA wants this to be the "new normal."

2012 Bilateral APAs Finalized or Renewed by Country



APMA Goals

- “Certainty sooner”
- Find new efficiencies in processing bilateral APAs and double-tax allocation cases (e.g., no handoff, case selection/channeling)
- More strategic in interactions with treaty partners (e.g., earlier consideration of bilateral issues)
- Achieve same results whether MAP or APA case
- Has APMA been successful so far? With a few hiccups, yes.

APMA Execution of Strategy

- IRS team has active CA engagement from Day 1 for bilateral APAs
  - Previously, APA could have one position, and CA might develop another
- Expect new Rev. Procs. to be released for public comments soon
- Areas where Rev. Procs. need improvement
  - Appeals and Exam coordination; documentation and penalty rules; etc.

APMA – Observations

– Newly hired project leaders are eager, hardworking, practical (sometimes to a fault) and inexperienced
– Consider climate/staffing in other country
– May still reduce compliance costs and will provide greater predictability for financial reporting despite large upfront investment
– Change to APMA has made APAs faster and cheaper; are a better option compared with only two years ago

APAs and MAP Cases: What Does The Future Hold

- What will be the medium term and long term impact of the G20/OECD BEPS initiative?
  - Will the demand for APAs increase due to need for certainty?
  - Will the readiness of administrations to compromise go down as MNEs will be “deemed guilty” by definition?
- What will be the impact of arbitration on both MAP cases and APAs? Already we are seeing an effect – U.S. wants to settle cases where it might lose.

APAs and MAP Cases: What Does The Future Hold

– Against the background of the emerging discussion of marketing intangibles, market premia, location savings etc., will APAs on sales and distribution activities in emerging countries in the future be possible at less than an 8% to 10% operating margin?
– What risks do new concepts such as people functions imply for APAs on IP holding structures?
– APA and MAP trends: APA and MAP trends different in BRICs and in non-BRIC developed countries

Transfer Pricing Audits and TPO

Transfer Pricing Specialists

- **TPO Director**
  Sam Maruca
  - **Executive Assistant Technical**
    Nanette Hamilton
    - **IPN Manager**
      John Kaffenberg
  - **Executive Assistant Operations**
    Carla Langland
  - **Transfer Pricing Territory Mgr – West**
    Nancy Bronson
  - **Transfer Pricing Territory Mgr – Central**
    Tom Ralph
  - **Transfer Pricing Territory Mgr – East**
    Matt Hartman
  - **Special Projects Deputy**
    Stan Perry
  - **Special Projects Deputy**
  - **Special Projects Deputy**
    Eli Hoory
  - **Senior Economic Advisor**
    Bill Morgan
  - **Senior Tax Advisor**
    Howard Berger
  - **Director APMA**
    Dick McAlonan

The TPO's Approach to Transfer Pricing

- "Fundamentally, we have to produce winners . . . We need to take a litigator's approach from the very beginning."
  - Sam Maruca, Director, TPO, June 4, 2012.
- "We have a goal of upping our game. We want to make sure that case selection and staffing are done correctly, so that starts with making sure we're working the right cases. There will be some cases that we'll get very excited about… [T]hey'll help us establish possibly more favorable precedent in the area."
  - Sam Maruca, October 3, 2012.

The TPO’s Approach to Transfer Pricing

- “If you want us in and out fast, explain your business. That’s not typically what I’m seeing.”
  - Sam Maruca, June 4, 2012.

- Goal: For TPO to be “on par with the best-run professional firms, dedicated to putting positions on the table that are every bit as good as those firms can put on the table.
  - Sam Maruca, June 6, 2012.

The TPO's Approach to Transfer Pricing

- First, try to understand the economics of the transaction
- Then, see if law can be reconciled with reasonable outcome.
  - System might be better off with fewer rules so common sense can prevail
  - Our challenge is that courts and lawyers like "comparable uncontrolled transaction methods and are not comfortable with income methods."

    - Sam Maruca, February 13, 2013

The TPO's Approach To Transfer Pricing

– "Taxpayers tend to emphasize letter of the law such as definitions that maybe were not designed with this type of transaction in mind, and they take the position that certain assets or items transfer for free."

