MAURICE A. DEANE SCHOOL OF LAW
HOFSTRA LAW

Meltzer Lippe

2016

# PRIVATE WEALTH & TAXATION INSTITUTE

Continuing Professional Education Series

# DAY 2

# FRIDAY

# MAY 20, 2016

Program held at
121 Hofstra University –Room 308, Hempstead, NY 11549

# Private Wealth & Taxation Institute

## Day 2 – May 20, 2016

### Timed Agenda

| | |
|---|---|
| 8:00 – 8:30am | **Breakfast and Sign In** |
| 8:30 – 8:45am | **Introduction to Program**<br>*Stephen M. Breitstone* |
| 8:45 – 9:45am | **The Full Price of a Mistake: Tax Penalties, Transferee and Fiduciary Liability**<br>*Megan L. Brackney and Bryan C. Skarlatos* |
| 9:45 – 11:00am | **Meet Your Taxpayer Advocate: Major Challenges Facing Taxing Authorities and the Taxpayer Advocate's Role in Assisting Taxpayers**<br>*IRS Service Taxpayer Advocate Nina E. Olson, NYS Taxpayer Rights Advocate Margaret Neri, NYC Taxpayer Advocate Diana Leyden, Robert N. Brown, CPA and Laurie B. Kazenoff* |
| 11:00 – 11:15am | **Break** |
| 11:15 – 12:15pm | **Surrogate's Court Practice Update**<br>Hon. John M. Czygier, Jr., *Eric W. Penzer, Hon. A. Gail Prudenti and Jason J. Smith* |
| 12:15 – 1:30pm | **Lunch** |
| 1:30 – 2:30pm | **Coming Clean with Offshore Accounts-The Current Status of Voluntary Offshore Disclosure**<br>*Professor Linda Galler, Kelly A. McGowan and Mordy Serle* |
| 2:30 – 3:30pm | **Developments in Income Taxation of Real Estate, Capital Gains Taxation and 1031 Exchanges**<br>*Professor Bradley T. Borden, Glenn M. Johnson and Mark E. Wilensky* |
| 3:30 – 4:30pm | **Recent Changes in the Regulation of Tax Practice and Ethics**<br>*Professor Linda Galler* |

**Questions and Answer period will follow each topic**

6.0 CLE credits in Professional Practice
1.0 CLE credits in Ethics
7.0 CPE credits in Taxation

## Table of Contents

## Day 2

## Friday, May 20, 2016


1. **Bios of Speakers**

2. **The Full Price of a Mistake: Tax Penalties, Transferee Liability and Fiduciary Liability**
   Megan L. Brackney and Bryan C. Skarlatos

3. **Meet Your Taxpayer Advocate: Major Challenges Facing Taxing Authorities and the Taxpayer Advocate's Role in Assisting Taxpayers**
   IRS Service Taxpayer Advocate Nina E. Olson, NYS Taxpayer Rights Advocate Margaret Neri, NYC Taxpayer Advocate Diana Leyden, Robert N. Brown, CPA and Laurie B. Kasenoff

4. **Surrogate's Court Practice Update**
   Hon. John M. Czygier, Jr., Eric W. Penzer, Hon. A. Gail Prudenti and Jason J. Smith

5. **Coming Clean with Offshore Accounts-The Current Status of Voluntary Offshore Disclosure**
   Professor Linda Galler, Kelly A. McGowan and Mordy Serle

6. **Developments in Income Taxation of Real Estate, Capital Gains Taxation and 1031 Exchanges**
   Professor Bradley T. Borden, Glenn M. Johnson and Mark E. Wilensky

7. **Recent Changes in the Regulation of Tax Practice and Ethics**
   Professor Linda Galler

# 1

**Professor Bradley T. Borden, Brooklyn Law School**

Brad is a Professor of Law at Brooklyn Law School where he teaches Federal Income Taxation, Partnership Taxation, Taxation of Real Estate Transactions, and Unincorporated Business Organizations. Before entering the legal academy, he practiced law at Oppenheimer, Blend, Harrison & Tate, Inc., in San Antonio, Texas, and now frequently works as an expert witness or consultant in cases related to partnership and real estate taxation. He is also Of Counsel with the New York law firm Tjong & Hsia, LLP.

Brad is the author of several books and numerous articles in leading tax and legal journals. His books include TAX-FREE LIKE-KIND EXCHANGES (Civic Research Institute, 2nd ed. 2015), TAXATION AND BUSINESS PLANNING FOR REAL ESTATE TRANSACTIONS (LexisNexis 2011); LIMITED LIABILITY ENTITIES: A STATE BY STATE GUIDE TO LLCS, LPS AND LLPS (Wolters Kluwer, seven annual updates); and REAL ESTATE TRANSACTIONS BY TAX-EXEMPT ENTITIES, 591-3rd/480-2nd T.M. (2015). He is also preparing manuscripts for TAXATION AND BUSINESS PLANNING FOR PARTNERSHIPS AND LLCS (Aspen Publishers, forthcoming 2016); TAX, LEGAL, AND FINANCIAL ASPECTS OF REAL ESTATE JOINT VENTURES (Civic Research Institute); and TAX ISSUES FOR REAL ESTATE DEVELOPERS, (Tax Management Portfolio). His articles are published in professional journals such as Business Entities, The Journal of Taxation, Probate and Property, Real Estate Taxation, Tax Management Real Estate Journal, and Tax Notes, and law reviews such as Brooklyn Law Review, Florida Law Review, Florida Tax Review, Georgia Law Review, Houston Law Review, Iowa Law Review, Kansas Law Review, University of Pennsylvania Journal of Business Law, The Tax Lawyer, and Virginia Tax Review.

Brad is a fellow of the American College of Tax Counsel and a past chair of the Sales, Exchanges & Basis Committee of the ABA Section of Taxation. He earned a B.B.A. and M.B.A. from Idaho State University and a J.D. and LL.M. in taxation from University of Florida Fredric G. Levin College of Law, he is licensed to practice law in New York and Texas, and he is a certified public accountant.

**Megan L. Brackney, Partner**
**Kostelanetz & Fink, LLP**

Megan L. Brackney joined Kostelanetz & Fink in 2004, and concentrates her practice in the areas of tax controversies, and civil and white collar criminal litigation. Ms. Brackney received her J.D. from the University of Kansas School of Law and her LL.M. in Taxation from New York University. Prior to joining Kostelanetz & Fink, LLP, Ms. Brackney was an Assistant United States Attorney for the Southern District of New York. Ms. Brackney is a member of the New York State Bar Association Tax Section's Executive Committee, a Fellow of the American College of Tax Counsel, a Council Director for the American Bar Association Section of Taxation, and the former Chair of the Taxation Committee of the New York County Lawyers' Association. Ms. Brackney annually contributes to the two-volume ABA publication, *Effectively Representing Your Client Before the IRS* and is a regular columnist for the "Tax Controversy Corner" of The Journal of Pass-through Entities, and serves on the editorial board of the Journal of Taxation and The Tax Lawyer. Ms. Brackney has been recognized by New York Super Lawyers" since 2012.

Meltzer, Lippe, Goldstein & Breitstone, LLP

## Stephen M. Breitstone

*"Want more? Demand Better! Hire Us."*

Vice Chairman
516-747-0300 Ext. 241
sbreitstone@meltzerlippe.com

Stephen M. Breitstone, in addition to being the Vice Chairman of the firm, also leads the Private Wealth & Taxation Group at Meltzer Lippe.
He is counsel to many of the firm's wealthiest and most prominent clients, providing sophisticated tax and estate planning advice for several large New York real estate families, private equity funds, Wall Street investment bankers, fund managers, corporate executives, large estates and others. He has pioneered many novel tax planning techniques – some combining his broad knowledge of partnership taxation and estate planning. Steve began his practice in large New York City law firms, after graduating from law school in 1982. While beginning to practice as a tax lawyer, Steve studied for his LL.M in Taxation at New York University School of Law and taught courses as an adjunct professor in taxation at Cardozo Law School. During that period, his clientele comprised mainly of large domestic and international institutions and public corporations. After practicing for some years in the large public corporate arena, Steve decided to reestablish his practice and began representing a more entrepreneurial clientele. He started to represent high net worth individuals with real estate holdings and closely-held businesses. During the early 1990's Steve's practice evolved with the changing economic climate. He became increasingly involved in structuring and negotiating real estate workouts and joint ventures. As economic conditions improved, with the rise of the bull market and rapidly accelerating merger and acquisition activity, Steve played a key role as tax advisor in connection with Meltzer Lippe's prominent corporate practice in structuring transactions. He also played a key role in structuring the tax aspects of Meltzer Lippe's technology oriented client activities.

Steve is a frequent lecturer and author of numerous published articles on taxation of real estate transactions and estate planning for real estate owners. Steve currently teaches the course in Tax and Business Planning for Real Estate Transactions as an adjunct professor at Cardozo Law School. Steve has lectured at the NYU Institute on Federal Taxation, Practicing Law Institute, Notre Dame Tax and Estate Planning Conference, Bloomberg BNA Tax Management Real Estate Board, Bloomberg BNA Tax Management Estate Planning Board, National Multi-Housing Conference; and the Federation of (1031) Exchange Accommodators and for many more institutions. Steve has also lectured at the American Bar Association Tax Section on topics such as Foreign Investment in U.S. Real Estate and Income Tax and Estate Planning for leveraged real estate and many other topics.. He is a leader in development of the partnership freeze, an estate planning technique that avoids many income tax pitfalls for leveraged real estate and maximizes the bases step up at death. Steve is a nationally recognized authority on section 1031 exchanges.

On behalf of the firm's clients, Steve has interfaced with top policy makers Washington, DC including the Chairman of the Senate Finance Committee, to discuss legislative proposals and reforms such as estate tax reform or repeal and carried interest proposals. As the Fiscal Cliff was approaching, Steve moderated a program on Tax Policy at the NYU Institute on Federal Taxation. Steve has also testified before the U.S. House of Representatives Small Business subcommittee at hearings regarding the repeal of the estate tax. Steve has been in high demand from national news media for expert commentary on issues pertaining Carried Interest, Tax Treatment of Ponzi Scheme Victims, Estate tax matters impacting celebrities, Presidential Candidate Mitt Romney's Intentional Defective Grantor Trust (IDGT) and more. As a result, Steve has been interviewed by

**Education:**
New York University, B.S.

Cardozo Law School, J.D.

New York University, LL.M.

**Honors:**
- AV-Preeminent
  - Martindale-Hubbell
- NYU Institute on Federal Taxation
  - Advisory Board Member
- Cardozo Law School
  - Dean's Advisory Board Member
- Adelphi University
  - Dean's Advisory Board Member

**Bar Admissions:**
New York State Bar

**Publications:**
- What Happens to My Debts When I Die?
- Dividing a Real Estate Empire: The Mixing Bowl Alternative
- Madoff Victims Who Paid Taxes on Scheme Seek Refunds
- Carried Interest Bill – Impact on Real Estate Partnerships
- Carried Interest Bill – A 'Death Trap' for Real Estate Partnerships
- Faulty IRA Beneficiary Designations Explode Estate Plans
- Section 1031 "like-kind" exchanges – Use of Tenants in Common to "Pool" Capital and to Create Liquidity
- Popular Estate Planning Techniques Can Cause Income Tax Horrors For Real Estate Owners
- IRS Expands Tax-Free Exchanges of Real Estate

CBS Evening News, ABC News, Fox News, Fox Business News, News 12, Long Island, Accounting Today, Bloomberg News, Dow Jones, The Wall Street Journal, Newsday, etc.

Steve's style of practice is personal, not institutional; and his client's goals and objectives are his priority. Steve resides in Melville, Long Island with his wife Jill, who is also a lawyer. He has two children in college. He enjoys sailing, skiing, woodworking, politics and charitable work including a number of pro-Israel organizations.

- Lapsing 2012 Estate Planning Opportunities & large Estates Holding Businesses and Real Estate
- Estate Planning for Negative Capital
- Reckoning With New York's Marital Right of Election
- Income and Transfer Tax Planning for Negative Capital – The Entity Freeze Solution

190 Willis Avenue, Mineola, NY 11501
Phone: 516-747-0300 Fax: 516-747-0653 E-mail: theadvantage@meltzerlippe.com

**Robert N. Brown, CPA, CGMA**

Robert Brown has spent more than 35 years in public practice serving small to middle market companies and individuals in the areas of tax preparation, tax planning, tax controversy, estate planning, ,multi-state taxation, tax representation, financial statement preparation and management advisory services.

Mr. Brown currently serves as president of the Nassau Suffolk Chapter of the National Conference of CPA Practitioners. He is a member of the American Institute of Certified Public Accounts, the AICPA Private Companies Practice Section, the New York State Society of Certified Public Accountants, and the National Conference of CPA Practitioners.

**Hon. John M. Czygier, Jr.**

John M. Czygier, Jr. was admitted to practice law in New York State in 1975. After serving as a prosecutor in the Suffolk County District Attorney's office, he entered private practice and, for twenty-five years, concentrated in estate administration and estate litigation in the New York metropolitan area. He was awarded an "AV" rating by Martindale-Hubbell, the highest rating for practicing attorneys. He is a member of the Suffolk County Bar Association, where he served as Director, Chair of the Surrogate's Court Committee and Co-Chair of the Bench Bar Committee. He is also a member and former Director of the Suffolk County Women's Bar Association. While in private practice, Surrogate Czygier served as a Mental Hygiene Law Article 81 Court Examiner for New York and Suffolk Counties, and was counsel to the Public Administrator of Suffolk County.

On April 26, 2001, Judge Czygier was appointed Judge of the Surrogate's Court of Suffolk County by Governor George Pataki and subsequently confirmed by the New York State Senate on May 8, 2001. In November, 2001 he was elected to a ten-year term, and was re-elected in November 2011.

Judge Czygier is currently the only sitting Surrogate in New York State who is a Judicial Fellow of the prestigious American College of Trust and Estate Counsel. The College is a national organization of approximately 2600 lawyers elected to membership by demonstrating the highest level of integrity, commitment to the profession, competence and experience as trust and estate counselors.

In October of 2000, Judge Czygier was elected to the Fellows of the New York Bar Foundation. He is a member of the Surrogate's Association of the State of New York, where he previously served as Secretary/Treasurer and Vice President and President. He is a member of the Trusts and Estates Law Section of the New York State Bar Association where he served on the Estate and Trust Administration Committee, and was formerly a vice-chairman of the Estate Litigation Sub-Committee. He has also served on the Committee on Trusts, Estates & Surrogate's Courts of the Association of the Bar of the City of New York.

In addition to his involvement in numerous professional associations, Surrogate Czygier has played an active role on various Committees to improve the law, administration and practice in the Surrogate field. Judge Czygier has served as a member of the Surrogate's Court Advisory Committee to the Chief Administrative Judge of the Courts of the State of New York since his appointment in 1999 by the Hon. Jonathan Lippman. He has also been a member of the EPTL-SCPA Legislative Advisory Committee; the mission of both committees is to review existing statutes and to draft legislation. In 2009, he was appointed to The Administrative Board for the Offices of the Public Administrator where he now serves as Chair; and he was recently named the Chairman of the Distinguished Alumni on the Bench at Hofstra Law School. He is a member of the Continuing Legal Education Faculty of the Suffolk Academy of Law, and lectures on the topic of Wills and Estates to professional and civic organizations. He has lectured on various aspects of Trust and Estate Law at numerous law schools and state and local bar associations.

Judge Czygier has also been a contributing author to Warren's Heaton on Surrogates' Courts (Matthew Bender) and to Weinstein, Korn & Miller New York Civil Practice (Matthew Bender), and has written for the New York State Bar Association Trusts and Estates Newsletter, the New York Law Journal, and the New York State Bar Association Journal.

**Professor Linda Galler – Hofstra University**

Linda Galler is Professor of Law at the Maurice A. Deane School of Law at Hofstra University, where she teaches a variety of tax courses. Professor Galler also is the Director of the Hofstra Federal Tax Clinic, representing low income taxpayers in federal and state tax controversies and litigation. She is the lead author of "Regulation of Tax Practice," published by LexisNexis as part of its Graduate Tax Series, and is a former chair of the ABA Tax Section's Standards of the Tax Practice Committee.

Professor Galler is Senior Tax Counsel to the New York City law firm Curtis, Mallet-Prevost, Colt & Mosle LLP, where she consults in the areas of international taxation, corporate taxation, administrative practice and court procedure.

MAURICE A. DEANE SCHOOL OF LAW

HOFSTRA LAW

# Biography

**Glenn M. Johnson**

Tel +1 202 327 6687
Fax +1 866 401 3681
Email glenn.johnson@ey.com

Glenn M. Johnson is a Principal in Ernst & Young LLP's US National Tax Department, and the Director of the Leasing Tax Services. Glenn is experienced in planning leasing and other asset-based structured transactions. In the past several years, he has provided US tax services with respect to many infrastructure projects. In addition, Glenn has significant experience concerning deferred like kind exchange transactions where he advises on a wide range of tax and operational issues.

Glenn, who joined Ernst & Young in 1998, earned his LL.M. in Taxation from Georgetown University Law School; his J.D., with honors, from Boston University School of Law; and his B.A. in Economics from Wesleyan University. Glenn also is active in a number of civic and charitable organizations.

Meltzer, Lippe, Goldstein & Breitstone, LLP

# Laurie B. Kazenoff

*"Want more? Demand Better! Hire Us."*

Counsel
516-747-0300 Ext. 283
lkazenoff@meltzerlippe.com

Laurie B. Kazenoff is Counsel to the firm's Tax Law Practice.

Laurie has over 30 years of experience in Tax Controversy as a Senior Attorney with IRS Chief Counsel litigating before the U.S. Tax Court; an Estate Tax Attorney with the IRS Estate and Gift Tax Division; a Senior Manager in Tax Controversy for a nationally ranked New York City accounting firm and as owner of her own Tax Controversy practice.

Laurie's practice concentrates in IRS and New York State tax controversies including Examinations, Appeals, and Tax Court litigation involving all types of entities and tax issues. She represents clients before the IRS and NYS Collection Divisions including Collection Due Process and Equivalency Hearings, addressing IRS Notices of Lien, Levies, New York State Warrants, New York State license suspensions due to tax assessments, Responsible Person and Sales Tax assessments, negotiation of settlements including Offers in Compromise, Installment Agreements and Penalty Abatements. Subspecialties include Estate and Gift Tax issues and Pension Plan Qualification issues. She also handles New York State Residency issues.

Clients include high profile and high net worth individuals, corporations, partnerships and other entities in investment banking, law, real estate, engineering, architecture, medicine, entertainment, fashion, media, construction, manufacturing, sports and technology.

Representative cases in private practice include the complete abatement of Responsible Person Assessments in cases against officers in the offending corporations, in the amounts of $2,000,000 and $300,000, respectively. She has reached favorable payment agreements for both corporate and individual officers liable for withholding taxes in separate cases where over $1.7 million and $2 million was owed, respectively, and in cases involving sales taxes owed of over $1.5 million. She has reached favorable settlements involving New York State residency issues. She has resolved cases for numerous clients involving both Offers and Installment Payment Agreements with both the IRS and New York State Collection Divisions. She has favorably resolved cases in pending court cases, saving thousands in litigation costs for her clients. She has successfully represented clients in the abatements of penalties in various situations involving hundreds of thousands of dollars, including late filing, late payment and negligence penalty cases due to reasonable cause. She has favorably settled collection cases with both the IRS and New York State involving high profile individuals and businesses, including a $17 million options case. She has negotiated favorable settlements with both the IRS and Department of Labor involving pension plan qualification and compliance issues including a challenge to a $1.3 million adjustment against a non-profit corporation. She has successfully represented clients in the releases of levies and liens, negotiated installment payment agreements and offers in compromise, and in some cases collection activity was stayed altogether due to lack of collection potential. She has also negotiated favorable settlements and achieved "no change" results in a number of IRS and NYS examinations.

While a Senior Attorney with IRS Chief Counsel, Laurie litigated cases before the United States Tax Court and was counsel to the Brooklyn District's Employee Plans and Exempt Organizations Division. She handled high profile cases involving the qualification of pension plans and excise tax

**Education:**
University of Pennsylvania, Honors B.A.

Temple University, J.D.
Beasley School of Law

Temple University, LL.M.
Beasley School of Law

**Bar Admissions:**
New York State Bar

New Jersey State Bar

Pennsylvania State Bar

United States Tax Court

Federal Court of Claims

issues of major institutions. She was a member of Chief Counsel's Tax Exempt Bonds initiative and was also a part of the Coordinated Examination Programs involving Colleges, Universities, and Hospitals involving major tax exempt institutions located in the North Atlantic Region. She was also counsel to the Collection Division responsible for the review of Offers in Compromise, priorities in Bankruptcy, and issues involving IRS Liens and Levies. She was an Instructor for Chief Counsel's Employee Plans Litigation Attorney Training Program in Washington, D.C. and also lectured to other Brooklyn District Counsel attorneys on Employee Benefit topics, including Prohibited Transactions and Minimum Funding Deficiencies.

Laurie received an Honors B.A. from the University of Pennsylvania; and earned her J.D. and LL.M. (Taxation) degrees from Temple University Beasley School of Law, completing her final year of her LL.M. at New York University.

Professional Associations include the New York State, Nassau County and Suffolk County Bar Associations, Taxation Committees, and the Association of Certified Fraud Examiners.

190 Willis Avenue, Mineola, NY 11501
Phone: 516-747-0300 Fax: 516-747-0653 E-mail: theadvantage@meltzerlippe.com

NYC
Department of Finance

# Diana Leyden
# New York City's 1st Taxpayer Advocate

With an extensive career in tax advocacy, Diana Leyden joined the New York City Department of Finance to open and head the Office of the Taxpayer Advocate in July 2015. Before joining city government, she was the founder and director of the University of Connecticut School of Law tax clinic — a free legal service that helps low-income taxpayers with tax problems — which she led since 1999. In that position, Diana also served as clinic professor, where she trained and supervised many law students on how to represent clients in tax court. She has also set up free tax preparation sites in Hartford, Connecticut, so that families can claim the Earned Income Tax Credit offered in the state.

Diana began her career in tax law right after receiving her J.D. from University of Connecticut School of Law, when she served as a law clerk to The Hon. Herbert Chabot at the United States Tax Court. She later practiced corporate and tax exempt tax law with Steptoe & Johnson, LLP in Washington, D.C., as well as Powers & Hall and Day Pitney LLP, both in Boston, Massachusetts. In 1988, Diana took a position as an appeals officer and then as an appeals bureau manager in the Massachusetts Department of Revenue. She later worked as a staff attorney in the Connecticut Department of Revenue Services.

In 2005, Diana was awarded the American Bar Association Section of Taxation Janet Spragens Pro Bono Award for her work on behalf of low-income taxpayers. She is also the author of *Advocating for Low Income Taxpayers: A Clinical Studies Casebook*, published in 2008. Diana received a B.A. from Union College, and also holds a Master of Laws from Georgetown University Law Center.

# Kelly A. McGowan

*"Want more? Demand Better! Hire Us."*

Associate
516-747-0300 Ext. 205
kmcgowan@meltzerlippe.com

**Education:**
Wake Forest University, B.A.
Hofstra University School of Law, J.D.

**Bar Admissions:**
New York State Bar
New Jersey State Bar

Kelly A. McGowan is an Associate in the Firm's Trusts & Estates Practice Group. Kelly assists individuals and families in the preservation and transfer of wealth by creating estate plans that provide for and protect her client's loved ones and secure their wealth for future generations. In doing so, she prepares wills, various types of trusts, durable powers of attorney, living wills and health care proxies. In addition to tax planning, Kelly tailors each client's estate plan for his or her specific needs and goals, including planning for minor children and second marriages. She also creates family companies to preserve control over family assets and counsels individuals on charitable giving, including establishing charitable trusts.

Kelly also advises trustees in their administration of trusts, including amending and decanting irrevocable trusts and handling accounting proceedings. Kelly counsels executors, trustees and beneficiaries in contested probate and contested administration proceedings in Surrogate's Courts throughout Long Island, New York City and New Jersey. She also advises clients in bringing assets back to the United States from overseas through the Offshore Voluntary Disclosure program with the IRS and New York State.

Kelly received her J.D. from Hofstra University School of Law, where she attended as a Merit Scholar and served as the Managing Editor of Staff of the American College of Trust and Estate (ACTEC) Law Journal and the Vice President of the Moot Court Board. Kelly earned her B.A. in Anthropology and History from Wake Forest University.

Prior to joining Meltzer Lippe, Kelly served as a legal intern for the Nassau County District Attorney's Office and the Hofstra Law School Disaster Relief Clinic where she assisted victims of Hurricane Sandy.

Kelly was born and raised on Long Island. In her spare time she enjoys traveling abroad and scuba diving. Kelly is admitted to practice in New York and New Jersey.

*New York State*
*Department of Tax and Finance*

**Margaret Neri**
Taxpayer Rights Advocate and Ethics Officer

W.A Harriman Campus
Albany, NY 12227
518.530-5303
Margaret.neri@tax.ny.gov

Margaret Neri was appointed Taxpayer Rights Advocate in July, 2014. She oversees the Office of Taxpayer Rights Advocate, continuing a mission that began as a formal departmental function in 2009 to help New York State taxpayers by balancing taxpayer assistance with enforcement of NYS tax laws. In addition, she helps promote taxpayer rights and responsibilities, and identify recurring issues that could highlight opportunities to enhance Department policies and procedures and improve compliance.

Previously, Ms. Neri worked as a litigator in the Office of Counsel.

Ms. Neri also serves as the Tax Department's Ethics Officer, providing guidance to managers and supervisors and training for our employees across the state.

Ms. Neri has made an important commitment to advocacy and public service at a professional and personal level for many years. Before joining the Tax Department, she was in private practice concentrating in hospital finance, health care, and judgment enforcement. She also served as an Albany County Family Court law guardian. Ms. Neri is a long-time community volunteer, lending her time and energy to a variety of local nonprofit organizations in the Capital Region.

Ms. Neri earned her Juris Doctor from Albany Law School in 1982.

**Nina E. Olson, New York State Taxpayer Rights Advocate**

Nina E. Olson, the National Taxpayer Advocate, is the voice of the taxpayer at the IRS and before Congress. Under her leadership, the Taxpayer Advocate Service helps hundreds of thousands of people e very year resolve problems with the IRS and addresses systemic issues within the IRS. Her Annual Report to Congress identifies the most serious problems facing taxpayers and recommends solutions. In 20142015, the IRSCongress codified the adopted the Taxpayer Bill of Rights for which Ms. Olson had long advocated, placing dozens of existing rights in the Internal Revenue Code into ten fundamental rights, and making them clear, understandable, and accessible for taxpayers and IRS employees alike. She is a graduate of Bryn Mawr College and North Carolina Central School of Law, and she holds a Master of Laws degree in taxation from Georgetown University Law Center.

FARRELLFRITZ PC
BECAUSE SUCCESS MATTERS.

# Eric W. Penzer

## Estate Litigation

**Partner** | 516-227-0618 | epenzer@farrellfritz.com

**LOCATION:** Uniondale

Eric Penzer is a partner concentrating in trust and estate litigation. His practice includes contested probate proceedings, fiduciary accounting proceedings, discovery proceedings, and other litigation related to estates and trusts. He is a frequent contributor to Farrell Fritz's New York Trusts & Estates Litigation blog.

Mr. Penzer is a frequent author of articles on trust and estate litigation practice and lectures extensively on the subject. He is a member of the Executive Committee of the Trusts and Estates Law Section of the New York State Bar Association, a Chairperson of its Practice and Ethics Committee, and a former Chairperson of its Litigation Committee. Mr. Penzer is a member of the New York City Bar Association's Trusts, Estates, and Surrogate's Court Committee, and the Nassau County Bar Association's Surrogate's Court Estates & Trusts Committee.

Mr. Penzer has an AV Preeminent Martindale-Hubbell Peer Review Rating. In 2016, he was selected to The Best Lawyers in America. Mr. Penzer was selected for inclusion on the 2014 and 2015 *Super Lawyers New York - Metro Edition* list (Estate & Trust Litigation), having previously been included on the 2011 Super Lawyers Rising Stars list. In 2009, he was the recipient of *Long Island Business News*' "40 Under 40" award, honoring professionals for their business leadership and community involvement.

He is a Vice President and member of the Board of Directors of The Safe Center LI, located in Bethpage, a non-profit agency serving the victims of domestic abuse and child abuse. He is also a member of the Board of Directors of the Long Island Elite, an organization dedicated to promoting the growth and development of Long Island's business executives by combining community outreach, fundraising for Long Island charities, mentoring, and professional networking. In 2015, Mr. Penzer received the Nassau County Bar Association's Access to Justice Award for his pro bono work.

Mr. Penzer is a former intern to the Honorable Arthur D. Spatt, United States District Judge for the Eastern District of New York. He received his Juris Doctor in 1996 from Fordham University School of Law, where he was an Associate Editor of the Fordham Intellectual Property, Media & Entertainment Law Journal. In 1993, he received his Bachelor of Arts Degree from the State University of New York at Stony Brook.

Mr. Penzer is admitted to practice in the State of New York, in the United States District Courts for the Eastern and Southern Districts of New York, and in the United States Court of Appeals for the Second Circuit.

**Office**
Uniondale
1320 RXR Plaza
Uniondale, NY 11556-1320

**Practice Areas**
Estate Litigation
Trusts & Estates

**Education**
Fordham University School of Law
State University of New York at Stony Brook

JUDGE A. GAIL PRUDENTI

**Hon. A. Gail Prudenti**
**Executive Director of the Center for Children, Families and the Law and Special Advisor to the Dean**

B.A., Marymount College of Fordham University
LL.B. University of Aberdeen, Aberdeen, Scotland, United Kingdom

On September 1, 2015, the Honorable A. Gail Prudenti was named Executive Director of the Center for Children, Families and the Law at the Maurice A. Deane School of Law at Hofstra University, where she also serves as Special Advisor to the Dean.

Prior to her current position at Hofstra Law, Judge Prudenti distinguished herself as a well- respected jurist and hands-on administrator throughout a judicial career that lasted more than two decades. Most recently, she served as the Chief Administrative Judge of the courts of New York State, having been appointed by Chief Judge Jonathan Lippman on December 1, 2011. As Chief Administrative Judge, she supervised the administration and operation of the statewide court system, with a budget of over $2.7 billion, 3,600 state and locally paid Judges and 15,000 non-judicial employees in over 350 court facilities. In addition, she served as a member of the Oversight Board for Judiciary Civil Legal Services in New York, which grants annual awards totaling $85 million to legal service providers to the indigent throughout the state.

Prior to her appointment as Chief Administrative Judge, she served as the Presiding Justice of the Appellate Division for the Second Judicial Department in New York State, the first woman to hold that position, having been appointed thereto, in February 2002, by then-Governor George E. Pataki. Before that, she was the first woman from Suffolk County to serve as an Associate Justice of the Appellate Division for the Second Judicial Department. Prior to ascending to the Appellate Division, Judge Prudenti was the Administrative Judge for the Tenth Judicial District (Suffolk County) for almost three years. At the time of her appointment as a District Administrative Judge, in February of 1999, Judge Prudenti was also the Surrogate of Suffolk County and was the first and only Surrogate in New York to hold the position of a District Administrative Judge.

In August 2011, then-Presiding Justice Prudenti was designated to serve as a Judge of the Court of Appeals for the hearing and determination of the appeal and any related motions in the case of Matter of World Trade Center Bombing Litigation.

Judge Prudenti's judicial career began in 1991 when she was elected to the New York State Supreme Court where she served until 1995, at which time she began her term as the first woman elected Surrogate of Suffolk County. In 1996, during her tenure as Surrogate, Judge Prudenti was also designated as an Acting Supreme Court Justice and received the additional responsibilities of presiding over a dedicated Guardianship Part. After six years as the Surrogate, Judge Prudenti was reelected to the Supreme Court bench.

She earned her law degree from the University of Aberdeen, in Scotland, which also awarded her an honorary Doctorate of Laws in 2004 and an honorary appointment as Professor in the School of Law. She graduated from Marymount College of Fordham University with honors. Her first position was in the Suffolk County Surrogate's Court where she was a Clerk and then a Law Assistant. For two years following her service in the Surrogate's Court, she served as an Assistant District Attorney for Suffolk County. Over the next decade, she was a private practitioner specializing in trusts and estates and was special counsel to the New York City Patrolmen's

Benevolent Association's Widows and Orphans Fund. She has had extensive litigation experience in all the Surrogate's Courts in the metropolitan area.

Her legal writings are extensive. Hundreds of Judge Prudenti's decisions have been published and she has contributed articles to many publications, such as *The New York Law Journal*, *Newsday*, *The Suffolk Lawyer* and

*The Jurist*. She has also published handbooks for guardians ad litem and has written extensively on guardianship proceedings.

Additionally, Judge Prudenti has been a frequent lecturer throughout Suffolk County, Long Island, and the State, appearing at seminars and other functions sponsored by the Suffolk Academy of Law, the New York State Bar Association, the New York State Surrogate's Association, the Office of Court Administration, the University of the State of New York at Stony Brook, Touro Law Center, the Diocese of Rockville Centre, and the Roman Catholic Diocese of Brooklyn, to name a few.

The judge is a member of the Advisory Panel of Judges of the New York State Lawyer Assistance Trust Program, a member of the Council of Chief Judges of the National Center for State Courts, a former chairperson of the Office of Court Administration's Mental Health Curriculum Committee for Trial Judges, co-chair of the Chief Judge's Task Force on Delay in the Courts, a member of the Chief Judge's Commission on Public Access to Court Records, a former member of the Chief Administrative Judge's Judicial Legislative Group and a member of the OCA's Gender Bias and Anti-Discrimination Panel. In addition, the judge is a member of the Judicial Section of the American Bar Association, the former Presiding Member of the Judicial Section of the New York State Bar Association, a member of the New York State Trial Lawyers Association and the New York State Women's Bar Association, a former co-chair of the Surrogate's Court Committee of the Suffolk County Bar Association, a member of the Suffolk County Women's Bar Association, which she helped found, and a member of the Board of Directors of the Suffolk County Columbian Lawyers Association.

Meltzer, Lippe, Goldstein & Breitstone, LLP

# Mordy Serle

*"Want more? Demand Better! Hire Us."*

Associate
516-747-0300 Ext. 282
mserle@meltzerlippe.com

Mordy Serle is an Associate in the Tax-Exempt Organizations and Trust and Estates Group of Meltzer Lippe. Mordy concentrates his practice in state and tax planning, estate administration and wealth preservation. Mordy has counseled clients on sophisticated planning techniques that have resulted in substantial tax-efficiencies and savings from federal and state gift , estate, generation-skipping transfer and income taxes.

These techniques include creating family limited partnerships and family limited liability corporations, sales to grantor trusts, leveraging tax-exempt gifts, insurance trusts, grantor retained annuity trusts and qualified personal residence trusts.

His practice also includes trust and estate administration, where he has counseled executors and trustees on proper trust and estate administration, probate, post-mortem tax planning, preparing federal and state tax returns and fiduciary duties.

Prior to joining Meltzer Lippe, Mordy was an associate in the Trust and Estates Groups of the Debevoise & Plimpton, LLP and then Willkie, Farr & Gallagher, LLP.

Mordy received his J.D. from Columbia Law School, where he was designated a Harlan Fiske Stone Scholar. Mordy received his First Rabbinic degree from Yeshiva Shaar Hatorah, New York.

Prior to attending law school Mordy lived abroad in Jerusalem, Israel for two years, where he studied in the Mir Yeshiva, Jerusalem on an Advanced Talmudic Studies Fellowship. Mordy's oldest son, Abie, now seven, was born in Jerusalem. Mordy lives in Brooklyn with his wife, Chana, Abie, Yisrael, his second son-aged five, and his two year old daughter, Yaelle.

**Education:**
Yeshiva Shaar Hatorah, First Rabbinic

Columbia University, J.D.

**Honors:**
- Columbia University
  - Harlan Stone Fiske Scholar

**Bar Admissions:**
New York State Bar

**Bryan C. Skarlatos**
**Kostelanetz & Fink, LLP**

Mr. Skarlatos represents clients in tax audits, civil tax litigation, criminal tax investigations, voluntary disclosures and IRS whistle-blower matters.

Chambers USA Guide to Leading Lawyers states that Mr. Skarlatos is "extremely knowledgeable and very well connected to the various taxing authorities...Clients applaud him as being exceptionally brilliant at coming up with great outcomes."

Mr. Skarlatos is an Adjunct Professor at NYU School of Law where he teaches a course on Tax Penalties and he has taught several courses on tax procedure, penalties and ethics to various offices of the IRS. Mr. Skarlatos is co-chair of the annual NYU Tax Controversy Forum and chair of the annual Practicing Law Institute program on "Nuts and Bolts of Tax Penalties."

Mr. Skarlatos has been the chair of several tax committees at the American Bar Association, New York State Bar Association, New York City Bar Association and New York County Lawyer's Association and he is a Fellow of the American College of Tax Counsel. He has been recognized in "Chambers USA", "Best Lawyers in America", where was selected as Lawyer of the Year for Tax Litigation in New York City and "New York Super Lawyers", where he was selected as one of the "Top 100 Attorneys" in the New York Metro Area.

Mr. Skarlatos regularly speaks and publishes articles on the topics of civil tax litigation, tax penalties and criminal tax prosecutions and is frequently quoted in media outlets such as CNN, the New York Times, the Wall Street Journal, USA Today, Forbes, Barron's, Reuters, Bloomberg, Tax Notes and the BNA Daily Tax Reporter.

Meltzer, Lippe, Goldstein & Breitstone, LLP

# Jason J. Smith

*"Want more? Demand Better! Hire Us."*

Partner
516-747-0300 Ext. 182
jsmith@meltzerlippe.com

**Education:**
New York University, B.S., Magna Cum Laude
Yale Law School, J.D.

**Bar Admissions:**
New York Bar
Connecticut Bar

Jason J. Smith is a Partner in the Firm's Trusts & Estates Practice Group.

Jason focuses his practice on estate planning, asset protection, estate and trust administration and litigation.

Jason's estate planning practice includes assisting individuals and families with tax-efficient and practical estate and gift planning, including the preparation of wills, revocable living trusts, insurance trusts and qualified personal residence trusts, grantor retained annuity trusts and dynasty trusts.

He also counsels clients on asset protection strategies, including the use of trusts and the preparation of prenuptial agreements. His estate and trust administration practice dovetails with his trusts and estates litigation practice, where he advises clients in contested will and probate proceedings, fiduciary removal proceedings, trust construction cases, contested accountings proceedings, discovery and turnover proceedings and conservatorships and guardianship matters. Jason's trusts and estates litigation practice is augmented by his prior experience representing clients in complex commercial, class action, intellectual property and medical malpractice cases at the trial and appellate levels in both federal and state courts. He represents and advises a diverse range of clients, including those in the lesbian, gay, bisexual and trans gender (LGBT) community.

Previously Jason practiced as a trusts and estates attorney at the Manhattan office of Katten Muchin Rosenman, LLP.

Some of Jason's recent publications include "Ding Dong, Is DOMA Dead? What Opportunities Exist for Same-Sex Couples as We Enter 2014?".

Jason received his J.D. from Yale University Law School, and his B.S., *magna cum laude*, from New York University. While in law school Jason served as managing editor of the Yale Journal of Law & Technology.

Jason is admitted to practice in New York and Connecticut, as well as the U.S. District Court for the District of Connecticut.

Meltzer, Lippe, Goldstein & Breitstone, LLP

# Mark E. Wilensky

*"Want more? Demand Better! Hire Us."*

Partner
516-747-0300 Ext. 284
mwilensky@meltzerlippe.com

Mark E. Wilensky is Partner to the Firm's Tax Law Group. Prior to joining the firm Mark was a tax attorney in the New York City office of Roberts & Holland LLP for twelve years.

A large part of Mark's practice involves advising clients looking to sell, exchange, lease, or refinance real estate and take advantage of the tax deferral opportunities offered by section 1031 exchanges, installment sales, and long-term lease agreements. Mark frequently works with real estate counsel at the Firm advising clients operating as partnerships, limited liability companies, or S corporations on ways to achieve tax deferral from an exchange of property without triggering gain from receipt of taxable "boot."

Another large part of Mark's practice involves working with the Firm's corporate counsel advising business entities on ways to divide a business among shareholders or partners without triggering taxable gain or otherwise counseling clients operating as limited liability companies or S corporations on ways to take advantage of the lower tax rates on capital gains when selling all or a portion of a business.

Mark also has experience settling New York State and City residency audits and advising clients on New York State and City real estate transfer tax, mortgage recording tax, and sales taxes.

Mark chaired the American Bar Association Tax Section's Sales, Exchanges & Basis Committee from 2012 through June 2014 and is a frequent speaker at Tax Section meetings. Mark was honored by the Tax Section as a Nolan Fellow in 2011. Mark is a member of the Bloomberg BNA Real Estate Advisory Board.

Some of Mark's recent presentations include a discussion of the tax treatment of so-called "drop & swap" section 1031 exchanges and a discussion of the 3.8% Medicare tax on net investment income.

Mark is currently teaching a course in Federal Income Taxation of Real Estate Transactions as an Adjunct Professor at Cardozo School of Law.

Mark brings a sense of humor to the table. An improv enthusiast, Mark regularly takes classes with some of New York City's finest improv performers and periodically takes the stage himself with his classmates for performances at venues in New York City.

Mark and his wife Aysen keep busy raising their lovable domestic shorthair cats, Findik and Fistik.

**Education:**
Johns Hopkins University, B.S.

The University of Chicago, M.A.

Columbia University, J.D.

New York University, LL.M.

**Honors:**
- 2012 Nolan Fellow American
  - Bar Association Tax Section
- American Bar Association Tax Section Sales, Exchange & Basis Committee
  - Chairman
- Bloomberg BNA Real Estate
  - Advisory Board Member
- Columbia University
  - Harlan Fiske Stone Scholar

**Bar Admissions:**
United States Tax Court

**Publications:**
- Dividing a Real Estate Empire: The Mixing Bowl Alternative

# 2

# THE FULL PRICE OF A MISTAKE: TAX PENALTIES, TRANSFEREE LIABILITY AND FIDUCIARY LIABILITY

**PRIVATE WEALTH & TAXATION INSTITUTE**
Continuing Professional Education Series

# The Full Price of a Mistake: Tax Penalties, Transferee Liability, and Fiduciary Liability

Bryan C. Skarlatos
Megan L. Brackney

KOSTELANETZ & FINK

Part 1: Tax Penalties and Defenses

## What's Happening Out There?

- More penalties are being assessed
  - The number of accuracy-related penalties assessed each year against individual taxpayers has increased dramatically from 58,366 in 2005 to 554,467 in 2014
    - From the IRS Data Book
- Why?
  - Are there more bad taxpayers?
  - Or is the Service asserting more penalties?

## THE SERVICE HAS CHANGED ITS APPROACH TO PENALTIES

Chief Counsel Notice 2004-36

- Revenue Agents should consider, develop, and impose penalties where appropriate;
- Chief Counsel attorneys must evaluate the hazards of litigation with respect to penalties separately from the hazards with respect to the underlying tax adjustment;
- The mere fact that a taxpayer obtained professional advice does not, in itself, constitute a defense to penalties.

Appeals Memorandum dated June 21, 2004

- Appeals will no longer trade penalty issues. Penalties still should be settled, but the settlement should be based on the merits and hazards surrounding each penalty issue standing alone.

## PROCEDURE FOR ASSESSING PENALTIES

IRM 20.1.5.1(2) (7/1/2008)

- Penalties must be considered in every case;
- Penalties must be developed as the audit progresses;
- Appropriate application of penalties can be determined only after all the facts and circumstances have been developed.

IRC 6751(b)

- Requires written supervisory approval of the initial determination of a penalty by the immediate manager or higher level official of the employee initially proposing the penalty.

IRM 20.1.1.5.1.6(3) (7/1/2008)

- The Service also requires a managerial review on the non-assertion of penalties when there is a substantial understatement of tax under IRC 6662(d).

## Three Main Types of Penalties

Delinquency Penalties

Accuracy-Related Penalties

Civil and Criminal Fraud Penalties

## Delinquency Penalties

Three different delinquency penalties

- 6651(a)(1) – Failure to File
- 6651(a)(2) – Failure to Pay Tax Shown on Return
- 6651(a)(3) – Failure to Pay Tax Not Shown on Return

## Failure to File Penalty

Failure to file return on due date of return
- Including extensions

5% per month or part thereof

25% maximum

Unless the failure is due to reasonable cause and not willful neglect
Fraudulent failure to file
- 15% per month
- 75% maximum

## Failure to Pay Tax Shown on Return

Failure to pay on date prescribed for such payment
- There are no extensions of time to pay

.5% per month or part thereof

25% maximum

Unless the failure is due to reasonable cause and not willful neglect
- Deemed reasonable cause:
  - If valid extension of time to file
  - 90% of tax due paid
  - Return filed by extended due date
  - Remaining amount due paid with return

## Failure to Pay Tax Not Shown on Return

Failure to pay within 21 days from date of notice and demand for payment
- Or 10 days if amount is $100,000 or more

.5% per month or part thereof

25% maximum

Unless the failure is due to reasonable cause and not willful neglect

## Defenses

All of the delinquency penalties are subject to a defense if the delinquency was caused by "reasonable cause" and not "willful neglect"

- Taxpayer must have exercised ordinary business care and prudence but nevertheless was unable to file or pay on time without suffering undue hardship
- Consider all facts and circumstances
  - Lavish or extravagant business expenses
  - Speculative or illiquid investments
  - Anticipated income

## Reliance on Professionals

United States v. Boyle, 469 US 241 (1985)

- Executor of estate hired a lawyer to handle the estate, including filing the Form 706
- Executor had no experience with estate taxes
- Executor called the lawyer several times to determine if return was filed
- Despite assuring the executor that it would be taken care of, the lawyer failed to file on time

## Supreme Court's Holding

This case does not involve reliance on erroneous advice of counsel regarding a question of law

"When an accountant or an attorney advises a taxpayer on a matter of law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice."

"By contrast, one does not have to be a tax expert to know that returns have fixed filing deadlines and that taxes must be paid when they are due. In short, tax returns imply deadlines. Reliance by a lay person on a lawyer is of course common but that reliance cannot function as a substitute for compliance with an unambiguous statute...such reliance is not reasonable cause for a late filing penalty under 6651(a)(1)."

## Practice Tip – First Time Abatement

IRM 20.1.1.3.6.1

- Reasonable Cause Assistant provides an option for penalty relief for the FTF, FTP and FTD penalties if
  - Taxpayer had no prior penalties (except estimated tax penalty) for the preceding 3 years; and
  - Taxpayer has filed (or is on extension) for all returns and paid or arranged to pay any tax due
    - If taxpayer is not in compliance, opportunity should be given to comply before considering FTA

Does not apply to estate tax returns or accuracy related or fraud penalties

Must request it

- If denied, ask for supervisor or request taxpayer assistance

## IRC § 6662: Accuracy-Related Penalty on Underpayments

Polices the accuracy of positions taken on the tax return

Defines how sure a taxpayer has to be before taking a position on the return

## IRC § 6662: Accuracy-Related Penalty on Underpayments

20% penalty for:

- (1) Negligence or disregard of rules or regulations
- (2) Substantial understatement of income tax
- (3) Substantial valuation misstatement
- (4) Substantial overstatement of pension liabilities
- (5) Substantial estate or gift tax valuation misstatement
- (6) Transaction lacks economic substance or fails to meet requirements of any similar rule of law

## IRC § 6662: Accuracy-Related Penalty on Underpayments

40% penalty for:

- (1) ***Gross*** valuation misstatement of valuation, pension liabilities, or estate and gift
- ***Undisclosed*** transaction that lacks economic substance or fails to meet requirements of any similar rule of law
- ***Undisclosed*** foreign financial asset understatement

## Negligence Defined:

- Any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary and reasonable care in the preparation of a tax return. See IRC § 6662(c) and Treas. Reg. § 1.6662-3(b).
- Negligence also includes the failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. See Marcello v. Commissioner, 380 F.2d 499, 506 (5th Cir. 1967).
- No negligence if return position has a reasonable basis.

## Disregard of Rules or Regulations

"Disregard" includes any careless, reckless or intentional disregard of rules or regulations.

Not imposed if:

- (1) adequate disclosure on properly completed Form 8275 (Disclosure Statement) or Form 8275-R (Regulation Disclosure Statement), and
- (2) in the case of a position contrary to a regulation, the position represents a good faith challenge to the validity of a regulation.

## Substantial Understatement Penalty

Substantial Understatement of Income Tax

- **Individuals:** Understatement exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000.
- **Corporations:** Understatement exceeds the lesser of (i) 10 percent of the tax required to be shown on the return (or, if greater, $10,000), or (ii) $10,000,000.

## Reduction of Understatement for Substantial Authority or Disclosure

A "substantial understatement" of tax is reduced by any portion of the understatement

- That is supported by "Substantial Authority"; or
- That is supported by a "Reasonable Basis" AND is "Adequately Disclosed"

## Important Definitions

Substantial Authority

- There is substantial authority if the weight of authority in support of the position is substantial in relation to the weight of authority contrary to the position
  - Only enumerated authorities can be considered
  - Cannot consider the possibility of audit

Reasonable Basis

- There is a reasonable basis if the position is supported by some authority
  - Higher than merely arguable or "not frivolous"

Adequately Disclosed

- Form 8275, Schedule UTP or as indicated by Rev. Proc.
  - Does not apply to negligence or tax shelter items

## Substantial/Gross Valuation Misstatement Penalty

- Underpayment must exceed $5,000
- $10,000 in the case of a corporation, not S corporation

- Substantial valuation misstatement = 50% or more of the correct valuation
  - Then a 20% penalty
- Gross valuation misstatement = 200% or more of the correct valuation
  - Then a 40% penalty

## Substantial Estate or Gift Tax Valuation Misstatement Penalty

Underpayment must exceed $5,000

Substantial valuation misstatement = 65% or less than the correct valuation
- Then a 20% penalty

Gross valuation misstatement = 40% or less than the correct valuation
- Then a 40% penalty

## ECONOMIC SUBSTANCE PENALTY

On March 30, 2010, the Health Care and Education Reconciliation Act:

- Codified the Economic Substance Doctrine in section 7701(o);
- Added a strict liability penalty on any underpayment attributable to a non-economic substance transaction as described in section 6662(b)(6) or underpayment attributable to the failure to meet the requirements of any similar rule of law; and
- Amended sections 6664(c) and (d)(2) to remove the reasonable cause exception for any portion of an underpayment or reportable transaction understatement attributable to a non-economic substance transaction described in section 6662(b)(6).

*The amendments are generally effective for transactions entered into after March 30, 2010.*

## ECONOMIC SUBSTANCE PENALTY

20% penalty on underpayment arising from a transaction that lacks economic substance or fails to meet the requirements of a similar rule of law.

A transaction lacks economic substance unless

- The transaction changes in a meaningful way the taxpayer's economic position AND
- The taxpayer had a substantial non-tax purpose for entering into the transaction.

Penalty is increased to 40% unless the transaction was adequately disclosed.

There is no reasonable cause or good faith defense.

- This is a STRICT LIABILITY penalty.

## Undisclosed Foreign Financial Asset Penalty

40% penalty on any understatement arising from an undisclosed foreign financial asset

Undisclosed foreign financial asset is any asset that was supposed to be reported on form such as an 8936, 5471, 8865, or 3520.

## IRC § 6664: Reasonable Cause and Good Faith Defense

No penalty for any portion of an understatement for which there is reasonable cause and with respect to which the taxpayer acted in good faith.

Reliance on professional

- Was the advisor competent and independent?
- Did the taxpayer provide accurate and necessary information to the advisor?
- Did the taxpayer actually rely in good faith on the advisor?

## Tax Fraud

Civil Fraud – IRC 6663

- Must be proven by "clear and convincing evidence"
- 75% penalty

Criminal Fraud – IRC 7201, 7206, etc.

- Must be proven "beyond a reasonable doubt"
- Jail
- Plus taxes and penalties

## Avoidance Distinguished From Evasion

Avoidance of taxes is not a criminal offense.

Any attempt to reduce, avoid, minimize, or alleviate taxes by legitimate means is permissible. *Gregory v. Helvering*, 293 U.S. 465 (1935).

Tax Avoidance

- One who avoids taxes by legitimate means does not conceal or misrepresent.
- He or she shapes events to reduce or eliminate tax liability and, upon the happening of the events, makes a complete disclosure.

## Avoidance Distinguished From Evasion

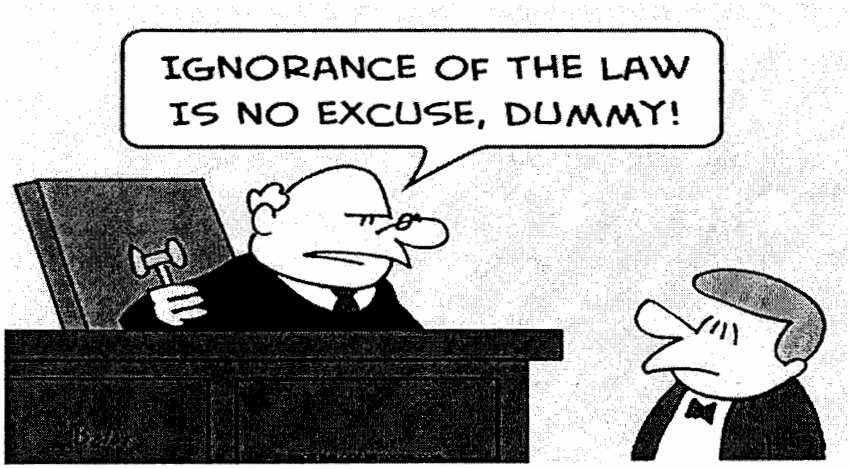
Tax Evasion Has Badges of Fraud

- Evasion involves some affirmative acts to evade or defeat tax or payment of tax.
  - Examples of affirmative acts are deceit, subterfuge, camouflage, concealment, attempts to color or obscure events, or make things seem other than they are. IRM, pt. 25.1.1.2.4(2) (Dec. 16, 2011).
  - Common evasion schemes include intentional understatement or omission of income, claiming fictitious or improper deductions, false allocation of income, improper claims, credits or exemptions, and/or concealment of assets. IRM, pt. 25.1.1.2.4(3) (Dec. 16, 2011).

## Willfulness Is The Key!

- ☐ Tax Fraud and Willful FBAR penalties all require willfulness
- ☐ Tax Crimes all require willfulness

Is Ignorance Of The Law A Defense To Tax Penalties?

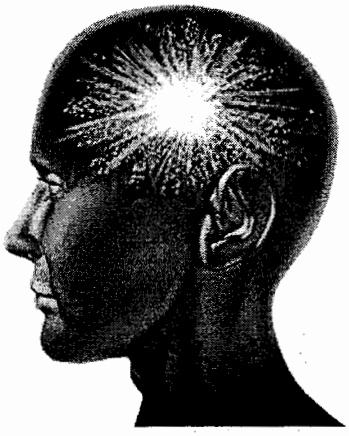



The Tax Law Is So Confusing That Ignorance Can Be A Defense

## Willfulness is Subjective

- Willfulness is defined as "an intentional violation of a known legal duty."
- This is a purely subjective test.
  - Ignorance of the law is a defense to prosecutions or penalties based on willfulness!
    - Cheek v. United States, 498 U.S. 192 (1991)

## How Can The IRS Prove A Subjective State Of Mind?



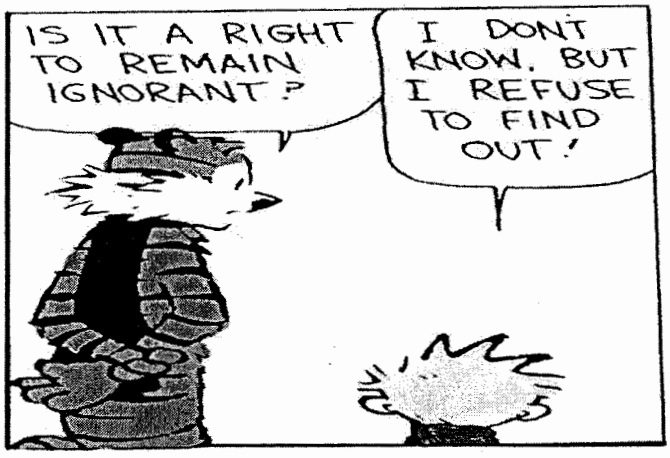
## Circumstantial Evidence; Like Tracks In The Snow

## Circumstantial Evidence of Willfulness

- Indicia of willfulness (a/k/a "badges of fraud")
  - Use of a bank secrecy jurisdiction
  - Numbered account or pseudonym or structures to hide identity
  - Moving the money to another undisclosed location
  - Double set of books
  - False invoices or other documents
  - Repeated failure to pay tax or report assets as required
  - Lying or delaying during audit

## Willful Blindness

## I Didn't Know I Had To Report That!



## Part 2: Transferee and Fiduciary Liability

- IRC 6901: Transferee Liability
- IRC 6324: Transferee Liability for Estate Tax
- 31 U.S.C. § 3713(b): Fiduciary Liability

## Transferee Liability under IRC 6901

IRC 6901 contains two conditions that must be met for the IRS to collect unpaid taxes of the transferor from a transferee of property:

**Transferee prong**. The person must be a "transferee" within the meaning of Section 6901 (the definition being very inclusive), and

**Liability prong**. There must be an independent basis under state law or state equity principles for holding the transferee liable for the transferor taxpayer's unpaid tax.

The "Government's substantive rights are precisely those which other creditors would have under [State] law", and accordingly, the Commissioner must show that an independent basis exists under State law or State equity to hold transferees liable for the putative tax."
*Alterman v. Comm'r of Internal Revenue*, T.C. Memo. 2015-231.

## Who is a "Transferee"?

Under IRC 6901(h), a transferee includes donee, heir, legatee, devisee, and distributee.

For estate taxes, a transferee also includes any person who is personally liable for any part of such tax. Subsequent transferees also meet this definition.

## Transferee Liability – NY State Law

NY Debtor and Creditor Law § 273 provides that "[e]very conveyance made and every obligation incurred by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to his actual intent if the conveyance is made or the obligation is incurred without a fair consideration."

Actual motive or intent to defraud on the part of the transferor need not be shown.

A person is deemed insolvent when "the present fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured." § 271[1]

Fair consideration requires that the exchange not only be for equivalent value, but also that the conveyance be made in good faith. § 272.

## Statute of Limitations for Assessment of Transferee Liability under IRC 6901

IRC 6901(c) permits the IRS to assess the transferee in the same manner as it assesses the tax itself, but with an additional year added on to the statute of limitation.

Essentially, the IRS has one year after the tax could have been *assessed* against the transferor to assess tax based on transferee liability.

## Recent IRC 6901 Cases

*Julia R. Swords Trust v. Comm'r*, 142 T.C. 317 (2014)

*William S. Stuart, Jr. v. Comm'r*, 144 T.C. 235 (2015)

*Tricarichi v. Comm'r*, T.C. Memo. 2015-201

*Shockley v. Comm'r*, T.C. Memo. 2015-113

*John M. Alterman Trust v. Comm'r*, 2015-231

*Andrew v. United States*, 91 F. Supp. 3d 739 (2015)

## Transferee Liability under IRC 6324

IRC 6324 imposes liability on the transferees of a decedent's estate when the estate itself fails to pay its federal taxes.

Essentially, it affords the Government a separate remedy against the beneficiaries of an estate when the estate divests itself of the assets necessary to satisfy its tax obligations, at least to the extent of the value of the gift.

The federal statute itself creates the liability, and thus we do not look to state law (unlike IRC 6901).

## Statute of Limitations for Assessment of Transferee Liability under IRC 6324

IRC 6324(b) does not explicitly state a statute of limitations for a donee's personal liability. Generally, if an action could be timely commenced against the donor under IRC 6501 (assessment) and IRC 6502 (collection), an action against the donee under IRC 6324(b) will be timely.

## Fiduciary Liability under 31 U.S.C. § 3713(b)

A personal representative "paying any part of a debt of the . . . estate before paying a claim of the Government is liable to the extent of the payment for unpaid claims of the Government."

An executor of an estate can be personally liable for taxes, penalties, and interest if: (i) the executor distributed assets of the estate; (ii) the distribution rendered the estate insolvent; and (iii) the distribution took place after executor had notice of the government's claim.

## Fiduciary Liability, Cont.

For fiduciary liability to attach, "the executor must have knowledge of the debt owed by the estate to the United States or notice of facts that would lead a reasonably prudent person to inquire as to the existence of the debt owed before making the challenged distribution or payment."

Once the executor is on inquiry notice, he or she must make reasonable efforts to discover the unpaid claim.

## Fiduciary Liability, Cont.

It is well-settled that "claim of the United States" includes income taxes and interest, assessed and unassessed;

It is also well-settled that "claim" includes assessed penalties;

It is less clear whether it would include *unassessed* penalties which are in the discretion of IRS to impose.

## Statute of Limitations for Assessment of Fiduciary Liability

The statute of limitations for assessment against a fiduciary is "not later than 1 year after the liability arises or not later than the expiration of the period for *collection* of the tax in respect of which such liability arises, whichever is the later." IRC 6901(c)(3).

## Limiting Fiduciary Liability

Discuss compliance during estate planning;

As executor, conduct reasonable investigation of decedent's compliance, e.g., look for unreported foreign assets;

If discover non-compliance, file delinquent returns and/or amend income tax returns, using voluntary disclosure program, as appropriate;

Reserve funds to pay potential claims of IRS.

File Form 5495, "Request for Discharge From Personal Liability Under IRC 2204 or 6905."

The executor must indicate each year and type of tax for which he or she is seeking discharge, and attach the applicable tax returns.

If the Service does not notify the executor of the amount due within 9 months, the executor is automatically discharged from personal liability. Treas. Reg. § 301.6905-1(a).

If the IRS notifies the executor of the amount of tax due, the executor is discharged from all personal liability upon full payment.

# 3

# MEET YOUR TAXPAYER ADVOCATE: MAJOR CHALLENGES FACING TAXING AUTHORITIES AND THE TAXPAYER ADVOCATE'S ROLE IN ASSISTING TAXPAYERS

# PREFACE: Introductory Remarks by the National Taxpayer Advocate

## HONORABLE MEMBERS OF CONGRESS:

I respectfully submit for your consideration the National Taxpayer Advocate's 2015 Annual Report to Congress. Section 7803(c)(2)(B)(ii) of the Internal Revenue Code requires the National Taxpayer Advocate to submit this report each year and in it, among other things, to identify at least 20 of the most serious problems encountered by taxpayers and to make administrative and legislative recommendations to mitigate those problems.

The year 2015 has been a memorable one for taxpayer rights. On November 19 through 21, over 160 people from 22 countries gathered at the National Archives and the Internal Revenue Service to participate in the Inaugural International Conference on Taxpayer Rights. The conference was convened by the National Taxpayer Advocate and co-sponsored by the American Bar Association Section of Taxation, the American College of Tax Counsel, the American Tax Policy Institute, the International Association of Tax Judges, the International Fiscal Association — USA Branch, and Tax Analysts. It included two days of presentations by speakers from countries as diverse as South Africa, Greece, Mexico, Sweden, Canada, England, Australia, and the United States, as well as a mini-conference on the third day with a panel of, and discussions by, taxpayer advocates and ombuds from around the world. The conference laid a foundation for continuing work and scholarship in the area of taxpayer rights, particularly as they derive from human rights' conventions, constitutional law, and statutes.[1]

On the evening of the first day of the International Conference on Taxpayer Rights, I stood in the Rotunda of the National Archives and viewed the documents on which the United States is founded — the Declaration of Independence, the Constitution, and the Bill of Rights. I was struck by James Madison's language quoted in a display about our nation's path to adopting a Bill of Rights:

> I think we should obtain the confidence of our fellow citizens in proportion as we fortify the rights of the people against the encroachments of the government.

It is fitting that, less than one month after I read this statement at the historic conference, Congress passed and the President signed into law legislation that codified the provisions of the Taxpayer Bill of Rights (TBOR), an act I have been advocating for since 2007.[2] The need for and protections afforded by the TBOR cannot be overstated. In today's environment of low confidence and even distrust of the federal government and the IRS, the agency's adherence to the principles of the TBOR will demonstrate to taxpayers that they have reason to trust that it will administer the nation's tax laws fairly and justly.

---

1 To see the conference agenda and abstracts of papers, visit www.taxpayerrightsconference.com. As papers from the conference are formally published in Tax Notes, The Tax Lawyer, and other journals, we will make them publicly available on this website. Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, § 401 (2015). The law requires the Commissioner to "ensure that employees of the Internal Revenue Service are familiar with and act in accord with taxpayer rights as afforded by other provisions of this title." The bill provides that these rights include the *right to be informed*, the *right to quality service*, the *right to pay no more than the correct amount of tax*, the *right to challenge the position of the Internal Revenue Service and be heard*, the *right to appeal a decision of the Internal Revenue Service in an independent forum*, the *right to finality*, the *right to privacy*, the *right to confidentiality*, the *right to retain representation*, and the *right to a fair and just tax system*. To its credit, the IRS itself announced its adoption of the Taxpayer Bill of Rights in June 2014. However, congressional action carries the force of law and makes a significant statement about the value our elected representatives place on taxpayer rights.

2 The National Taxpayer Advocate has been recommending that Congress codify the Taxpayer Bill of Rights since 2007. See National Taxpayer Advocate 2007 Annual Report to Congress 478-98 (Legislative Recommendation: *Taxpayer Bill of Rights and De Minimis "Apology" Payment*).

The Taxpayer Bill of Rights is the roadmap to effective tax administration. Congress has set the IRS on this path by codifying the TBOR. It is now up to the IRS to more fully incorporate taxpayer rights into everything it does. However, I have significant concerns that the IRS is embarking on a path that will unintentionally undermine taxpayer rights rather than enhance them, thereby eroding taxpayer trust further. I discuss these concerns in the remainder of this preface, and specifically in the first Most Serious Problem: *Taxpayer Service: The IRS Has Developed a Comprehensive "Future State" Plan That Aims to Transform the Way It Interacts With Taxpayers, But Its Plan May Leave Critical Taxpayer Needs and Preferences Unmet.*

### The IRS Future State Vision and Its Implications for Taxpayer Rights

In response, in part, to significant budget cuts since 2010, the IRS has undertaken a multi-year exercise to develop a concept of operations (CONOPS) or "future state vision." This exercise is long overdue and I commend the IRS for undertaking it. Not surprisingly, the IRS future state now under internal discussion proposes changes in agency operations that assume a constrained funding environment and therefore minimizes agency costs. As a result, these proposed changes have serious ramifications for taxpayers and taxpayer rights. Most significantly, the IRS future state vision redefines tax administration into a class system, where only taxpayers who are the most *non*compliant or who can "pay to play" will receive concierge-level service or personal attention.[3] The compliant or trying-to-comply taxpayers will be left either struggling for themselves or paying for assistance they formerly received for free from the IRS.

The language in the few future state documents that are publicly available is commendable enough.[4] For example, there is laudatory language about improving taxpayer service by giving taxpayers self-service options ("Facilitate voluntary compliance by empowering taxpayers with secure innovative tools and support") and by working with third parties such as software companies, Circular 230 tax professionals, and other preparers ("Leverage and collaborate with external stakeholders"). There is discussion about being data-driven ("Select highest value work using data analytics and a [sic] robust feedback loops") and conducting behavioral research ("Understand non-compliant taxpayer behavior and develop approaches to deter and change it"). I note, however, that there is no stated commitment to understanding *compliant* taxpayer behavior and developing approaches to *maintain and enhance it.* The focus of this document is primarily on enforcement challenges.

Yet even as the IRS has been and is now holding internal discussions, it is eliminating services without any future state substitutes for those services in place. As we describe in the #1 Most Serious Problem and throughout this report, the IRS is reducing assistance to taxpayers despite the absence of significant research into taxpayers' needs and preferences for assistance or the effect of service reductions on taxpayers' willingness or ability to comply voluntarily with their tax obligations. The implications of these decisions and actions are far-reaching and should be discussed publicly *before* the IRS implements them.

### A Brief Level-Setting: The Current State of Tax Administration Today

For fiscal year (FY) 2015, the IRS collected over $2.8 trillion dollars (net of refunds), or over 90 percent of federal receipts. Figure 1 below shows the breakdown of contributors to the public fisc by type of tax payment.

---

3 I am indebted to Professor Keith Fogg, Visiting Professor of Law and Director of Federal Tax Clinic Legal Services Center at Harvard Law School, for his inspired use of the phrase "concierge service."

4 See, e.g., *Tax Enforcement in a Resource-Challenged World* (32nd Annual National Institute on Criminal Tax Fraud and the Fifth National Institute on Tax Controversy, Las Vegas, NV, Dec. 9-11, 2015) slide 7. All quotes in this paragraph are from this document.

**FIGURE 1, Federal Tax Receipts by Type of Tax, FY 2015**[5]

| Tax Type | Trillions of Dollars | Percent of Revenue |
|---|---|---|
| Individual Income Taxes | $1.541 | 47% |
| Corporate Income Taxes | $0.344 | 11% |
| Social Security/Retirement Benefits | $1.065 | 33% |
| Excise Taxes | $0.098 | 3% |
| Other | $0.201 | 6% |

Almost half of federal tax receipts are from individuals, including sole proprietors. Another third are paid by employers — many of which are small businesses. Yet the tax administration issues impacting these taxpayers get very little attention these days — particularly the needs and preferences of individual taxpayers. Note that about 45 percent of individual taxpayers have income at or below 250 percent of the Federal Poverty Level and thus are considered by Congress as unable to afford professional representation in tax disputes.[6] Keep this in mind as I describe the reality of tax administration for the masses of individual and small business/self-employed taxpayers.

During FY 2015, the IRS received over 100 million phone calls from taxpayers or their representatives.[7] Here is a snapshot of what they experienced:

**FIGURE 2, IRS Telephone Performance on Accounts Management and Select Lines**[8]

| Phone Line | Level of Service | Average Speed of Answer (minutes) |
|---|---|---|
| Accounts Management | 38.1% | 30.5 |
| Taxpayer Protection Unit | 24.6% | 29.6 |
| Installment Agreements/Balance Due | 37.0% | 34.8 |
| NTA Toll-Free | 43.7% | 16.2 |
| Practitioner Priority Service | 47.6% | 46.6 |

The "Level of Service" (or LOS) refers to the percentage of calls the IRS answers among all calls routed to customer service representatives. On all Accounts Management telephone lines combined, the IRS answered only about 38 percent of its calls — meaning about 62 percent of calls simply didn't get through. The 38 percent of taxpayers who spoke with an assistor waited on hold an average of over 30 minutes before reaching a representative. But there was considerable variation among the IRS's dozens of phone lines, as Figure 2 indicates.

5 Congressional Budget Office, *The Budget and Economic Outlook 2012-2025*, 95; IRS FY 2016 Budget in Brief.

6 IRS Compliance Data Warehouse (CDW), Individual Returns Transaction File (Tax Year 2014). Internal Revenue Code (IRC) § 7526 provides that taxpayers with incomes at or below 250 percent of the Federal Poverty Level who are in controversies with the IRS are eligible for *pro bono* or nominal fee assistance from Low Income Taxpayer Clinics.

7 IRS, Joint Operations Center (JOC), *Snapshot Reports: Enterprise Snapshot, IRS Enterprise Total* (Sept. 30, 2015).

8 IRS, JOC, *Snapshot Reports: Product Line Detail* (Sept. 30, 2015).

As we have described in this year's Most Serious Problems about revenue protection and identity theft,[9] IRS fraud detection filters in FY 2015 had false positive rates ranging from 30 to 37 percent. In the Taxpayer Protection Program (TPP), IRS filters suspend return processing when they identify a risk of identity theft. To verify one's identity and continue return processing, a taxpayer can either call the IRS or try to authenticate online. The IRS detected and stopped approximately 4.8 million suspicious tax returns from January 1 through November 30, 2015. Well over 40 percent of these suspended returns are a result of the TPP, which had a false positive rate of 36.2 percent for this same timeframe. (This false positive rate is up from 19.8 percent for calendar year 2014).[10] All of these legitimate taxpayers were desperately attempting to free up their refunds, yet at one point during the filing season the level of service on the TPP line was below ten percent for three consecutive weeks — meaning more than 90 percent of the calls were not answered![11] At another point the wait time was 60 minutes.[12] By the end of the fiscal year, the service levels were somewhat improved but still abysmal — 24.6 percent LOS and a 29.6 minute wait time.

Taxpayers who filed a balance due return and attempted to call the IRS during 2015 to make payment arrangements faced another daunting task. The IRS sends these taxpayers a series of notices that list a phone number to call; this is the same phone line a taxpayer selects to make payment arrangements if he or she calls the main toll-free "1040" number. Yet in FY 2015, the LOS on that line was 37.0 percent, and the average speed of answer (ASA) was 34.8 minutes. That is, *almost two-thirds* of these calls went unanswered. Now, these are taxpayers who owe the federal government money. They are calling to pay their taxes, or they are calling to tell the IRS they can't pay their taxes because they are experiencing economic hardship. Yet the IRS isn't able to pick up the phone to talk to them!

What happens to these taxpayers when the IRS doesn't pick up the phone? Well, after a certain period of time, the taxpayer's account is moved to the Automated Collection System (ACS), which, true to its name, searches out lien and levy sources so it can *automatically* file a Notice of Federal Tax Lien against the taxpayer's property or levy upon the taxpayer's bank account or wages. The IRS doesn't know the taxpayer has been trying to call it. Nor does the IRS make any effort to call the taxpayer before it automatically takes enforcement action against the taxpayer. By the time the taxpayer gets assigned to ACS, the IRS assumes the taxpayer has been unresponsive and is not trying to comply — despite the lousy levels of service on the pre-ACS phone lines.

How do these taxpayers feel when the first contact they actually have with the IRS is a lien filing or a levy on their wages? How will they behave with respect to their tax obligations in the future? What message is the IRS sending when it doesn't engage with the taxpayer and then takes an enforcement action? These are not theoretical questions. They go to the heart of the relationship the taxpayer has with his or her government (as represented by the IRS), and they have everything to do with the degree to which a taxpayer is willing to comply with the tax laws.

---

9 See Most Serious Problem: *Revenue Protection: Hundreds of Thousands of Taxpayers File Legitimate Tax Returns That Are Incorrectly Flagged and Experience Substantial Delays in Receiving Their Refunds Because of an Increasing Rate of "False Positives" Within the IRS's Pre-Refund Wage Verification Program, infra*; Most Serious Problem: *Identity Theft (IDT): The IRS's Procedures for Assisting Victims of IDT, While Improved, Still Impose Excessive Burden and Delay Refunds for Too Long, infra.*

10 IRS, *Global Identity Theft Report* (Nov. 2015).

11 IRS, JOC, *FY 2015 Weekly TPP Snapshot* (weeks ending Feb. 28, 2015 [9.7 percent], Mar. 7, 2015 [7.6 percent], and Mar. 14, 2015 [9.8 percent]).

12 IRS, JOC, *FY 2015 Weekly TPP Snapshot* (week ending Feb.28, 2015).

Before I discuss taxpayer or tax morale,[13] consider these data points. Ninety-eight percent of all tax revenue collected by the IRS is paid voluntarily. Less than two percent is collected through direct enforcement action.[14] If the IRS were to collect ten percent less in enforcement revenue, tax revenue would drop by less than $6 billion. But if voluntary payments were to decrease by ten percent, tax revenue would drop by more than $280 billion.[15] In light of this data, just where should we be putting our attention and our resources?

### A Discussion of First Principles: What Is Taxation About?

Simply put, taxation involves taking money from one person and applying that taking to the greater good of many, if not all. That is an extraordinary thing to ask of people. A tax system depends on taxpayers being willing to offer up their hard-earned or saved dollars and let their money be applied to everyone's — or someone else's — benefit.

So the central question in tax administration is: How do we promote that willingness? What does the tax administrator need to do to maintain and expand taxpayers' willingness to pay their taxes? Stated another way, how should the tax administrator behave so it doesn't undermine or lose taxpayers' willingness to comply with the tax laws? The answers to these questions should drive both the current and future state of the IRS.

### The Dynamics Between Power and Trust, Taxpayer and the Tax Agency

When we talk about taxpayers' willingness to comply, we really have to consider the relationship between the taxpayer and the government. This essentially involves an analysis of the dynamics between power and trust. Specifically, the government — and by extension, the tax agency — holds the awesome power of the state. For the tax system to work, the taxpayer has to trust that the government will use its power wisely and legitimately. If it does, taxpayers will be more willing to comply with the tax laws and meet their tax obligations.[16]

Power can be either coercive or legitimate.[17] Trust can be reason-based or learned. The dynamics between the type of power and the type of trust define and influence the climate of government-taxpayer interaction. We can have an antagonistic environment, or one that is service-oriented, or one that is cooperative. These climates of interaction define the kind of compliance we can achieve. In an antagonistic environment, you will have enforced compliance — which is very expensive, and often involves the use of both

---

13 "Tax Morale" is the "collective name for all the non-rational factors and motivations — such as social norms, personal values and various cognitive processes — that strongly affect an individual's voluntary compliance with laws." National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 139 (Marjorie E. Kornhauser, *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*).

14 In FY 2015, the IRS collected total tax revenue of about $3.3 trillion and refunded about $400 billion. Only $54.2 billion (about 1.9 percent) is classified as "Enforcement Revenue." Government Accountability Office (GAO), GAO-16-146, *Financial Audit: IRS's Fiscal Years 2015 and 2014 Financial Statements* 25 (Nov. 2015), *available at* www.gao.gov/assets/680/673614.pdf.

15 About $3.3 trillion in gross revenue collections less refunds of $403 billion and less enforcement revenue of $54.2 billion comes to about $2.84 trillion in net taxes voluntarily paid. Ten percent of $2.84 trillion is more than $280 billion. By contrast, ten percent of IRS enforcement revenue is only slightly greater than $5.4 billion. See GAO, GAO-16-146, *Financial Audit: IRS's Fiscal Years 2015 and 2014 Financial Statements* 25 (Nov. 2015).

16 See Tom R. Tyler, *Why People Obey the Law* (Princeton, Princeton University Press) 2006. For a more recent exploration of the role of procedural justice in shaping perceptions of legitimacy of law enforcement agencies and actions, see Tom R. Tyler, Phillip Atiba Goff & Robert J. MacCoun, *The Impact of Psychological Science on Policing in the United States: Procedural Justice, Legitimacy, and Effective Law Enforcement*, *Psychological Science in the Public Interest*, Vol. 16(3), 75-109 (2015).

17 For a detailed analysis of the dynamic between power, trust, and the compliance environment, see Katharina Gangl, Eva Hofmann & Erich Kirchler, *Tax Authorities' Interaction with Taxpayers: A Conception of Compliance in Social Dilemmas by Power and Trust*, New Ideas in Psychology 37, 13-23 (2015). See *also* Erich Kirchler, *The Economic Psychology of Tax Behaviour* (Cambridge, Cambridge University Press) (2007).

coercive and legitimate power, but very little trust. In a service-oriented environment, you will have voluntary compliance — but it is still a choice by the taxpayer; the taxpayer is learning that the government can be trusted to apply its power legitimately. The holy grail for tax administration is a cooperative environment of committed compliance — where compliance has become a way of life. The taxpayer trusts and expects the government will use its power appropriately and wisely (legitimately) and thus is willing to come forward when he or she makes mistakes, knowing that the government will listen and engage with the taxpayer.[18] The taxpayer, in turn, is willing to make the personal sacrifice of paying taxes for the greater good.

### The IRS Is Increasingly a Pay-to-Play System, Which Erodes Trust in the Tax System

Reading between the lines of the IRS future state vision, the IRS appears to replace traditional IRS employee-to-taxpayer interaction with online and third-party interactions. That is, the vision essentially eliminates IRS-taxpayer personal interaction except in the context of enforcement actions. Now, I understand that virtually all taxpayers would love to live their lives without *any* interaction with the IRS. But as I noted earlier, tens of millions of taxpayers need to contact and interact with the IRS every year. Over nine million taxpayers receive post-refund notices and experience refund delays every year.[19] The issues underlying those interactions are vitally important to each of those taxpayers — and the resolution of those contacts could literally impact the livelihood or survival of a person or a business.[20]

In the IRS future state, if a taxpayer wants to talk with the IRS about his concerns, he will be pretty much out of luck. He will be directed first to a website or an online account, the outlines of which are very vague and the creation of which may undermine significant taxpayer protections.[21] The online account will not provide for the kind of discussion necessary to ensure the IRS understands the details of the taxpayer's circumstances, or whether the taxpayer understands what the IRS is telling him or her.

---

18 This is why the Taxpayer Bill of Rights, adopted by the IRS in 2014 and codified on December 18, 2015, by the Consolidated Appropriations Act, 2016, includes the *right to challenge the IRS's position and be heard*. It is not enough for the taxpayer to have the right to challenge the IRS; the IRS must also *listen* to the taxpayer and *hear* his complaint.

19 For a breakdown of these notices, see Most Serious Problem: *Taxpayer Service: The IRS Has Developed a Comprehensive "Future State" Plan That Aims to Transform the Way It Interacts with Taxpayers, But Its Plan May Leave Critical Taxpayer Needs and Preferences Unmet, infra.*

20 In the Most Serious Problems section of this Annual Report, we have provided numerous examples of the harm that can befall taxpayers if they are unable to make personal contact with the IRS. *See, e.g.*, Most Serious Problems: *Practitioner Services: Reductions in the Practitioner Priority Service Phone Line Staffing and Other Services Burden Practitioners and the IRS, infra*; *Revenue Protection: Hundreds of Thousands of Taxpayers File Legitimate Tax Returns That Are Incorrectly Flagged and Experience Substantial Delays in Receiving Their Refunds Because of an Increasing Rate of "False Positives" Within the IRS's Pre-Refund Wage Verification Program, infra; Identity Theft (IDT): The IRS's Procedures for Assisting Victims of IDT, While Improved, Still Impose Excessive Burden and Delay Refunds for Too Long, infra; Automated Substitute for Return (ASFR) Program: Current Selection Criteria for Cases in the ASFR Program Create Rework and Impose Undue Taxpayer Burden, infra; International Taxpayer Service: The IRS's Strategy for Service on Demand Fails to Compensate for the Closure of International Tax Attaché Offices and Does Not Sufficiently Address the Unique Needs of International Taxpayers, infra; Individual Taxpayer Identification Numbers (ITINs): IRS Processes Create Barriers to Filing and Paying for Taxpayers Who Cannot Obtain Social Security Numbers, infra; Earned Income Tax Credit (EITC): The IRS Does Not Do Enough Taxpayer Education in the Pre-Filing Environment to Improve EITC Compliance and Should Establish a Telephone Helpline Dedicated to Answering Pre-filing Questions From Low Income Taxpayers About Their EITC Eligibility, infra; Earned Income Tax Credit (EITC): The IRS Is Not Adequately Using the EITC Examination Process as an Educational Tool and Is Not Auditing Returns With the Greatest Indirect Potential for Improving EITC Compliance, infra.*

21 For a detailed discussion about individual and tax professional access to online accounts, see Most Serious Problem: *Taxpayer Access to Online Account System: As the IRS Develops an Online Account System, It May Do Less to Address the Service Needs of Taxpayers Who Wish to Speak with an IRS Employee Due to Preference or Lack of Internet Access or Who Have Issues That Are Not Conducive to Resolution Online, infra*; and Most Serious Problem: *Preparer Access to Online Accounts: Granting Uncredentialed Preparers Access to an Online Taxpayer Account System Could Create Security Risks and Harm Taxpayers, infra.* For a discussion of our concerns about "self-service" and "just-in-time" options, see National Taxpayer Advocate 2012 Annual Report to Congress 180-91 (Most Serious Problem: *The Preservation of Fundamental Taxpayer Rights Is Critical As the IRS Develops a Real-Time Tax System*).