  - Sam Maruca, June 5, 2013

– "I think our odds can only improve if we paint an accurate picture of the functions, assets, risks of parties, explain clearly how . . . a businessman or –woman would evaluate the investment opportunities."

  - Sam Maruca, June 5, 2013

The TPO’s Approach To Transfer Pricing

- Second looks: Exam has requested that taxpayers extend statutes of limitation to give the TPO time to re-examine cases previously developed.
- For disputes arising under the 2009 cost sharing and 2007 services regulations:
  - Engagement earlier by TPO specialists, outside economists
  - New regulations bless the income method for initial buy-ins, acquisition price method for acquisition buy-ins, and aggregation

The TPO's Approach to Transfer Pricing

– TPO's focus not limited solely to large intangibles buy-ins; tangible goods and services transactions in play
– Emphasis on hiring professionals with outside/business experience
– More guidance forthcoming on self-initiated adjustments
– Impact of Quality Examination Process on early engagement?
– What about threats of increased use of summonses?

Global Developments

China: Grading Documentation by Tax

Main Content	Key Issue	Specific Requirement	Requirement Met or Not		
			Yes	No	N/A
1. Organizational Structure	Organizational structure and ownership of the business group to which the Entity is a subsidiary	Whether the following is fully disclosed: the organizational structure and ownership of the business group or unit to which the Entity is a subsidiary	Yes		
		Is there a description of the various levels of holding parties up till the ultimate holder of the Entity? If the ultimate holder is a listed company, then show it as such; otherwise show it as the actual operational holder.	Yes		Ask the entity to verify if the parent company is publicly listed.
	Year-to-year change of related parties relationship	Whether year-to-year change of related p arties is disclosed.	Yes		
		Whether any transactions involving ownership change-over are disclosed			Ask the entry to verify if there have been such actions

China: Grading Documentation by Tax Bureau

Note:

1. This form is for companies undertaking test on contemporaneous transfer pricing.

2. There can be three different results, namely “Yes”, “No” and“N/A”. Please tick one as appropriate.

3. Overall evaluation of the quality of contemporaneous transfer pricing can be one of the following: “Excellent”, “Fair”, and “Poor”.

4. When giving evaluation, focus on bold typed columns. If 2 to 3 items in bold typed columns do not meet the requirement, then overall evaluation should be “Fair”; if 4 or over do not meet the requirement, then it should be “Poor”.

China: Country Practice

– Views on low-risks, routine functions
  – Contract R&D
    – Holistic approach to R&D
    – Cost plus is not adequate
  – Contract Manufacturing
    – Reliance on custom valuation
    – Practical methods to deal with toll manufacturing
  – Marketing and Sales
    – Extra efforts evidenced by expenses have to be considered
    – Resort to profit split or make comparability adjustment

SAT Position on BEPS

Dr. Liao Tizhong

Liao said the world is calling for a ''sound and fair international tax system, which cannot be too far away.''

"I am hopeful that BEPS will achieve a balance between revenue, fairness, and sovereignty that the world currently lacks."

"There should be a link between where profits are guaranteed and where they are taxed."

Bloomberg BNA-Tax Management Transfer Pricing Report™

SAT Position on Royalties and LSA

from Dr. Liao Tizhong

‘‘a lot of research has been done in China but China is still paying 3 percent to the parent company.’’ Questioning the fairness of that practice, he said, ‘‘A 3 percent royalty 10 years later is obviously wrong.’’

“Location-specific advantages are unavoidable. Like it or not, Chinese related parties must be appropriately remunerated for their location-specific advantages and are entitled to additional profit when they improve their foreign related party’s original intangibles.”