**When you add on the additional burden of paying "user fees" for actions and services that are rightly considered core duties and responsibilities of tax administration officials, the financial burden and consequence of pay-to-play becomes even greater. Fundamental rights are now up for sale.**

Alternatively, the taxpayer will have to pay a tax professional or purchase a tax software add-on for services the taxpayer previously received for free from the government in exchange for his willingness to cooperate and comply with the tax laws.

What is being lost in this vision of the future is the interest in and relationship with actual taxpayers — a dialogue with taxpayers. The IRS is designing its system so it can deal with taxpayers *en masse*. I understand how budget and workload constraints could drive the IRS to adopt this approach. In fact, the IRS performs "mass processing" responsibilities well — it will likely have processed about 150 million individual income tax returns, almost 11 million business entity returns, and over 2.1 billion information returns last year.[22] But *taxpayers* are not returns — they are *people* (or businesses run by people). If the *taxpayer* has a problem or needs some particular information, that's where the system (and the vision) breaks down. That taxpayer in the future will have to undertake "self-service" or obtain "for-fee" third-party assistance.

This approach transforms our tax system into a pay-to-play system. Those who are sophisticated enough to understand their tax problem or their tax needs and can navigate the self-help options well enough to protect their rights will be able to do so. Those who have the ability to pay a third party to navigate the IRS and protect their rights will do so. But for those who have neither the expertise, the time, nor the resources to navigate these options — they will be up a creek. They will make mistakes with self-help; they will agree to assessments and adjustments they never should; and they will forfeit significant due process protections like the right to go to the United States Tax Court or have a Collection Due Process hearing — all because they can't talk with an IRS employee about their situation or because they can't afford to pay someone to help them. This creates a two-class tax system — those who can pay and those who can't. It undermines the fundamental *right to a fair and just tax system*. When you add on the additional burden of paying "user fees" for actions and services that are rightly considered core duties and responsibilities of tax administration officials, the financial burden and consequence of pay-to-play becomes even greater. Fundamental rights are now up for sale.[23]

### An Online Account Will Be Helpful But Comes With Significant Risks and Is No Replacement for Person-to-Person Interaction

I am fully in support of robust online services. Since 2009, I have been calling for the IRS to create online taxpayer accounts with full information about a taxpayer's tax returns, with the ability to export W-2 and 1099 information to software programs, check on the status of return and refund processing, correspondence, and other account transactions, and receive electronic acknowledgements. I also support Circular 230 tax professionals' and preparers' access to those accounts, with proper taxpayer authorization and so long as the taxpayer is informed of his right to receive, electronically or otherwise, notification of every online transaction made on his or her behalf. A well-designed taxpayer account will send due date notifications and updates on relevant current guidance. It will give taxpayers and their representatives the

22 IRS Pub. 6187, *Calendar Year Projections of Returns by Major Processing Category* (Fall 2015); IRS Pub. 6292, *Fiscal Year Return Projections for the United States 2015-2022* (Fall 2015); IRS Pub. 6961, *Calendar Year Projections of Withholding and Information Return Documents for the United States and IRS Campuses* (2015 Update).

23 See Most Serious Problem: *IRS User Fees: The IRS May Adopt User Fees to Fill Funding Gaps Without Fully Considering Taxpayer Burden and the Impact on Voluntary Compliance, infra.*

ability to communicate by email, to schedule appointments for phone conferences with the IRS, and to conduct virtual face-to-face conferences via computer.

But when you expand that access to unregulated preparers or to other third parties, I have significant concerns. We already see the problems in this population of preparers relating to the Earned Income Tax Credit (EITC),[24] where certain unregulated, untrained preparers prey on vulnerable taxpayers.[25] Why would we want to give these preparers even more access to taxpayer information? And yet, if we don't provide these preparers access to taxpayer accounts, it is very likely the tens of millions of taxpayers who use these preparers won't be able or won't want to utilize their own online accounts, thereby carving a big hole in the IRS's online strategy. Thus, through its single-minded emphasis on online accounts, the IRS creates a situation where it will face enormous pressure to open up taxpayer account access to all unregulated return preparers.

Moreover, not every activity can or should be done online. Many things relating to tax require a conversation. People want to talk about the things that matter to them. And few things matter more to people than talking about what is going to happen to their money.

### Less Secrecy and More Transparency: The IRS Needs to Start Its Future State Visions Now by Engaging With Taxpayers About Its Proposals and Plans

What is driving the IRS to think this way and go down this path of a two-class tax system? To some extent, the IRS is a victim of its own apparent efficiency at moving masses of data and work, as evidenced by the fact that Congress has continued to hand it major new programs to administer including the Patient Protection and Affordable Care Act (ACA)[26] and the Foreign Account Tax Compliance Act (FATCA).[27] After five years of overall budget decreases, the IRS FY 2016 budget provides for much needed increases in taxpayer service funding, but it still leaves the IRS budget almost 19 percent below its FY 2010 funding level in inflation-adjusted terms,[28] and it does not even begin to account for the additional costs the IRS incurred to implement the ACA and FATCA.

In this environment of more work and inadequate funding, it is easy to bash the IRS. This bashing, in turn, can produce a bunker mentality in the IRS that makes it wary of sharing things with the public until

---

24 See IRC § 32.

25 See Most Serious Problem: *Earned Income Tax Credit (EITC): The IRS's EITC Return Preparer Strategy Does Not Adequately Address the Role of Preparers in EITC Noncompliance, infra.*

26 Pub. L. No. 111-148, 124 Stat. 119 (2010). For detailed discussion of current issues in ACA administration, see Most Serious Problem: *Affordable Care Act (ACA) – Business: The IRS Faces Challenges in Implementing the Employer Provisions of the ACA While Protecting Taxpayer Rights and Minimizing Burden, infra*; Most Serious Problem: *Affordable Care Act – Individuals: The IRS Is Compromising Taxpayer Rights As It Continues to Administer the Premium Tax Credit and Individual Shared Responsibility Payment Provisions, infra*: Legislative Recommendation: *Affordable Care Act Information Reporting: Allow Taxpayer Identification Number Matching for Filers of Information Returns Under IRC §§ 6055 and 6056, infra.*

27 Pub. L. No. 111-147, Title V, Subtitle A, 124 Stat. 71, 97 (2010). For detailed discussion of our concerns regarding IRS FATCA implementation, see Most Serious Problem: *International Taxpayer Service: The IRS's Strategy for Service on Demand Fails to Compensate for the Closure of International Tax Attaché Offices and Does Not Sufficiently Address the Unique Needs of International Taxpayers, infra*; Legislative Recommendation: *Foreign Account Reporting: Eliminate Duplicative Reporting of Certain Foreign Financial Assets and Adopt a Same-Country Exception for Reporting Financial Assets Held in the Country in which a U.S. Taxpayer Is a* Bona Fide *Resident, infra*; Legislative Recommendation: *Chapter 3 and Chapter 4 Credits and Refunds: Protect Taxpayer Rights by Aligning the Rules Governing Credits and Refunds for Domestic and International Withholding, infra.*

28 In FY 2010, the agency's appropriated budget stood at $12.1 billion. In FY 2016, its budget was set at $11.2 billion, a reduction of nearly eight percent over the six-year period. Inflation over the same period is estimated at nearly 11 percent. See Office of Management and Budget, *Fiscal Year 2016 Budget of the U.S. Government, Historical Tables*, Table 10.1 (showing Gross Domestic Product (GDP) and year-to-year increases in the GDP), *available at* https://www.whitehouse.gov/sites/default/files/omb/budget/fy2016/assets/hist.pdf.

they are absolutely finalized.[29] But that means the IRS will almost certainly miss things and get things wrong, precisely because it hasn't engaged the public and floated proposals publicly before they become set in stone.[30]

**This bashing, in turn, can produce a bunker mentality in the IRS that makes it wary of sharing things with the public until they are absolutely finalized. But that means the IRS will almost certainly miss things and get things wrong, precisely because it hasn't engaged the public and floated proposals publicly before they become set in stone.**

For any vision of the future to work, the IRS needs to engage taxpayers in the process. Taxpayers, in turn, need to speak up, get engaged, and hold the IRS accountable for responding to their needs. They need to contact their representatives in Congress and explain to them in real terms what it is like to interact with the IRS — the good and the bad. Tax professionals need to insist on a dialogue with the tax agency and push, push, push for greater transparency. They need to explain to their elected representatives why the current trajectory in tax administration is bad for tax compliance and just what it means for the representatives' constituents. Most importantly, Congress needs to assert its oversight authority and insist that the IRS come now, sooner not later, to explain the specifics of its future state vision. And those same hearings should include representatives of taxpayer segments as well as tax professionals. It is important that these hearings be kept separate from the hearings Congress has conducted in recent years on actual or perceived IRS shortcomings. Developing a consensus about the future state vision for our nation's tax system requires a single-minded focus on assessing the objectives of the tax system, what taxpayers need to comply with their tax obligations, and how to balance competing objectives. Finally, I believe the IRS should put its plan for the future out to the public for notice and comment.

Now, here is what I am going to do in 2016 to further the discussion of the IRS future state vision and to ensure that U.S. taxpayers have a voice in the process. I will be going around the country and holding public hearings on this topic. I will invite members of Congress and representatives of different taxpayer populations and stakeholders to join me so we can consider diverse viewpoints, and gather suggestions and descriptions of taxpayers' needs.

I am also going to highlight why taxpayers should care about what kind of IRS we have. There is no other federal agency that interacts as often with United States citizens and residents (and increasingly, non-residents). It is in taxpayers' best interests that they speak up about what kind and manner of assistance they need from the tax agency.

29 Indeed, as we obtained information from the IRS to produce this Annual Report to Congress, the IRS has asserted that numerous data points and documents we intended to include in the report are "official use only" and may not be made public. Never before has the IRS made this assertion in so many instances, and never before have we ultimately failed to come to agreement on some disputed items. To avoid the risk my staff or I could be subject to disciplinary action for unauthorized disclosure, we have been forced to redact portions of text in some sections, and we have omitted relevant information in others. See, e.g., Most Serious Problem: *IRS User Fees: The IRS May Adopt User Fees to Fill Funding Gaps Without Fully Considering Taxpayer Burden and the Impact on Voluntary Compliance, infra*; Most Serious Problem: *Earned Income Tax Credit (EITC): The IRS's EITC Return Preparer Strategy Does Not Adequately Address the Role of Preparers in EITC Noncompliance, infra*.

30 One area in which the IRS is sharing its vision of the future is its plans to reorganize the Large Business & International (LB&I) Operating Division. Senior IRS officials have discussed and shared materials about the reorganization at several practitioner meanings in recent months. While this is to be commended, I note that LB&I caters to the part of the taxpayer population that can "pay to play" and expects (and receives) concierge-level service. No such plans have been shared about the IRS future state plans for the approximately 150 million individual taxpayers, much less the approximately 54 million small business taxpayers.

### Conclusion

Every day, the IRS faces the daunting task of juggling an increasing and diverse workload involving both revenue collection and benefits payments, with the relentless demands of doing everything in as cost-efficient a manner possible. But for the IRS to do its job well, it must start from the perspective of what government is about — namely, it is of the people, by the people, and for the people. The government is funded by taxes paid by the people. Therefore, the future state vision of the IRS needs to be designed around the needs of the people. If it is, it will be effective and efficient. Most importantly, it will be trusted by the people. As always, I look forward to working with Congress and the IRS to make this so.

Respectfully submitted,

Nina E. Olson
National Taxpayer Advocate
31 December 2015

**PRIVATE WEALTH & TAXATION INSTITUTE**
Continuing Professional Education Series

# Taxpayer Rights Advocate

**DEPARTMENT OF TAXATION AND FINANCE**
**Margaret Neri**

1

## Office of the Taxpayer Rights Advocate

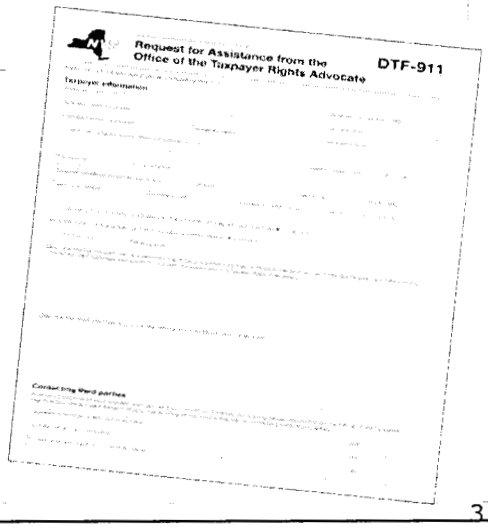
- Created in 2009
- 9 full-time advocates
- One-on-one assistance to taxpayers
- 2300 cases each year
- 70% of taxpayers receive full or partial relief

2

## Form DTF-911

**Submit via**

- **Mail**
- **Fax**
- **Telephone**
  **(518) 530-4357**


Request for Assistance from the Office of the Taxpayer Rights Advocate

DTF-911

3

## How we work

**The Compliance Continuum**

4

## Advocacy Brings Results

- Six year time limit to docket sales tax warrants
- New 20 year statute of limitation for collections (August 2011)
- New "responsible person" policy for passive investors in LLCs and limited partnerships. See TSB-M-11(6)S (April 14, 2011)
- Offer in Compromise reform (August 17, 2011)
- New legislation: suspending statute of limitations for credit or refund in cases of financial disability due to serious mental or physical impairment (August 2014)
- Metropolitan Commuter Transportation Mobility Tax – simplified return and payment process for self-employed individuals

5

## Current Initiatives (2016)

- Taxpayer Bill of Rights
- New application for relief for minor investors in LLCs and LLPs
- Review of Offer in Compromise standards
  - criminal convictions
  - payments – finding a way forward
- Power of Attorney – new revised form

6

## Contact Information

- Margaret Neri

Email: Margaret.Neri@tax.ny.gov
Address: Department of Taxation and Finance
Taxpayer Rights Advocate Office
Bldg. #9, Room 241
W. A. Harriman Campus
Albany, NY 12227
NYS Tax Department Website: www.tax.ny.gov
OTRA Helpline: (518) 530-HELP (4357)

7

**Efficiency ● Integrity ● Fairness**

8

# PRIVATE WEALTH & TAXATION INSTITUTE

Continuing Professional Education Series

## The NYC Office of the Taxpayer Advocate

**BY**

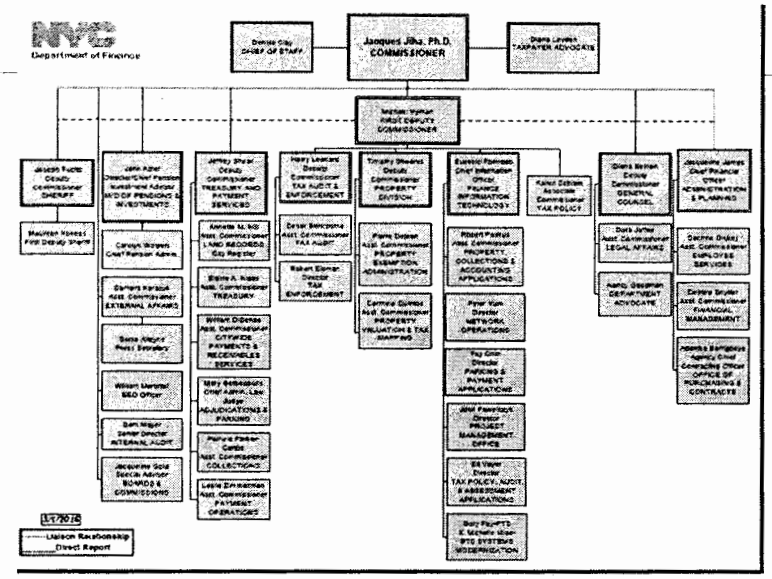
Diana Leyden

NYC Taxpayer Advocate

Department of Finance

## The NYC Department of Finance-many things to many people

- DOF is more than just a taxing agency.
- Various responsibilities include:
  - Administering business & excise taxes, but not NYC sales tax or personal income taxes.
  - Valuing all NYC property and administering the NYC property tax.
  - Collecting other agency charges- water, sewer, sidewalk repairs, Environmental Business Charges- building violations, sanitation violations, etc.
  - Parking Tickets
  - Sheriff's Department
  - Rent Freeze
- Also NYS laws may control what DOF can do with respect to administering its laws. Sometimes the New York City Council may adopt local laws that apply only to NYC.




## What is the role of the Taxpayer Advocate?

- Created administratively to help taxpayers with business and excise tax problems and property tax problems (including Rent Freeze.)
- Who supported creating the Taxpayer Advocate office?
  - Professional groups
  - City Council
  - Commissioner of Finance
- Webpage: http://www1.nyc.gov/site/finance/about/taxpayer-advocate.page

## How is the Office of the Taxpayer Advocate organized?

- Borrowed shamelessly from the IRS NTA.
- Taxpayer Advocate, 1 Attorney Advisor, 2 Case Advocates (one for property and one for collection), and a Tax Analysts
- Operating procedures very similar to NTA.
- We handle both inquiries and cases.
- We identify systemic issues

## What kinds of cases come to NYC OTA?

- Lots of process questions- DOF had not traditionally published how it operates. Telephone numbers for particular persons are not published.
- Some unique hardship cases due to application of policies that do not make sense or deny taxpayers notice.
- For Business taxes, DOF created a new service unit, so most of the cases go there. We handle lots of denied penalty cases. OICs not well developed.
- For property taxes, the law does not allow much in the way of relief for hardship. But the rules for how properties are valued and assessed are complex and create a lot of confusion among property owners.

## Other role of OTA/Taxpayer Advocate

- Taxpayer Advocate reports directly to Commissioner. Independent voice.
- Taxpayer Advocate is part of senior staff and cabinet.
- Taxpayer Advocate is public face of DOF- attending conferences, information sessions held by DOF or City Council members.
- Other roles- on working group for ADA compliance, notice redesign, liaisoning with other agencies.

## How is NYC OTA like NTA?

- Reports directly to Commissioner.
- Works cases and has authority to issue OARs (Operations Assistance Requests) and TAO s(Taxpayer Assistance Orders)
- Works on systemic problems.

## How is NYC OTA different from NTA?

- Office is not created by statute.
- OTA does not report directly to City Council- report by OTA to Commissioner, Commissioner reports to City Council as a condition to funding the office.
- No jurisdiction over personal income tax.
- DOF does not have an internal call center. Inquiries from the public have to go through a central 3-1-1 system.

## NEWLY ADOPTED NYC Taxpayer Bill of Rights

- Right to be informed.
- Right to Quality Service
- Right to Pay No More Than the Correct Amount of Tax
- Right to Understand How Your Property Tax is Determined
- Right to Challenge the Department of Finance's Position and Be Heard
- The Right to Finality
- The Right to Privacy
- The Right to Confidentiality
- The Right to Retain Representation
- The Right to a Fair and Just Tax System

## Successes are very sweet…

- In the first 5 months we have been open, we have refunded $139,833 and abated $ $1.75M in taxes.
- We have handled 218 inquiries and opened 113 cases. Our average turn around time for cases was 52 days.
- We have issued 5 TAOs, 3 granted, 1 withdrawn and 1 pending.
- We have developed a penalty handbook.
- We have prompted the redesign of Property Tax benefit applications and championed a project to redesign the annual Notice of Property Value.

## Lessons for other local revenue agencies

- Most property taxpayers have no one to help them understand how their property is valued or taxed. The Taxpayer Advocate is key to building trust in property taxes. The Taxpayer Advocate also helps property owners who cannot afford to hire an attorney to challenge the value in court.
- Taxpayer Advocates are important facilitators with other agencies, thereby cutting the red tape for consumers.
- Taxpayer Advocates are cultural brokers.

## Lessons learned in the first year…

- People within the agency DO NOT like change. Many are career employees with over 50% eligible to retire in 5 years. They have served under many commissioners many of whom made many changes.
- NYC taxpayers do not trust DOF. Due to prior bad acts some taxpayers believe that DOF is corrupt or political. Hard to convince taxpayers when we cannot grant the relief they want that it is not political.
- In a large city like NYC, may need to have Case Advocates in each Borough.
- Culture within DOF of bureaucratic oppression (enforcement rather customer centric) is hard to change.
- The position needs to be legislated into law, not an administrative appointment and should have a 5 year term.
- The Taxpayer Advocate should submit an annual report directly to City Council.

## Annual report on the Office of the Taxpayer Advocate

- The Commissioner is required to submit a report to the City Council as a condition to appropriating money to fund the Taxpayer Advocate Office:

"No later than May 1, 2016, as a condition of the funds in units of appropriation 001 and 011, the Commissioner of the Department of Finance shall submit to the Council an annual report detailing the number and nature of inquiries received by the Taxpayer Advocate regarding property tax exemptions or business tax exemptions, whichever is applicable for Fiscal 2016. Such report shall also include the number, nature, and resolution of complaints received by the Taxpayer Advocate; any recommendations made by the Taxpayer Advocate to the commissioner; the acceptance and denial rates of such recommendations by the commissioner; and the number and nature of inquiries referred to the Taxpayer Advocate by the ombudspersons at the Department; and the number and nature of inquiries referred to the Taxpayer Advocate by 311."

# 4

# SURROGATE'S COURT PRACTICE UPDATE

McKinney's Consolidated Laws of New York Annotated
Surrogate's Court Procedure Act (Refs & Annos)
Chapter 59-a. Of the Consolidated Laws (Refs & Annos)
Article 21. Miscellaneous Proceedings (Refs & Annos)

McKinney's SCPA § 2102

§ 2102. Proceedings for relief against a fiduciary

Effective: December 20, 2014
Currentness

A proceeding may be commenced to require a fiduciary:

1. To supply information concerning the assets or affairs of an estate relevant to the interest of the petitioner when the fiduciary has failed after request made upon him in writing therefor.

2. To set apart and turn over exempt property to which a spouse or child is entitled or if it has been lost, injured or disposed of to pay the value thereof or the amount of injury thereto.

3. After reservation for the payment of the expenses of administration to pay the reasonable funeral expenses of a decedent if there are funds available for such payment.

4. To pay a claim which has been allowed, to deliver a specific bequest or property to a person entitled thereto or to pay a legacy, distributive share, interest in a trust or a claim for an administration expense, and when a trustee is unable to deliver personal property to the person entitled, to pay the value thereof.

5. To pay in advance to any beneficiary of an estate all or part of any beneficial interest to which he is entitled when the property of the estate applicable to the payment of debts, legacies and expenses exceeds by at least one-third the amount of all known claims, legacies having priority and beneficial interests of the same class and the beneficiary needs such payment for his support or education or of his family.

6. To comply with such directions as the court may make whenever two or more fiduciaries disagree with respect to any issue affecting the estate.

*7. Repealed by L.2014, c. 404, § 3, eff. Dec. 20, 2014.*

**Credits**
(L.1966, c. 953. Amended L.1967, c. 685, § 119; L.1968, c. 259, § 34; L.1980, c. 503, § 26; L.1985, c. 634, § 3; L.1993, c. 514, § 47; L.2014, c. 404, § 3, eff. Dec. 20, 2014.)

**Editors' Notes**

## SUPPLEMENTARY PRACTICE COMMENTARIES

By Margaret Valentine Turano

### 2014

Under this section, a beneficiary may commence a proceeding to require the executor to "supply information concerning the assets or affairs of an estate relevant to the interest of the beneficiary when the fiduciary has failed after request made upon him in writing ...." In *Matter of Marienhoff*, N.Y.L.J., August 15, 2013, at 30, col. 1 (Surrogate's Court, Nassau County), the petitioners' only interests were in specific bequests of personal property under the propounded will and another will on file in the Surrogate's Court. They had, therefore, no right under this section to information about how much money the decedent had, whether the executors had opened an estate bank account, what securities the decedent owed, whether he owned mortgages and notes, or whether he had transferred any property shortly before his death.

* * *

This section permits the court to direct a fiduciary to act when two fiduciaries cannot agree on a matter "affecting the estate." In *Matter of Hansel*, N.Y.L.J., May 20, 2014, at 26, col. 3 (Surrogate's Court, Nassau County), the decedent had transferred stock, which comprised the bulk of the estate, to her grandchildren and great-grandchildren, reserving the right to demand it back. She did demand it back, and when they refused to give it, she commenced an action in the Supreme Court to recover the stock. The two fiduciaries (the decedent's two daughters) disagreed on whether to continue the action. Since it was arguably an estate asset and its ownership therefore affected the estate, the court directed the daughters to continue the Supreme Court action.

### 2013

For a case in which the surviving spouse could not meet her proof under this section that the "property of the estate applicable to the payment of debts, legacies and expenses exceed ... by at least one third the amount of all known claims, *see Matter of Zaharopoulos*, N.Y.L.J., March 11, 2013, at 31 (Surrogate's Court, Queens County).

### 2012

This section's subparagraph (6) allows the court to resolve differences between two co-fiduciaries. In *Matter of Thomson*, N.Y.L.J., December 12, 2011, at 22, col. 3 (Surrogate's Court, New York County), the court declined to do so. The decedent's son and daughter were co-fiduciaries of her estate and equal beneficiaries of a cooperative apartment.

The fiduciaries were disputing the best use of the apartment. The son wanted to remain in the residential portion and to rent out the commercial portion. The daughter wanted to rent out the whole thing. The daughter also petitioned under SCPA 2107, and the court declined to substitute its judgment

for the fiduciary's deeming it an issue of the "management of property that [had] been distributed to individual beneficiaries...."

## PRACTICE COMMENTARIES

by Margaret Valentine Turano

This section, like SCPA § 2101, incorporates parts of several earlier statutes and organizes the provisions that relate to actions against a fiduciary. It permits seven distinct proceedings against a fiduciary, commenceable by other fiduciaries, creditors and persons interested. In addition, under SCPA § 202 the court can, in any proceeding, grant any relief it has jurisdiction to grant, even if the movant did not specifically ask for it or asked for it in the wrong proceeding. *See, e.g., Matter of Arrathoon*, N.Y.L.J., January 3, 2008, at 33, col. 6 (Surrogate's Court, New York County), where the court accelerated the discovery proceeding of a 93-year-old widow and addressed issues of title to exempt property that she should technically have raised in a proceeding under this section's subparagraph (2).

The numbering below corresponds with the proceeding's subparagraph in the statute.

(1) The petitioner, having first asked the fiduciary for the information in writing to no avail, may seek information that relates to her interest in the estate. A co-fiduciary has standing here, since she must protect the estate's interests if the other co-fiduciary is doing wrong. *Wiener v. Spahn*, 60 A.D.3d 586, 876 N.Y.S.2d 380 (1st Dep't 2009).

(2) The petitioner may seek to acquire for the decedent's spouse or children the property "set off" by EPTL 5-3.1 and exempt from creditors. These beneficiaries need not await an accounting even in an insolvent estate because the EPTL 5-3.1 exemption has priority over creditors' claims. If the fiduciary has lost, damaged or disposed of the exempt property, the court can order her to pay the spouse or children its value.

(3) The petitioner may seek payment of funeral expenses after the fiduciary has reserved a fund for administration expenses. That reservation reiterates the priority of administration expenses over funeral expenses. SCPA § 1811 directs that funeral expenses be paid out of the first moneys received by the fiduciary but makes them subject to administration expenses. (*See also* EPTL 5-3.1, where the spouse is entitled to (the first) $25,000 in cash, but it is subject to funeral expenses if they have not been paid.) Former law (S.C.A. § 216) contained timing limitations that the legislature did not include in this section, but as with all miscellaneous proceedings, the court may decide to defer its decision until the judicial accounting.

(4) A creditor who has obtained a judgment or whose claim the fiduciary has allowed, a claimant for administration expenses, and beneficiaries entitled to payment out of the estate may petition for their payment. *See, e.g., Matter of Rappaport*, N.Y.L.J., June 19, 1987, at 16, col. 3 (Surrogate's Court, Westchester County) (petition for payment of trust income). The practitioner needs to be mindful of the seven-month period under SCPA § 1802, before which he cannot make distributions of the estate to beneficiaries without liability to creditors.

(5) A beneficiary may petition for advance payment of his legacy if the estate is at least one-third larger than what is necessary to pay debts, expenses and other legacies with priority over the petitioner's (see the order of abatement in EPTL 13-1.3), but only if he can show that he needs the advance for his own or

his family's support or education. If the estate has more than enough funds to cover its obligations and a beneficiary seeks a partial distribution, the court will determine whether the fiduciary has a good reason for withholding it. *See Matter of Ehmer*, 272 A.D.2d 542, 708 N.Y.S.2d 143 (2d Dep't 2000) (executor failed to substantiate his reason for withholding funds from beneficiary, and court ordered distribution); *Matter of Selzer*, N.Y.L.J., December 18, 1995, at 29, col. 1 (Surrogates's Court, New York County) (fiduciary had partial interest in asset and beneficiary alleged that fiduciary was using her fiduciary status to manage and control asset to exclusion of beneficiary). The court can order advance payment even in cases where the petitioner has not finally proven her right to it, *see Matter of Castellone*, N.Y.L.J., August 8, 2003, at 24, col. 6 (Surrogate's Court, Suffolk County), but in that case the court would always require a full refunding bond. *See Matter of Goldman*, 150 A.D.2d 267, 541 N.Y.S.2d 788 (1st Dep't 1989); *Matter of Milbank*, 49 A.D.2d 848, 374 N.Y.S.2d 105 (1st Dep't 1975). This subparagraph's predecessor, S.C.A. § 221, included a waiting period, which the legislature declined to readopt.

(6) An interested person, including a fiduciary, may petition the court to resolve an issue when fiduciaries disagree between or among themselves. *See, e.g., Matter of Stanley*, 240 A.D.2d 268, 660 N.Y.S.2d 107 (1st Dep't 1997) (to extent one co-administrator disagrees with other, it can ask court to resolve matter); *Matter of Heim*, N.Y.L.J., July 2, 2001, at 32, col. 5 (Surrogate's Court, Suffolk County) (court ordered fiduciary to cooperate in sale of estate assets and winding up of estate). Before a 1993 amendment, this relief was available only for the resolution of disagreement among the fiduciaries on the very narrow issue of the custody of money or other property. By L.1993, c. 514, § 47, the legislature recognized that such a provision woefully underestimated the kinds of disagreements fiduciaries could have, and expanded it.

(7) As of July 28, 1985, the legislature amended EPTL 11-1.5 to provide for interest on general legacies, and it simultaneously amended this section so the person entitled to such interest would have a procedure for obtaining it. L.1985, c. 634, § 3.

**REVISORS' NOTES**

There has been combined in this section the kinds of relief which may be obtained against a fiduciary.

Subdivision 1 contains the relief provision of S.C.A. § 199.

Subdivision 2 contains the relief provision of S.C.A. § 201.

Subdivision 3 contains the relief provision of S.C.A. § 216 with removal of the first sentence of that section to SCPA art. 18 and of the last two sentences of that section to SCPA art. 22. It is also made clear in subdivision 3 that administration expenses are preferred.

Subdivision 4 contains the relief provision of S.C.A. §§ 217, 219 and 220.

Subdivision 5 contains the relief provision of S.C.A. § 221.

Subdivision 6 contains the relief provision of S.C.A. § 228.

No change in substance in any of these provisions is intended.

See Legis.Doc. (1964) No. 19, p. 44.

Notes of Decisions (155)

McKinney's S. C. P. A. § 2102, NY SURR CT PRO § 2102
Current through L.2016, chapters 1 to 33, 50 to 58.

End of Document

39 Westchester B.J. 43

**Westchester Bar Journal**
Winter/Spring, 2014

# NOT THE KIND OF DISCOVERY YOU WERE THINKING OF: A PRIMER ON DISCOVERY PURSUANT TO SECTION 2103 OF THE SURROGATE'S COURT PROCEDURE ACT

Anthony J. Enea, Esq. [a1]



AN ESTATE'S FIDUCIARY IS CHARGED with the obligation of marshaling the decedent's assets. This duty may require the fiduciary to engage in some sleuthing in order to uncover information concerning estate assets and liabilities which may be in the possession of others. This often occurs when during the period of time in close proximity to the decedent's death assets are transferred to third parties or there is an issue as to whether or not assets titled in the name of the decedent and others are truly joint assets passing by operation of law or are property held jointly for convenience purposes only. Additionally, there may arise the occasion where the fiduciary is (1) uncertain as to whether he has possession of all of the estate property; or (2) believes that estate property, or information relevant to that property, is being purposefully withheld from the estate.

*44 To remedy this situation, § 2103 of the Surrogate's Court Procedure Act (SCPA) allows an estates legal representative to commence a discovery proceeding. Said proceeding differs from the disclosure vehicles available pursuant to Article 31 of the Civil Practice Law and Rules (CPLR), which will not be discussed in this article.

## Initiating a Discovery Procedure

Pursuant to Article VI, § 12 of the New York State Constitution, the surrogate's court has jurisdiction over "all actions and proceedings relating to the affairs of decedents, probate of wills, administration of estates and actions and proceedings arising thereunder or pertaining thereto." However, a petitioner's right to initiate a discovery proceeding in the surrogate's court is not absolute. Provided that the court has personal and subject matter jurisdiction, and the necessary parties have standing to bring such action, it is within the court's discretion to grant discovery. As such, pursuant to § 2102(b) of the SCPA, the surrogate may entertain or reject a request for discovery, or reserve the matter for later determination in an accounting or other proceeding. Unless rejected in a writing within fifteen days of submission, a discovery proceeding is deemed to have been entertained by the court. A court may reject a request for discovery pursuant to § 2103 of the SCPA for a variety of reasons, including lack of personal or subject matter jurisdiction.

Discovery is an important vehicle for the fiduciary to either obtain information relevant to potential estate assets or discover withheld property. Pursuant to § 2103(1) of the SCPA, a fiduciary is permitted to initiate a discovery proceeding against an individual who has possession or control, or information or knowledge of, any personal property or real property in which the decedent had an interest. This action is similar to that of a conversion or replevin and, absent fraud, is subject to a three year statute of limitations. However, a breach of fiduciary duty action is subject to a six year statute of limitations.

As discussed above, a discovery proceeding may be brought by a legal representative of the estate, including a temporary administrator or preliminary executor. However, there may be the case where the fiduciary (in his or her personal capacity) has control of the property at issue and is unwilling to turn it over to estate? If the fiduciary

is unwilling or unable to initiate a §2103 action due to a conflict of interest, then a distributee, beneficiary or financial institution acting as a stakeholder may apply for restricted or limited letters of administration pursuant to SCPA §702 or SCPA §902 for purposes of commencing a discovery proceeding against the fiduciary.

**Discovery's Two Stages: Inquisitorial and Turnover**

Discovery may have two stages, inquisitorial and turnover. If it is unclear whether a third party has control or possession of the estate property in question, or if a fiduciary believes that a respondent has information relevant to estate property, then petitioner may make an inquiry. The scope of the inquisitorial stage is quite broad to allow the fiduciary to discover pertinent facts relevant to the estate's assets and debts.

At the inquisitorial stage of discovery petitioner alleges upon information and ***45** belief, that a third-party respondent such as an estate beneficiary has possession of (or information concerning) a decedents assets and such assets should be delivered to or paid to the fiduciary. The proceeding is commenced by the filing of a petition along with an order to attend and be examined. The petition must identify the following: (1) the decedent; (2) the property in question; (3) the date the fiduciary was appointed as such; (4) facts supporting the proponent's claim that the respondent has possession, control or knowledge of the property or money at issue; and (5) the relief sought.

**Inquisitorial Stage**

At the inquisitorial stage, the proponent is not required to allege facts demonstrating that the estate is the owner of the money or property. However, the proponents allegations must be sufficient to justify the inquiry. The petition must set forth the relief requested, including, but not limited to an inquiry, examination or injunctive relief. In the Order to Attend, petitioner should consider seeking a temporary restraining order against the respondent to obviate the risk that the property at issue may be disposed of pending the outcome of the proceeding. Additionally, the proponent may submit an affidavit in support of the allegations presented in the petition.

In response to such a petition, the court will use its subpoena power to direct the respondent to appear for examination via the order to attend. Pursuant to § 2103(5) of the SCPA and § 8001 of the CPLR, a certified copy of the order must be served on the respondent along with the witness subpoena fee. The Surrogate's subpoena power is limited to New York State and, as such, personal jurisdiction is limited to witnesses within the states boundaries. In addition, proper service is paramount because failure to meet the statutory requirements set forth above may result in a dismissal of the proceeding. Conversely, the court may issue a supplemental order allowing the proponent to correct the jurisdictional defect by properly serving the order.

There is no requirement that the respondent file an answer during the inquisitorial stage. As such, a respondent may:

1. Appear on the return date of the citation without filing an answer;

2. Answer the petition generally;

3. Answer the petition and assert title to the property in question;

4. Answer the petition and admit possession, not title, of the property in question; or

5. File an answer and turnover the property in question to the estate.

At the conclusion of the inquisitorial phase, petitioner must demand that the respondent file an answer and turnover the property at issue. A respondent who asserts possession of and title to such property is required to file a verified answer to the petition.

A turnover request may be made simultaneously with an inquiry. An inquiry may also be converted to a turnover proceeding. However, if it is clear that the respondent has possession of the property at issue, a petitioner may avoid the inquisitorial stage ***46** altogether and request that the respondent deliver such property to the estate. If a petitioner did not ask for an examination or inquiry, then he must make factual allegations supporting his position and demand the turnover to the estate of the assets in question.

**Turnover proceeding**

In a turnover proceeding, the court issues a citation to the respondent alleged to have control or possession over the property at issue to show cause why he should not deliver the property, its value or proceeds. On the return date of the citation, the court conducts a hearing to determine whether the respondent has possession or control of such property and, if so, whether the estate is entitled to the property. If the respondent defaults on the return date, and the allegations set forth in the turnover petition were made solely upon information and belief, then the court will schedule an inquest. During the inquest, the onus is on petitioner to present evidence to the court concerning the property's value and that such property was owned by the decedent when he died and is currently in the respondent's possession. The respondent must be given notice of the inquest as directed by the Surrogate.

The court may grant summary relief to petitioner based upon uncontested allegations of title set forth in the petition Furthermore, both petitioner and respondent may demand a jury trial. However, injunctive relief must be pursued by a separate order. Pursuant to the CPLR, disclosure is only available after the issue is joined, which occurs when the respondent files a verified answer in the proceeding. Discovery would then be governed by the rules as set forth in Article 31 of the CPLR governing discovery and disclosure.

Clearly, whether one is engaged in either the inquisitorial or turnover phase of an SCPA §2103 discovery proceeding it is imperative that one be armed with the factual and legal arguments to be able to establish that the property in issue truly belongs to the decedent's estate. Reliance on speculation and conjecture as to the true ownership of property will not be sufficient.

Footnotes

a] ANTHONY J. ENEA, ESQ. is the managing member of Enea, Scanlan & Sirignano, LLP. Mr. Enea is a Past President of the Westchester County Bar Association and is the President of the Westchester County Bar Foundation. Mr. Enea is the Immediate Past Chair of the Elder Law Section of the New York State Bar Association and is a Past President and a Founding Member of the New York Chapter of the National Academy of Elder Law Attorneys (NAELA). Mr. Enea wishes to acknowledge the contributions and assistance of firm associate, Helene Rahal, Esq., to the preparation of this article.

McKinney's Consolidated Laws of New York Annotated
Surrogate's Court Procedure Act (Refs & Annos)
Chapter 59-a. Of the Consolidated Laws (Refs & Annos)
Article 21. Miscellaneous Proceedings (Refs & Annos)

McKinney's SCPA § 2104

§ 2104. Inquiry; trial and decree

Currentness

1. Upon the return of the order, whether or not the respondent answers, the petitioner may examine him with respect to the allegations of the petition. If it appears thereon that an issue of title to any property as defined in 103 or the proceeds or value thereof is raised, if he has not theretofore done so, the respondent shall be directed to serve and file an answer accordingly, but the examination, if directed by the court, shall continue. When an issue of title is raised that issue shall be tried as a litigated issue.

2. Any claim of title to or the right to the possession of any property of the decedent or the estate must be made by verified answer.

3. If the possession of the property be denied, proof of that issue may be presented by any party. The court may in an appropriate case make an interim decree directing the delivery of property not claimed by verified answer and continue the proceeding for determination of any litigated issue.

4. If it appears that the petitioner is entitled to the possession of any property the decree shall direct delivery thereof to him or if the property shall have been disposed of or diverted the decree may direct the payment of the proceeds or the value of the property or may impress a trust upon the proceeds or make any determination which the supreme court might decree in following trust property or funds.

5. If it be determined that the petitioner is not entitled to the property or the proceeds or value thereof the court may determine the respective interests of the other claimants thereto.

6. If during the proceeding, other than a trial of issues raised by answer, a respondent is examined concerning any personal communication or transaction between himself and the decedent such examination shall not be deemed to be a waiver of the provisions of CPLR 4519.

**Credits**
(L.1966, c. 953. Amended L.1967, c. 685, § 120; L.1993, c. 514, § 49.)

**Editors' Notes**

**SUPPLEMENTARY PRACTICE COMMENTARIES**

by Margaret Valentine Turano

**2015**

If a petitioner under this section alleges fraud, she must plead it with particularity. The Court of Appeals has held that when a plaintiff has alleged fraud and the facts relating to the fraud are largely "within the knowledge of" the party accused of fraud, it will not require "talismanic, unbending allegations," which are "sometimes ... unavailable prior to discovery." *See Pludeman v. Northern Leasing Systems, Inc.*, 10 N.Y.3d 486, 860 N.Y.S.2d 422, 890 N.E.2d 184 (2008). In *Matter of English*, N.Y.L.J., June 9, 2015, at 28, col. 2 (Surrogate's Court, Kings County), the petitioner did not allege fraud in her initial petition; rather, she alleged that the fiduciaries were holding some of the decedent's property that should be part of the estate and offered several documents supporting her petition. When the fiduciaries replied that her proceeding was time-barred under CPLR 214(3), she sought to have the statute of limitations for fraud (CPLR 214(8)) apply. That was her first time alleging fraud.

The court rejected her position. The *Pludeman* court, it said, reiterated that a fraud claim has to allege the facts to establish the fraud. Her original motion never mentioned it, which violated the CPLR 3016(b) requirement that the pleading has to give the defendant notice of the claims against him.

## PRACTICE COMMENTARIES

by Margaret Valentine Turano

This section sets forth the procedures on the return date of the SCPA § 2103 discovery proceeding. The respondent may file an answer or not, and in either case the petitioner has a right to examine her on the allegations raised in the petition, which is the inquiry or "inquisitorial" stage of the discovery proceeding (subparagraph (1)). A general denial by the respondent does not create an issue. If title to property becomes an issue, the court must direct the respondent to file a verified answer, which is the only way she can assert ownership of the asset (subparagraph (2)). The issue of contested title then becomes the trigger for the hearing stage of the discovery proceedings, but the court can direct that the examination may continue (subparagraph (3)).

During the inquiry stage, the petitioner may question the respondent on matters that would ordinarily be within the Dead Man's Statute (CPLR 4519) without waiving her right to assert it later at the hearing stage (subparagraph (6)).

If the respondent denies having the property, any party can offer proof to refute the denial (subparagraph (3)). If the respondent claims ownership of some but not all the property, the court can direct the respondent to give the rest to the fiduciary and can continue the proceeding with respect to property still in litigation.

The court can make a decree disposing of the property to the petitioner, the respondent or other parties (subparagraphs (4) and (5)). Although the Surrogate's Court usually does not have jurisdiction over disputes between living parties, *Matter of Piccione*, 57 N.Y.2d 278, 456 N.Y.S.2d 669, 442 N.E.2d 1180 (1982), in this instance the legislature expressly gave the Surrogate that power because, having heard all the evidence, the Surrogate is in a good position to determine ownership. ("It seems a needless

waste of time after the court has heard all of the proof in a discovery proceeding, having found that the estate does not have title, to compel the claimants to resort to another court to determine the same issue." Revisers' Notes to SCPA § 2104). The court can impress a constructive trust on the property if it has wound up in the wrong hands (subparagraph (4)).

The party who makes the claim has the burden of proving it. The petitioner has the burden of proving the estate's right to the property. *See Matter of Rabinowitz*, 5 Misc.2d 803, 159 N.Y.S.2d 492 (Surrogate's Court, Nassau County 1957) (executor had burden of proving that widow had money decedent withdrew from bank on day before death); *Matter of Brownstein*, N.Y.L.J., January 29, 1985, at 11, col. 5 (Surrogate's Court, Queens County) (petitioner failed to satisfy burden of proof that property in respondent's hands was obtained by fraud or undue influence).

**REVISORS' NOTES**

This section contains the substance of S.C.A. § 206 with the addition of subdivisions 1, 5 and 6.

Unlike a reverse discovery proceeding under S.C.A. § 206-a which is merely declaratory of existing law, In re Mathesen's Estate, 1936, 161 Misc. 367, 292 N.Y.S. 147, a discovery proceeding is purely statutory, the relief thereunder having been constantly expanded.

In some respects the proceeding corresponds to a replevin action in other courts. In re Hagan's Estate, 1935, 157 Misc. 378, 283 N.Y.S. 605. While it has been said that it is in no sense equitable in nature, Matter of Hagan, supra, but that incidental equitable relief may be granted, In re Blair's Will, 1934, 151 Misc. 192, 271 N.Y.S. 118, modified 242 A.D. 689, 272 N.Y.S. 864, it is held that the court has complete equitable jurisdiction in such proceeding. In re Cofer's Estate, 1923, 121 Misc. 292, 200 N.Y.S. 906. As noted in the Revisers' Notes under § 2104, while the proceeding is entitled one for discovery an order will not be granted unless specific property is set forth in the petition. Further the refusal to issue the order is not appealable. In re Braloff's Will, 1955, 285 A.D. 1177, 140 N.Y.S.2d 874.

The procedure on return of the order is unique. A general denial does not create an issue and the proceeding continues as an inquiry and not a trial. In re Gergely's Estate, Surr.1948, 84 N.Y.S.2d 321, affirmed 274 A.D. 1053, 86 N.Y.S.2d 463, appeal dismissed 299 N.Y. 627, 86 N.E.2d 181. The same result follows if the respondent appears and does not answer. If he files a verified answer the manner of answer determines which party has the burden of proof. This may lead to needless legal skirmishing. See In re Hossan's Estate, 1937, 162 Misc. 333, 294 N.Y.S. 516. If the respondent merely claims title in himself the petitioner has the burden of proof. In re Rabinowitz's Estate, 1957, 5 Misc.2d 803, 159 N.Y.S.2d 492. If he claims title by gift he has the burden of proof. Id. If he appears and submits to examination and it appears thereon that he claims title, in many courts he is then required to file an answer. This has been made statutory. In re Akin, 248 N.Y. 202. Where an answer is served the inquiry phase ends and there is an issue of title. Ordinarily an examination before trial is thereafter had. To obviate this unnecessary procedure and also to permit the fiduciary to obtain all information which may help him in discovering estate assets it is provided in subdivision 1 that whether or not the respondent answers the examination may continue by direction of the court. If no answer is filed and an issue of title is raised by the respondent he is required to file an answer accordingly but the examination may continue if directed by the court. Where the application is for the purpose of obtaining information, but no specific property is claimed, the procedure would correspond somewhat to the disclosure permitted under CPLR 3102(c), i.e. in the nature of discovery for the purpose of framing a petition.

Subdivision 5 is intended to abrogate the present rule that where the court determines in such proceeding that the estate has no interest in the property, even though all the parties making claim thereto are before the court

it may not determine title as between such parties. The note to the amendment of 1939 makes this clear. See also In re Krasnofsky's Estate, 1936, 157 Misc. 759, 284 N.Y.S. 738; In re Jacobsen's Estate, 1942, 178 Misc. 479, 35 N.Y.S.2d 40; In re Baquiche's Estate, 1956, 4 Misc.2d 614, 152 N.Y.S.2d 146. On the other hand in a reverse discovery proceeding under S.C.A. § 206-a the court has been held to have jurisdiction to determine title as between adverse claimants when the estate has no interest. See In re Cunningham's Will, Surr.1946, 61 N.Y.S.2d 648; In re Theiss' Estate, 1936, 161 Misc. 533, 292 N.Y.S. 315, affirmed 249 A.D. 798, 293 N.Y.S. 507; In re Kopperl's Estate, 1949, 197 Misc. 640, 95 N.Y.S.2d 14. It seems a needless waste of time after the court has heard all of the proof in a discovery proceeding, having found that the estate does not have title, to compel the claimants to resort to another court to determine the same issue.

Subdivision 6 is intended to make clear that in the inquisitorial phase of a discovery proceeding the provisions of CPLR 4519 do not apply. In re Garland's Will, Surr.1950, 97 N.Y.S.2d 442; In re Bodker's Estate, Sur.1945, 72 N.Y.S.2d 237; In re Schulman's Estate, 1947, 189 Misc. 672, 72 N.Y.S.2d 239, appeal dismissed 75 N.Y.S.2d 517. CCP § 2709 provided that if the witness in a discovery proceeding be examined concerning any personal communication or transaction between the decedent and himself all objections under CCP § 829 to his testimony as to the same in any future litigation was waived. CCP § 829 was the predecessor of CPA § 347 and the present CPLR 4519. In 1914 the sections of the Code of Civil Procedure dealing with discovery proceedings were condensed into 2 sections and this evidentiary provision omitted. In 1921 with the enactment of the Surrogate's Court Act these sections became §§ 205 and 206 of that act with the omission continued.

Notes of Decisions (274)

McKinney's S. C. P. A. § 2104, NY SURR CT PRO § 2104
Current through L.2016, chapters 1 to 33, 50 to 58.

End of Document

McKinney's Consolidated Laws of New York Annotated
Surrogate's Court Procedure Act (Refs & Annos)
Chapter 59-a. Of the Consolidated Laws (Refs & Annos)
Article 21. Miscellaneous Proceedings (Refs & Annos)

McKinney's SCPA § 2105

§ 2105. Proceeding to compel delivery of property
by a fiduciary which is claimed by another or others

Currentness

1. A person having a claim to property as defined in 103 or the proceeds thereof alleged to be in the possession of or under the control of a fiduciary may present to the court which has jurisdiction over the estate a petition showing the facts and praying that the fiduciary be required to show cause why he should not be required to deliver the property or the proceeds thereof.

2. Process shall issue accordingly to the fiduciary.

3. Upon return of process the court must hear the proofs of the parties, determine the issues, and if claim shall have been made to the property or the proceeds thereof by a person or persons other than the fiduciary, the court shall determine the respective interests of the parties in the property or the proceeds or value thereof and make a decree accordingly.

**Credits**
(L.1966, c. 953. Amended L.1980, c. 503, § 28; L.1993, c. 514, § 50.)

**Editors' Notes**

**SUPPLEMENTARY PRACTICE COMMENTARIES**

By Margaret Valentine Turano

**2012**

Under this section, a person entitled to property the fiduciary is holding can petition the court for an order directing the fiduciary to show cause why he should not deliver the property to the claimant, and the Surrogate can then determine the respective parties' interests in the property.

In *Mirvish v. Mott*, 18 N.Y.3d 510, 942 N.Y.S.2d 404, 965 N.E.2d 906 (2012), the decedent had given sculptures to her companion over the years by delivering to him a photograph of the sculpture along with a writing stating that it was a gift. When she died, the companion produced a photo of the sculpture called "The Cry" with a handwritten note on the back saying that it was a gift and thanking him for taking good care of her during her illness. While the decedent was alive, the Marlborough

Gallery held the sculpture, and its president, after consulting with the decedent and her family, agreed to loan it to France for exhibition in the Tuileries Gardens in Paris, where it remained at the decedent's death.

Meanwhile, the companion sold his interest in the sculpture to Mirvish, an art dealer. When the decedent died, the executor told conflicting stories: one that he had sold "The Cry," and the other that he offered the sculpture for sale to the French government.

The executor petitioned under SCPA 209(4), which permits the court to "determine the rights of any persons claiming an interest therein, as against the decedent, or as between themselves, and to construe any instruments made by [the decedent] affecting such property," and Mirvish petitioned under this section to require the executor to transfer the sculpture to him. The Surrogate granted Mirvish's motion for summary judgment, finding that the decedent had validly gifted the sculpture to her companion. The Appellate Division reversed, holding that the claim had arisen when the gallery loaned the sculpture to France and that Mirvish was therefore barred by the statute of limitations, and that the companion's claim was barred by the Dead Man's Statute.

The Court of Appeals reversed and ruled simply that the decedent had satisfied all the elements of a valid gift: she intended to make a gift; she delivered the gift constructively via the photograph and the note; and the donee accepted it. The Dead Man's Statute does not preclude reliance on the presumption of delivery that arises when the donee possesses the gift instrument. Both the executor and Mirvish petitioned the Surrogate's Court to resolve the issue of ownership, and the court determined that Mirvish had validly acquired the sculpture from the decedent's companion. If the statute of limitations were to bar the claim, no one would have a right to the sculpture even though the court determined that Mervish was the true owner.

* * *

This is the appropriate section under which to recover money an attorney-in-fact wrongfully took from the decedent under the power of attorney. In *Matter of Goodwin*, N.Y.L.J., April 10, 2012, at 31, col. 1 (Surrogate's Court, Suffolk County), for example, the decedent's will divided her estate among her four children equally. Her daughter was her agent under a durable power of attorney, and using it, the daughter transferred assets into her own name. She signed a document stating that she was transferring the decedent's assets to make her mother eligible for government benefits and that the assets would pass as the decedent directed in her will.

The decedent's son moved for summary judgment ordering his sister to return the assets to the estate. He argued that the decedent was suffering from dementia and could not have authorized the transfers. The court held that the brother had made a *prima facie* case for summary judgment and that the sister had to "assemble... and reveal sufficient other proof to establish a genuine issue of fact for trial" (citing *Matter of Maikowski*, 24 A.D.3d 258, 808 N.Y.S.2d 174 (1st Dep't 2005)). It ordered the sister to return the funds to the estate and file an accounting, at which time it would set the attorneys' fees.

## PRACTICE COMMENTARIES

by Margaret Valentine Turano

This section governing discovery proceedings against fiduciaries (sometimes called "reverse discovery proceedings") derives from S.C.A. § 206-a, but like its analogue, SCPA § 2103, it has changed a great deal. It permits a person having a claim to property under the fiduciary's control to petition the court to order the fiduciary to show cause why he should not deliver the property to its rightful owner (subparagraph (1)). Since the legislature amended it by L.1993, c. 514, § 50, the statute explicitly permits the discovery of both real and personal property. Before the amendment, a party could not bring the proceeding to discover real property under this section, but the Surrogates would entertain it under SCPA § 202, which gives them jurisdiction over all issues relating to the affairs of a decedent. *See, e.g., Matter of Phillips*, N.Y.L.J., January, 14, 1987, at 15, col. 2 (Surrogate's Court, Nassau County); *and see* the Practice Commentary to SCPA § 2103.

In 1980 the legislature made this section applicable to inter vivos trusts, over which the Surrogate was simultaneously given jurisdiction. *See* L.1980, c. 503, § 28; SCPA § 207. (The 1980 law put jurisdiction over inter vivos trusts in SCPA § 209, and the legislature moved it to SCPA § 207 by L.1984, c. 128.)

The petitioner must be "a person having a claim to property" (subparagraph (1)). *See, e.g., Matter of Ferrari*, N.Y.L.J., October 20, 2010, at 35, col. 6 (Surrogate's Court, Richmond County) (decedent's son proved to court's satisfaction that H-1 Hummer in his deceased mother's name had actually belonged to him); *Tiffany v. Tiffany*, N.Y.L.J., October 1, 2001, at 27, col. 2 (Surrogate's Court, Westchester County) (court dismissed proceeding because petitioner did not have interest in New York property decedent had conveyed to lifetime trust until Massachusetts court in which he had contested both trust and decedent's will made its decision).

The fiduciary is the only person entitled to process (subparagraph (2)). This statute's predecessor, S.C.A. § 206-a, required service on all interested parties, but the legislature eliminated that burdensome and unnecessary requirement when it enacted the SCPA by L.1966, c. 953. This conforms Surrogate's Court practice to Supreme Court practice. *See* CPLR § 1204; Revisers' Notes to SCPA § 2105.

On the return date, the court conducts a hearing and determines the respective interests of the fiduciary and the party claiming the property (subparagraph (3)). If persons other than the fiduciary claim the property in the course of the hearing and the court has personal jurisdiction over them, the court can decide their interests as well (subparagraph (3)).

This statute, unlike SCPA § 2103, does not provide specifically for an "inquisitorial" stage, but the parties may avail themselves of the CPLR Article 31 discovery procedures.

Whether parties are entitled to a jury trial in the reverse-discovery proceeding of this section depends on whether the relief sought is equitable or legal. In *Matter of Rivara*, 12 A.D.3d 611, 785 N.Y.S.2d 469 (2d Dep't 2004), for example, the executor and the decedent's widow were debating whether the corporate stock the executor has listed in his probate papers in fact belonged to her, and she sought to enjoin him from selling them. The court held that because an injunction is equitable relief, the widow had no right to a jury trial, citing *Matter of Schneier*, 74 A.D.2d 22, 426 N.Y.S.2d 624 (4th Dep't 1980). If she had petitioned for the return of property, which is akin to the common-law replevin action, she would have been entitled to a jury trial.

Claims flowing between the estate and another entity, such as a corporation, can be tried together using a combination of this statute and SCPA § 2103, as I discussed in the Practice Commentary to SCPA § 2103.

**REVISORS' NOTES**

Condensation of S.C.A. § 206-a with the following changes:

There has been eliminated the necessity for serving any one other than the fiduciary. If instead of commencing a proceeding under S.C.A. § 206-a, a claimant elects to begin an action in the supreme court for the same relief there is no need to serve any one other than the fiduciary with process. There should be no different rule under this section.

There has been added in subdivision 3 the authority which presently exists to determine title as between claimants when it is determined the estate has no interest. In re Cunningham's Will, Sur.1946, 61 N.Y.S.2d 648; In re Theiss' Estate, 1936, 161 Misc. 533, 292 N.Y.S. 315, affirmed 249 A.D. 798, 293 N.Y.S. 507; In re Kopperl's Estate, 1949, 197 Misc. 640, 95 N.Y.S.2d 14. This authority is therefore made explicit.

Notes of Decisions (122)

McKinney's S. C. P. A. § 2105, NY SURR CT PRO § 2105
Current through L.2016, chapters 1 to 33, 50 to 58.

End of Document

# SURROGATE'S PRACTICE AND PROCEEDINGS Discovery Proceedings: Part 1 - Untangling the Procedural Maze News

**NYLJ Publication Date: Aug 22, 2003**
**Volume: 230 | Page: 30 | Column: 3**

News
Discovery Proceedings: Part 1 - Untangling the Procedural Maze

Charles F. Gibbs and Colleen F. Carew

A certain amount of sleuthing is required when administering an estate. Rare is the fiduciary who knows everything about the decedent's assets and liabilities. Where the fiduciary encounters resistance by someone who refuses to disclose information about an estate, or deliver assets, she may file a discovery proceeding under 2103 and 2104 of the SCPA.[1]

Clarity, Uniformity Lacking

Ask four estate practitioners to outline the procedure for commencing and prosecuting a discovery proceeding under 2103 and 2104, and you are likely to receive four different answers. Do not assume from the variety of responses that any one is incorrect or correct, which is precisely the problem. Although the statutes set forth the procedure for commencing the proceeding, the point when issue must be joined is not clearly delineated. The joinder of an issue determines which party has the burden of proof. Without the benefit of complete pleadings, pretrial disclosure may proceed without clarity. Compounding the problem is a lack of uniformity in the practice among the surrogate's courts. The result is a rather amorphous practice.

Our navigation of discovery proceedings takes the written form of a global positioning satellite (GPS), that newfangled device which provides a driver with both directions and a map, and when the driver takes a wrong turn, or hits an unidentified dead end, will steer you back on track.

Dual Usage of Discovery Term

In Surrogate's Court practice, the term discovery has a dual usage. Discovery denotes a statutory proceeding for acquiring information about and/or recovering estate assets. It also refers to the process whereby parties to a proceeding may obtain relevant information under Article 31 of the CPLR. With a limited exception, disclosure under the CPLR presumes that an action or proceeding has been commenced and issue joined by the filing of a response. Surrogate's Court pleadings consist of a petition and answer or objections. The pleadings identify the relief sought and establish the parameters of a dispute.

Unique to surrogate's practice is the ability of a person interested in an estate to engage in limited disclosure-type discovery before filing a pleading. Two common examples in our practice are: 1) where a person adversely affected by a will examines the attesting witnesses under SCPA 1404, and 2) where a beneficiary examines an accounting fiduciary under SPCA 2211(2). The person having the interest, typically the respondent, is given the right to gather information concerning the subject matter, whether it be the making of a will or the administration of the estate, before filing a responsive pleading.

Such free inquiries are also intended to deter litigation. For example, a potential objectant may be dissuaded from filing objections after examining the attesting witnesses or accounting fiduciary. Another advantage, is that the person having the interest is not subject to similar disclosure by the proponent of the will or accounting fiduciary until after filing objections or an answer.

Two Stages

A discovery proceeding may have two stages: 1) the inquisitorial stage, whereby the fiduciary seeks to examine another who is alleged to have knowledge of estate assets; and 2) the turnover stage. The person subject to the inquiry is referred to as the respondent.

Practitioners' colloquial use of the term discovery to identify both the inquisitorial and turnover stages furthers the confusion. Stage one is similar to the free inquiry permitted parties in a probate or accounting proceeding. During this stage the fiduciary is gathering facts. Without such stage one inquiry, a fiduciary could be forced to commence a proceeding to recover property without a sufficient factual basis to support the allegations, a result exactly the opposite of the judicial policy against frivolous and meritless litigation. Further, prosecuting vague uninformed claims could result in the loss of the opportunity to recover estate assets.

During the inquisitorial stage one of a discovery proceeding no dispute need exist in order for the fiduciary to obtain information about estate assets from the respondent.[2] For example, a fiduciary may seek information to ascertain the value of an asset,[3] or whether decedent made lifetime gifts which would effect the filing of an estate tax return.[4] Frequently, a fiduciary knows that the respondent received property from the decedent -- for example, a joint bank account was created, but needs to determine the bona fides of the transaction. Or, the fiduciary may be aware that a person exercised control over the decedent, but has no idea whether such control resulted in the improper transfer of assets. Employing the oft-used phrase, a discovery proceeding is a license to fish.

Fiduciary's Options

The discovery proceeding is commenced by filing a verified petition together with an order to attend and be examined. Under SCPA 2103 (1)(c), the fiduciary may seek 1) an inquiry, or 2) delivery of the property, or 3) both inquiry and delivery.

The inquisitorial and turnover stages have distinctly different characteristics, yet the relief may be combined. A parsing of the differences highlights the problems which arise when petitioner seeks both an inquiry and the delivery of property in one proceeding.

Where the fiduciary is merely seeking to gather information, the allegations need only be sufficient to justify an inquiry, not a cause of action. The fiduciary need only have reason to believe that a person has knowledge or information with respect to money or property belonging to the estate (SCPA 2103 [1][c]). Persons interested in the estate may be made respondents in the stage one proceeding but only the petitioner can depose the target respondent. Upon conclusion of the examination, the petitioner may determine that no further action is required, thereby concluding the proceeding.

In the order to attend, the court directs respondent to appear on the return date for examination. The order to attend is akin to a subpoena and must be served in accordance with both SCPA 2103(5) and CPLR 8001 (requiring payment of a witness fee). Because the surrogate's subpoena power does not extend beyond the state's boundary, personal jurisdiction is limited to persons within New York state.[5] A colleague's novel solution to this jurisdictional conundrum was to seek the issuance of a commission to examine the respondent out of state.[6]

Respondent does not have to file an answer to the order to attend. Thus, issue is not joined and disclosure pursuant to Article 31 of the CPLR is not available during this inquisitorial stage one of the proceedings.[7]

One risk to moving by order to attend is that the respondent may intentionally evade service. Substituted service under SCPA 307 may be made upon respondent.[8] However, petitioner cannot obtain an order of contempt against a respondent who fails to appear in response to an order to attend that was not personally served.

Another risk is that the property may be disposed of during the pendency of the proceeding. Petitioner should consider seeking, in the order to attend, a temporary restraining order against the respondent's disposing of the subject property. The application for such relief must be supported by allegations sufficient to demonstrate to the court a likelihood of ultimate success in recovering the property and the presence of a real risk that the property may be disposed of during the pendency of the proceeding. If the court grants the temporary restraining order (TRO), the respondent can move to dissolve it.

The fiduciary who does not need to gather facts to support a petition for turnover of property may skip the stage one inquisition and petition for recovery of the property or its proceeds. Citation would issue to the respondent (SCPA 2103 [3]). Provided the property is in New York, or was in New York at the time the dispute arose,[9] petitioner may obtain personal jurisdiction over a nondomiciliary by service of a citation. Respondent must file an answer to the petition, or default, and both sides have the right to engage in pretrial disclosure under Article 31 of the CPLR.

Where the petitioner seeks by order to attend both an inquiry and turnover of the property, or its proceeds, even where petitioner anticipates that title will be disputed by the respondent, petitioner maximizes the use of the free inquiry without being subject to an examination or disclosure. However, petitioner may find himself or herself stuck in a procedural morass.

Respondent's Options

It is the nature of the response that dictates how the matter will proceed. A respondent may: 1) default; or 2) appear for examination; or 3) file an answer generally denying the allegations; or 4) file an answer and claim ownership to the property; or 5) file an answer and admit possession but not ownership. Whenever an issue over title is raised, the matter will ultimately proceed to trial by the court or a jury.

If the respondent defaults on the return date of the order to attend or files an answer denying possession, the matter may be set down for a hearing at which time petitioner must establish that the estate is entitled to the property (SCPA 2104 [3]). Without obtaining the disclosure petitioner was seeking from the defaulting respondent, petitioner may have great difficulty proving the estate's entitlement to the property at an ex parte hearing

Where respondent answers the petition with a general denial of the allegations, an issue over title does not arise and petitioner must proceed with CPLR disclosure followed by a hearing to establish the estate's right to the property. It is not until respondent files an answer that petitioner may obtain pretrial disclosure.[10]

The order to attend typically provides that the respondent is to be examined at the courthouse (22 NYCRR 207.28). However, few surrogates enforce this rule which was enacted at a time when the surrogate's courts had stenographers on staff to record such examinations. With the advent of electronic recording devices, the court's resources are limited and many surrogates permit the parties to schedule the examination on a date and at a place convenient to them. As a general rule, the surrogate does not preside over respondent's examination. The mystery of surrogate's practice is uncovering the local practice (which may be found in decisions, or where they exist, written rules issued by the court).

Where title is disputed ... that issue shall proceed as a litigated issue (SCPA 2104 [1]). Under SCPA 2104, subdivision 2, a respondent claiming title, or possession of decedent's property, must file an answer.

Typical of the authors' experience is the situation where the respondent does not file an answer on the return date and appears for examination, during which he or she claims ownership to the property.

SCPA 2104 (1) provides:

... If it appears thereon that an issue of title to any property as defined in 103 or the proceeds or value thereof is raised, if he has not theretofore done so, the respondent shall be directed to serve and file an answer accordingly.

Although the statute requires that the respondent claiming title file an answer, the onus is on the petitioner to ensure that happens. Without a restraint, it is not in the respondent's best interest to voluntarily file an answer. The matter may lay dormant if the petitioner fails to demand an answer or seek additional relief from the court.

Obtaining an Answer

The method for obtaining an answer varies among the courts.

In some counties, on the return date of an order to attend the surrogate will direct the parties to proceed accordingly or submit the matter. No further action is taken by the court. At the conclusion of respondent's examination, petitioner is required to file a second proceeding for delivery of the property, even where such relief was requested in the order to attend. In one county, the secondary proceeding may be commenced by service of a supplemental order to attend. The reader will not find these rules in the statute, leaving the unknowing practitioner at a clear disadvantage.

Other courts make the direction to answer informally, on the return date, or at some other time when the parties are before the court. If the direction to answer is not contained in a written order, then petitioner cannot seek contempt against the respondent who fails to comply. Occasionally, readers will see a decision where the court directs a respondent to file an answer. Again, the decision must constitute the order of the court, or be reduced to an order, to be effective for obtaining further relief against the recalcitrant respondent.

Another procedure employed is where the court issues a pre-trial order for disclosure specifying the dates for respondent's examination, the filing of an answer, and all other disclosure. While this practice provides a welcomed framework for the proceeding, it places petitioner in the position of having to outline disclosure demands before having had an opportunity to gather information, thus defeating the purpose of the inquiry stage.

In many discovery proceedings, the parties chart their own course, eventually appearing before the surrogate in response to a motion or the filing of a note of issue. It is hit or miss whether this approach will work. Several years ago, one of the authors was retained, at the 11th hour, to represent a respondent who had been directed by the court to appear for a jury trial concerning a dispute over title to real property once held in decedent's name. Extensive disclosure, which spanned a two-year period, followed the service of the order to attend. During this period, respondent never filed an answer. While preparing the matter for trial it became apparent that certain evidentiary rules, and the possibility of the burden of proof shifting, were critical to the outcome. The court denied a requested adjournment. Thus, drafting the order framing issues was an impossible task.

Conclusion

A consequence of this hodgepodge practice is that the playing field is not level. Respondent is able to delay

the proceeding and cause additional expense to the estate by defaulting, withholding the filing of an answer, or denying the allegations in the petition. The utility of the discovery proceeding becomes diluted by the practice.

We offer this analysis, not to criticize a particular local practice, but rather to highlight the difficulties for consideration by our bar associations and Legislature. Until there is change, the burden is on the petitioner whose best offense may be to bifurcate the proceeding. Obtaining an order restraining respondent, and any institution where assets are located, from transferring the property pending a hearing, should serve as a strong incentive for respondent and ensure that the proceeding moves expeditiously. Where the facts indicate that estate property is the possession of another person, then the fiduciary should consider skipping the inquiry stage and move directly for turnover of the property by service of citation.

A simple practice solution may be found in probate proceedings whereby an answer or objections must be filed within 10 days of completion of respondent's examination of the attesting witnesses (see, SCPA 1404, SCPA 1410). Similarly, SCPA 2103 could provide that the order to attend contain a direction that respondent file an answer within a specified time period following his or her examination. Issue is then joined and the parties proceed with disclosure under the CPLR.

Our proposal addresses just one aspect of the difficulties with discovery proceedings. A significant problem arises where the respondent defaults, or files an answer generally denying the allegations, and has not claimed title. How does the petitioner prove the estate's entitlement to the property?

In our next column, Discovery Proceedings -- Part 2 we will explore the burden of proof, when it shifts, and particular evidentiary issues impacted by the current practice.

1. Under SCPA 2105, a proceeding may be brought against a fiduciary to obtain property in his or her possession.

2. Matter of Laflin, 128 Misc2d 348, 490 NYS2d 102 (Sur Ct Nassau Co 1985), affd 111 AD2d 924 (2d Dept 1986).

3. Matter of Granowitz, 150 AD2d 446, 541 NYS2d 55 (2d Dept 1989).

4. Matter of Laflin, supra.

5. Siemens GmbH v Gres, 37 AD2d 768, 324 NYS2d 639 (1st Dept 1971); Matter of Mirsky, 145 Misc2d 438, 546 NYS2d 951 (Sur Ct Bronx Co 1989).

6. The authors wish to thank Paul Foster and Gary B. Freidman for sharing their strategy for obtaining an inquiry from an out-of-state respondent.

7. Matter of Lukas, 79 Misc2d 24, 360 NYS2d 549 (Sur Ct Westchester Co 1974).

8. Matter of Marko, 56 Misc2d 138, 287 NYS2d 776 (Sur Ct New York Co 1968).

9. See SCPA 210 [2][a]); Matter of Cooke, 112 Misc2d 167, 446 NYS2d 189 (Sur Ct Nassau Co 1982).

10. Matter of Lukas, supra.

# SURROGATE'S PRACTICE AND PROCEEDINGS Discovery Proceedings, Part 2 - Identifying the Burden of Proof News

**NYLJ Publication Date: Oct 17, 2003**
**Volume: 230 | Page: 17 | Column: 1**

News
Discovery Proceedings, Part 2 - Identifying the Burden of Proof

Charles F. Gibbs and Colleen F. Carew

Our last column concluded with the procedural morass facing the practitioner in a discovery proceeding and added a promise to address the additional problem of identifying the party with the burden of proof (New York Law Journal, Aug. 22, 2003, at p. 3).

As we noted previously, Surrogate's Court Procedure Act (SCPA) 2103 discovery proceedings commenced by the estate's fiduciary typically take two forms. Where the fiduciary wishes to investigate the existence and location of property that may have been owned by her decedent, the petition seeks information from the respondent. The result of this inquisition-type proceeding may lead the fiduciary to go on to step 2 and seek recovery of specific property from the respondent, or from another. Alternatively, the fiduciary may dispense with the inquisition step and seek recovery of property from the respondent. Questions concerning burden of proof arise only when the petitioning fiduciary seeks recovery of property. Matter of Rabinowitz[1] illustrates the difficulty that can arise when an inquiry proceeds to a step 2 recovery of property: [T]he questions relating to the right to an inquiry are often confused with those of burden of proof, probably because there is often no clearly defined moment when the 'inquiry' ends and the 'trial' begins.

This confusion can be compounded because there is no fixed time by which a respondent must serve an answer to the petition, or even serve an answer at all. However, a respondent who wishes to claim ownership of the subject property must serve an answer asserting title.

Respondent's answer initially dictates upon whom the burden of proof falls. In addition to asserting ownership to property once held by decedent, by an answer respondent may: 1) admit possession but not ownership; 2) generally deny the allegations; and 3) assert affirmative defenses, or all three items.

Before addressing how the respondent's answer implicates the burden of proof, a brief primer on the burden is in order.

Primer on Burden of Proof

Black's Law Dictionary (Sixth Edition) defines the burden of proof as follows:

In the law of evidence, the necessity or duty of affirmatively proving a fact or facts in dispute on an issue raised between the parties in a cause. The obligation of a party to establish by evidence a requisite degree of belief concerning a fact in the mind of the trier of fact or the court.

While the burden of proof never shifts to the other party, the burden of going forward may shift. If the party with the initial burden presents a prima facie case it becomes incumbent upon the other party to rebut such proof by contradictory evidence.

The point at which a party has established a prima facie case in a discovery proceeding is not an objective test. Whether a prima facie case has been established depends upon the quantum and quality of the evidence, including the credibility of the witnesses. The surrogate may rule sua sponte, at any point in the hearing, a ruling is not required unless one party moves for judgment after the other party has completed her case in chief.

General Rules

A respondent who asserts title, as a result of a gift from decedent or otherwise, assumes the burden to establish the gift or other facts resulting in the transfer.[2] Proof must be by clear and convincing evidence.[3] The burden may be difficult to meet because the Dead Man's Statute, CPLR 4519, can be invoked to bar the respondent at trial from testifying concerning the alleged gift.

Where respondent admits possession, but not ownership of property, the burden is on the petitioner to establish the estate's right to the property. Such proof may be implicit in respondent's answer or testimony during an examination. For example, in Matter of Humphreys,[4] the executor sought to recover a diamond ring from respondent. At her examination, respondent admitted that decedent gave her the ring for the purpose of transmitting it to another person. Respondent's admission established petitioner's prima facie case of decedent's ownership of the ring. Similarly, where respondent fails to file an answer, or enters a general denial, the petitioning fiduciary has the burden to establish that decedent held title to the disputed property.[5]

In Matter of Rabinowitz, the executor sought to recover funds from a bank account allegedly transferred by decedent to his widow shortly before his death. The widow did not file an answer. At the hearing, the widow denied that decedent held title to the disputed account. Because respondent did not concede that decedent once held title to the account, petitioner was obligated to prove that title was held in decedent's name. Petitioner failed to establish that the disputed funds in the widow's possession were the same as withdrawn by decedent. The proceeding was dismissed.

Could Rabinowitz be read to permit a respondent to avoid assuming the burden of ownership by simply denying petitioner's allegations?

Initially, it appears that a respondent who defaults or files an answer generally denying the allegations will maintain a strategic advantage because he or she avoids assuming the burden of proof. In the absence of an answer, 2104 of the SCPA expressly requires that petitioner present proof of the estate's entitlement to the property and that respondent is in possession of it. Traditionally, where no answer is filed, petitioner presents proof of title and/or value at an inquest.

In Matter of Jurgens,[6] Surrogate John M. Czygier Jr. instructs that a general denial may not inure to respondent's advantage because under SCPA 509 petitioner's uncontroverted allegations of fact may be accepted as due proof of title in determining a motion for summary judgment. The executor in Jurgens sought to recover from respondent substantial funds that were withdrawn over a four-year period from brokerage accounts held at an institution where respondent worked, and from other accounts held by decedent. Respondent filed an answer and asserted certain defenses related to the proper forum for determination of the executor's claims. In particular, respondent contended that the court lacked jurisdiction because the matter was governed under the National Securities Arbitration Act. Respondent did not deny the specific allegations of the petition. Respondent did, however, deny possession of the assets and asserted as an alternative response, that if he had possession he was the owner of the funds.

Surrogate Czygier granted summary judgment to the petitioner, who he found had established by clear and convincing evidence that decedent owned the disputed assets. Respondent's failure to file a pleading raising a triable issue of fact left the court with petitioner's uncontroverted allegations of title, thereby entitling her to summary judgment. Respondent was directed to turn over the disputed accounts, or pay the value thereof to petitioner.

Defenses Raised in Answer

Respondent may assert other defenses in the answer, such as the statute of limitations, which if granted will cut off petitioner's right to seek recovery of the property regardless of the validity of the transfer. Where such a defense is raised, a preliminary determination must be made, and if granted, may result in dismissal of the proceeding.

The statutory period of limitations in which a proceeding must be commenced is set forth under Article 2 of the CPLR. An SCPA 2103 turnover proceeding is akin to a replevin or conversion action, both of which are governed by the three-year statute of limitations.[7]

An example of how the limitation period impacts a discovery proceeding is found In Matter of Hyman,[8] where the dispute concerned bonds. Decedent died in 1982. In May 2000, the executors filed a discovery proceeding against decedent's daughter and the surviving spouse. Parenthetically, one month later the executors were ordered to account for their 18-year administration. The basis for the discovery proceeding was a safe deposit box inventory, which one of the executors saw in 1979, that included certain bonds owned by decedent's corporation. Twenty years later, the executor allegedly recalled seeing the inventory and commenced a proceeding to discover assets. The court dismissed the proceeding as untimely.

Reading between the lines, it appears that the discovery proceeding was an offensive stratagem by the executors to fend off a surcharge claim by the beneficiaries for their failure to collect the bonds. A surcharge against the executors for their failure to collect the bonds would not be time-barred, as, absent repudiation, there is no limitation period where a fiduciary has not accounted.[9]

Defense of fraud or constructive trust may extend limitation period. A fiduciary may be able to defeat the respondent's statute of limitations defense by showing fraud or constructive trust, which extends the period for seeking recovery of estate assets. The limitation period to commence a proceeding for fraud is six years from the commission of the fraud or two years from the date of its discovery.[10] An action for constructive trust must be commenced within six years of the wrong.[11]

Constructive trust elements. A constructive trust operates to prevent the holder of property from unjustly enriching himself or herself to the detriment of another. It is an equitable remedy applied where a party establishes four elements: 1) a fiduciary or confidential relationship; 2) a promise, express or implied; 3) a transfer made in reliance upon the promise and 4) unjust enrichment.[12] Where all four elements are established, the holder of the property is treated as a trustee for the beneficiary.

On occasion, the court will frame the issue in a discovery proceeding as one sounding in constructive trust. In Matter of Terzian,[13] a motion for summary judgment, Surrogate Eve M. Preminger applied the six-year limitation period to seek the imposition of a constructive trust, to the administrator's proceeding to recover the proceeds of a buyout of a leasehold from decedent's brother, Archie. The landlord of the building where decedent resided sought to buy out leases in order to raze the building and erect a new one. Decedent was physically and mentally disabled. Archie, who lived in the same building, conceded that he handled the buyout of decedent's interest and received the proceeds in his name. Thereafter, Archie established a joint account with decedent, but alleged he used his own funds. Archie later purchased a cooperative apartment

where decedent lived with their mother, again allegedly from other assets. In 1995, decedent's daughter asked Archie for some of the proceeds from the buy out. Archie refused petitioner's request. Decedent died in 1998, and his daughter, as the administrator of the estate, commenced the discovery proceeding one year later.

The action to recover based upon the respondent's alleged unjust enrichment accrues at the point when a party knows, or should have known, that another has unjustifiably retained the benefit of a transaction or has failed to fulfill a promise. In Terzian, the point when decedent's daughter demanded the proceeds from the buyout (1995) triggered the running of the six-year limitation period. Thus, the action commenced three years later was timely.

Framing the Issue

Matter of Kurzius[14] presents a formula for identifying the burden of proof in the context of framing a statement of issues for a trial in a discovery proceeding. The decision also demonstrates the fluidity of the burden as it shifts with the allegations raised in the pleadings.

The dispute in Kurzius concerned the alleged transfer by decedent of her home and tangible personal property to her son Robert. Petitioner, decedent's daughter, sought to recover the proceeds from the sale of such property. Robert filed an answer in which he denied knowledge of decedent's personal property, admitted that decedent once owned the house and alleged that she gave it to him. He subsequently sold the house.

Petitioner had the burden to establish the estate's entitlement to the unidentified personal property. By admitting that decedent once owned the house and that she gave it to him, he assumed the burden to prove the conveyance, whether as a gift or for consideration.

Following Robert's answer, petitioner alleged in a supplemental petition that Robert held the proceeds of sale from the house as a constructive trustee for the benefit of the estate, that decedent lacked capacity to transfer her house and that Robert exerted undue influence over decedent or committed a fraud to obtain the house. In effect, petitioner sought to invalidate decedent's transfer of the house to Robert.

How Allegations Shift Burden

In Kurzius, Robert had the burden of proof of establishing that decedent gave him the house by clear and convincing evidence. After completing his case in chief, petitioner would then proceed with her rebuttal case. Petitioner had the burden of proving, by a preponderance of the evidence, her allegations of constructive trust, lack of capacity of the donor, undue influence and fraud, or all of those items. In the event petitioner established that Robert was in a confidential relationship to decedent (an element of constructive trust), the burden of going forward would shift to Robert to show by clear and convincing evidence that the transfer was freely and voluntarily made, not the result of undue influence, fraud or duress.

The party who claims title by gift must meet the higher standard of clear and convincing proof instead of the usual civil standard of preponderance of the evidence. The preponderance standard is said to be satisfied by slightly more evidence in favor of one party (i.e., that one party's evidence more likely than not establishes the facts). By comparison, the clear and convincing standard is said to require evidence of a much higher level of probability, approaching near certainty in support of the party's burden of proof. Bearing in mind that these standards are tests of weight and not merely quantity, it is not surprising that there is no bright line of demarcation for either standard. In short, a party meets its burden of proof under both standards when the trier of fact says so.

Bill of Particulars

Given that the burden of proof is not static in a discovery proceeding, what is the best means of ascertaining

which party will carry the burden at trial? In Matter of Boyhan,[15] the court suggested that the bill of particulars is a useful device to ensure a full exposition of the issues for trial. In Boyhan, the executor sought to recover money transferred from decedent's savings account to the respondent. Respondent answered by claiming title, but did not allege how title was acquired. The executor sought amplification of the answer by way of a bill of particulars. The court noted: [A]s the trial should be an open meeting on the merits, both sides should have a fair opportunity, in advance of trial, to garner evidence. There is so much merit in a disclosure of facts in advance of trial that it should be allowed whenever legitimately sought. (Citations omitted) The authors share Surrogate's Cox opinion.

1. 5 Misc2d 803, 159 NYS2d 492 (Sur Ct Nassau Co. 1957).

2. Matter of Van Alstyne, 207 NY 298, 100 NE 802 (1913).

3. Matter of Abramowitz, 38 AD2d 387, 329 NYS2d 932 (2d Dept 1972), affd 32 NY2d 654, 342 NYS2d 855 (1973).

4. 35 Misc2d 404, 230 NYS2d 309 (Sur Ct Nassau Co. 1962).