“In China, this glass costs $1.00. In the United States, maybe it is $10.00. Why? Because in China it does not include the price of pollution. It does not include the price of social security. It does not include the price of the injuries of the employees who make the glass. And the cost of the labor is much lower”

Bloomberg BNA-Tax Management Transfer Pricing Report™

China: Controversies On the Rise

- The Current System is a Recipe for Controversies
  - Transfer pricing rules are sketchy, no detailed guidance for implementation
  - Positions in China Country Practice of UN Manual not in line with OECD TPG
  - No uniformed case selection, may result in selective enforcement
  - SAT is becoming more aggressive in audits

China: Audit Practice

- No unified case selection
- Audit targets:
  - Large volume controlled transactions
  - Long time loss-making or low profitability
  - Below-average margin
  - Profit level not matching FAR
  - Transactions with related parties in havens
  - No related-party transaction disclosure or contemporaneous documentation

China: Challenges for SAT

- Lack of qualified staff
  - Central level: 7
  - National level: 250
- Lack of comparables
  - Limited size of listed companies
  - Single-function subsidiaries
- Quantification of LSAs
- Intangibles and risks

China: Statistics Update 2012

– Number of audits authorized: 233
– Number of cases closed: 175
– Shortfall tax collected: 4.6 Billion RMB (700 million US$)
– 9 cases resulted in collection of shortfall tax of more than 100 million RMB each.
– APAs: 11 bilateral
– Map: 9 corresponding adjustment agreement

China: Focus of Controversies

- Royalties
  - Ministry of Commerce set ceiling of 5%
  - MNEs with whole supply chain in China find very difficult to remit profits out of China
- Contact R&D
  - Holistic approach toward R&D
  - No double dips
- Business Restructuring
  - No special rules
  - Local offices losing revenue will likely start audits and give taxpayers hard times

China: Taxpayers Need to be Prepared:

- Applying for APAs
- Revising transfer pricing policy to accommodate new positions
- Devising new defense strategies

China: Dispute Resolution

- Audit settlements.
- Administrative appeals.
- Litigation.
- MAPs.
- APAs.

China: Current Status of APAs

– SAT is overloaded with APA applications.
– Current System for APAs is not efficient.
– Process is still moving.
– SAT is selective about applications.
– SAT prefers BAPAs with NA and European countries.

India: 2013 Circulars & Safe Harbor Rules

– Series of Circulars
  – CBDT issued series of circulars in an attempt to create uniformity in transfer pricing and provide guidance relating to taxation of R&D centers
  – Particularly focused on information technology (“IT”), IT enabled services (“ITES”), and software industries

– Final Safe Harbor Rules
  – CBDT issued draft and final safe harbor rules
  – Provide safe harbors for low-risk R&D activities for IT, ITES, certain financial, automotive, and generic pharmaceutical industries

Highlights of Final Safe Harbor Rules

Taxpayer Favorable Aspects:

- Must file an election
- Election period can be from one to five years (rather than two years, as in the draft rules)
- Taxpayer may opt-out by providing a declaration to the Assessing Officer

Taxpayer Unfavorable Aspects:

- Disallow election where principal is in a no tax or low-tax jurisdiction
- Significant pressure on APAs seeking a markup lower than safe harbors

Safe Harbor Markups

Transaction / Cap (if any)	Safe Harbor Provision
Software development services, aggregate amount not exceeding approx. USD 80M	20%
Software development services, aggregate amount exceeding approx. USD 80M	22%
ITES, aggregate amount not exceeding approx. USD 80M	20%
ITES, aggregate amount exceeding approx. USD 80M	22%
KPO services	25%
Contract R&D wholly or partly related to software development	30%
Contract R&D wholly or partly related to generic pharmaceuticals	29%

Brazil: The New RPM Profit Margins (Import transactions)

- Law No. 12,715/12 provides for different margins based on sectors, regardless of the activity performed by the Brazilian company (*i.e.*, distribution or manufacturing), as of calendar-year 2013 (optional for 2012):
  - **I. 40% applicable to:**
    - a) pharmaceutical and pharmaceutical chemical products
    - b) tobacco products
    - c) optical, photographic and cinematographic equipment and instrument
    - d) machinery, apparatus and equipment for dental medical and hospital use
    - e) extraction of oil and natural gas
    - f) products derived from petroleum
  - **II. 30% to the sectors of:**
    - a) chemical products
    - b) glass and glass products
    - c) cellulose, paper and paper products
    - d) metallurgy
  - **III. 20% to all other sectors**

Safe Harbor on Exports – “End of Good Times”

- Until December 31, 2012 – No need to comply with a transfer pricing method if exporter operated at a minimum of 5% net profit margin (before CIT) calculated over the export revenues (average of current year + 2 previous ones)
  - Not applicable to transactions with tax havens

- As of January 1st, 2013 - Normative Ruling No. 1,312/12 increased from 5% to 10% the minimum net profit margin
  - The safe harbor will not apply if export revenues to related parties exceed 20% of the total amount of the net export revenues
  - Safe harbor not available for exporters of commodities subject to negotiation in exchange markets with international coverage
  - Same restriction to tax havens

- 5% revenues imperfect safe harbour” – company still may be able to elect to the “5% revenues imperfect safe harbour”, if its export net revenues to related parties do not exceed 5% of its total net revenues.