5. Matter of Beyer, 3 Misc2d 819, 155 NYS2d 669 (NY Sur Ct 1956).

6. NYLJ, June 26, 2003, at 27, col 6 (Sur Ct Suffolk Co.)

7. CPLR 214 (3); CPLR 210; Matter of Norstar Trust Co., 132 AD2d 973, 518 NYS2d 502 (4th Dept 1987), leave denied 70 NY2d 614 (1988).

8. NYLJ, May 10, 2002, at 18, col 3 (New York Co.)

9. Matter of Barabash, 31 NY2d 76, 334 NYS2d 890 (1972).

10. CPLR 213 (8).

11. CPLR 213 (1).

12. Simonds v. Simonds, 45 NY2d 233. 408 NYS2d 359 (1978).

13. NYLJ, May 10, 2002, at 18, col 4 (New York Co.)

14. NYLJ, May 27, 1992, at 30, col 3 (Nassau Co.)

15. 27 Misc 2d 770, 210 NYS2d 942 (Sur Ct NY Co. 1960).

67-APR N.Y. St. B.J. 64

**New York State Bar Journal**
March/April, 1995

Department
Improving Law Practice

# DISCOVERY UNDER THE SURROGATE'S COURT PROCEDURE ACT: A PRIMER

Gary E. Bashian, Anthony J. Enea[a1]



Often when the issue of a discovery proceeding is raised in either a Will contest, accounting contest or related litigated estate matter, the initial reaction by the attorney is to assume that reference is being made to the discovery and disclosure permitted by Article 31 of the Civil Practice Law and Rules. [1] While the attorney would be correct in believing that the provisions of Article 31 of the CPLR and other laws relevant to practice and procedure apply in the Surrogate's Court, a discovery proceeding in the Surrogate's Court, as many attorneys have learned the hard way, is a beast of a different color. [2]

The purpose of this article is to acclimate the general practitioner with some of the intricacies of Sections 2103 and 2104 of the Surrogate's Court Procedure Act (SCPA) relevant to a discovery proceeding and to briefly touch upon what is commonly referred to as a reverse discovery proceeding permitted by Section 2105 of the SCPA. [3]

**Purpose of a Discovery Proceeding**

The fiduciary of an estate is statutorily obligated to take immediate action to collect on behalf of the estate all of the assets belonging to the decedent. [4] However, the fiduciary may be uncertain as to whether or not he or she has obtained possession of all assets belonging to the decedent. The fiduciary will often have first hand knowledge or be privy to information that property presently in the possession of others (the respondent) may in fact, have belonged to the decedent on the date of his death. The issue facing the fiduciary is what steps can he or she undertake to obtain the information necessary to determine whether the property in the possession of others belongs to the decedent's estate and how to obtain a Court adjudication of title to said property.

It has been our experience, particularly in a Will contest where the fiduciary knows that property has been transferred by the decedent during the period where the decedent's testamentary capacity is in question or during the period that the alleged undue influence or fraud was practiced, that the fiduciary must utilize the provisions of Section 2103 and 2104 of the SCPA to either, 1) ascertain who has possession of said property, or 2) if it is known who has possession to have a Court adjudication of title to the property if title is contested.

**Commencement of a Discovery Proceeding**

Section 2103(1) of the SCPA permits a fiduciary to present a petition to the Court which has jurisdiction over the estate stating upon knowledge or information and belief that personal property as defined or the proceeds or value thereof which should be paid to him (the fiduciary) is either:

**(a) in the possession or control of a person who withholds it from him, whether possession or control was obtained prior to creation of the estate or subsequent thereto, or**

**(b) within the knowledge or information of a person who refuses to impart knowledge or information he may have concerning it or to disclose any other fact which will aid the petitioner in making discovery of the property, or**

**(c) he has reason to believe, in the possession or control of a person described in subparagraph (a) of this subdivision or within the knowledge or information of a person described in subparagraph (b) of this subdivision and praying that an inquiry be had respecting it and that the respondent be ordered to attend and be examined accordingly and to deliver the property if in his control.**

**The petition may be accompanied by an affidavit or other written evidence to support it.** [5]

The property that could be the subject of a discovery proceeding includes any and all personal or real property in which the decedent had any interest. [6] The statutory inclusion of real property as part of the definition of property that is discoverable became effective on January 1, 1994, as part of the amendments made by Chapter 514 Section 48 of the Laws of New York. [7] Property which the decedent had any interest in is defined to include a chose in action, money deposited and all property rights of the depositor consequent on the deposit of money by a decedent, grantor or fiduciary or for his account. [8]

If the Surrogate's Court, upon review of the petition is satisfied that there are reasonable grounds for examining the respondent, it will make an order to that effect. However, if the petition does not seek an inquiry or examination of the respondent but seeks that property be delivered to the fiduciary the Surrogate's Court will issue a citation to the person allegedly in control or possession of the property ordering him to show cause why he should not deliver the property, its proceeds or value to the fiduciary of the estate. [9]

Thus, the discovery proceeding has two separate and distinct stages:
**(a) The "inquisitorial stage" which is utilized when the fiduciary is not sure whether or not the respondent is in possession *65 or control of estate property and wants to examine him to find out. If the Court finds that reasonable grounds for the examination exist in its discretion it can order the respondent to appear and be examined;** [10] **and**

**(b) The "hearing stage" which is utilized when the fiduciary knows that the respondent has possession or control of property which the fiduciary believes belongs to the estate. During this stage the Court will issue a citation to the person allegedly having possession of the property ordering him or her to show cause why the property, its proceeds or value should not be delivered to the fiduciary.** [11]

Deciding whether to proceed under the inquisitorial phase or hearing phase of the discovery proceeding is the most important decision the fiduciary who has decided to commence a discovery proceeding will have to make. Its ramifications are immediately discernible. For example, the Court in *Matter of Lucas* held that the respondent during the inquisitorial stage of a discovery proceeding would not be permitted to disclosure and production of documents under Section 3120 of the CPLR. [12] The Court opined that a discovery proceeding during the inquisitorial stage is akin to an examination before trial. Until the Petitioner has established a prima facie case for the recovery of the property and the proceeding continued beyond the examination of the respondent, discovery and production of documents permitted under CPLR 3120 should be restricted as in those cases involving the use of discovery prior to an examination before trial. The Court further opined that if the proceeding continues beyond

the examination of the respondent it would then be appropriate for the respondent to have available the disclosure permitted by Section 3120 of the CPLR regarding disclosure and the production of documents. [13]

Perhaps most illustrative of the differing paths a discovery proceeding will travel is the different methods of process required to obtain jurisdiction over the respondent when either the inquisitorial stage or hearing stage is pursued.

In *Estate of Mirsky*, the Court commented that it has found that many attorneys are unaware that the discovery proceeding will proceed on differing paths depending upon which method of process provided for in Section 2103(3) of the SCPA is selected. [14] The Court stated that when the petition contains a request for an inquiry or deposition of the respondent, the respondent is to be served with an order to appear to be examined. However, if the petition states that petitioner is aware that the property is in the possession or control of the respondent, a citation not an order is issued to the respondent ordering the respondent to show cause why the property should not be delivered to the petitioner.

In *Mirsky*, the petitioner requested that an inquiry be made about funds allegedly in possession of the respondent which belonged to the decedent. Based upon this request the Court entered an order requesting the respondent to appear before the Court and be examined. The Court order further provided that the respondent be personally served with a copy of the order and supporting papers and that the witness be paid a subpoena fee. The respondent was personally served and paid the witness fee. However, the respondent failed to appear before the Court on the date set forth in the order. The petitioner acting upon the default moved for an inquest. Subsequently, an attorney made a limited appearance on behalf of the respondent and argued that the Court could not grant any relief against the respondent because the respondent was not served with the order in New York. [15]

The respondent citing *Matter of Marko*, argued that a discovery proceeding which is commenced by an order to attend and be examined is in the nature of a specialized subpoena and that the fact that Section 2103(5) requires that a witness fee be paid substantiates this. [16] In *Mirsky*, the Court held that although a subpoena may be served under appropriate circumstances within New York by substituted service, Judiciary Law Section 2-b(1) provides that the issuance of a subpoena requires the "attendance of a person found in the state to testify." [17] The Court in *Mirsky* in denying the Petitioner's request for an inquest ***66** cited *Siemens & Halske, Gmbh v. Gres*, in support of its decision that long arm jurisdiction was inapplicable to the service of a subpoena and that the out-of-state service of a subpoena is void. [18] The petitioner in *Mirsky* was permitted to serve a citation upon respondent directing her to show cause why she should not deliver the property allegedly belonging to the decedent to the petitioner. For all practical purposes when dealing with an out-of-state respondent the petitioner should move directly into the hearing stage of the discovery proceeding. [19]

**Factors to Consider in Commencing a** SCPA Section 2103 **Proceeding**

An important consideration for the attorney deciding whether to pursue either the inquisitorial or hearing phase of a discovery proceeding is the impact of Section 4519 of the CPLR, commonly known as the Dead Man Statute. Section 4519 of the CPLR prohibits an interested party from giving testimony as to transactions with the decedent. [20]

In the *Matter of the Estate of Christy B. Detweiler*, the applicability of CPLR 4519 to a discovery proceeding was addressed. [21] The Court citing *Matter of Lalor* reaffirmed that judicial precedent made it clear that the protection of Section 4519 of the CPLR is not available during the inquisitorial phase of a Section 2103 discovery proceeding. However, if the discovery proceeding "judicially metamorphoses" into a trial on the merits of title,

then the protection of CPLR 4519 will be available upon timely objection being made. [22] The Court in *Detweiler* analogized the evidence developed in the inquisitorial phase of a discovery proceeding to evidence adduced on an examination before trial. Thus, the Court held the evidence produced during the inquisitorial phase was not before the Court on the trial phase, unless it was specifically made a part of the trial proceedings. The Court stated that this could be done by either again presenting the nonobjectionable testimony during the trial phase or by simply offering the nonobjectionable testimony from the inquisitorial phase in evidence during the trial on the merits of title. [23] The restrictions created by Section 4519 of the CPLR are an important consideration for the attorney preparing for a discovery proceeding. The limitations it will place on the testimony proffered during a hearing on the merits of title will be significant. [24]

Another important consideration for the attorney commencing a Section 2103 discovery proceeding is the statute of limitations. A Section 2103 proceeding has been likened to a conversion or replevin action which pursuant to Section 214(3) of the CPLR have a three year statute of limitations. [25] In *Matter of Norstar Trust Company,* [26] the Court held that in the absence of any allegation of fraud or other bad faith conduct on the part of the respondent the three year statute of limitations for a replevin or conversion action pursuant to Section 214(3) of the CPLR applied. [27]

In *Norstar*, during the period of October 4, 1977 to November 20, 1980, various transfers of personal property and money were made by the decedent to the respondent/appellant. The petitioner alleged that it had become aware of the facts and circumstances concerning the alleged transfers of money and property from the decedent in March of 1982. The petitioner had received letters testamentary on July 9, 1982. The Court held that the Section 2103 discovery proceeding having been commenced four years later was time barred.

Finally, the attorney should be cognizant of the fact that the subject matter jurisdiction of the Surrogate's Court has been broadened in recent years. A significant portion of this expansion has occurred through legislative enactment. *Section 12 of Article VI of the Constitution of the State of New York* provides that the jurisdiction of the Surrogate's Court extends to "...all actions and proceedings relating to the affairs of decedents, probate of wills, administration of estates and actions and proceedings thereunder or pertaining thereto." [28] The Surrogate's Court in *Matter of Rothko*, interpreted Article VI as to include any matter relating to the affairs of a decedent. [29]

*Matter of Piccione*, best illustrates the expansive reading given to the subject matter jurisdiction of the Surrogate's Court. [30] In *Piccione*, the executors of an estate commenced a proceeding for damages arising out of a contract to lease real property which later became an asset of the decedent's estate. The Surrogate's Court of Nassau County in *Piccione*, held that the Surrogate's Court had jurisdiction to determine the matter in controversy as it unquestionably affects the administration of an estate. The Court in *Piccione*, cited a variety of recent decisions that broadly interpreted the subject matter jurisdiction of the Court particularly in discovery proceedings. For example, in *Matter of Ryan*, the Court held that the jurisdiction of the Surrogate's Court extended to the interpretation of contracts for the sale of securities. [31]

On January 1, 1994, the definition of "property" stated in Section 2103(2) of the SCPA was amended to include any and all real property in which the decedent had any interest. [32] Thus by legislative enactment the broad subject matter jurisdiction of the Surrogate's Court has been further expanded. [33]

**Inquiry, Trial and Decree Under Section 2104 of the SCPA**

Section 2104 of the SCPA creates the procedural parameters for what will transpire once the Surrogate's Court has issued an Order that there exists reasonable grounds for examining the respondent and if title to the property

in question has been established by the petitioner.[34] Pursuant to Section 2104(1) upon the return date of the Order irrespective of whether or not the respondent has submitted ***67** an answer, the petitioner is permitted to examine him with respect to the allegations delineated in the petition.[35] This allows the petitioner to question the respondent as to the whereabouts of assets that petitioner believes should be part of the decedent's estate.

In *Matter of Coon's Estate*, the Court held that pursuant to Section 2104(1) of the SCPA, if the respondent claims title to any of the property in question, the respondent must then file a verified answer. Once the verified answer has been filed and served, the Surrogate's Court must then place the matter on the calendar for a trial with respect to any issues of title.[36]

In *Matter of Nutrizio*, the Court held that once the respondent has answered and raised an issue as to the legal title of the property in question and the Surrogate is satisfied that there exists a bona fide issue of legal title; then the constitutional right of a trial by jury exists and the party's motion for such a jury trial should at once be granted.[37]

If the respondent merely asserts a general denial of the allegations in the petition and does not allege title to or the right to possession of any of the property in question, then the discovery proceeding will continue as if no answer were filed.[38] The failure of the respondent to answer is not considered a default, the petitioner still has the burden of proving his or her title to the property and the right to possession of it.[39]

Pursuant to Section 2104(4), once the petitioner has established that he or she is entitled to possession of any property the Court will enter a decree directing delivery of the property or if the property has been disposed of or diverted the decree may direct the payment of the proceeds or the value of the property or may impress a trust upon the proceeds or make any determination which the Supreme Court might decree in following trust property or funds.[40] Section 2104(f) grants the Surrogate's Court with authority to fashion the appropriate relief once the petitioner has established title to or the right to possession of the property in question.[41]

Finally, Section 2104(6) of the SCPA, provides that the protection afforded by Section 4519 of the CPLR (Dead Man Statute) is not waived upon a trial of the issues if during the inquisitorial phase of a 2103 proceeding the respondent is questioned as to any transactions or communications between himself and the decedent.[42]

**Reverse Discovery Proceeding-Section 2105 of the SCPA**

We have at length reviewed the means by which the fiduciary of an estate can discover whether or not the decedent's property is in the possession of others and recover said property which he believes rightfully belongs to the decedent's estate. Briefly, *Section 2105(1) of the SCPA* permits *any person* having any claim to property or the proceeds thereof which are allegedly in the possession or under the control of the fiduciary of an estate to present a petition to the Court showing facts and praying that the fiduciary be required to show cause why he should not deliver the property or the proceeds thereof.[43] Pursuant to Section 2105(2) only the fiduciary is required to be served with process. Thus, any person commencing a Section 2105 discovery proceeding is not required to cite all of the beneficiaries or parties interested in the estate.[44]

Like a 2103 proceeding once the fiduciary raises an issue to title of the property in question, the parties are entitled to a jury trial of said issue of title or possession of property.[45]

**Conclusion**

As the above stated illustrates a discovery proceeding commenced pursuant to Sections 2103 and 2104 of the SCPA is fraught with many different procedural rules that an attorney would not normally associate with discovery and disclosure permitted pursuant to Article 31 of the CPLR. The practitioner embarking upon commencing a 2103 proceeding should carefully review the relevant statutory provisions and case law.

Footnotes

a1 **Gary E. Bashian and Anthony J. Enea are Of Counsel to Smith, Ranscht, Connors, Mutino, Nordell & Sirignano, P.C., White Planis, New York and Greenwich, Connecticut. They concentrate their practices in estate and trust litigation.**

1 *CPLR Article 31, Sections 3101 through 3140.*

2 SCPA Section 102.

3 SCPA Sections 2103, 2104 and 2105.

4 EPTL Section 11-1.1.

5 SCPA Section 2103(1).

6 SCPA Section 2103(2).

7 Laws of New York 1993, ch. 514, Section 48.

8 SCPA Section 2103(2).

9 SCPA Section 2103(3).

10 *SCPA Section 2103(5).*

11 SCPA Section 2103(4).

12 Matter of Lukas, 79 Misc.2d 24, 360 N.Y.S.2d 549 (1974).

13 *Id.*

14 Estate of Mirsky, 145 Misc.2d 438, 546 N.Y.S.2d 951 (1989).

15 Mirsky, p. 439.

16 Matter of Marko, 56 Misc.2d 138, 139, 287 N.Y.S.2d 776 (1968).

17 Mirsky, p. 440.

18 *Siemens & Halske, Gmbh v. Gres, 37 A.D.2d, 768, 324 N.Y.S.2d 639 (1971).*

19 Mirsky, p. 440.

20 SCPA Section 4519.

21 Matter of Estate of Christy B. Detweiler, 121 Misc.2d 757, 467 N.Y.S.2d 766 (1983).

22 Matter of Lalor 28 A.D.2d 66.

23 Detweiler, p. 455.

24 CPLR Section 4519.

25 CPLR Section 214(3).

26 Matter of Norstar Trust Company, 132 A.D.2d 973, 518 N.Y.S.2d 502, App. Denied 70 N.Y.2d 614, 524 N.Y.S.2d 432 (1987).

27 CPLR 214(3).

28 Article VI of the Constitution of the State of New York, Section 12.

29 Matter of Rothko, 69 Misc.2d 752, 330 N.Y.S.2d 915 (1972).

30 Matter of Piccione, 57 N.Y.2d 278, 456 N.Y.S.2d 669 (1983).

31 Matter of Ryan, 63 Misc.2d 415.

32 SCPA 2103(2).

33 *Id.*

34 SCPA 2104(1).

35 Id.

36 Matter of Coon's Estate, 87 A.D.2d 966, 451 N.Y.S.2d 202.

37 Matter of Nutrizio, 211 N.Y. 8 (1924, 1st Department).

38 Matter of Lukas, 79 Misc.2d 24 (1974).

39 *Id.*

40 SCPA 2104(4).

41 *Id.*

42 SCPA 2104(6).

43 SCPA 2105(1).

44 SCPA 2105(2).

45 SCPA 2105(3).

67-APR NYSTBJ 64

# 5

# COMING CLEAN WITH OFFSHORE ACCOUNTS
# THE CURRENT STATUS OF
# VOLUNTARY OFFSHORE DISCLOSURE

IRS

# Offshore Voluntary Disclosure Program
# Frequently Asked Questions and Answers 2014

Effective for OVDP Submissions Made On or After July 1, 2014

| # | Questions | Answers |
|---|---|---|
| 1. | Is this a new offshore voluntary disclosure program? | No. This is a continuation of the program introduced in 2012 with modified terms, but for purposes of referring to this modified program, it may be referred to as the 2014 OVDP. The IRS's prior Offshore Voluntary Disclosure Program (2009 OVDP), and Offshore Voluntary Disclosure Initiative (2011 OVDI), and the 2012 OVDP have demonstrated the value of uniform penalty structures for taxpayers who come forward voluntarily and report their previously undisclosed foreign accounts and assets. These initiatives have enabled the IRS to centralize the civil processing of offshore voluntary disclosures and to resolve a very large number of cases without examination. Because the implementation of the Foreign Account Tax Compliance Act (FATCA) and the IRS and Department of Justice offshore enforcement efforts continue to raise the risk of detection of taxpayers with undisclosed foreign accounts and assets for the foreseeable future, it has been determined that 2012 OVDP should be modified and made available to taxpayers who wish to voluntarily disclose their offshore accounts and assets to avoid prosecution and limit their exposure to civil penalties but have not yet done so. Unlike the 2009 OVDP and the 2011 OVDI, the 2014 OVDP has no set deadline for taxpayers to apply. However, the terms of this program could change at any time. For example, the IRS may increase penalties or limit eligibility in the program for all or some taxpayers or defined classes of taxpayers – or decide to end the program entirely at any time. |
| 1.1. | Were any significant changes made to the 2012 OVDP? If so, what are they? | Changes have been made to the 2012 OVDP, including some which may be considered significant.<br>• A 50% offshore penalty applies if either a foreign financial institution at which the taxpayer has or had an account or a facilitator who helped the taxpayer establish or maintain an offshore arrangement has been publicly identified as being under investigation or as cooperating with a government investigation. See FAQ 7.2.<br>• As described below, FAQ 17 concerning filing delinquent Report of Foreign Bank and Financial Accounts (commonly known as an FBAR) has been |

| | | |
|---|---|---|
| | | replaced and superseded. See "Options Available For U.S. Taxpayers with Undisclosed Foreign Financial Assets".<br>• As described below, FAQ 18 concerning filing certain delinquent international information returns has been replaced and superseded. See "Options Available For U.S. Taxpayers with Undisclosed Foreign Financial Assets".<br>• The reduced penalty structure under former FAQs 52 and 53 has been eliminated due to the expansion of the Streamlined Filing Compliance Procedures. See "Options Available For U.S. Taxpayers with Undisclosed Foreign Financial Assets" for a discussion of the various options for taxpayers with international tax compliance issues.<br>• FAQs 31 through 41 pertaining to the asset base to which the offshore penalty applies have been modified to promote clarity and consistency of application.<br>• FAQ 23 has been modified to require additional information for preclearance by Criminal Investigation.<br>• The Offshore Voluntary Disclosures Letter and attachment have been modified.<br>• FAQ 7 has been modified to require that the offshore penalty be paid at the time of the OVDP submission.<br>• FAQ 25 has been modified to require that account statements be provided for all foreign financial accounts regardless of account balance and to provide that voluminous documents not requiring original signatures may be submitted on CD or DVD.<br>• The following FAQs have been deleted as moot: 16, 17, 18, 19, 51.1, 51.2, 52, and 53. |
| 1.2. | What is the effective date of these modified FAQs? | These modified FAQs are effective for all new submissions made on or after July 1, 2014. |
| 1.3. | If I applied to OVDP prior to the effective date of these modified FAQs and my case has not yet been resolved by means of a closing agreement (Form 906), may I request consideration under these FAQs? | Yes. A taxpayer who made an OVDP submission prior to July 1, 2014 may elect to have his case considered under these FAQs. A taxpayer or his representative must communicate that request in writing to the examiner assigned his case and provide all documents and information required by these FAQs. See FAQ 25. If no examiner has been assigned, send the documents and information to:<br><br>Internal Revenue Service<br>3651 S. I H 35 Stop 4301 AUSC<br>Austin, TX 78741<br>Attn: OVDP Determination |
| 1.4. | If I applied to OVDP prior to the effective date of the expanded Streamlined Filing Compliance Procedures, may I request consideration under those | See the separate set of Frequently Asked Questions for information about eligibility and the process for requesting transitional treatment under the terms of the Streamlined Filing Compliance Procedures in your OVDP case. |

| | | |
|---|---|---|
| | procedures? | |
| 2. | What is the objective of this program? | The objective remains the same as the 2009 OVDP, the 2011 OVDI, and the original 2012 OVDP: to bring taxpayers that have used undisclosed foreign accounts and assets, including those held through undisclosed foreign entities, to avoid or evade tax into compliance with United States tax and related laws. |
| 3. | How does this program differ from the IRS's longstanding voluntary disclosure practice or the 2009 OVDP and 2011 OVDI? | The Voluntary Disclosure Practice is a longstanding practice of IRS Criminal Investigation whereby CI takes timely, accurate, and complete voluntary disclosures into account in deciding whether to recommend to the Department of Justice that a taxpayer be criminally prosecuted. It enables noncompliant taxpayers to resolve their tax liabilities and minimize their chance of criminal prosecution. When a taxpayer truthfully, timely, and completely complies with all provisions of the voluntary disclosure practice, the IRS will not recommend criminal prosecution to the Department of Justice for any issue relating to tax noncompliance or failure to file Report of Foreign Bank and Financial Accounts (commonly known as an FBAR reported on FinCEN Form 114, previously Form TD F 90-22.1). This current offshore voluntary disclosure program is a counterpart to Criminal Investigation's Voluntary Disclosure Practice. Like its predecessors, the 2009 OVDP, which ran from March 23, 2009 through October 15, 2009, and the 2011 OVDI, which ran from February 8, 2011 through September 9, 2011, it addresses the civil side of a taxpayer's voluntary disclosure of foreign accounts and assets by defining the number of tax years covered and setting the civil penalties that will apply. Unlike the 2009 OVDP and the 2011 OVDI, there is no set deadline for taxpayers to apply. However, the terms of this program may change at any time. For example, the IRS may increase penalties or limit eligibility in the program for all or some taxpayers or defined classes of taxpayers or decide to end the program entirely at any time. |
| 4. | Why should I make a voluntary disclosure? | Taxpayers holding undisclosed foreign accounts and assets, including those held through undisclosed foreign entities, should make a voluntary disclosure because it enables them to become compliant, avoid substantial civil penalties, and generally eliminate the risk of criminal prosecution for all issues relating to tax noncompliance and failing to file FBARs. In contrast, taxpayers simply filing amended returns or filing through the Streamlined Filing Compliance Procedures do not eliminate the risk of criminal prosecution. Making a voluntary disclosure also provides the opportunity to calculate, with a reasonable degree of certainty, the total cost of resolving all offshore tax issues. Taxpayers who do not submit a voluntary disclosure run the risk of detection by the IRS and the imposition of substantial penalties, including the fraud penalty and foreign information return penalties, and an increased risk of criminal prosecution. The IRS remains actively engaged in identifying those with undisclosed foreign financial accounts and assets. Moreover, increasingly this |

| | | |
|---|---|---|
| | | information is available to the IRS under tax treaties, through submissions by whistleblowers, and from other sources and will become more available under the FATCA and Foreign Financial Asset Reporting (IRC § 6038D). |
| 5. | What are some of the civil penalties that might apply if I don't participate in the OVDP and the IRS examines me? | Depending on a taxpayer's particular facts and circumstances, the following penalties could apply:<br><br>• A penalty for failing to file FBARs. United States citizens, residents and certain other persons must annually report their direct or indirect financial interest in, or signature authority (or other authority that is comparable to signature authority) over, a financial account that is maintained with a financial institution located in a foreign country if, for any calendar year, the aggregate value of all foreign financial accounts exceeded $10,000 at any time during the year. The civil penalty for willfully failing to file an FBAR can be as high as the greater of $100,000 or 50 percent of the total balance of the foreign financial account per violation. See 31 U.S.C. § 5321(a)(5). Non-willful violations that the IRS determines were not due to reasonable cause are subject to a $10,000 penalty per violation.<br><br>• Beginning with the 2011 tax year, a penalty for failing to file Form 8938 reporting the taxpayer's interest in certain foreign financial assets, including financial accounts, certain foreign securities, and interests in foreign entities, as required by IRC § 6038D. The penalty for failing to file each one of these information returns is $10,000, with an additional $10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of $50,000 per return.<br><br>• A penalty for failing to file Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts. Taxpayers must also report various transactions involving foreign trusts, including creation of a foreign trust by a United States person, transfers of property from a United States person to a foreign trust and receipt of distributions from foreign trusts under IRC § 6048. This return also reports the receipt of gifts from foreign entities under IRC § 6039F. The penalty for failing to file each one of these information returns, or for filing an incomplete return, is the greater of $10,000 or 35 percent of the gross reportable amount, except for returns reporting gifts, where the penalty is five percent of the gift per month, up to a maximum penalty of 25 percent of the gift.<br><br>• A penalty for failing to file Form 3520-A, Information Return of Foreign Trust With a U.S. Owner. Taxpayers must also report ownership interests in foreign trusts, by United States persons with various interests in and powers over those trusts under IRC § 6048(b). The penalty for failing to file each one of |

these information returns or for filing an incomplete return, is the greater of $10,000 or 5 percent of the gross value of trust assets determined to be owned by the United States person.

- A penalty for failing to file Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations. Certain United States persons who are officers, directors or shareholders in certain foreign corporations (including International Business Corporations) are required to report information under IRC §§ 6035, 6038 and 6046. The penalty for failing to file each one of these information returns is $10,000, with an additional $10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of $50,000 per return.
- A penalty for failing to file Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Taxpayers may be required to report transactions between a 25 percent foreign-owned domestic corporation or a foreign corporation engaged in a trade or business in the United States and a related party as required by IRC §§ 6038A and 6038C. The penalty for failing to file each one of these information returns, or to keep certain records regarding reportable transactions, is $10,000, with an additional $10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency.
- A penalty for failing to file Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation. Taxpayers are required to report transfers of property to foreign corporations and other information under IRC § 6038B. The penalty for failing to file each one of these information returns is ten percent of the value of the property transferred, up to a maximum of $100,000 per return, with no limit if the failure to report the transfer was intentional.
- A penalty for failing to file Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships. United States persons with certain interests in foreign partnerships use this form to report interests in and transactions of the foreign partnerships, transfers of property to the foreign partnerships, and acquisitions, dispositions and changes in foreign partnership interests under IRC §§ 6038, 6038B, and 6046A. Penalties include $10,000 for failure to file each return, with an additional $10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of $50,000 per return, and ten percent of the value of any transferred property that is not reported, subject to a $100,000 limit.

| | | |
|---|---|---|
| | | • Fraud penalties imposed under IRC §§ 6651(f) or 6663. Where an underpayment of tax, or a failure to file a tax return, is due to fraud, the taxpayer is liable for penalties that, although calculated differently, essentially amount to 75 percent of the unpaid tax.<br>• A penalty for failing to file a tax return imposed under IRC § 6651(a)(1). Generally, taxpayers are required to file income tax returns. If a taxpayer fails to do so, a penalty of 5 percent of the balance due, plus an additional 5 percent for each month or fraction thereof during which the failure continues may be imposed. The penalty shall not exceed 25 percent.<br>• A penalty for failing to pay the amount of tax shown on the return under IRC § 6651(a)(2). If a taxpayer fails to pay the amount of tax shown on the return, he or she may be liable for a penalty of .5 percent of the amount of tax shown on the return, plus an additional .5 percent for each additional month or fraction thereof that the amount remains unpaid, not exceeding 25 percent.<br>• An accuracy-related penalty on underpayments imposed under IRC § 6662. Depending upon which component of the accuracy-related penalty is applicable, a taxpayer may be liable for a 20 percent or 40 percent penalty. |
| 6. | What are some of the criminal charges I might face if I don't participate in the OVDP and the IRS examines me? | Possible criminal charges related to tax matters include tax evasion (IRC § 7201), filing a false return (IRC § 7206(1)) and failure to file an income tax return (IRC § 7203). Willfully failing to file an FBAR and willfully filing a false FBAR are both violations that are subject to criminal penalties under 31 U.S.C. § 5322. Additional possible criminal charges include conspiracy to defraud the government with respect to claims (18 U.S.C. § 286) and conspiracy to commit offense or to defraud the United States (18 U.S.C. § 371).<br><br>A person convicted of tax evasion is subject to a prison term of up to five years and a fine of up to $250,000. Filing a false return subjects a person to a prison term of up to three years and a fine of up to $250,000. A person who fails to file a tax return is subject to a prison term of up to one year and a fine of up to $100,000. Failing to file an FBAR subjects a person to a prison term of up to ten years and criminal penalties of up to $500,000. A person convicted of conspiracy to defraud the government with respect to claims is subject to a prison term of up to not more than 10 years or a fine of up to $250,000. A person convicted of conspiracy to commit offense or to defraud the United States is subject to a prison term of not more than five years and a fine of up to $250,000. |
| **KEY FEATURES OF PROGRAM** | | |
| 7. | What are the requirements of the Offshore Voluntary Disclosure | Under the terms of the Offshore Voluntary Disclosure Program, taxpayers must: |

| | | |
|---|---|---|
| | Program? | • Provide all documents required by FAQ 25;<br>• Cooperate in the voluntary disclosure process, including providing information on foreign accounts and assets, institutions and facilitators, and signing agreements to extend the period of time for assessing Title 26 liabilities and FBAR penalties;<br>• Pay 20-percent accuracy-related penalties under IRC § 6662(a) on the full amount of your offshore-related underpayments of tax for all years;<br>• Pay failure-to-file penalties under IRC § 6651(a)(1), if applicable;<br>• Pay failure-to-pay penalties under IRC § 6651(a)(2), if applicable;<br>• Pay, in lieu of all other penalties that may apply to the undisclosed foreign accounts, assets and entities, including FBAR and offshore-related information return penalties and tax liabilities for years prior to the voluntary disclosure period, a miscellaneous Title 26 offshore penalty equal to 27.5 percent (or 50 percent in circumstances described in FAQ 7.2) of the highest aggregate value of OVDP assets as defined in FAQ 35 during the period covered by the voluntary disclosure (the 27.5 percent and 50 percent penalties are together referred to in these FAQs as the "offshore penalty");<br>• Submit full payment of any Title 26 tax liabilities for years included in the offshore disclosure period, applicable interest, an offshore penalty, accuracy-related penalties for offshore-related underpayments, and, if applicable, the failure-to-file and failure-to-pay penalties or, if the taxpayer is unable to make full payment, make good faith arrangements with the IRS to pay in full (see FAQ 20 for more information) (note: the suspension of interest provisions of IRC § 6404(g) do not apply to interest due in this program);<br>• Execute a Closing Agreement on Final Determination Covering Specific Matters, Form 906; and<br>• Agree to cooperate with IRS and Department of Justice offshore enforcement efforts, if requested, by providing information about financial institutions and other facilitators who helped the taxpayer establish or maintain an offshore arrangement. |
| 7.1. | What if I have unreported income from a domestic source or some other undisclosed income tax liability that is not related to foreign financial accounts? | As was the case with the 2009 OVDP and the 2011 OVDI, the OVDP is available to taxpayers who have both foreign and domestic issues to disclose. The Voluntary Disclosure Practice requires a complete, accurate, and truthful disclosure. Consequently, in addition to disclosing all items relating to foreign financial accounts, OVDP submissions must correct any previously unreported income from domestic sources, inappropriate deductions or credits claimed, or other incomplete, inaccurate or untruthful items on the originally filed returns. The offshore penalty structure |

| | | |
|---|---|---|
| | | only resolves liabilities and penalties related to offshore noncompliance. Domestic portions of a voluntary disclosure are subject to examination. See FAQ 24. |
| 7.2. | What if the government is investigating the foreign financial institution where I hold my account or another facilitator who assisted in establishing or maintaining my offshore arrangement? | Beginning on August 4, 2014, any taxpayer who has an undisclosed foreign financial account will be subject to a 50-percent miscellaneous offshore penalty if, at the time of submitting the preclearance letter to IRS Criminal Investigation: an event has already occurred that constitutes a public disclosure that either (a) the foreign financial institution where the account is held, or another facilitator who assisted in establishing or maintaining the taxpayer's offshore arrangement, is or has been under investigation by the IRS or the Department of Justice in connection with accounts that are beneficially owned by a U.S. person; (b) the foreign financial institution or other facilitator is cooperating with the IRS or the Department of Justice in connection with accounts that are beneficially owned by a U.S. person or (c) the foreign financial institution or other facilitator has been identified in a court- approved issuance of a summons seeking information about U.S. taxpayers who may hold financial accounts (a "John Doe summons") at the foreign financial institution or have accounts established or maintained by the facilitator.<br>Examples of a public disclosure include, without limitation: a public filing in a judicial proceeding by any party or judicial officer; or public disclosure by the Department of Justice regarding a Deferred Prosecution Agreement or Non-Prosecution Agreement with a financial institution or other facilitator. A list of foreign financial institutions or facilitators meeting this criteria is available.<br>Once the 50-percent miscellaneous offshore penalty applies to any of the taxpayer's accounts or assets in accordance with the terms set forth in the paragraph above, the 50-percent miscellaneous offshore penalty will apply to all of the taxpayer's assets subject to the penalty (see FAQ 35), including accounts held at another institution or established through another facilitator for which there have been no events constituting public disclosures of (a) or (b) above. |
| 8. | How does the offshore penalty framework work? Can you provide an example? | The offshore penalty applies to OVDP assets as defined in FAQ 35. The values of OVDP assets are aggregated for each year and the offshore penalty is calculated at the applicable rate (either 27.5 percent or 50 percent) of the highest year's aggregate value during the period covered by the voluntary disclosure. If the taxpayer has multiple OVDP assets where the highest value of some OVDP assets is in different years, the values of OVDP assets are aggregated for each year and a single offshore penalty is calculated at the applicable rate of the highest year's aggregate value.<br>For example, assume the taxpayer had the following amounts in a foreign financial account over the period covered by his voluntary disclosure. It is assumed for purposes of the example that the $1,000,000 was in the account before 2005 and was not unreported income in 2005. |

| Year | Amount on Deposit | Interest Income | Account Balance |
|---|---|---|---|
| 2005 | $1,000,000 | $50,000 | $1,050,000 |
| 2006 | | $50,000 | $1,100,000 |
| 2007 | | $50,000 | $1,150,000 |
| 2008 | | $50,000 | $1,200,000 |
| 2009 | | $50,000 | $1,250,000 |
| 2010 | | $50,000 | $1,300,000 |
| 2011 | | $50,000 | $1,350,000 |
| 2012 | | $50,000 | $1,400,000 |

(NOTE: This example does not provide for compound interest, and assumes the taxpayer is in the 35-percent tax bracket, does not have an investment in a Passive Foreign Investment Company (PFIC) and files a return but does not include the foreign financial account or the interest income on the return. This example further assumes that the taxpayer is subject to a 27.5 percent offshore penalty.)

If the taxpayer in the above example comes forward and his voluntary disclosure is accepted by the IRS, he faces this potential scenario:
He would pay $553,000 plus interest. This includes:

- Tax of $140,000 (8 years at $17,500) plus interest,
- An accuracy-related penalty of $28,000 (i.e., $140,000 x 20%), and
- A miscellaneous offshore penalty (see FAQ 7) of $385,000 (i.e., $1,400,000 x 27.5%).

If the taxpayer didn't come forward, when the IRS discovered his tax and FBAR noncompliance, he would have to pay substantially more in penalties. The taxpayer would also be liable for interest and possibly additional penalties, and an examination could lead to criminal prosecution.

The civil liabilities outside the Offshore Voluntary Disclosure Program potentially include:

- The tax, accuracy-related penalties, and, if applicable, the failure-to-file and failure-to-pay penalties, plus interest, as described above,
- FBAR penalties totaling up to $3,825,000 for willful failures to file complete and correct FBARs (2007 - $575,000, 2008 - $600,000, 2009 - $625,000, 2010 - $650,000, and 2011 - $675,000, and 2012 - $700,000),
- The potential of having the fraud penalty (75 percent) apply, and
- The potential of substantial additional information return penalties if the foreign financial account is held through a foreign entity such as a trust or

| | | |
|---|---|---|
| | | corporation and required information returns were not filed.<br><br>In addition, if the taxpayer is not in OVDP and the foreign noncompliance started before 2005, the Service may examine tax years prior to 2005. |
| 9. | What years are included in the OVDP disclosure period? | The voluntary disclosure period is the most recent eight tax years for which the due date has already passed. Thus, for taxpayers who submit a voluntary disclosure prior to the due date (or properly extended due date) for the 2013 tax year, the disclosure must include each of the tax years 2005 through 2012 in which they have undisclosed OVDP assets. For taxpayers who submit a voluntary disclosure after the due date (or properly extended due date) for 2013, the disclosure must include each of the tax years 2006 through 2013 in which they have undisclosed OVDP assets. For disclosures made in successive years, any additional years for which the due date has passed must be included, but a corresponding number of years at the beginning of the period will be excluded, so that each disclosure includes an eight year period.<br><br>The eight-year voluntary disclosure period does not include fully tax compliant years. For taxpayers who establish that they began filing timely, original, compliant returns that fully reported previously undisclosed OVDP assets (see FAQ 35) before making the voluntary disclosure, the voluntary disclosure period will begin with the eighth year preceding the most recent year for which the return filing due date has not yet passed, but will not include the compliant years. For example, for a taxpayer who had historically filed income tax returns omitting the income from a securities account in Country A, who began reporting that income on his timely, original tax and information reporting returns for 2009 through 2012 without making a voluntary disclosure, and who files a voluntary disclosure in January 2014, the voluntary disclosure period will be 2005 through 2008. |
| 10. | What are my options if my OVDP asset involves passive foreign investment company (PFIC) issues? | A significant number of cases submitted under the 2009 OVDP and 2011 OVDI involved PFIC investments. A lack of historical information on the cost basis and holding period of many PFIC investments makes it difficult for taxpayers to prepare statutory PFIC computations and for the Service to verify them. As a result, resolution of voluntary disclosure cases could be unduly delayed. Therefore, for purposes of this program, the Service is offering taxpayers an alternative to the statutory PFIC computation that will resolve PFIC issues on a basis that is consistent with the Mark to Market (MTM) methodology authorized in IRC § 1296 but will not require complete reconstruction of historical data.<br>The terms of this alternative resolution are:<br><br>• If elected, the alternative resolution will apply to all PFIC investments in cases that have been accepted into this program. The initial MTM computation of |

gain or loss under this methodology will be for the first year of the OVDP application, but could be made after that year depending on when the first PFIC investment was made. For example, for the earliest disclosures under this program, the first year of the OVDP application will be the calendar year ending December 31, 2005. This will require a determination of the basis for every PFIC investment, which should be agreed between the taxpayer and the Service based on the best available evidence.

- A tax rate of 20 percent will be applied to the MTM gain(s), MTM net gain(s) and gains from all PFIC dispositions during the voluntary disclosure period under the OVDP, in lieu of the rate contained in IRC § 1291(a)(1)(B) for the amount allocable to the current year and IRC §1291(c)(2) for the deferred tax amount(s) allocable to any other taxable year.
- A rate of 7 percent of the tax computed for PFIC investments marked to market in the first year of the OVDP application will be added to the tax for that year, in lieu of the interest charge mechanism described in IRC §§ 1291(c) and 1296(j).
- MTM losses will be limited to unreversed inclusions (generally, previously reported MTM gains less allowed MTM losses) on an investment-by-investment basis in the same manner as IRC § 1296. During the voluntary disclosure period under the OVDP, these MTM losses will be treated as ordinary losses (IRC § 1296(c)(1)(B)) and the tax benefit is limited to the tax rate applicable to the MTM gains derived during the voluntary disclosure period (20%). MTM and/or disposition losses in any subsequent year on PFIC assets with basis that was adjusted upward as a result of the alternate resolution in voluntary disclosure years, will be treated as capital losses. Any unreversed inclusions at the end of the voluntary disclosure period will be reduced to zero and the MTM method will be applied to all subsequent years in accordance with IRC § 1296 as if the taxpayer had acquired the PFIC stock on the last day of the last year of the voluntary disclosure period at its MTM value and made an IRC § 1296 election for the first year beginning after the voluntary disclosure period. Thus, any subsequent year losses on disposition of PFIC stock assets in excess of unreversed inclusions arising after the end of the voluntary disclosure period will be treated as capital losses.
- Regular and Alternative Minimum Tax are both to be computed without the PFIC dispositions or MTM gains and losses. The tax from the PFIC transactions (20% plus the 7% for the first year, if applicable) is added to (or subtracted from) the applicable total tax (either regular or AMT, whichever is higher). The tax and interest (i.e., the 7% for the first year of the voluntary disclosure) computed

| | | |
|---|---|---|
| | | under the OVDP alternative MTM can be added to the applicable total tax (either regular or AMT, whichever is higher) and placed on the amended return in the margin, with a supporting schedule.<br>• Underpayment interest and penalties on the deficiency are computed in accordance with the Internal Revenue Code and the terms of the OVDP.<br>• For any PFIC investment retained beyond the voluntary disclosure period, the taxpayer must continue using the MTM method, but will apply the normal statutory rules of IRC § 1296 as well as the provisions of IRC §§ 1291-1298, as applicable.<br>Before electing the alternative PFIC resolution, a taxpayer with PFIC investments should consult his tax advisors to ensure that the issue is material in his case and that the alternative is in fact preferable to the statutory computation in his situation. If the taxpayer does not elect to use the alternative PFIC computation, the PFIC provisions of IRC §§ 1291-1298 apply. |
| 11. | Previously deleted. | |
| **ELIGIBILITY FOR THIS PROGRAM** | | |
| 12. | Who is eligible to make a voluntary disclosure under this program? | Taxpayers who have legal source funds invested in undisclosed OVDP assets (see FAQ 35) and meet the requirements of IRM 9.5.11.9 are eligible to apply for IRS Criminal Investigation's Voluntary Disclosure Practice and the OVDP penalty regime. The OVDP is available only to address the taxpayer's own liability. Individuals who facilitated the tax noncompliance of others are not eligible to participate in OVDP. Taxpayers who have made a submission under the Streamlined Filing Compliance Procedures are not eligible to participate in OVDP. See FAQ 21 for other ways a taxpayer may be rendered ineligible to participate in the OVDP. |
| 13. | Are entities, such as corporations, partnerships and trusts eligible to make voluntary disclosures? | Yes. Entities are eligible to participate in the OVDP. |
| 14. | I'm currently under examination. May I participate in the OVDP? | No. If the IRS has initiated a civil examination for any year, regardless of whether it relates to undisclosed OVDP assets (see FAQ 35), the taxpayer will not be eligible to participate in the OVDP. A taxpayer under criminal investigation by CI is also ineligible. In these circumstances, the taxpayer or the taxpayer's representative should discuss undisclosed financial accounts and assets with the agent. |
| 15. | What if a taxpayer has already filed amended returns reporting income from OVDP assets without making a voluntary disclosure (i.e. "quiet disclosure")? | The IRS is aware that some taxpayers have made "quiet disclosures" by filing amended returns, by filing delinquent FBARs, and paying any related tax and interest for previously unreported income from OVDP assets (see FAQ 35) without otherwise notifying the IRS. Taxpayers who have already made "quiet disclosures" are encouraged to participate in the OVDP by submitting an application, along with copies of their previously filed returns (original and amended), and all other required documents and information (see FAQ 25) to the IRS's Voluntary Disclosure Coordinator (see FAQ |

| | | |
|---|---|---|
| | | 24). Taxpayers are encouraged to avail themselves of the protection from criminal prosecution and the favorable penalty structure offered under the OVDP. Unlike a voluntary disclosure through the OVDP, quiet disclosures provide no protection from criminal prosecution and may lead to civil examination and the imposition of all applicable penalties. |
| 16. | Consolidated into FAQ 15. | |
| 17. | Deleted. FAQ 17 has been replaced and superseded by section 3 in "Options Available For U.S. Taxpayers with Undisclosed Foreign Assets." If you have circumstances covered by former FAQ 17, you should not use OVDP and should see section 3 of the "Options Available For U.S. Taxpayers with Undisclosed Foreign Accounts." | |
| 18. | Deleted. FAQ 18 has been replaced and superseded by section 4 in "Options Available For U.S. Taxpayers with Undisclosed Foreign Assets." If you have circumstances covered by former FAQ 18, you should not use OVDP and should see section 3 of the "Options Available For U.S. Taxpayers with Undisclosed Foreign Accounts." | |
| 19. | Deleted | |
| 20. | If I don't have the ability to full pay, can I still participate in this program? | Yes. The terms of this program require the taxpayer to pay with his submission the tax, interest, offshore penalty, and accuracy-related penalty, and, if applicable, the failure-to-file and failure-to-pay penalties. However, it is possible for a taxpayer who is unable to make full payment of these amounts to request the IRS to consider other payment arrangements. If you cannot pay the total amount of tax, interest, offshore penalty, and other penalties required, submit your proposed payment arrangement and a completed Collection Information Statement (Form 433-A, Collection Information Statement for Wage Earners and Self-employed Individuals, or Form 433-B, Collection Information Statement for Businesses, Collection Information Statement for Businesses, as appropriate). The burden will be on the taxpayer to establish inability to pay, to the satisfaction of the IRS, based on full disclosure of all assets and income sources, domestic and foreign, under the taxpayer's control. Assuming that the IRS determines that the inability to fully pay is genuine, the taxpayer must work out other financial arrangements, acceptable to the IRS, to resolve all outstanding liabilities to be entitled to the penalty structure of this program. |
| 21. | If the IRS has served a John Doe summons or made a treaty request | |

| | | |
|---|---|---|
| | seeking information that may identify a taxpayer as holding an undisclosed OVDP asset, does that make the taxpayer ineligible to make a voluntary disclosure under this program? | No. The mere fact that the Service served a John Doe summons, made a treaty request, or has taken similar action does not make every member of the Joe Doe class or group identified in the treaty request or other action ineligible to participate. But such activity may subject a taxpayer to a higher offshore penalty at the rate of 50 percent. See FAQ 7.2.<br>Once the Service or the Department of Justice obtains information under a John Doe summons, treaty request, or other similar action that provides evidence of a specific taxpayer's noncompliance with the tax laws or Title 31 reporting requirements, that particular taxpayer will become ineligible for OVDP and Criminal Investigation's Voluntary Disclosure Practice. For this reason, a taxpayer concerned that a party subject to a John Doe summons, treaty request, or similar action will provide information about him to the Service should apply to make a voluntary disclosure as soon as possible.<br>Furthermore, there are two other ways in which an otherwise eligible taxpayer will become ineligible. First, if a taxpayer appeals a foreign tax administrator's decision authorizing the providing of account information to the IRS and fails to serve the notice as required under existing law, see 18 U.S.C. 3506, of any such appeal and/or other documents relating to the appeal on the Attorney General of the United States at the time such notice of appeal or other document is submitted, the taxpayer will be ineligible to participate. Second, the IRS may determine that certain taxpayer groups that have or had accounts held at a specific financial institution will be ineligible due to U.S. government actions in connection with the specific financial institution. |
| **OVDP PROCESS** | | |
| 22. | Can my representative talk to the IRS without revealing my identity? | Yes, but hypothetical situations present the potential for misunderstandings. Hypotheticals rarely contain all relevant facts. Posing a hypothetical does not satisfy the requirements for making a voluntary disclosure. If the IRS receives information relating specifically to the taxpayer's undisclosed OVDP assets (see FAQ 35) while the hypothetical question is pending, the taxpayer may become ineligible to make a voluntary disclosure. If practitioners have questions about the terms of the voluntary disclosure program, they should contact the IRS OVDP Hotline at (267) 941-0020 or find more information on the 2012 Offshore Voluntary Disclosure Program page. |
| 23. | How do I request preclearance before I submit my offshore voluntary disclosure? | For the OVDP, the preclearance process is as follows:<br><br>1. Taxpayers or representatives send a facsimile to the IRS – Criminal Investigation Lead Development Center (LDC) with:<br>(a) Applicant identifying information including complete names, dates of birth (if applicable), tax identification numbers, addresses, and telephone numbers. |

| | | |
|---|---|---|
| | | (b) Identifying information of all financial institutions at which undisclosed OVDP assets (see FAQ 35) were held. Identifying information for financial institutions includes complete names (including all DBAs and pseudonyms), addresses, and telephone numbers.<br><br>(c) Identifying information of all foreign and domestic entities (e.g., corporations, partnerships, limited liability companies, trusts, foundations) through which the undisclosed OVDP assets (see FAQ 35) were held by the taxpayer seeking to participate in the OVDP; this does not include any entities traded on a public stock exchange. Information must be provided for both current and dissolved entities. Identifying information for entities includes complete names (including all DBAs and pseudonyms), employer identification numbers (if applicable), addresses, and the jurisdiction in which the entities were organized.<br><br>(d) Executed power of attorney forms (if represented).<br>The LDC fax number to request preclearance before making an offshore voluntary disclosure is (267) 941-1115. In the case of jointly filed returns, if each spouse intends to apply for OVDP, each spouse should request preclearance.<br><br>The LDC fax number to request preclearance before making an offshore voluntary disclosure is (267) 941-1115. In the case of jointly filed returns, if each spouse intends to apply for OVDP, each spouse should request preclearance.<br><br>2. Criminal Investigation will notify taxpayers or their representatives via fax whether or not they are eligible to make an offshore voluntary disclosure. It may take up to 30 days for Criminal Investigation to notify taxpayers or their representatives of the decision.<br><br>Preclearance does not guarantee a taxpayer acceptance into the OVDP. Taxpayers pre-cleared for OVDP must follow the steps outlined below (FAQ 24) within 45 days from receipt of the fax notification to make an offshore voluntary disclosure. Taxpayers must truthfully, timely, and completely comply with all provisions of the OVDP.<br>Taxpayers or representatives with questions regarding preclearance may call the IRS-CI OVDP Hotline at (267) 941-1607. For all other offshore voluntary disclosure questions call the IRS OVDP Hotline at (267) 941-0020. |
| 24. | How do I make an offshore voluntary disclosure, and where should I submit my offshore voluntary disclosure to determine whether I am conditionally accepted under this program? | For the OVDP, submit an offshore voluntary disclosure as follows:<br><br>1. Taxpayers or their representatives should mail their Offshore Voluntary Disclosure Letter and attachment to the following address:<br>Internal Revenue Service |

| | | |
|---|---|---|
| | | Voluntary Disclosure Coordinator<br>1-D04-100<br>2970 Market Street<br>Philadelphia, PA 19104<br><br>2. Criminal Investigation will review the Offshore Voluntary Disclosure Letter and notify taxpayers or representatives by mail or facsimile whether their offshore voluntary disclosures have been preliminarily accepted as timely or declined. Criminal Investigation intends to complete its work within 45 days of receipt of a complete Offshore Voluntary Disclosure Letter.<br><br>Once a taxpayer's disclosure has been preliminarily accepted by CI as timely, the taxpayer must complete the submission and cooperate with the civil examiner in the resolution of the civil liability before the disclosure is considered complete.<br>All non-offshore voluntary disclosures not covered under this program should follow the domestic voluntary disclosure instructions at the bottom of the How to make an Offshore Voluntary Disclosure page.<br>Taxpayers who are making both an offshore voluntary disclosure and a domestic voluntary disclosure should follow the process for offshore voluntary disclosures, but indicate on the Offshore Voluntary Disclosure Letter that they are also making a domestic voluntary disclosure. |
| 24.1 | What should I do if my spouse also wishes to make a voluntary disclosure under OVDP? | In situations where spouses both desire to participate in OVDP, they may do so jointly or separately. If spouses make a joint submission, they must include all required information and documents for each spouse and clearly indicate the intention to disclose jointly. If spouses make separate submissions, each spouse must complete and submit all required information and documents. See FAQs 22 through 25. |
| 25. | After I am notified by CI that my disclosure is preliminarily accepted as timely, what other information will I be required to provide? | The letter from CI will instruct the taxpayer or his representative to submit the full voluntary disclosure submission to the Austin Campus within 90 days of the date of the timeliness determination. The voluntary disclosure submission must be sent in two separate parts.<br><br>1. Payment to the Department of Treasury in the total amount of tax, interest, offshore penalty, accuracy-related penalty, and, if applicable, the failure-to-file and failure-to-pay penalties, for the voluntary disclosure period must be sent with information identifying the taxpayer name, taxpayer identification number, and years to which the payments relate. To ensure payments are properly posted to the taxpayer's account, separate checks should be made for each tax year which would include all applicable tax, interest, accuracy-related penalties, and failure-to-file and failure-to-pay penalties. The offshore penalty should be paid by a separate check. These payments are advance payments; consequently, any credit or refund of the payments is subject to the limitations of IRC § 6511. |

If you cannot pay the total amount of tax, interest, offshore penalty, and other penalties as described above, submit your proposed payment arrangement and a completed Collection Information Statement (Form 433-A, Collection Information Statement for Wage Earners and Self-employed Individuals, or Form 433-B, Collection Information Statement for Businesses, as appropriate) (see FAQ 20). Send letters containing the taxpayer's identifying information and all checks in a single envelope to:

Internal Revenue Service
3651 S. I H 35
Stop 1919 AUSC
Austin, TX 78741
ATTN: Offshore Voluntary Disclosure Program

2. All other required items listed below must be sent to:

   Internal Revenue Service
   3651 S. I H 35
   Stop 4301 AUSC
   Austin, TX 78741
   ATTN: Offshore Voluntary Disclosure Program

   a. **All applicants**: Copies of previously filed original (and, if applicable, previously filed amended) federal income tax returns for tax years covered by the voluntary disclosure;

   b. **All applicants:** Complete and accurate amended federal income tax returns (for individuals, Form 1040X) or original Form 1040 (if delinquent) for all tax years covered by the voluntary disclosure, with applicable schedules detailing the amount and type of previously unreported income from foreign financial accounts or domestic sources (e.g., Schedule B for interest and dividends, Schedule D for capital gains and losses, Schedule E for income from partnerships, S corporations, estates or trusts and, for years after 2010, Form 8938, Statement of Specified Foreign Financial Assets). For taxpayers who began filing timely, original, compliant returns that fully reported previously undisclosed foreign financial accounts before making the voluntary disclosure for certain years of the offshore disclosure period, copies of the previously filed returns for the compliant years. If you are submitting a copy of a previously filed return, write "COPY" on the top of the first page of the return.

   c. **All applicants:** Copy of your completed and signed Offshore Voluntary Disclosure Letter (including enclosures and attachments) submitted to Criminal Investigation.

d. **All applicants:** A completed Foreign Account or Asset Statement for each previously undisclosed OVDP asset during the voluntary disclosure period.

e. **All applicants:** A completed and signed Taxpayer Account Summary With Penalty Calculation.

f. **All applicants:** Properly completed and signed agreements to extend the period of time to assess tax (including tax penalties) and to assess FBAR penalties. The agreements to extend the period of time to assess tax and FBAR penalties must follow the instructions provided. Failure to extend the period of time to assess tax and assess FBAR penalties according to the instructions will render your OVDP submission incomplete.

g. **All applicants disclosing foreign financial accounts:** Copies of filed Reports of Foreign Bank and Financial Accounts (commonly known as FBARs reported on FinCEN Form 114, previously Form TD F 90-22.1) for foreign financial accounts maintained during the period of your voluntary disclosure. See FAQs 44-46 for further information on FBAR filing requirements, including the requirement that FBARs be filed electronically.

h. **All applicants:** Copies of statements for all financial accounts reflecting all account activity for each of the tax years covered by your voluntary disclosure. For OVDP assets (see FAQ 35) other than foreign financial accounts, provide all relevant documents pertaining to the asset. For example, if a taxpayer has foreign issued life insurance with cash value, provide all documents governing the policy and, if any, all legal and tax opinions issued to the taxpayer relating to the policy.

i. **All applicants disclosing foreign entities:** A statement identifying all foreign entities, whether held directly or indirectly, for the tax years included in the voluntary disclosure, and a statement concerning ownership or control of such entities.

j. **All applicants disclosing foreign entities:** If foreign entities held OVDP assets (see FAQ 35), provide complete and accurate information returns (or amended returns, if applicable) required to be filed, including but not limited to Forms 3520, 3520-A, 5471, 5472, 926, 8865, and 8938 for all tax years included in the voluntary disclosure. If the taxpayer requests that the Service waive information reporting requirements, the taxpayer must submit a completed and signed "Statement on Abandoned Entities" form. See FAQ 29.

| | | |
|---|---|---|
| | | k. **Applicants with estate and gift tax issues:** If the taxpayer is a decedent's estate, or is an individual who participated in the failure to report an OVDP asset (see FAQ 35) in a required gift or estate tax return, either as executor or advisor, provide complete and accurate amended estate or gift tax returns (original estate or gift tax returns if not previously filed) for tax years included in the voluntary disclosure correcting the underreporting or omission of OVDP assets (see FAQ 35).<br><br>l. **Applicants with Passive Foreign Investment Company (PFIC) issues:** A statement whether the amended or delinquent returns involve PFIC issues during the tax years covered by the OVDP period, and if so, whether the taxpayer chooses to elect the alternative to the statutory PFIC computation that resolves PFIC issues on a basis that is consistent with the mark to market (MTM) methodology authorized in IRC § 1296 but does not require complete reconstruction of historical data. See FAQ 10.<br><br>m. **Applicants with Canadian registered retirement savings plans (RRSPs) or registered retirement income funds (RRIFs) who wish to make late elections to defer U.S. tax on earnings:** Provide the documents required in FAQ 54.<br><br>You may also be contacted by an examiner for specific additional information to process your voluntary disclosure. The examiner will certify that your voluntary disclosure is correct, accurate, and complete by reviewing your records along with your amended or delinquent income tax returns. The examiner will also verify the tax, interest, and civil penalties you owe.<br>A complete submission is required for acceptance into the program.<br>Taxpayers may submit voluminous documents not requiring original taxpayer signatures (e.g., bank statements, entity organization documents, etc.) on a compact disc (CD) or a USB removable storage device (flash drive). See FAQ 25.2. |
| 25.1 | What if I cannot make a complete submission by the date specified in the letter from Criminal Investigation? | A taxpayer may request an extension of the deadline to complete his submission. A taxpayer requesting an extension must submit his name, address, date of birth, social security number, and telephone number and should submit as much of the information described in FAQ 25 as possible with his written request for extension, including at a minimum the properly completed and signed agreements to extend the period of time to assess tax (including tax penalties) and to assess FBAR penalties.<br>Requests for up to a 90-day extension must include a statement of those items that are missing, the reasons why they are not included, and the steps taken to secure them. Requests for extensions must be made in |

| | | |
|---|---|---|
| | | writing and sent to the Austin Campus on or before the date specified in the letter from Criminal Investigation for completing the voluntary disclosure:<br>Internal Revenue Service<br>3651 S. I H 35 Stop 4301 AUSC<br>Austin, TX 78741<br>ATTN: Offshore Voluntary Disclosure Program |
| 25.2 | Are there any requirements or procedures for submitting documents on a compact disc (CD) or a USB removable storage device (flash drive)? | Yes. These procedures may be used only by professional firms with established record retention policies.<br><br>1. The representative must submit an original, signed paper Agreement for Digital Submission of OVDP Documentation. A copy of the Form 2848 must be attached. There must be one signed agreement for each taxpayer. The only exception is that married taxpayers who are submitting joint returns for all years included in the disclosures may submit only one Agreement for Digital Submission of OVDP documentation.<br>2. All other required OVDP documents other than the Agreement for Digital Submission of OVDP documentation may be submitted digitally.<br>3. All required OVDP documents, or as many as possible, should be transferred to a CD or flash drive.<br>4. All required OVDP required OVDP documents being submitted digitally must be submitted in a format that does not permit editing or changing the stored information without warning, e.g. .PDF. The preferred format is .PDF.<br>5. The digital documents should **not** be password protected. Documents submitted on a CD or flash drive will be handled in the same secure manner as paper documents.<br>6. The digital documents should be arranged in separate folders in the same sequence as a paper submission would be assembled.<br>7. The CD or flash drive must be labeled with the last four digits only of the taxpayer's Taxpayer Identification Number. |
| 26. | Who will process my voluntary disclosure after I have submitted the information described in FAQ 25? | After you send in your full and complete submission as described in FAQ 25, your case will be assigned to a civil examiner to complete the certification of your tax returns for accuracy, and completeness. If you have also made a domestic voluntary disclosure as part of your offshore voluntary disclosure, the domestic disclosure will be treated as a disclosure under the Voluntary Disclosure Practice and may be assigned to a different examiner. |
| 27. | Will my voluntary disclosure be subject to an examination? | Normally, no examination will be conducted with respect to an offshore voluntary disclosure made under this program, although the Service reserves the right to conduct an examination. The normal process is to assign the voluntary disclosure to an examiner to certify |

| | | |
|---|---|---|
| | | the accuracy and completeness of the voluntary disclosure. The certification process is less formal than an examination and does not carry with it all the rights and legal consequences of an examination. For example, the examiner will not send the usual taxpayer notices, the certification process will not constitute a "second examination" if one or more years in the voluntary disclosure has previously been examined, and the taxpayer will not have appeal rights with respect to the Service's determination. However, the examiner has the right to ask any relevant questions, request any relevant documents, and even make third party contacts, if necessary, to certify the accuracy of the amended returns, without converting the certification to an examination. If you have also made a domestic voluntary disclosure as part of your offshore voluntary disclosure, the domestic disclosure will be treated as a disclosure under the Voluntary Disclosure Practice and an examination may be opened for that part of the disclosure. |
| 28. | How long should the process take before it is completed? | Because every case is different, there is no way to predict how long the process will take for you. However, the IRS has taken certain steps to improve our efficiency in processing cases. Moreover, there are certain steps you can take to expedite matters. If you have not already done so, you should have delinquent or amended tax returns prepared now because they must be submitted with your package by the date specified in the letter from Criminal Investigation for completing the voluntary disclosure. You should also gather all other documents and information required for the OVDP. See FAQ 25. Case assignments to specific examiners are delayed when required documents are not timely provided. Once the case is assigned to an examiner to certify your completed voluntary disclosure, most cases should be resolved expeditiously. The OVDP generally operates on a first-come, first-served basis. |
| 29. | My OVDP assets were held in the name of a foreign entity that I controlled. However, the sole purpose of the entity was to conceal my ownership of the assets, and I intend to abandon the entity now that I am making a voluntary disclosure. Do I still have to file the delinquent information returns for the entity? | A taxpayer who holds OVDP assets (see FAQ 35) through a foreign entity he controls, such as a corporation or a trust, is required to file information returns for that entity (e.g., Form 5471 for a foreign corporation and Forms 3520 and 3520-A for a foreign trust), regardless of whether the taxpayer honored the form of the entity in his dealings with the OVDP assets. However, in cases where the taxpayer certifies under penalty of perjury that the entity had no purpose other than to conceal the taxpayer's ownership of assets and liquidates and abandons the entity, the Service may agree to waive the requirement that delinquent information returns be filed if it concludes it is in the Service's interest to do so. Taxpayers wishing to request the Service to disregard a foreign entity will be required to certify under penalty of perjury that the entity had no purpose other than to conceal the taxpayer's ownership of assets and that it has been liquidated and abandoned by filing a Statement on Abandoned Entities. |
| | | |

| | | |
|---|---|---|
| 30. | What should I do if I am having difficulty obtaining my records from overseas? | If you are having difficulty obtaining records, carefully document your attempts. For phone conversations, note the date, time, and duration of the call; note the complete name of the employee of the foreign financial institution with whom you speak. For correspondence, make a photocopy of all correspondence to and from the foreign financial institution. We recommend using a delivery or postal service that provides delivery confirmation or a return receipt for all correspondence sent to foreign financial institutions. Provide your documentation relating to your attempts to obtain records to the examiner handling your case, or if your case is not yet assigned, contact the IRS OVDP Hotline at (267) 941-0020. Our experience with offshore cases in recent years has shown that taxpayers are ultimately successful in retrieving copies of statements and other records from foreign financial institutions. |
| **CALCULATING THE OFFSHORE PENALTY** | | |
| 31. | When determining the highest value of each OVDP asset for each year what exchange rate should be used? | Convert foreign currency by using the foreign currency exchange rate at the end of the year regardless of when during the year the highest value was reached. In valuing currency of a country that uses multiple exchange rates, use the rate that would apply if the currency in the account were converted into United States dollars at the close of the calendar year. Each OVDP asset is to be valued separately. |
| 32. | If a taxpayer's violation includes unreported foreign individual accounts and business accounts (for an active business), does the offshore penalty include the business accounts? | Yes. Assuming that there is unreported gross income with respect to all the accounts, they all will be included in the penalty base. No distinction is drawn based on whether the account is a business account or a savings or investment account. |
| 33. | Is there a de minimis unreported income exception relating to tax noncompliance and the offshore penalty? | No. No amount of unreported gross income is considered de minimis for purposes of determining whether there has been tax noncompliance with respect to an OVDP asset. Even one dollar of unreported gross income from an OVDP asset will bring it into the offshore penalty base. |
| 34. | If the look back period is eight years, what does the taxpayer do if the taxpayer held foreign real estate, sold it before the voluntary disclosure period, and did not report the gain on his return for the year of sale? Does the taxpayer compute the offshore penalty on the highest aggregate balance in the voluntary disclosure period? What, if anything, does the Service expect a taxpayer to do with respect to tax noncompliance in a year prior to the voluntary disclosure period? | Gain realized on a foreign transaction occurring before the voluntary disclosure period does not need to be included as part of the voluntary disclosure. If the proceeds of the transaction were repatriated and were not offshore during the voluntary disclosure period, they will not be included in the base for the offshore penalty. On the other hand, if the proceeds remained offshore during any part of the voluntary disclosure period, they will be included in the base for the offshore penalty. The purpose of the OVDP is to bring taxpayers into compliance for the voluntary disclosure period with the expectation that compliance will continue into the future. In exchange for coming forward through OVDP, the taxpayer agrees to pay the tax, interest, and accuracy-related (or delinquency) penalty for the voluntary disclosure period, plus a miscellaneous offshore penalty in lieu of all other liabilities and penalties that may apply. |
| 35. | What kinds of assets does the | The offshore penalty is intended to apply to all of the |

| | | |
|---|---|---|
| | offshore penalty apply to? | taxpayer's offshore holdings that are related in any way to tax non-compliance, regardless of the form of the taxpayer's ownership or the character of the asset ("OVDP assets"). OVDP assets include all assets directly or indirectly owned by the taxpayer, including financial accounts holding cash, securities or other custodial assets; tangible assets such as real estate or art; and intangible assets such as patents or stock or other interests in a U.S. or foreign business. If such assets are indirectly held or controlled by the taxpayer through an entity, the penalty may be applied to the taxpayer's interest in the entity or, if the Service determines that the entity is an alter ego or nominee of the taxpayer, to the taxpayer's interest in the underlying assets. Tax noncompliance includes failure to report gross income from the assets, as well as failure to pay U.S. tax that was due with respect to the funds used to acquire the asset. |
| 35.1. | If a taxpayer holds OVDP assets through an entity or a series of entities, may the taxpayer apply valuation discounts such as a discount reflecting lack of marketability, a discount for holding a minority interest, or a discount for holding a tenants in common interest? | No. The offshore penalty will be applied to the taxpayer's interest in the underlying OVDP assets without regard to valuation discounts. |
| 36. | A taxpayer owns valuable land and artwork located in a foreign jurisdiction. This property produces no income and there were no reporting requirements regarding this property. Must the taxpayer report the land and artwork and pay the offshore penalty? What if the property produced income that the taxpayer did not report? | The answer to the first question depends on whether the non-income producing assets were acquired with funds improperly non-taxed. The offshore penalty is intended to apply to offshore assets that are related to tax non-compliance. Thus, if offshore assets were acquired with funds that were subject to U.S. tax but on which no such tax was paid, the offshore penalty would apply regardless of whether the assets are producing current income. Assuming that the assets were acquired with after-tax funds or from funds that were not subject to U.S. taxation, if the assets have not yet produced any gross income, there has been no U.S. taxable event and no reporting obligation to disclose. The taxpayer will be required to report any current income from the property or gain from its sale or other disposition at such time in the future as the income is realized. Because there has not been tax noncompliance, the offshore penalty would not apply to those assets.<br>In answer to the second question, if the assets produced gross income subject to U.S. tax during the voluntary disclosure period which was not reported, the assets will be included in the penalty computation regardless of the source of the funds used to acquire the assets. If the foreign assets were held in the name of an entity such as a trust or corporation, there would also have been an information return filing obligation that may need to be disclosed. See FAQ 5. |
| 37. | If a taxpayer transferred funds from one unreported foreign financial account to another during the voluntary disclosure period, will | No. If the taxpayer can establish that funds were transferred from one account to another, any duplication will be removed before calculating the offshore penalty. However, the burden will be on the taxpayer to establish |

| | | |
|---|---|---|
| | he have to pay the offshore penalty on both accounts? | duplication. |
| 38. | If, in addition to other noncompliance, a taxpayer has failed to file an FBAR to report an account over which the taxpayer has signature authority but no beneficial interest (e.g., an account owned by his employer), will that foreign financial account be included in the base for calculating the taxpayer's offshore penalty? | No. The account the taxpayer has mere signature authority over will be treated as unrelated to the tax noncompliance the taxpayer is voluntarily disclosing. The taxpayer may cure the FBAR delinquency for this account at any time prior to being contacted by the IRS regarding an income tax examination or delinquent returns by filing the FBAR with an explanatory statement. See section 3 of "Options Available For U.S. Taxpayers with Undisclosed Foreign Financial Assets " for instructions. The answer might be different if: (1) the account over which the taxpayer has signature authority is held in the name of a related person, such as a family member or an entity controlled by the taxpayer; (2) the account is held in the name of a foreign entity for which the taxpayer had a Title 26 reporting obligation; or (3) the account was related in some other way to the taxpayer's tax noncompliance (e.g., was used by the taxpayer as a conduit). In these cases, the taxpayer may have an OVDP asset to which the offshore penalty applies. See FAQ 35. |
| 39. | Parents have a jointly owned foreign account on which they have made their children signatories; the children have an FBAR filing requirement but no income. How should the family correct this, and how will the offshore penalty be applied? | Signatories with no ownership interest in the account, such as the children in this scenario, should file delinquent FBARs with explanatory statements. See section 3 of "Options Available For U.S. Taxpayers with Undisclosed Foreign Financial Assets" for instructions. As for the parents, only one offshore penalty will be applied with respect to voluntary disclosures relating to the same foreign financial account. In the example, the parents will be jointly required to pay a single offshore penalty (at the applicable offshore penalty rate of either 27.5 percent or 50 percent) on the account. This can be satisfied by one parent paying the total offshore penalty or by each paying a portion, at the taxpayers' option. However, any joint owner of a foreign financial account who does not make a voluntary disclosure may be examined and subject to all applicable penalties. |
| 40. | If multiple taxpayers are co-owners of an OVDP asset , who will be liable for the offshore penalty? | In the case of co-owners, each taxpayer who makes a voluntary disclosure will be liable for the penalty on his percentage ownership of the highest value of the OVDP asset. The burden will be on the disclosing taxpayer claiming ownership of less than 100 percent of the OVDP asset to establish the extent of his ownership. His voluntary disclosure is effective as to his tax liability only. It does not cover the other co-owners. The IRS may examine any co-owner who does not make a voluntary disclosure. Co-owners examined by the IRS will be subject to all applicable penalties. |
| 41. | If there are multiple individuals with signature authority over an OVDP asset held in the name of a trust, does everyone involved need to file delinquent FBARs? If so, must everyone pay the offshore penalty? | Only one offshore penalty will be applied with respect to voluntary disclosures relating to the same OVDP asset. The penalty may be allocated among the taxpayers with beneficial ownership making the voluntary disclosures in any way they choose. The reporting requirements for filing an FBAR, however, do not change. Therefore, every person who is required to file an FBAR must file one. |

**STATUTE OF LIMITATIONS**

| | | |
|---|---|---|
| 42. | How can the IRS propose adjustments to tax for more than three years without either an agreement from the taxpayer or a statutory exception to the normal three-year statute of limitations for making those adjustments? | As a condition to participate in the OVDP and receive the benefits of the OVDP's penalty structure, the taxpayer must agree to the assessment of tax and penalties for all voluntary disclosure years. If the taxpayer does not agree to the tax, interest, and penalties proposed by the voluntary disclosure examiner, the case will be referred to the field for a complete examination of all issues. In that examination, normal statute of limitations rules will apply. If no exception to the normal three-year statute applies, the IRS will only be able to assess tax, penalty and interest for three years. However, if the period of limitations was open because, for example, the IRS can prove a substantial omission of gross income, six years of liability may be assessed. Similarly, if there was a failure to file certain information returns, such as Form 3520, Form 5471, or Form 8938, the statute of limitations will not have begun to run. If the IRS can prove fraud, there is no statute of limitations for assessing tax. In addition, the statute of limitations for assessing FBAR penalties is six years from the date of the violation, which would be the date that an unfiled FBAR was due to have been filed. 31 U.S.C. § 5321(b)(1). |
| 43. | Will I be required to complete and sign agreements to extend the period of time to assess tax (including tax penalties) and to assess FBAR penalties for any years that are otherwise set to expire while my voluntary disclosure is being processed by the IRS? | Yes. Properly completed and signed agreements to extend the period of time to assess tax (including tax penalties) and to assess FBAR penalties are required to be submitted as part of the voluntary disclosure package (see FAQ 25). |
| **FBAR QUESTIONS** | | |
| 44. | If I had an FBAR reporting obligation for years covered by the voluntary disclosure, what version of the FBAR should I use to report my interests in foreign financial accounts? | Taxpayers are required to file FBARs electronically at FinCEN's website. On the cover page of the electronic form, select "Other" as the reason for filing late. An explanation box will appear. In the explanation box, enter "OVDP." Taxpayers who are unable to file electronically may contact FinCEN's Regulatory Helpline at 1-800-949-2732 or 1-703-905-3975 (if calling from outside the United States) to determine possible alternatives to electronic filing. |
| 45. | A taxpayer has two foreign financial accounts. No FBARs were filed. The taxpayer reported all income from one account but not the other. Mechanically, how does the taxpayer report this? | Taxpayers are required to file a single FBAR reporting all foreign financial accounts meeting the reporting requirement. The taxpayer should make a voluntary disclosure for the omitted income and file the delinquent FBARs with respect to both accounts. The account with no income tax issue is unrelated to the taxpayer's tax noncompliance, so no penalty will be imposed with respect to that account. |
| 46. | If a taxpayer is uncertain about whether he is required to file an FBAR with respect to a particular foreign financial account, how can the taxpayer get help with this question? | Information about FBAR filing requirements is available on FinCEN's website.<br>Help with questions about FBAR filing requirements is also available by telephone or e-mail. Call 1-866-270-0733 (toll free within the United States) or 1-313-234-6146 (not a toll-free number) from 8 a.m. to 4:30 p.m. |

| | | |
|---|---|---|
| | | Eastern time, except for weekends and federal holidays. Submit written questions by e-mail addressed to FBARQuestions. Do not call the IRS OVDP Hotline with questions about whether you have an FBAR filing requirement. The purpose of the IRS OVDP Hotline is to answer questions about how to make voluntary disclosures and what penalties apply. |
| **TAXPAYER REPRESENTATIVES** | | |
| 47. | I have a client who may be eligible to make a voluntary disclosure. What are my responsibilities to my client under Circular 230? | The IRS anticipates that taxpayers will seek qualified tax and legal advice and representation in connection with considering and making a voluntary disclosure. If a taxpayer seeks the advice of a tax practitioner, the practitioner must exercise due diligence in determining the correctness of any oral or written representations made to the client about the program and the implications for that taxpayer of going forward. If the taxpayer decides to proceed with the disclosure, the practitioner must exercise due diligence in determining the correctness of any oral or written representations that the practitioner makes during the representation to the Department of the Treasury. The practitioner must avoid giving, or participating in giving, false or misleading information to the Department of the Treasury or giving a false or misleading opinion to the taxpayer. If the taxpayer decides not to make the voluntary disclosure despite the taxpayer's noncompliance with United States tax laws, Circular 230 requires the practitioner to advise the client of the fact of the client's noncompliance and the consequences of the client's noncompliance. A practitioner whose client declines to make full disclosure of the existence of, or any taxable income from, a foreign financial account during a taxable year, may not prepare the client's income tax return for that year without being in violation of Circular 230. |
| 48. | Are there special considerations for completing Form 2848, Power of Attorney and Declaration of Representative? | Yes. In addition to being authorized to represent the taxpayer for tax years within the voluntary disclosure period, the power of attorney must specifically authorize you to represent the taxpayer for income tax, civil penalties, and FBARs. See a sample power of attorney. |
| **CASE RESOLUTION** | | |
| 49. | If the taxpayer and the IRS cannot agree to the terms of the OVDP closing agreement, will mediation with Appeals be an option with respect to the terms of the closing agreement? | No. The penalty framework for offshore voluntary disclosure and the agreement to limit tax exposure to an eight year period are nonnegotiable terms under the OVDP. If any part of the closing agreement is unacceptable to the taxpayer, the taxpayer may opt out and the case will be examined and all applicable penalties will be imposed (see FAQ 51). After a full examination, any tax and penalties imposed by the Service may be appealed, but the Service's decision on the terms of the OVDP closing agreement may not be appealed. |
| 50. | Will examiners have any discretion to settle offshore voluntary disclosure cases? | No. Offshore voluntary disclosure examiners do not have discretion to settle cases for amounts less than what is properly due and owing. However, because the offshore penalty is a proxy for the FBAR penalty, civil fraud penalty, other penalties imposed under the |

| | | |
|---|---|---|
| | | Internal Revenue Code, and potential liabilities for years prior to the voluntary disclosure period, there may be cases where a taxpayer making a voluntary disclosure would owe less outside of the OVDP. Under no circumstances will taxpayers be required to pay a penalty greater than what they would otherwise be liable for under the maximum penalties imposed under existing statutes for the years included in the disclosure period.<br>Examiners will compare the amount due under this offshore program to the tax, interest, and applicable penalties (at their maximum levels and without regard to issues relating to reasonable cause, willfulness, mitigation factors, or other circumstances that may reduce liability) for all years within the disclosure period that a taxpayer would owe outside of the OVDP. The taxpayer will pay the lesser amount. If the taxpayer disagrees with the result, the taxpayer may request that the case be referred for an examination of all relevant years and issues (see FAQ 51). |
| 50.1 | On May 13, 2015 the IRS released the memorandum titled "Interim Guidance for Report of Foreign Bank and Financial Accounts (FBAR) Penalties." Does the May 13, 2015 Interim FBAR Guidance impact the computation of maximum FBAR penalties under FAQ 50? If so, how? | Yes. The May 13, 2015 Interim FBAR Guidance impacts the maximum penalty analysis under FAQ 50. The maximum willful FBAR penalty under the May 13, 2015 Interim FBAR Guidance is "100 percent of the highest aggregate balance of all unreported foreign financial accounts during the years under examination." Hence, the FAQ 50 analysis now requires using the lesser of the maximum willful FBAR penalty under the May 13, 2015 Interim FBAR Guidance or the statutory maximum penalty for all years within the disclosure period. |
| 51. | If, after making a voluntary disclosure, a taxpayer disagrees with the application of the offshore penalty, what can the taxpayer do? | If the offshore penalty is unacceptable to a taxpayer, that taxpayer must indicate in writing his decision to withdraw from or opt out of the program. Once made, this election is irrevocable. An "opt out" is an election made by a taxpayer to have his case handled under the standard audit process. Some taxpayers may prefer this approach; in some cases the results under the OVDP may appear too severe given the facts of the case. In other cases, this is less clear. In these less clear cases, the IRS will protect its interests and the integrity of the voluntary disclosure program. In these cases, the IRS will likely conduct full scope examinations. We anticipate that opting out will be appropriate for a discrete minority of cases. Moreover, to the extent that issues are found in a full-scope examination that were not disclosed by the taxpayer, those issues may be the subject of review by Criminal Investigation. In either case, opting out is at the sole discretion of the taxpayer and the taxpayer will not be treated in a negative fashion merely because he chooses to opt out.<br>The specific procedures for opting out are set forth in a separate guide titled Opt Out and Removal Guide for the 2009 OVDP, 2011 OVDI, and now the OVDP. Taxpayers are reminded that, even after opting out of the Service's civil settlement structure, they remain within Criminal Investigation's Voluntary Disclosure Practice. Therefore, taxpayers are still required to |

| | | |
|---|---|---|
| | | cooperate fully with the examiner by providing all requested information and records and must still pay or make arrangements to pay the tax, interest, and penalties they are ultimately determined to owe. If a taxpayer does not cooperate and make payment arrangements, or if after examination, issues exist that were not disclosed prior to opt out, the case may be referred back to Criminal Investigation. |
| 51.1 | Deleted | |
| 51.2 | Deleted | |
| 51.3 | If I opt out of the OVDP and undergo a regular examination, is there a chance my case could be referred back to Criminal Investigation for penalties or prosecution? | Yes. Criminal Investigation's Voluntary Disclosure Practice provides a recommendation that you not be prosecuted for violations up to the date of your disclosure. If your disclosure is ultimately determined to have not been complete, accurate, and truthful, or if you commit a crime after the date of your voluntary disclosure, you are potentially subject to penalties and prosecution. |
| 52. | Deleted. If you have circumstances covered by former FAQ 52, you should not use OVDP and should see section 2 of the "Options Available For U.S. Taxpayers with Undisclosed Foreign Financial Assets ". | |
| 53. | Deleted. If you have circumstances covered by former FAQ 53, you should not use OVDP and should see section 2 of the "Options Available For U.S. Taxpayers with Undisclosed Foreign Financial Assets." | |
| 54. | Deleted | |
| 54.1. | Deleted | |
| 54.2. | I have a Canadian registered retirement savings plan (RRSP), registered retirement income fund (RRIF), or other similar Canadian retirement plan. I am an "eligible individual" as defined in § 4.01 of Rev. Proc. 2014-55. Under the procedures in effect prior to the issuance of Rev. Proc. 2014-55, I did not make a timely election pursuant to Article XVIII(7) of the U.S.–Canada income tax treaty to defer U.S. income tax on undistributed income earned by my Canadian retirement plan.<br>How should I report my Canadian retirement plan in the OVDP, and will it be included in the penalty base? | Under § 4.02 of Rev. Proc. 2014-55, you are treated as having made the election. See Rev. Proc. 2014-55, § 7. In addition, your Canadian retirement plan will not be included in the offshore penalty base. In your OVDP submission please state that you are an "eligible individual" under Rev. Proc. 2014-55.<br>You may need to report your interest in the Canadian retirement plan on FBARs or Forms 8938. Please refer to the instructions for these forms for more information. See also the submission requirements in FAQ 25. |
| 54.3. | Same facts as FAQ 54.2 except I am not an "eligible individual" because I failed to satisfy the | If you submit tax returns through the OVDP and resolve your OVDP case with a closing agreement, you will be afforded relief consistent with Rev. Proc. 2014-55. |

| | | |
|---|---|---|
| | requirement for filing a U.S. Federal income tax return for each tax year during which I was a U.S. citizen or resident as required by § 4.01 B) of Rev. Proc. 2014-55. How should I report my Canadian retirement plan in the OVDP, and will it be included in the penalty base? | Further, your Canadian retirement plan will not be included in the offshore penalty base. If this applies to you, please refer to this FAQ in your OVDP submission.<br>You may need to report your interest in the Canadian retirement plan on FBARs or Forms 8938. Please refer to the instructions for these forms for more information. See also the submission requirements in FAQ 25. |
| 54.4. | Same facts as FAQ 54.2 except I am not an "eligible individual" because I reported as gross income on a U.S. Federal income tax return some or all of the accrued but undistributed earnings in my Canadian retirement plan, thereby failing the requirement of § 4.01 C) of Rev. Proc. 2014-55. I now realize I could have deferred the tax on the accrued but undistributed earnings in my Canadian retirement plan.<br>How do I correct my reporting of accrued but undistributed earnings in my Canadian retirement plan in the OVDP, and will my Canadian retirement plan be included in the penalty base? | If you submit amended income tax returns through the OVDP and resolve your OVDP case with a closing agreement, you will be afforded relief consistent with Rev. Proc. 2014-55. Further, your Canadian retirement plan will not be included in the offshore penalty base. If this applies to you, please refer to this FAQ in your OVDP submission.<br>You may need to report your interest in the Canadian retirement plan on FBARs or Forms 8938. Please refer to the instructions for these forms for more information. See also the submission requirements in FAQ 25. |
| 55. | I have a retirement or pension plan in a foreign country (other than a Canadian RRSP, RRIF, or other similar Canadian retirement plan) that I do not believe should be included in the offshore penalty base. What should I do? | If you have a retirement or pension plan in a foreign country (other than a Canadian RRSP, RRIF, or other similar Canadian plan) for which you believe there is no U.S. reporting requirement and that you believe should not be included in the offshore penalty base, you should contact the OVDP hotline at (267) 941-0020.<br>Please provide the OVDP Hotline specific information including (i) the country where the plan is maintained, (ii) whether the plan is employer-sponsored, and (iii) whether any income tax treaty provisions may apply. |