Deductibility of Interest on Intercompany Loans

- Agreements executed until 2012:
  - No transfer pricing scrutiny if contracts were registered with the Central Bank of Brazil (as generally was the case)
  - If “repactuation” or “novation” – deemed a new agreement

- Agreements executed as of January 1st, 2013:
  - The registration of the agreement with the Central Bank is no longer relevant for transfer pricing purposes (still relevant for Central Bank purposes)
  - Interest is only deductible up to the following interest rates, increased by a spread to be defined by the Minister of Finance:
  - a) Loans in USD with a prefixed interest rate: sovereign bonds of Brazil issued in the foreign market in USD;
  - b) Loans in BRL with a prefixed interest rate: the sovereign bonds of Brazil issued in the foreign market in BRL; and
  - c) Other cases: LIBOR (6-month term)

Canadian Transfer Pricing Audits

- Risk assessment selection process being phased in
  - Large taxpayers will all be risk rated over five year phase in period
  - Process involves interviews with senior management on various governance, tax risk management, and other issues
  - Multiple tiers, rating drives nature and scope of audits

- Industry co-ordinating offices (financial, pharmaceutical, oil and gas, automotive)

Canadian Transfer Pricing Audits

- Issues requiring mandatory referrals to headquarters:
  - Cost contribution arrangements
  - Intangibles/royalties
  - Reassessments after treaty limitation periods
    - Chrysler Canada case

- IP Migrations: Examinations often begin by asking whether transaction would happen or happen in that form rather than addressing valuation issues

Transfer Pricing Review Committee Feedback on Penalties

- Contemporaneous documentation required by tax return due date
- Must be “complete and accurate in all material respects”
- Penalties if taxpayers have not made reasonable efforts:
  - If adjustment exceeds the lesser of 10% of revenue or C$5 million
  - Penalty is 10% of the adjustment

Reasons for Penalties*

– Paragraph 247(4)(a), cases where CD not made or obtained by documentation due date:	26 (20%)
– Subparagraph 247(4)(a)(i) through (vi), cases where CD not complete and accurate in all material respect of:	
– (i) property or service	53 (41%)
– (ii) terms and conditions	63 (48%)
– (iii) identity of participants	48 (37%)
– (iv) functions, assets, and risks	89 (68%)
– (v) data and methods used	97 (75%)
– (vi) assumptions, strategies, and policies	85 (65%)
– Paragraph 247(4)(c), cases where CD not provided within three months of CD letter	45 (35%)
– Subsection 247(3), general determination	17 (13%)

* Source: Presentation by Jennifer Ryan, Director International Tax Division, CRA, February 24, 2011

Financial Transactions Environment

- Discussions with senior CRA officials:
- Thin cap rule not a safe harbour, rather it is a cap on the arm's length principle
  - However, the arm's length principle could be a binding limit below the thin cap limit
- Significant implications for acquisition financing into Canada
  - Arm's length principle to be applied to determine amount of debt acquisition company can sustain
- All terms and conditions subject to review and challenge in financial transactions

Current Developments – Canadian APA Program

- Significantly increased disclosure requirements at pre-filing stage
- More intense scrutiny and evaluation of facts and issues by CRA prior to inviting taxpayers to prepare an APA submission/request
- Stricter acceptance criteria:
  - Cases no longer eligible for APA consideration include:
    - Restructurings
    - Intangible migrations and certain other intangibles cases
    - Cases without “stable cycle or period of time” prior to APA years
- Objective: avoid accepting cases likely to “[end] up in arbitration” or be “un-negotiable”
- Resource constraints – now sharing economists from audit

Thank You!