*Page Last Reviewed or Updated: 08-Feb-2016*

IRS

# Streamlined Filing Compliance Procedures for U.S. Taxpayers Residing in the United States Frequently Asked Questions and Answers

Effective for Streamlined Submissions Made On or After July 1, 2014

| # | Questions | Answers |
|---|---|---|
| Q1. | Is the 5-percent penalty for Streamlined Domestic Offshore filers intended to reach foreign financial assets in which the taxpayer has no personal financial interest or only a partial interest? | No. Read literally, the third paragraph of the description of the scope of the Streamlined Domestic Offshore Procedures says that the penalty applies to all reportable but unreported foreign financial assets. However, the penalty is not intended to reach assets in which the taxpayer had no financial interest, such as an employer's account over which the taxpayer had only signature authority, or portions of assets in which the taxpayer had no personal financial interest. In order to address questions left open by the brief definition of assets in the penalty base in the Streamlined Domestic Offshore Procedures the Service will apply the principles announced in OVDP FAQs 31 through 33, 35.1, and 38 through 41. |
| Q2. | I am a U.S. resident making a Streamlined Domestic Offshore submission. In addition to foreign financial accounts and assets, I own an income producing rental property in a foreign jurisdiction that is not reportable on FBAR or Form 8938. Is the real estate included in the Streamlined Domestic Offshore penalty base? | No. Any asset (tax compliant or non-compliant) that was not the kind of asset reportable on either FBAR or Form 8938 is not included in the penalty base for the Streamlined Domestic Offshore Procedures. |
| Q3. | The Streamlined Domestic Offshore Procedures provide that foreign financial assets subject to the 5-percent penalty include assets that should have been, but were not, reported on Form 8938. The instructions for Form 8938 provide that any assets reported on timely filed Forms 3520 or 5471 need not be reported on Form 8938 for the same tax year. Are assets I report on delinquent Forms 3520 or 5471 excluded from the 5-percent penalty base? | No. The instruction referred to was designed to eliminate the burden of duplicate reporting and does not affect the definition of "foreign financial asset." All assets that meet the definition of "foreign financial asset" in the instructions for Form 8938 and not reported on that form should be included in the 5-percent penalty base, unless the taxpayer reported them on timely filed Forms 3520 or 5471. |
| Q4. | I am a U.S. resident making a Streamlined Domestic Offshore submission. I am the 100-percent owner of an incorporated business with various assets, including financial accounts. Does the 5-percent penalty base include the stock in the corporation or just the underlying financial | The penalty base includes the stock in the corporation (and not the underlying financial accounts) unless it is a disregarded entity for federal income tax purposes. Under the instructions for Form 8938, stock in a foreign corporation is a specified foreign financial asset. Whether the stock in the foreign |

| | | |
|---|---|---|
| | accounts? | corporation or the underlying foreign financial accounts are reportable on Form 8938, and therefore are included in the penalty base, depends on whether the corporation is a disregarded entity. If it is, the instructions require the reporting of the underlying foreign financial accounts, which would then be included in the penalty base. However, if the corporation is not a disregarded entity, then the instructions provide that the taxpayer is not considered the owner of the underlying assets solely as a result of the taxpayer's status as a shareholder.<br>The same principle would apply to assets that are held in a foreign partnership or trust. |
| Q5. | How should I value stock in a foreign corporation that is included in the 5-percent penalty base for Streamlined Domestic Offshore filers? | Any reasonable method of valuing the stock, such as using the balance sheet on the Form 5471, for purposes of calculating the 5-percent penalty. No valuation discounts may be taken on foreign financial assets subject to the 5-percent penalty. The principles in 2014 OVDP FAQ 35.1 are applied to Streamlined Domestic Offshore submissions. |
| Q6. | How do I calculate the 5-percent penalty for Streamlined Domestic Offshore filers? | Begin the computation by identifying the assets included in the penalty base for each of the last six years. These assets include:<br>• For each of the six years in the covered FBAR period, all foreign financial accounts (as defined in the instructions for FinCEN Form 114) in which the taxpayer has a personal financial interest that should have been, but were not reported, on an FBAR;<br>• For each of the three years in the covered tax return period, all foreign financial assets (as defined in the instructions for Form 8938) in which the taxpayer has a personal financial interest that should have been, but were not, reported on Form 8938.<br>• For each of the three years in the covered tax return period, all foreign financial accounts/assets (as defined in the instructions for FinCEN Form 114 or IRS Form 8938) for which gross income was not reported for that year.<br>Once the assets in the penalty base have been identified for each year, enter the value of the taxpayer's personal financial interest in each asset as of December 31 of the applicable year on the Certification by U.S. Person Residing in the United States for Streamlined Domestic Offshore Procedures (Form 14654). For any year in which a foreign financial account was FBAR compliant and (for the most recent three years) in which a foreign financial asset was both Form 8938 and Form 1040 compliant, the amount entered |

| | | |
|---|---|---|
| | | on the form will be zero. Once the asset values have been entered on the form, add up the totals for each year and select the highest aggregate amount as the base for the 5-percent penalty. |
| Q7. | I am a U.S. resident who filed compliant tax returns (including Forms 8938) and FBARs for the most recent three years for which tax returns were due. However, I failed to properly report a foreign financial asset in years prior to that and did not make a voluntary disclosure. I am otherwise eligible to make a Streamlined Domestic Offshore submission. May I make a streamlined submission and, if so, how is the 5 percent penalty calculated? | You may make a streamlined submission. Because the most recent three years are fully compliant, there will be no assets in the penalty base for those years. Follow the procedure in answer 6 above for the three years prior to that to calculate the aggregate year-end account balances and year-end asset values for each of those three years. The penalty is 5 percent of the highest aggregate amount. When making your submission, attach the certification to a Form 1040X for only the most recent tax year for which you filed an income tax return showing a zero change in tax. Please write "Streamlined Domestic Offshore" in red ink at the top of the Form 1040X. |
| Q8. | I have a Canadian registered retirement savings plan (RRSP), registered retirement income fund (RRIF), or other similar Canadian retirement plan. I am an "eligible individual" as defined in § 4.01 of Rev. Proc. 2014-55. Under the procedures in effect prior to the issuance of Rev. Proc. 2014-55, I did not make a timely election under Article XVIII(7) of the U.S.–Canada income tax treaty to defer U.S. income tax on undistributed income earned by my Canadian retirement plan.<br>How should I report my Canadian retirement plan with my Streamlined submission, and will it be included in the penalty base? | Under § 4.02 of Rev. Proc. 2014-55, you are treated as having made the election. See Rev. Proc. 2014-55, § 7. Your Canadian retirement plan will not be included in the 5-percent penalty base. In the narrative statement of facts on Form 14654, please state that you are an "eligible individual" under Rev. Proc. 2014-55.<br>You may need to report your Canadian retirement plan on FBARs or Forms 8938. Please refer to the instructions for these forms for more information. |
| Q9. | Same facts as FAQ 8 except my Canadian retirement plan is the only foreign financial asset I own or control, and, consequently, I had no unreported gross income from any foreign financial assets. Do I need to report my Canadian retirement plan under the Streamlined Domestic Offshore Procedures? | No. You do not need to report your interest in the Canadian retirement plan under the Streamlined Domestic Offshore Procedures. Please file any required delinquent FBARs pursuant to the Delinquent FBAR Submission Procedures and any required delinquent Forms 8938 with a reasonable cause statement pursuant to the Delinquent International Information Return Submission Procedures. |
| Q10. | Same facts as FAQ 8 except I am not an "eligible individual" because I reported as gross income on a U.S. Federal income tax return some or all of the accrued but undistributed earnings in my Canadian retirement plan. See § 4.01 C) of Rev. Proc. 2014-55. But I now realize I could have deferred the tax on the accrued but undistributed earnings in my Canadian | If you submit amended income tax returns through the Streamlined Domestic Offshore Procedures and meet the requirements discussed below, you will be afforded relief consistent with Rev. Proc. 2014-55 for the tax years included in your submission.<br>This procedure is not available if you reported as gross income on a U.S. Federal income tax return accrued but undistributed earnings in a Canadian retirement plan for one or more tax years beyond the scope of your |

| | | |
|---|---|---|
| | retirement plan. Additionally, I have other tax compliance issues that need to be corrected through a Streamlined submission.<br>How do I correct my reporting of accrued but undistributed earnings in my Canadian retirement plan, and will my Canadian retirement plan be included in the penalty base? | Streamlined submission. Additionally, this procedure is not available if you failed to report any and all distributions received from the plan as if you had made an election under Article XVIII(7) of the U.S.–Canada income tax treaty. See § 4.01 D) of Rev. Proc. 2014-55. In these cases, you must seek the consent of the Commissioner as directed by § 4.04 of Rev. Proc. 2014-55.<br>If you qualify to use this procedure, your Canadian retirement plan will not be included in the 5-percent penalty base. In the narrative statement of facts on Form 14654, please state that you have met the other requirements to be an "eligible individual" under § 4.01 of Rev. Proc. 2014-55. See A), B), and D) of § 4.01 of Rev. Proc. 2014-55. Please also state that the reporting of accrued but undistributed earnings was limited to the tax years in your Streamlined submission.<br>You may need to report your Canadian retirement plan on FBARs or Forms 8938. Please refer to the instructions for these forms for more information. |
| Q11. | Same facts as FAQ 8 except I am not an "eligible individual" because I reported as gross income on a U.S. Federal income tax return some or all of the accrued but undistributed earnings in my Canadian retirement plan. See § 4.01 C) of Rev. Proc. 2014-55. But I now realize I could have deferred the tax on the accrued but undistributed earnings in my Canadian retirement plan. Additionally, I have no other tax compliance issues that need to be corrected through a Streamlined submission | You should not use the Streamlined Domestic Offshore Procedures because you have no tax compliance issues beyond reporting accrued but undistributed earnings in your Canadian retirement plan. Therefore, you should follow normal procedures for filing amended income tax returns or seek the consent of the Commissioner as directed by § 4.04 of Rev. Proc. 2014-55.<br>You may need to report your Canadian retirement plan on FBARs or Forms 8938. Please refer to the instructions for these forms for more information. |
| Q12. | I made a Streamlined Domestic Offshore submission and provided amended income tax returns, a Form 14654, Certification by U.S. Person Residing in the United States for Streamlined Domestic Offshore Procedures, and payment of all tax, penalty, and interest. I recently realized that I included in the highest account balance/asset value of my foreign financial assets my Canadian registered retirement savings plan (RRSP), registered retirement income fund (RRIF), or other similar Canadian retirement plan. Further, I am an "eligible individual" as defined in section 4.01 of Rev. Proc. 2014-55. May I request reconsideration of the miscellaneous offshore penalty amount due to the inclusion of my Canadian retirement plan in the penalty base? How do I do so? | Yes, you may request reconsideration of the miscellaneous offshore penalty amount. Complete and sign Form 14708, Streamlined Domestic Penalty Reconsideration Request Related to Canadian Retirement Plans (form pending publication as of the date of posting of this FAQ), and mail it to:<br><br>Internal Revenue Service<br>3651 South I-H 35<br>Stop 4305 AUSC<br>Attn: Streamlined Unit<br>Austin, TX 78741<br><br>**Example**: The taxpayer reported on her original certification a highest account balance/asset value of $130,000, consisting of year-end balances of the following foreign financial assets:<br><br>Checking account $10,000 |

| | | |
|---|---|---|
| | | Savings account $20,000<br>RRSP account $100,000<br>Total $130,000<br><br>The taxpayer computed the miscellaneous offshore penalty as $6,500 ($130,000 x 5%). The taxpayer would like to request reconsideration of the miscellaneous offshore penalty amount. She computes her revised highest account balance/asset value as follows:<br><br>Checking account $10,000<br>Savings account $20,000<br>Total $30,000<br><br>After removing the value of the RRSP, the revised miscellaneous offshore penalty amount is $1,500 ($30,000 x 5%). In completing Form 14708, the taxpayer should enter $6,500 on Line 1, $1,500 on Line 2, and $5,000 on Line 3.<br>This example assumes that the revised highest account balance/asset value is in the same year as the original certification. But the revised highest account balance/asset value may be for a different year. If your revised highest account balance/asset value is for a different year than that in your original certification, please complete the appropriate section of Form 14708 to indicate the change. |
| Q13 | What facts do I need to include in completing the narrative statement of facts portion of the Form 14654? | Provide specific reasons for your failure to report all income, pay all tax, and submit all required information returns, including FBARs. Include the whole story including favorable and unfavorable facts. Specific reasons, whether favorable or unfavorable to you, should include your personal background, financial background, and anything else you believe is relevant to your failure to report all income, pay all tax, and submit all required information returns, including FBARs. Additionally, explain the source of funds in all of your foreign financial accounts/assets. For example, explain whether you inherited the account/asset, whether you opened it while residing in a foreign country, or whether you had a business reason to open or use it. And explain your contacts with the account/asset including withdrawals, deposits, and investment/management decisions. Provide a complete story about your foreign financial account/asset.<br>The following points address common situations that may apply to you: |

| | | |
|---|---|---|
| | | • We realize that many taxpayers failed to acknowledge their financial interest in or signature authority over foreign financial accounts on Form 1040, Schedule B. If you (or your return preparer) inadvertently checked "no" on Schedule B, line 7a, simply provide your explanation.<br>• We realize that some taxpayers that owned or controlled a foreign entity (e.g., corporation, trust, partnership, IBC, etc.) failed to properly report ownership of the entity or transactions with the foreign entity. If you (or your return preparer) inadvertently failed to report ownership or control of the foreign entity or transactions with the foreign entity, explain why and include your understanding of your reporting obligations to the IRS and to foreign jurisdictions.<br>• If you relied on a professional advisor, provide the name, address, and telephone number of the advisor and a summary of the advice. Also provide background such as how you came into contact with the advisor and frequency of communication with the advisor.<br>• If married taxpayers submitting a joint certification have different reasons, provide the individual reasons for each spouse separately in the statement of facts. |
| Q14 | In one or more of the most recent 3 years for which the U.S. tax return due date (or properly applied for extended due date) has passed, I filed joint income tax returns. But my spouse/former spouse will not sign joint amended returns or a joint certification on Form 14654 for a Streamlined submission. What can I do? Am I precluded from using the Streamlined Domestic Offshore Procedures? | We understand that in certain cases (including but not limited to separation or divorce), your spouse/former spouse may not be willing to sign joint amended income tax returns or a joint certification on Form 14654.<br>You may submit a joint amended income tax return with only your signature to Streamlined Domestic Offshore Procedures so long as your joint amended return shows a net increase in tax. Please explain your inability to secure your spouse's/former spouse's signature in the narrative statement of facts on Form 14654. And write "SDO FAQ 14" in red ink in the area for your spouse's signature on the amended returns and Form 14654.<br>As a matter of routine processing, the Service will request the other spouse's signature on joint amended returns with only one signature. If at the time the Service makes a request for your spouse's/former spouse's signature on a joint amended return or joint certification you are still unable to secure your spouse's/former spouse's signature, please respond to the inquiry by referencing this FAQ.<br>You may not submit a joint amended income tax return with only your signature to Streamlined Domestic Offshore Procedures |

| | | |
|---|---|---|
| | | showing a **net decrease in tax or an increase in credit.** |
| Q15 | Who can I contact if I have general questions about the terms of the Streamlined Filing Compliance Procedures or completing Form 14654? | If you have questions about the terms of the Streamlined Filing Compliance Procedures or completing Form 14654, you may contact the OVDP Hotline at 267-941-0020.<br>The OVDP Hotline will not provide case-specific or legal advice. |

*Page Last Reviewed or Updated: 07-Jan-2016*

IRS

# Transition Rules: Frequently Asked Questions (FAQs)

| # | Questions | Answers |
|---|---|---|
| 1. | What is the purpose of transitional treatment under OVDP? | Transitional treatment under OVDP will allow taxpayers currently participating in OVDP who meet the eligibility requirements for the expanded Streamlined Filing Compliance Procedures announced on June 18, 2014, an opportunity to remain in the OVDP while taking advantage of the favorable penalty structure of the expanded streamlined procedures. The FAQs in this section explain when and how a taxpayer participating in OVDP can seek the favorable penalty structure of the expanded streamlined procedures. |
| 2. | When am I considered to be currently participating in an OVDP for purposes of receiving transitional treatment? | A taxpayer will be considered to be currently participating in an OVDP for purposes of receiving transitional treatment if:<br><br>1. Before July 1, 2014, he has mailed to IRS Criminal Investigation his OVDP voluntary disclosure letter and attachments as described in OVDP FAQ 24, and<br>2. As of July 1, 2014, he has either:<br>a. remained in OVDP but not yet completed the OVDP certification process where a Form 906 Closing Agreement has been fully executed by the IRS, or<br>b. opted out of OVDP, but not yet received a letter initiating an examination and enclosing a Notice 609.<br>A taxpayer who, as of July 1, 2014, has completed the OVDP certification process where a Form 906 Closing Agreement has been fully executed by the IRS will not be considered currently participating in an OVDP and thus will not be eligible for transitional treatment. |
| 3. | What if I made a request for OVDP pre-clearance before July 1, 2014, but not a full voluntary disclosure? | A taxpayer will not be considered to be currently participating in OVDP for purposes of receiving transitional treatment unless, as of July 1, 2014, he has mailed to IRS Criminal Investigation his voluntary disclosure letter and attachments as described in OVDP FAQ 24. Thus, a taxpayer who makes an offshore voluntary disclosure as outlined in FAQ 24 on or after July 1, 2014 will not be eligible for transitional treatment under OVDP, even though he may have made a request for OVDP pre-clearance before July 1, 2014. |
| 4. | What if I submitted my offshore voluntary | A taxpayer whose case has been removed from |

| | | |
|---|---|---|
| | disclosure prior to July 1, 2014, but my case was removed from OVDP by the IRS? | OVDP by the IRS is no longer participating in OVDP and thus is not eligible for the transitional treatment described in these FAQs. |
| 5. | What will be my results if I seek and receive transitional treatment? | Upon IRS approval, taxpayers currently participating in OVDP who meet the eligibility requirements of the Streamlined Foreign Offshore Procedures will not be required to pay the Title 26 miscellaneous offshore penalty prescribed under OVDP. Upon IRS approval, taxpayers currently participating in OVDP who meet the eligibility requirements of the Streamlined Domestic Offshore Procedures will not be required to pay the Title 26 miscellaneous offshore penalty at the OVDP rate to continue participation in OVDP, but will instead be subject the miscellaneous offshore penalty terms of the Streamlined Domestic Offshore Procedures. |
| 6. | What steps must I take to seek transitional treatment? | You are not required to opt out of the OVDP to receive transitional treatment, but you must provide to the IRS:<br>a. if not already submitted, all submission documents required under the voluntary disclosure program in which you are currently participating (submission documents for each OVDP can be accessed here as follows: 2009 OVDP, 2011 OVDI, and 2012 OVDP);<br>b.a written statement in the appropriate certification form that would be required under the Streamlined Filing Compliance Procedures signed under penalty of perjury certifying their non-willfulness with respect to all foreign activities/assets, specifically describing the reasons for the failure to report all income, pay all tax, and submit all required information returns, including FBARs, and, if the taxpayer relied on a professional advisor, including the name, address, and telephone number of the advisor and a summary of the advice; and<br>c. full payment of tax, interest, and any accuracy-related, failure-to-file, and/or failure-to-pay penalties that would be due under OVDP, if not already made.<br>This information must be provided to the IRS as follows:<br>• If you are currently working with an examiner on your OVDP case, send this information directly to the examiner.<br>• If you are not currently working with an examiner on your OVDP case, send this information to the Austin OVDP Unit at:<br>Internal Revenue Service<br>Offshore Voluntary Disclosure Unit - Streamlined Waiver Request<br>3651 South IH-35<br>Mail Stop 4301 AUSC<br>Austin, Texas 78741 |
| | | |

| | | |
|---|---|---|
| 7. | Is transitional treatment automatic? | No. Before transitional treatment is given, the IRS must agree that the taxpayer is eligible for transitional treatment and must agree that the available information is consistent with the taxpayer's certification of non-willful conduct. |
| 8. | How will my request for transitional treatment be evaluated by the IRS? | Each request for transitional treatment will be reviewed to determine whether the taxpayer is eligible for transitional treatment, the taxpayer's certification of non-willfulness is complete, and the available information is consistent with the certification. The examiner assigned to the case will make the initial determination and the examiner's manager must concur. A central review committee may also review the determination. For those cases designated for central committee review, the examiner will document the facts and rationale for the determination, document the taxpayer statement of facts, and prepare a summary of the case to be forwarded to the committee for review.<br>The central review committee will review the facts of the case and the examiners determination and rationale to determine if it is consistent with other determinations made across the IRS. The central review committee will advise the examiner of concurrence, non-concurrence, or additional actions required to process the request. The decision of the central review committee is final and may not be appealed.<br>There are no appeal rights within OVDP, including the determination of whether the taxpayer qualifies for transitional treatment. If the IRS does not agree that the taxpayer is entitled to transitional treatment, the case remains governed by the terms of the OVDP in which the taxpayer is participating. In these circumstances, if the OVDP miscellaneous offshore penalty is unacceptable to the taxpayer, the taxpayer may opt out of the OVDP and choose to have the case resolved in an examination process. |
| 9. | If I seek and receive transitional treatment, how will the other aspects of my OVDP case be affected? | All other terms of the OVDP in which the taxpayer is currently participating will continue to apply, including, but not limited to, the following:<br>• the OVDP disclosure period remains the same;<br>• execution of a Form 906 Closing Agreement is required;<br>• payment of accuracy-related, failure-to-file, and/or failure-to-pay penalties, if applicable, are required; and<br>• the alternative MTM PFIC resolution will continue to be available. |

DEPUTY COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

June 1, 2011

MEMORANDUM FOR COMMISSIONER, LARGE BUSINESS AND INTERNATIONAL DIVISION
COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

FROM: Steven T. Miller
Deputy Commissioner for Services and Enforcement

SUBJECT: Guidance for Opt Out and Removal of Taxpayers from the Civil Settlement Structure of the 2009 Offshore Voluntary Disclosure Program (2009 OVDP) and the 2011 Offshore Voluntary Disclosure Initiative (2011 OVDI)

Based on the feedback received from agents, managers, and practitioners, which demonstrated the need for additional guidance in the processing of offshore voluntary disclosure cases, I am issuing the attached guide to set forth the steps to be taken before and after a taxpayer opts out or is removed from the civil settlement structure of the 2009 OVDP or 2011 OVDI. Opt out and removal are two additional processes for resolving voluntary disclosure cases. The procedures have been designed to balance the interests at stake, to ensure fairness and consistency for all taxpayers in the 2009 OVDP and 2011 OVDI, and to allow for flexibility where necessary.

I want to thank you for all the hard work that has been done on these cases to date. I recognize that some of these cases involve difficult issues. I want to thank you for your continued diligence and professionalism especially as we continue to fine tune the program.

If you have any questions or comments about these procedures, please send an email to: *Opt Outs Removals Offshore Voluntary Disclosures.

Attachment

cc Chief Counsel
Commissioner, Tax Exempt and Government Entities
Chief, Criminal Investigation
Chief, Appeals

# OPT OUT AND REMOVAL GUIDE
# FOR 2009 OVDP AND 2011 OVDI

The purpose of this guide is to discuss procedures that apply when a taxpayer requests to opt out of the civil settlement structure of the 2009 OVDP or 2011 OVDI or when the Service determines that a taxpayer should be removed from the civil settlement structure.

An opt out is an irrevocable election made by a taxpayer to have his or her case handled under the standard audit process. This is different from removal, which is a determination made by IRS personnel to remove a taxpayer from the civil settlement structure of the 2009 OVDP or 2011 OVDI. In either scenario, after certain procedures are followed, the voluntary disclosure case is removed from the civil settlement structure and an examination is initiated. The procedures are set forth below.

It should be recognized that in a given case, the opt out option may reflect a preferred approach. That is, there may be instances in which the results under the applicable voluntary disclosure program appear too severe given the facts of the case. There will be other instances where this is less clear. In the latter case, the Service will look to ensure that the best interests of the government and the integrity of the voluntary disclosure program remain intact. In these cases, it is expected that full scope examinations will occur if opt out is initiated. It is expected that opt out will be appropriate for a discrete minority of cases. Moreover, to the extent that issues are found upon a full scope examination that were not disclosed, those issues may be the subject of review by the Criminal Investigation Division. In either case, opting out is at the sole discretion of the taxpayer and the taxpayer should not be treated in a negative fashion merely because he or she chooses to opt out.

The procedures in this guide do not apply to any taxpayers that have already signed a Form 906 closing agreement.

OPT OUT AND REMOVAL GUIDE
FOR 2009 OVDP AND 2011 OVDI

## I. Opt Out Procedures

***Steps to be taken before Opt Out:***

The Service has a responsibility to any taxpayer considering opting out and undergoing an examination to ensure that the taxpayer is making an informed decision. An opt out could result in a taxpayer owing more than the taxpayer would under the civil settlement structure, but it also could result in a taxpayer owing less. Moreover, the scope of any resulting examination may change from being limited to offshore accounts. To that end, examiners will take the following steps before a taxpayer makes the irrevocable decision to opt out:

1. Send Letter 4728 (Attachment 1) to the taxpayer setting forth the status of the voluntary disclosure certification, documents required to finalize the certification, and, if known, the tax, interest, and penalties likely to be due under the terms of the 2009 OVDP or 2011 OVDI civil settlement structure through the issuance of a closing agreement and related Form 4549-A.

2. If the taxpayer does not provide the documents or make arrangements to provide the documents within 30 days of the status letter in 1. above, the examiner will issue Letter 4564 (Attachment 2) explaining that the decision to opt out is irrevocable and must be made in writing. The letter reminds the taxpayer of the continuing responsibility to cooperate with the Service under Criminal Investigation's Voluntary Disclosure Practice and instructs the taxpayer to provide a written statement setting forth the facts of the case and a recommendation of the penalties that should apply and the rationale for the penalty recommendations within 20 days of receiving the letter from the IRS.

***Steps to be taken after Opt Out:***

3. Once the taxpayer has provided the items described in 2. above, the examiner will prepare a summary of the case. The summary will document whether the examiner agrees with the taxpayer's statement of facts and recommendation of the penalties that should apply. If the examiner disagrees with either, the examiner will document the disputed facts (or note the lack of evidence in a given area) and penalty recommendations as well as any other facts or circumstances of which the reviewing committee should be aware. The examiner's summary should also include a recap of the income tax and accuracy-related penalties for each of the years, the case history notes, and the examiner's recommendation as to applicable penalties and whether or not the opt out would likely result in a determination of a non-willful FBAR penalty and the dollar amount of that penalty if known. Finally, the examiner's summary will include a recommendation regarding the scope of the examination.

4. After the examiner has documented the items described in 3. above, the examiner will forward the taxpayer's statement of facts, penalty recommendation, and rationale along with the examiner's summary of the case, including the items described in 3. above, and the examiner's case history notes to the centralized review committee, which will be comprised of managers.

5. The centralized review committee will review the taxpayer's statement of facts and recommendation of the penalties that should apply and the rationale for the penalty recommendations along with the examiner's statement and case history notes in order to determine how the examination will proceed. The committee will decide on the appropriate level of examination, keeping in mind that the taxpayer is not to be punished (or rewarded) for opting out. The committee will determine whether to reassign the case for a normal examination along with a determination of the likely scope of such examination, to reassign the case to a Special Enforcement Program agent, or to assign the case for other treatment. In making this determination, the committee will consider whether the results under the applicable voluntary disclosure program appear too severe given the facts of the case. The committee will also consider the cooperation of the taxpayer and the representative during the certification process, including whether removal was under consideration at the time of opt out. The decision of the committee is final.

6. If the case is assigned for a full-scope examination, the examiner ordinarily will interview the taxpayer to finalize the scope of the exam. Unless otherwise instructed by the centralized review committee, the examiner must open all years included in the taxpayer's voluntary disclosure. Examiners must take steps to protect the statute of limitations for any year with an ASED within 210 days (see Attachment 6). Examiners must also ensure that the case is updated to project code 1089.

OPT OUT AND REMOVAL GUIDE
FOR 2009 OVDP AND 2011 OVDI

## II. Removal Procedures

It is anticipated that removal will occur only in those cases where the taxpayer or the taxpayer's representative has been demonstrably uncooperative, the lack of cooperation has been documented by the examiner, and the examiner has concluded that the case will not be resolved in an appropriate timeframe pursuant to the civil settlement structure of the 2009 OVDP or 2011 OVDI. This may occur, for example, in cases where the taxpayer/representative has not communicated with the agent after repeated requests since first filing the offshore disclosure; where the taxpayer/representative has been nonresponsive to both written and telephonic requests for longer than 60 days; or where a taxpayer/representative has received the Form 906 Closing Agreement for signature, but after 60 days, the taxpayer refuses to sign it and declines to opt out of the program.

Removal is an IRS determination based upon all of the facts and circumstances of the case and such determinations will only be made where agreement with the taxpayer cannot be reached within the parameters of the civil settlement structure of the 2009 OVDP or 2011 OVDI. If removal occurs, the protection from criminal prosecution under the 2009 OVDP and 2011 OVDI may be compromised. This does not mean prosecution will occur, merely that the taxpayer does not continue to have OVDP or OVDI protections.

***Steps to be taken before Removal:***

The Service has a responsibility to advise any taxpayer being considered for removal that an examination could result in a taxpayer owing more than the taxpayer would under the civil settlement structure of the 2009 OVDP or 2011 OVDI. To that end, examiners should take the following steps before a removal is effected:

1. Send Letter 4729 (Attachment 3) to the taxpayer setting forth the status of the voluntary disclosure certification, the documents required to finalize the certification, and, if known, the tax, interest, and penalties likely to be due under the terms of the civil settlement structure of the 2009 OVDP or 2011 OVDI. This letter should include the dates the examiner has contacted or attempted to contact the taxpayer during the course of the certification process.

2. If the taxpayer or representative responds to the letter with a documented, legitimate explanation for the apparent non-cooperation, the taxpayer's deadline may be extended up to 60 additional days. A decision to extend the deadline is a determination to be made by the examiner and manager and will be based upon the facts and circumstances put forward by the taxpayer.

3. In those instances where the letter results in productive discussions with the taxpayer, the examiner will take steps to ensure that the taxpayer understands the specific information, documentation, and cooperation that is required for the civil settlement to proceed. The examiner will document all discussions and retain copies of all written correspondence.

4. Continued non-response or inability to timely reach agreement with the taxpayer within 30 days after issuance of the letter described in 1. above will result in the issuance of Letter 4566 to the taxpayer that the taxpayer's case will be removed from the civil settlement structure of the 2009 OVDP or 2011 OVDI (Attachment 4). Taxpayers who receive this notice will be given an opportunity to seek review of the decision to remove the case by the examiner's Territory Manager. Requests for review must be in writing and postmarked within 30 days of the date of the notice. The notice will provide instructions as to how to request review of the decision to remove. The Territory Manager will respond to the taxpayer in writing. If the Territory Manager agrees with the taxpayer, the written response will set forth new deadlines for the taxpayer to provide the outstanding information. If the taxpayer does not meet these new deadlines, the taxpayer's case will be referred to the centralized review committee for assignment as a normal examination.

***Steps to be taken after Removal:***

5. If after review the Territory Manager agrees with the decision to remove the taxpayer from the civil settlement structure of the 2009 OVDP or 2011 OVDI, the centralized review committee comprised of managers will review the case and the examiner's case history notes to determine how the examination will proceed. The committee will determine whether to reassign the case for a normal examination including likely scope, to reassign the case to a Special Enforcement Program agent, or to reassign the case for other treatment. The decision of the committee is final.

6. If the case is assigned for a full-scope examination, the examiner ordinarily will interview the taxpayer to finalize the scope of the exam. Unless otherwise instructed by the centralized review committee, the examiner must open all years included in the taxpayer's voluntary disclosure. Examiners must take steps to protect the statute of limitations for any year with an ASED within 210 days (see Attachment 6). Examiners must also ensure the case is updated to project code 1090.

OPT OUT AND REMOVAL GUIDE
FOR 2009 OVDP AND 2011 OVDI

Attachments:

1. Letter 4728 Opt Out Status Letter
2. Revised Letter 4564
3. Letter 4729 Removal Status Letter
4. Letter 4566 Removal Letter
5. Potential Penalties
6. Statutes of Limitation

Attachment 1
Letter 4728 Opt Out Status Letter

**Internal Revenue Service**
**Office Mailing Address**
**City/State/Zip**

**Department of the Treasury**

**Date:**

**Taxpayer Identification Number**

**Tax Form:**

**Tax Period(s):**

**Person to Contact:**

**Employee ID:**

**Telephone Number:**

**Fax Number:**

Dear (Insert Taxpayer Name):

Based on the information you've provided to date, we've prepared the following enclosed documents to provide you with the status of your voluntary disclosure:

- Form 906, *Closing Agreement on Final Determination Covering Specific Matters,*
- Form 4549-A, *Income Tax Discrepancy Adjustments, and*
- Form 4564, *Information Document Request,* if additional information is required.

If you have additional information you believe may impact our findings, please provide it to me within 30 days. Providing this information timely will result in a prompt resolution of your case.

Sincerely yours,

[Insert signature]
[Insert name]
[Insert title]

Attachments:

Dates of contacts and requests for information
Form 906 Closing Agreement on Final Determination Covering Specific Matters
Form 4549-A Income Tax Discrepancy Adjustments
Form 4564 Information Document Request (if applicable)

We have requested information from you or attempted to contact you as follows:

| Date | Contact initiated by | Contact method | Result |
|---|---|---|---|
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |

Attachment 2
Revised Letter 4564

**Internal Revenue Service**
**Office Mailing Address**
**City/State/Zip**

**Department of the Treasury**

**Date:**

**Taxpayer Identification Number:**

**Tax Form:**

**Tax Period(s):**

**Person to Contact:**

**Employee ID:**

**Telephone Number:**

**Fax Number:**

Dear (Insert Taxpayer Name):

We are sending you this letter because you indicated you want to withdraw from the civil settlement structure relating to your voluntary disclosure. If you withdraw, the election is irrevocable. Further, you are still required to cooperate fully with the IRS in resolving your case. The preliminary acceptance letter you received from IRS Criminal Investigation states, in part, that you:

> "...must fully cooperate with the IRS in determining the correct and appropriate tax liability and pay or make bona fide arrangements to pay in full, any tax, interest, and penalties determined by the IRS to be applicable. This required cooperation includes the production of all requested documents and the taxpayer submitting to an interview if requested by the examining agent."

Therefore, whether you choose for your case to be resolved under the civil settlement structure of the initiative or under standard examination procedures, you must provide all information.

Within 20 days of the date of this letter, please indicate, in writing, whether you wish to withdraw. If you wish to withdraw, also include in your letter the facts of your case and a recommendation of the penalties that you believe should apply. Include in your letter a discussion of any mitigating factors such as reasonable cause or lack of willfulness.

Once you withdraw, the tax, interest, and penalties will not be determined under the terms of the initiative. Rather, your case will be audited under standard examination procedures. At the end of the examination, the agent will discuss with you the tax, interest, and penalties determined to be owed. A list of possible penalties that may be proposed is enclosed.

If you don't provide the requested information within 20 days of the date of this letter, we'll assume you do not wish to opt out. We'll remove you from the civil settlement structure and initiate an audit under standard examination procedures. It is important that you contact us immediately.

Sincerely,

[Insert signature]
[Insert name]
[Insert title]

Enclosure: List of Penalties

Attachment 3
Letter 4729 Removal Status Letter

**Internal Revenue Service**
**Office Mailing address**
**City/State/Zip**

**Department of the Treasury**

**Date:**

**Taxpayer Identification Number:**

**Tax Form:**

**Tax Period(s):**

**Person to Contact:**

**Employee ID:**

**Telephone Number:**

**Fax Number:**

Dear (Insert Taxpayer Name):

You submitted a voluntary disclosure requesting the civil settlement structure relating to offshore issues. Internal Revenue Service Criminal Investigation sent you a letter preliminarily accepting your voluntary disclosure as timely, but stating that the acceptance was conditional upon your cooperation with the IRS in the determination and payment of the civil tax liability for those years.

Since that time, as noted in the attached, we've requested documents necessary to resolve the tax, interest, and penalties resulting from your offshore account(s) and/or transaction(s). You haven't provided these documents: therefore, we're unable to resolve your case.

We're enclosing the Form 4564, *Information Document Request*, that we previously sent you. If we don't receive the documents within 30 days from the date of this letter, you will be removed from the civil settlement structure of the voluntary disclosure program. Removal from the civil settlement structure will result in your case being audited under standard examination procedures.

Sincerely,

[Insert signature]
[Insert name]
[Insert title]

Attachments:

Dates of contacts and requests for information
Form 906, Closing Agreement on Final Determination Covering Specific Matters (if applicable)
Form 4549-A, Income Tax Discrepancy Adjustments (if applicable)
Form 4564, Information Document Request

We have requested information from you or attempted to contact you as follows:

| Date of contact: | Contact initiated by: | Contact method: | Result: |
|---|---|---|---|
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |

Attachment 4
Letter 4566 Removal Letter

**Internal Revenue Service**
**Office Mailing Address**
**City/State/Zip**

**Department of the Treasury**

**Date:**

**Taxpayer Identification Number:**

**Tax Form:**

**Tax Period(s):**

**Person to Contact:**

**Employee ID:**

**Telephone Number:**

**Fax Number:**

Dear (Insert Taxpayer Name):

You submitted a voluntary disclosure requesting the civil settlement structure relating to your offshore issues. We've requested documents necessary to resolve the case, most recently on (insert date of Removal Status Letter).

We haven't received the requested documents; therefore, you will be removed from the civil settlement structure of this voluntary disclosure initiative. Your case will be audited under standard examination procedures.

You may request a review of this decision by submitting a written statement within 30 days from the date of this letter. Your request should include:

- a statement of the facts of the case,
- the documents in support of the facts, including any previously requested documents not yet provided, and
- your suggested course of action necessary to resolve your case.

Please direct your request to:

( 2nd Level Management or designee)
Address 1
Address 2

Sincerely,

[Insert signature]
[Insert name]
[Insert title]

Attachment 5

## Potential Penalties

Depending on a taxpayer's particular facts and circumstances, the following penalties may apply (these should be explained to the taxpayer):

- A penalty for failing to file the Form TD F 90-22.1 (Report of Foreign Bank and Financial Accounts, commonly known as an "FBAR"). United States citizens, residents and certain other persons must annually report their direct or indirect financial interest in, or signature authority (or other authority that is comparable to signature authority) over, a financial account that is maintained with a financial institution located in a foreign country if, for any calendar year, the aggregate value of all foreign accounts exceeded $10,000 at any time during the year. Generally, the civil penalty for willfully failing to file an FBAR can be as high as the greater of $100,000 or 50 percent of the total balance of the foreign account per violation. See 31 U.S.C. § 5321(a)(5). Non-willful violations that the IRS determines were not due to reasonable cause are subject to a $10,000 penalty per violation.

- A penalty for failing to file Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts. Taxpayers must also report various transactions involving foreign trusts, including creation of a foreign trust by a United States person, transfers of property from a United States person to a foreign trust and receipt of distributions from foreign trusts under IRC § 6048. This return also reports the receipt of gifts from foreign entities under IRC § 6039F. The penalty for failing to file each one of these information returns, or for filing an incomplete return, is 35 percent of the gross reportable amount, except for returns reporting gifts, where the penalty is five percent of the gift per month, up to a maximum penalty of 25 percent of the gift.

- A penalty for failing to file Form 3520-A, Annual Information Return of Foreign Trust With a U.S. Owner. Taxpayers must also report ownership interests in foreign trusts, by United States persons with various interests in and powers over those trusts under IRC § 6048(b). The penalty for failing to file each one of these information returns, or for filing an incomplete return, is five percent of the gross value of trust assets determined to be owned by the United States person.

- A penalty for failing to file Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations. Certain United States persons who are officers, directors or shareholders in certain foreign corporations (including International Business Corporations) are required to report information under IRC §§ 6035, 6038 and 6046. The penalty for

failing to file each one of these information returns is $10,000, with an additional $10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of $50,000 per return.

- A penalty for failing to file Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Taxpayers may be required to report transactions between a 25 percent foreign-owned domestic corporation or a foreign corporation engaged in a trade or business in the United States and a related party as required by IRC §§ 6038A and 6038C. The penalty for failing to file each one of these information returns, or to keep certain records regarding reportable transactions, is $10,000, with an additional $10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency.

- A penalty for failing to file Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation. Taxpayers are required to report transfers of property to foreign corporations and other information under IRC § 6038B. The penalty for failing to file each one of these information returns is ten percent of the value of the property transferred, up to a maximum of $100,000 per return, with no limit if the failure to report the transfer was intentional.

- A penalty for failing to file Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships. United States persons with certain interests in foreign partnerships use this form to report interests in and transactions of the foreign partnerships, transfers of property to the foreign partnerships, and acquisitions, dispositions and changes in foreign partnership interests under IRC §§ 6038, 6038B, and 6046A. Penalties include $10,000 for failure to file each return, with an additional $10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of $50,000 per return, and ten percent of the value of any transferred property that is not reported, subject to a $100,000 limit.

- Civil fraud penalties imposed under IRC §§ 6651(f) or 6663. Where an underpayment of tax, or a failure to file a tax return, is due to fraud, the taxpayer is liable for penalties that, although calculated differently, essentially amount to 75 percent of the unpaid tax.

- A penalty for failing to file a tax return imposed under IRC § 6651(a)(1). Generally, taxpayers are required to file income tax returns. If a taxpayer fails to do so, a penalty of 5 percent of the balance due, plus an additional 5 percent for each month or fraction thereof during which the failure continues may be imposed. The penalty shall not exceed 25 percent.

- A penalty for failing to pay the amount of tax shown on the return under IRC § 6651(a)(2). If a taxpayer fails to pay the amount of tax shown on the return, he or she may be liable for a penalty of .5 percent of the amount of tax shown on the return, plus an additional .5 percent for each additional month or fraction thereof that the amount remains unpaid, not exceeding 25 percent.

- An accuracy-related penalty on underpayments imposed under IRC § 6662. Depending upon which component of the accuracy-related penalty is applicable, a taxpayer may be liable for a 20 percent or 40 percent penalty.

OPT OUT AND REMOVAL GUIDE
FOR 2009 OVDP AND 2011 OVDI
(050911)

Attachment 6

## Statutes of Limitation

There are a number of exceptions to the general three-year statute of limitations under IRC § 6501(a). Depending on a taxpayer's particular facts and circumstances. one or more of these exceptions may apply:

1. IRC §§ 6501(c)(1) and (c)(2) allow assessment at any time if a tax return is false or fraudulent or there is a willful attempt to evade tax.

2. IRC § 6501(c)(8) allows an assessment within three years after the date certain offshore information returns are filed, including Forms 3520, 3520-A, 5471, and 5472.

3. IRC § 6501(e)(1)(A)(i) allows assessment within six years after the later of the due date or date filed if the taxpayer omits from gross income an amount properly includible therein and such amount is in excess of 25% of the amount of gross income stated in the return.

4. IRC § 6501(e)(1)(A)(ii) allows assessment within six years after the later of the due date or date filed if the taxpayer omits from gross income an amount properly includible therein and such amount exceeds $5,000 and is attributable to one or more foreign financial assets described in IRC § 6038D. This exception was added to the law in 2010 and applies to (1) returns filed after March 18, 2010, and (2) returns filed on or before March 18, 2010, if the statute of limitations has not otherwise expired as of March 18. 2010.

5. IRC § 6501(c)(4) allows the period for assessment to be extended for any period of time agreed upon in writing by the taxpayer and the IRS (e.g., by submitting Form 872).

6. The statute of limitations for assessment of the FBAR penalty is 6 years from the due date of the FBAR (Form TD-F-90-22.1). The FBAR due date is June 30 of the year following the reporting year. For example, the statute of limitations for a 2004 FBAR will expire June 30, 2011. The FBAR statute continues to run whether or not the FBAR was filed. The FBAR statute may be extended by consent.

**SCHEDULE B**
**(Form 1040A or 1040)**

Department of the Treasury
Internal Revenue Service (99)

# Interest and Ordinary Dividends

▶ Attach to Form 1040A or 1040.
▶ Information about Schedule B and its instructions is at *www.irs.gov/scheduleb*.

OMB No. 1545-0074

**2015**

Attachment Sequence No. **08**

Name(s) shown on return | Your social security number

## Part I Interest

(See instructions on back and the instructions for Form 1040A, or Form 1040, line 8a.)

**Note:** If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total interest shown on that form.

| | | | Amount |
|---|---|---|---|
| 1 | List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see instructions on back and list this interest first. Also, show that buyer's social security number and address ▶ | 1 | |
| 2 | Add the amounts on line 1 | 2 | |
| 3 | Excludable interest on series EE and I U.S. savings bonds issued after 1989. Attach Form 8815 | 3 | |
| 4 | Subtract line 3 from line 2. Enter the result here and on Form 1040A, or Form 1040, line 8a ▶ | 4 | |

**Note:** If line 4 is over $1,500, you must complete Part III.

## Part II Ordinary Dividends

(See instructions on back and the instructions for Form 1040A, or Form 1040, line 9a.)

**Note:** If you received a Form 1099-DIV or substitute statement from a brokerage firm, list the firm's name as the payer and enter the ordinary dividends shown on that form.

| | | | Amount |
|---|---|---|---|
| 5 | List name of payer ▶ | 5 | |
| 6 | Add the amounts on line 5. Enter the total here and on Form 1040A, or Form 1040, line 9a ▶ | 6 | |

**Note:** If line 6 is over $1,500, you must complete Part III.

## Part III Foreign Accounts and Trusts

(See instructions on back.)

You must complete this part if you **(a)** had over $1,500 of taxable interest or ordinary dividends; **(b)** had a foreign account; or **(c)** received a distribution from, or were a grantor of, or a transferor to, a foreign trust.

| | | Yes | No |
|---|---|---|---|
| 7a | At any time during 2015, did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country? See instructions | | |
| | If "Yes," are you required to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), to report that financial interest or signature authority? See FinCEN Form 114 and its instructions for filing requirements and exceptions to those requirements | | |
| b | If you are required to file FinCEN Form 114, enter the name of the foreign country where the financial account is located ▶ | | |
| 8 | During 2015, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See instructions on back | | |

# General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

## Future Developments

For the latest information about developments related to Schedule B (Form 1040A or 1040) and its instructions, such as legislation enacted after they were published, go to *www.irs.gov/scheduleb*.

## Purpose of Form

Use Schedule B if any of the following applies.

- You had over $1,500 of taxable interest or ordinary dividends.
- You received interest from a seller-financed mortgage and the buyer used the property as a personal residence.
- You have accrued interest from a bond.
- You are reporting original issue discount (OID) in an amount less than the amount shown on Form 1099-OID.
- You are reducing your interest income on a bond by the amount of amortizable bond premium.
- You are claiming the exclusion of interest from series EE or I U.S. savings bonds issued after 1989.
- You received interest or ordinary dividends as a nominee.
- You had a financial interest in, or signature authority over, a financial account in a foreign country or you received a distribution from, or were a grantor of, or transferor to, a foreign trust. Part III of the schedule has questions about foreign accounts and trusts.

# Specific Instructions

**TIP** *You can list more than one payer on each entry space for lines 1 and 5, but be sure to clearly show the amount paid next to the payer's name. Add the separate amounts paid by the payers listed on an entry space and enter the total in the "Amount" column. If you still need more space, attach separate statements that are the same size as the printed schedule. Use the same format as lines 1 and 5, but show your totals on Schedule B. Be sure to put your name and social security number (SSN) on the statements and attach them at the end of your return.*

## Part I. Interest

**Line 1.** Report on line 1 all of your taxable interest. Taxable interest generally should be shown on your Forms 1099-INT, Forms 1099-OID, or substitute statements. Include interest from series EE, H, HH, and I U.S. savings bonds. Also include any accrued market discount that is includible in income. List each payer's name and show the amount. Do not report on this line any tax-exempt interest from box 8 or box 9 of Form 1099-INT. Instead, report the amount from box 8 on line 8b of Form 1040A or 1040. If an amount is shown in box 9 of Form 1099-INT, you generally must report it on line 12 of Form 6251. See the Instructions for Form 6251 for more details. For more information on market discount and other investment income see Pub. 550.

***Seller-financed mortgages.*** If you sold your home or other property and the buyer used the property as a personal residence, list first any interest the buyer paid you on a mortgage or other form of seller financing. Be sure to show the buyer's name, address, and SSN. You must also let the buyer know your SSN. If you do not show the buyer's name, address, and SSN, or let the buyer know your SSN, you may have to pay a $50 penalty.

***Nominees.*** If you received a Form 1099-INT that includes interest you received as a nominee (that is, in your name, but the interest actually belongs to someone else), report the total on line 1. Do this even if you later distributed some or all of this income to others. Under your last entry on line 1, put a subtotal of all interest listed on line 1. Below this subtotal, enter "Nominee Distribution" and show the total interest you received as a nominee. Subtract this amount from the subtotal and enter the result on line 2.

**TIP** *If you received interest as a nominee, you must give the actual owner a Form 1099-INT unless the owner is your spouse. You must also file a Form 1096 and a Form 1099-INT with the IRS. For more details, see the* General Instructions for Certain Information Returns *and the* Instructions for Forms 1099-INT and 1099-OID.

***Accrued interest.*** When you buy bonds between interest payment dates and pay accrued interest to the seller, this interest is taxable to the seller. If you received a Form 1099 for interest as a purchaser of a bond with accrued interest, follow the rules earlier under *Nominees* to see how to report the accrued interest. But identify the amount to be subtracted as "Accrued Interest."

***Original issue discount (OID).*** If you are reporting OID in an amount less than the amount shown on Form 1099-OID, follow the rules earlier under *Nominees* to see how to report the OID. But identify the amount to be subtracted as "OID Adjustment."

***Amortizable bond premium.*** If you are reducing your interest income on a bond by the amount of amortizable bond premium, follow the rules earlier under *Nominees* to see how to report the interest. But identify the amount to be subtracted as "ABP Adjustment."

**Line 3.** If, during 2015, you cashed series EE or I U.S. savings bonds issued after 1989 and you paid qualified higher education expenses for yourself, your spouse, or your dependents, you may be able to exclude part or all of the interest on those bonds. See Form 8815 for details.

## Part II. Ordinary Dividends

**TIP** *You may have to file Form 5471 if, in 2015, you were an officer or director of a foreign corporation. You may also have to file Form 5471 if, in 2015, you owned 10% or more of the total (a) value of a foreign corporation's stock, or (b) combined voting power of all classes of a foreign corporation's stock with voting rights. For details, see Form 5471 and its instructions.*

**Line 5.** Report on line 5 all of your ordinary dividends. This amount should be shown in box 1a of your Forms 1099-DIV or substitute statements. List each payer's name and show the amount.

***Nominees.*** If you received a Form 1099-DIV that includes ordinary dividends you received as a nominee (that is, in your name, but the ordinary dividends actually belong to someone else), report the total on line 5. Do this even if you later distributed some or all of this income to others. Under your last entry on line 5, put a subtotal of all ordinary dividends listed on line 5. Below this subtotal, enter "Nominee Distribution" and show the total ordinary dividends you received as a nominee. Subtract this amount from the subtotal and enter the result on line 6.

**TIP** *If you received dividends as a nominee, you must give the actual owner a Form 1099-DIV unless the owner is your spouse. You must also file a Form 1096 and a Form 1099-DIV with the IRS. For more details, see the* General Instructions for Certain Information Returns *and the* Instructions for Form 1099-DIV.

## Part III. Foreign Accounts and Trusts

**TIP** *Regardless of whether you are required to file FinCEN Form 114 (FBAR), you may be required to file Form 8938, Statement of Specified Foreign Financial Assets, with your income tax return. Failure to file Form 8938 may result in penalties and extension of the statute of limitations. See www.irs.gov/form8938 for more information.*

**Line 7a—Question 1.** Check the "Yes" box if at any time during 2015 you had a financial interest in or signature authority over a financial account located in a foreign country. See the definitions that follow. Check the "Yes" box even if you are not required to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR).

***Financial account.*** A financial account includes, but is not limited to, a securities, brokerage, savings, demand, checking, deposit, time deposit, or other account maintained with a financial institution (or other person performing the services of a financial institution). A financial account also includes a commodity futures or options account, an insurance policy with a cash value (such as a whole life insurance policy), an annuity policy with a cash value, and shares in a mutual fund or similar pooled fund (that is, a fund that is available to the general public with a regular net asset value determination and regular redemptions).

***Financial account located in a foreign country.*** A financial account is located in a foreign country if the account is physically located outside of the United States. For example, an account maintained with a branch of a United States bank that is physically located outside of the United States is a foreign financial account. An account maintained with a branch of a foreign bank that is physically located in the United States is not a foreign financial account.

***Signature authority.*** Signature authority is the authority of an individual (alone or in conjunction with another individual) to control the disposition of assets held in a foreign financial account by direct communication (whether in writing or otherwise) to the bank or other financial institution that maintains the financial account. See the FinCEN Form 114 instructions for exceptions. Do not consider the exceptions relating to signature authority in answering Question 1 on line 7a.

***Other definitions.*** For definitions of "financial interest," "United States," and other relevant terms, see the instructions for FinCEN Form 114.

**Line 7a—Question 2.** See FinCEN Form 114 and its instructions to determine whether you must file the form. Check the "Yes" box if you are required to file the form; check the "No" box if you are not required to file the form.

If you checked the "Yes" box to Question 2 on line 7a, FinCEN Form 114 must be electronically filed with the Financial Crimes Enforcement Network (FinCEN) at the following website: *http://bsaefiling.fincen.treas.gov/main.html*. Do not attach FinCEN Form 114 to your tax return. To be considered timely, FinCEN Form 114 **must be received** by June 30, 2016.

**CAUTION** *If you are required to file FinCEN Form 114 but do not properly do so, you may have to pay a civil penalty up to $10,000. A person who willfully fails to report an account or provide account identifying information may be subject to a civil penalty equal to the greater of $100,000 or 50 percent of the balance in the account at the time of the violation. Willful violations may also be subject to criminal penalties.*

**Line 7b.** If you are required to file FinCEN Form 114, enter the name of the foreign country or countries in the space provided on line 7b. Attach a separate statement if you need more space.

**Line 8.** If you received a distribution from a foreign trust, you must provide additional information. For this purpose, a loan of cash or marketable securities generally is considered to be a distribution. See Form 3520 for details.

If you were the grantor of, or transferor to, a foreign trust that existed during 2015, you may have to file Form 3520.

Do not attach Form 3520 to Form 1040. Instead, file it at the address shown in its instructions.

If you were treated as the owner of a foreign trust under the grantor trust rules, you are also responsible for ensuring that the foreign trust files Form 3520-A. Form 3520-A is due on March 15, 2016, for a calendar year trust. See the instructions for Form 3520-A for more details.

WARNING: PRINTED VERSIONS OF THE BSA E-FILING FORMS ARE NOT FOR SUBMISSION AND WILL NOT BE PROCESSED BY FINCEN.

# Report of Foreign Bank and Financial Accounts

Version Number: 1.0

FinCEN Form 114 OMB No. 1506-0009 Effective October 1, 2013

The FBAR must be received by the Department of Treasury on or before June 30th of the year immediately following the calendar year being reported. The June 30th filing date may not be extended.

IMPORTANT : After you have completed this FBAR, you must **Sign the Form** and **Save** in order to activate the **Ready to File** button, which will direct you to a page where you can attach and submit your report. Click **Validate** to identify missing or incorrectly formatted data at any time during preparation of this report. Click **Print** to print a copy of this report for record keeping purposes.

**Filing name** (e.g. SMITH FBAR 2013)

**Sign the Form**

**If this report is being filed late, select the reason for filing late**

This form should be used to report a financial interest in, signature authority, or other authority over one or more financial accounts in foreign countries, as required by the Department of the Treasury Regulations 31 CFR 1010.350 . No report is required if the aggregate value of the accounts did not exceed $10,000.

## PRIVACY ACT AND PAPERWORK REDUCTION ACT NOTICE

Pursuant to the requirements of Public Law 93-579 (Privacy Act of 1974), notice is hereby given that the authority to collect information on FinCEN 114 in accordance with 5 USC 552a (e) is Public Law 91-508, 31 USC 5314, 5 USC 301; 31 CFR 1010.350. The principal purpose for collecting the information is to assure maintenance of reports where such reports or records have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings. The information collected may be provided to those officers and employees of any constituent unit of the Department of the Treasury who have a need for the records in the performance of their duties. The records may be referred to any other department or agency of the United States upon the request of the head of such department or agency for use in a criminal, tax, or regulatory investigation or proceeding. The information collected may also be provided to appropriate state, local, and foreign law enforcement and regulatory personnel in the performance of their official duties. Disclosure of this information is mandatory. Civil and criminal penalties, including in certain circumstances a fine of not more than $500,000 and imprisonment of not more than five years, are provided for failure to file a report, supply information, and for filing a false or fraudulent report. Disclosure of the Social Security number is mandatory. The authority to collect is 31 CFR 1010.350 (formerly 31 CFR 103.24) . The Social Security number will be used as a means to identify the individual who files the report. The estimated average burden associated with this collection of information is 20 minutes per respondent or record keeper, depending on individual circumstances. Comments regarding the accuracy of this burden estimate, and suggestions for reducing the burden should be directed to the Financial Crimes Enforcement Network, P. O. Box 39, Vienna, VA 22183, Attn: Office of Regulatory Policy.

WARNING: PRINTED VERSIONS OF THE BSA E-FILING FORMS ARE NOT FOR SUBMISSION AND WILL NOT BE PROCESSED BY FINCEN.

1 This report is for calendar year ended 12/31 [ ] Amended ☐ Prior Report BSA Identifier [ ]

## Part I Filer Information

2 Type of filer [ ] [ ]

3 U.S. Taxpayer Identification Number [ ]

3a TIN type [ ]

4 Foreign identification

a Type [ ] [ ]

b Number [ ]

c Country/Region of issue [ ]

5 Individual's date of birth [ ]

6 Last name or organization's name [ ]

7 First name [ ]

8 Middle name [ ]

8a Suffix [ ]

9 Address [ ]

10 City [ ]

11 State [ ]

12 ZIP/postal code [ ]

13 Country/Region [ ]

14a Does the filer have a financial interest in 25 or more financial accounts?

☐ Yes Enter number of accounts [ ]

☐ No

**If "Yes" is checked do not complete Part II or Part III, but retain records of this information**

14b Does the filer have signature authority over but no financial interest in 25 or more financial accounts?

☐ Yes Enter number of accounts [ ]

☐ No

**If "Yes" is checked Complete Part IV Items 34 through 43 for each person on whose behalf the filer has signature authority.**

## Part II Information on Financial Account(s) Owned Separately 1 of 1

15 Maximum account value

15a Maximum account value unknown ☐

16 Type of account

17 Financial institution name

18 Account number or other designation

19 Address

20 City

21 State

22 Foreign postal code

23 Country/ Region

## Part III Information on Financial Account(s) Owned Jointly 1 of 1

### Account Information

15 Maximum account value

15a Maximum account value unknown ☐

16 Type of account

17 Financial institution name

18 Account number or other designation

19 Address

20 City

21 State

22 Foreign postal code

23 Country/ Region

24 Number of joint owners

### Principal Joint Owner Information

25 Taxpayer Identification Number (TIN)

25 a TIN type

26 Last name or organization name

27 First name

28 Middle name

28a Suffix

29 Address

30 City

31 State

32 ZIP/postal code

33 Country/ Region

## Part IV Information on Financial Account(s) Where Filer has Signature or Other Authority but No financial Interest in the Account(s) 1 of 1

### Account Information

15 Maximum account value

15a Maximum account value unknown ☐

16 Type of account

17 Financial institution name

18 Account number or other designation

19 Address

20 City

21 State

22 Foreign postal code

23 Country/ Region

### Owner Information

34 Last name or organization name

35 Taxpayer Identification Number (TIN)

35 a TIN type

36 First name

37 Middle name

37a Suffix

38 Address

39 City

40 State/territory/province

41 ZIP/postal code

42 Country/Region

43 Filer's title with this owner

## Part V Information on Financial Account(s) Where Filer is Filing a Consolidated Report 1 of 1

### Account Information

15 Maximum account value

15a Maximum account value unknown ☐

16 Type of account

17 Financial institution name

18 Account number or other designation

19 Address

20 City

21 State

22 Foreign postal code

23 Country/ Region

### Owner Information

34 Organization name

35 Taxpayer Identification Number (TIN)

35 a TIN type

38 Address

39 City

40 State/territory/province

41 ZIP/postal code

42 Country/Region

**Signature** 44a Click here ☐ if this report is completed by a third party preparer, complete the third party preparer section.

44 Filer signature **Please return to the Home tab to sign the report.**

45 Filer title

46 Date of signature (Date of signature will be auto-populated when the report is signed )

**Third Party Preparer Use Only**

47 Preparer's last name

48 First name

49 Middle name/initial

50 Check ☐ if self employed

51 Preparer's TIN 51a TIN type

52 Contact phone number 52a Extension

53 Firm's name

54 Firm's TIN 54a TIN type

55 Address

56 City

57 State

58 ZIP/postal code

59 Country/Region

# MODERN USES OF PARTNERSHIPS
# IN
# ESTATE PLANNING

Paul S. Lee, J.D., LL.M.
Senior Regional Wealth Advisor
The Northern Trust Company
New York, NY
Email: PSL6@ntrs.com

TABLE OF CONTENTS

I. INTRODUCTION
- A. The New Tax Landscape
  - 1. Generally
  - 2. Pertinent Provisions of ATRA
    - a. Federal Transfer Tax Landscape
    - b. Pertinent Income Tax Provisions
  - 3. The Net Investment Income Tax (NIIT)
  - 4. NIIT: Trusts and Interests in Pass-Through Entities
    - a. Generally
    - b. Non-Grantor Trusts
    - c. Pass-Through Entities
    - d. Qualified Subchapter S Trusts
    - e. Electing Small Business Trusts
  - 5. Disparity among the States
- B. The New Paradigm in Estate Planning
  - 1. Ascendancy of Income Tax
  - 2. Maximizing the "Step-Up" in Basis
  - 3. Section 1014
    - a. General Rule: The "Step-Up" in Basis to Fair Market Value
    - b. New Sections 1014(f) and 6035 of the Code
    - c. Section 1014(e): The One Year Conundrum
    - d. Community Property and Elective/Consensual Community Property
  - 4. The Tax Nature of Particular Assets
    - a. Generally
    - b. Creator-Owned Intellectual Property, Intangible Assets, and Artwork
    - c. "Negative Basis"/"Negative Capital Account" Real Property Interests
    - d. Passive Foreign Investment Company (PFIC) Shares
    - e. Qualified Small Business Stock (QSBS)
- C. Why Partnerships?

II. TAX BASIS MANAGEMENT AND THE FLEXIBILITY OF PARTNERSHIPS
- A. Generally
- B. Anti-Abuse Rules
- C. Unitary Basis Rules
- D. Current and Liquidating Distributions
  - 1. Non-Liquidating "Current" Distributions
    - a. Cash Distributions
    - b. Property Distributions
    - c. Partnership Inside Basis

2. Liquidating Distributions
3. Distributions and "Hot Assets"
4. Mixing Bowl Transactions
5. Disguised Sale Rules
6. Distributions of Securities

E. Partnership Liabilities and Basis
F. Loss of Grantor Trust Status with Partnership Liabilities
G. Basis Issues with Transfers of Partnership Interests
1. Generally
2. Estate Planning Implications

H. Section 754 Election and Inside Basis Adjustments
I. Partnership Divisions
1. Generally
2. Tax Treatment of Partnership Divisions
3. Partnership Divisions in Tax Basis Management

J. Death of a Partner
1. Generally
2. Inside Basis Adjustments at Death
3. Section 732(d) Election: Avoiding the Section 754 Election

K. Maximizing the "Step-Up" and Shifting Basis
L. Family Partnership Examples
1. Example 1: Indemnifications and Divisions
2. Example 2: In-Kind Distributions and Section 754 Election

M. Basis Planning with Charitable Entities

III. INCOME TAX AVOIDANCE AND DEFERRAL WITH PARTNERSHIPS
A. Generally
B. "Splitting" Income with Partnerships
C. Non-Grantor Trusts: Distributions and Partnerships
D. Trust to Trust Preferred Partnership
E. Sale of Partnership Interests vs. Distributions In-Kind
1. Taxable Sale of Partnership Interests
2. Liquidating Distributions
3. Planning for FLPs: Sales vs. Distributions

IV. CREATIVE USES OF THE APPLICABLE EXCLUSION WITH PARTNERSHIPS
A. Qualified "Cost-of-Living" Preferred Interests
B. "Busted" Section 2701 Preferred Interests

V. PARTNERSHIP ELECTIONS
A. Section 754 Election
B. Section 704(c) Elections

VI. PLANNING WITH DISREGARDED ENTITIES
A. Generally
B. Are Grantor Trusts Disregarded Entities?
C. May Discounts Be Used When Valuing Interests in Disregarded Entities??
D. Conversion of Disregarded Entity to Partnership
E. Conversion of Partnership to Disregarded Entity
F. Disregarded Entities: Subchapter K and Capital Accounts
G. Planning Opportunities with Disregarded Entities

1. Inherent Leverage with No Income Tax Consequences
2. Disregarded Entities and S Corporations

VII. CONCLUSION

**Disclosure:**
These materials do not constitute and should not be treated as, legal, tax or other advice regarding the use of any particular tax, estate planning or other technique, device or suggestion, or any of the tax or other consequences associated with them. Although reasonable efforts have been made to ensure the accuracy of these materials and the presentation, neither Paul S. Lee nor The Northern Trust Corporation assumes any responsibility for any individual's reliance on the written or oral information presented during the presentation. Each attendee should verify independently all statements made in the materials and during the presentation before applying them to a particular fact pattern, and should determine independently the tax and other consequences of using any particular device, technique or suggestion before recommending it to a client or implementing it for a client.

# MODERN USES OF PARTNERSHIPS IN ESTATE PLANNING[1]

Paul S. Lee, J.D., LL.M.
Senior Regional Wealth Advisor
The Northern Trust Company
New York, NY
Email: PSL6@ntrs.com

## I. INTRODUCTION

### A. The New Tax Landscape

#### 1. Generally

a. The year 2013, with the enactment of the American Taxpayer Relief Act of 2012[2] ("ATRA") and the imposition of the 3.8% Medicare contribution tax on unearned passive income or net investment income[3] (hereinafter, the "NIIT") that was enacted as part of the Health Care and Education Reconciliation Act of 2010 ("HCERA"),[4] which amended the Patient Protection and Affordable Care Act ("PPACA"),[5] marked the beginning of a significant shift in how estate plans should be structured.

b. For many years, estate planning entailed aggressively transferring assets out of the estate of high-net-worth individuals during their lifetimes to avoid the imposition of estate taxes at their deaths and consequently giving up a "step-up" in basis adjustment under section 1014 of the Internal Revenue Code of 1986, as amended (the "Code"). Because the estate tax rates were significantly greater than the income tax rates, the avoidance of estate taxes (typically to the exclusion of any potential income tax savings from the "step-up" in basis) was the primary focus of tax-based estate planning for wealthy individuals.

c. The enactment of ATRA marked the beginning of a "permanent" change in perspective on estate planning for high-net-worth individuals. The large gap between the transfer and income tax rates, which was the mathematical reason for aggressively transferring assets during lifetime, has narrowed considerably, and in some states, there is virtually no difference in the rates. With ATRA's very generous applicable exclusion provisions, the focus of estate planning will become less about avoiding the transfer taxes and more about avoiding income taxes.

---

[1] Portions of this material were initially prepared for the 50th Annual Heckerling Institute on Estate Planning, published by LexisNexis Matthew Bender, and are reprinted with the permission of the Heckerling Institute and the University of Miami. I would like to thank and acknowledge Richard B. Robinson of Robinson, Diss and Clowdus, P.C., Richard L. Dees of McDermott Will & Emery LLP, and Cristin C. Keane of Carlton Fields Jorden Burt, P.A., for their significant contributions to these materials.

[2] P.L. 112-240, 126 Stat. 2313, enacted January 2, 2013.

[3] § 1411 of the Internal Revenue Code of 1986, as amended (the "Code"). Hereinafter, all section references denoted by the symbol § shall refer to the Code, unless otherwise noted.

[4] P.L. 111–152, 124 Stat. 1029, enacted March 30, 2010.

[5] P.L. 111-148, 124 Stat. 119, enacted on March 23, 2010.

d. The new tax landscape for estate planners in 2013 and beyond is transformed by increased income tax rates, and the falling transfer tax liability, at both the Federal and state level. On the Federal side, the income and transfer tax provisions that became effective January 1, 2013, were enacted as part of ATRA, PPACA, and HCERA (the NIIT). In the states, many states increased their income tax rates,[6] and a number of states continued the trend of repealing their state death tax (estate and inheritance tax).[7]

e. A complete discussion of all of the provisions of the Federal laws and the state laws is beyond the discussion of this outline. So, this outline will limit the discussion to the most relevant provisions.

2. Pertinent Provisions of ATRA

a. Federal Transfer Tax Landscape

(1) Summary of the Pertinent Income Tax Provisions

(a) The top estate, gift, and GST tax rate is 40%.[8]

(b) The basic applicable exclusion amount[9] (sometimes referred to as the "Applicable Exclusion Amount" or the "Applicable Exclusion") for each individual is $5 million,[10] indexed for inflation after 2011[11] ($5.45 million for 2016).[12]

(c) Reunification of the estate, gift and GST tax system (providing a GST exemption amount equal to the basic Applicable Exclusion Amount under section 2010(c)).[13]

(d) Permanent instatement of the "portability" of a deceased spouse's unused exclusion amount ("DSUE Amount").[14]

---

[6] For example, the California enactment in 2012 of the Temporary Taxes to Fund Education, commonly known as Proposition 30 that raised the highest marginal income tax bracket to 13.3%.

[7] For example, (i) effective April 1, 2014, New York modified its state estate tax to immediately increase the state estate tax exemption from $1,000,000 to $2,062,500 per person and eventually have the exemption equal the Federal Applicable Exclusion amount by 2019; (ii) July 23, 2013, North Carolina repealed its estate tax (effective date of January 1, 2013), The North Carolina Tax Simplification and Reduction Act, HB 998, and on May 8, 2013; and (iii) Indiana repealed its inheritance tax (effective date of January 1, 2013), Indiana House Enrolled Act No. 1001.

[8] § 2001(c) (for transfers above $1 million) and § 2641(a)(1).

[9] § 2010(c)(2); Temp. Treas. Reg. § 20.2010-1T(d)(2).

[10] § 2010(c)(3)(A); Temp. Treas. Reg. § 20.2010-1T(d)(3)(i).

[11] § 2010(c)(3)(B); Temp. Treas. Reg. § 20.2010-1T(d)(3)(ii).

[12] Rev. Proc. 2015-53, 2015-44 I.R.B. 615, Section 3.33.

[13] § 2631(c).

[14] § 2010(c)(4). Enacted as part of the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010, Pub. L. 111-312, 124 Stat. 3296 ("TRA 2010"). § 101(a)(2) of ATRA struck the "sunset" provisions of TRA 2010 by striking § 304 of TRA 2010.

(e) Repeal of the "sunset" provision with respect the foregoing transfer tax provisions.[15]

(2) Applicable Exclusion Amount

(a) ATRA "permanently" provides for a cost-of-living increase to the Applicable Exclusion Amount but does not provide for a decrease even in the event of deflation.[16] The Applicable Exclusion Amount can grow to a very large number.

(b) By way of example, if the cost-of-living index increases at a compound rate of 2.80% over the next 10 and 20 years (the cost-of-living adjustment from 1985 to 2014 has averaged 2.81% and the median has been 2.80%[17]), the Applicable Exclusion Amount will grow as follows:

| FORECASTED APPLICABLE EXCLUSION AMOUNT ($ MILLION) | | | |
|---|---|---|---|
| | 2016 | 2026 | 2036 |
| 2.80% COLI | $5.45 | $7.18 | $9.47 |

b. Pertinent Income Tax Provisions

(1) Increase of the highest Federal ordinary income tax bracket to 39.6%.[18]

(2) Increase of the highest Federal long-term capital gain bracket to 20%.[19]

(3) Increase of the highest Federal "qualified dividend income" rate to 20%.[20]

---

[15] § 101(a)(1) of ATRA provides for a repeal of the "sunset" provision in the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107-16, 115 Stat. 38, ("EGTRRA"). The "sunset" provision of EGTRRA is contained in § 901 ("All provisions of, and amendments made by, this Act [EGTRRA] shall not apply... to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010," and the "Internal Revenue Code of 1986 ... shall be applied and administered to years, estates, gifts, and transfers ... as if the provisions and amendments described [in EGTRRA] had never been enacted.").

[16] Temp. Reg. § 20.2010-1T(d)(3)(ii).

[17] Determined and published by the Bureau of Labor Statistics.

[18] § 1 (for individuals with taxable income over $413,200 and married individuals filing jointly with taxable income over $647,850). *See* Rev. Proc. Rev. Proc. 2014-61, 2014-47 I.R.B. 860, Section 3.01.

[19] § 1(h)(1)(D) (for individuals with taxable income over $406,750, married individuals filing joint returns with taxable income over $457,600, and for estates and trusts with taxable income over $12,150). *See* Rev. Proc. 2013-35, 2013-47 I.R.B. 537, Section 3.01.

[20] § 1(h)(11) (allowing such income to be considered "net capital gain").

3. The Net Investment Income Tax (NIIT)

a. A full and complete discussion of the 3.8% excise tax on net investment income[21] (hereinafter "NIIT") is beyond the scope of this outline but a general understanding is important. Fortunately, there are a number of better resources for that discussion.[22]

b. For taxable years starting in 2013, section 1411 imposes a 3.8% excise tax net investment income on "net investment income"[23] ("NII") which includes:

(1) "Gross income from interest, dividends, annuities, royalties, and rents,"[24] (passive income), other than such passive income that is "derived in the ordinary course of a trade or business"[25] that is not a "Passive Activity or Trading Company" (as defined below);

(2) Gross income derived from a "Passive Activity or Trading Company," which is defined as:

(a) A trade or business that is "a passive activity (within the meaning of section 469) with respect to the taxpayer;"[26] or

(b) A trade or business that trades in "financial instruments or commodities (as defined in section 475(e)(2))."[27]

(3) Gain "attributable to the disposition of property other than property held in a trade or business not described"[28] as a Passive Activity or Trading Company; or

(4) Gross income from the investment of working capital.[29]

c. In arriving at NII, the Code provides for "deductions . . . which are properly allocable to such gross income or net gain."[30]

d. For individuals, the NIIT is imposed on the lesser of:[31]

---

[21] § 1411.

[22] *See* Richard L. Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 1 & Part 2*, Tax Notes, Aug. 12. 2013, p. 683 and Aug. 19, 2013, p. 785, and Blattmachr, Gans and Zeydel, *Imposition of the 3.8% Medicare Tax on Estates and Trusts*, 40 Est. Plan. 3 (Apr. 2013).

[23] § 1411(c).

[24] § 1411(c)(1)(A).

[25] *Id.*

[26] § 1411(c)(2)(A).

[27] § 1411(c)(2)(B).

[28] § 1411(c)(2)(C).

[29] § 1411(c)(3), referencing § 469(e)(1)(B), which provides "any income, gain, or loss which is attributable to an investment of working capital shall be treated as not derived in the ordinary course of a trade or business." *See* Prop. Reg. § 1.1411-6(a).

[30] § 1411(c)(1)(B).

(1) NII; or

(2) The excess of:

(a) "modified adjusted gross income for such taxable year"[32] ("MAGI"), over

(b) The "threshold amount"[33] ($200,000 for individual taxpayers, $250,000 for joint taxpayers, and $125,000 for married taxpayers filing separately).[34]

e. For estates and trusts, the NIIT is imposed on the lesser of:[35]

(1) The undistributed NII for the taxable year, over

(2) The excess of:

(a) Adjusted gross income (as defined in §67(e)),[36] over

(b) "[T]he dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year"[37] ($12,400 of taxable income for 2016).[38]

f. The threshold amount for individuals does not increase with cost-of-living adjustments, but the taxable income amount threshold for trusts and estates does.

g. With respect to a disposition of a partnership interest or S corporation shares, the net gain will be subject to the NIIT but "only to the extent of the net gain which would be so taken into account by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest."[39]

h. The following are excluded from the definition of NII:

(1) Distributions from "a plan or arrangement described in section 401(a), 403(a), 403(b), 408, 408A or 457(b),"[40] specifically referring to: [41]

---

[31] § 1411(a)(1)(A).

[32] § 1411(a)(1)(B)(i). Modified adjusted gross income is "adjusted gross income" as adjusted for certain foreign earned income. § 1411(d).

[33] § 1411(a)(1)(B)(i).

[34] § 1411(b).

[35] § 1411(a)(2).

[36] § 1411(a)(2)(B)(i).

[37] § 1411(a)(2)(B)(ii).

[38] *See* Rev. Proc. 2015-53, 2015-44 I.R.B. 615, Section 3.01(e).

[39] § 1411(c)(4)(A).

[40] § 1411(c)(5).

(a) A qualified pension, stock bonus, or profit-sharing plan under section 401(a);

(b) A qualified annuity plan under section 403(a);

(c) A tax-sheltered annuity under section 403(b);

(d) An individual retirement account (IRA) under section 408;

(e) A Roth IRA under section 408A; and

(f) A deferred compensation plan of a State and local government or a tax-exempt organization under section 457(b).

(2) Gain or other types of income that generally would not be taxable under the Code, including: [42]

(a) Interest on state and local bonds (municipal bonds) under § 103.

(b) Deferred gain under the installment method under § 453.

(c) Deferred gain pursuant to a like-kind exchange under § 1031 and an involuntary conversion under § 1033.

(d) Gain on the sale of a principal residence under § 121.

4. NIIT: Trusts and Interests in Pass-Through Entities

a. Generally

(1) If an individual, estate, or trust owns or engages in a trade or business, the determination of whether the income is derived in an active or passive trade or business is made at the owner's level.[43]

(2) If an individual, estate, or trust owns an interest in a trade or business through a partnership or S corporation, the determination of whether the income is derived in an active or passive trade or business is made at the interest-holder level.[44] Provided, however, the issue of whether the gross income is derived from trading in financial instruments or commodities is determined at the entity level.[45]

---

[41] § 1411(c)(5) and Treas. Reg. §1.1411-8(a). *See also* REG-130507-11, Preamble and Proposed Regulations under Section 1411 (December 5, 2012), Fed. Reg. Vol. 77, No. 234, p. 72612-33 (hereinafter, "Preamble to § 1411 Proposed Regulations").

[42] *See* Preamble to § 1411 Proposed Regulations.

[43] Treas. Reg. § 1.1411-4(b)(1).

[44] Treas. Reg. § 1.1411-4(b)(2)(i).

[45] Treas. Reg. § 1.1411-4(b)(2)(ii).

(3) A trust, or any portion of a trust, that is treated as a grantor trust is not subject to NIIT.[46] The grantor will be deemed to have received all of the income from the trade or business. Hence, whether such trade or business is passive or active is determined at the grantor/owner level.

b. Non-Grantor Trusts

(1) The application of the NIIT to trusts that own closely-held business interests is controversial, and there is considerable uncertainty how a fiduciary that owns interests in a closely-held business can materially participate and thereby avoid the imposition of the tax.

(2) In *Mattie K. Carter Trust v. U.S.*,[47] the court held that in determining material participation for trusts the activities of the trust's fiduciaries, employees, and agents should be considered. The government argued that only the participation of the fiduciary ought to be considered but the court rejected that argument. In *Frank Aragona Trust v. Commissioner*,[48] the Tax Court held that the trust qualified for the real estate professional exception under section 469(c)(7) (deemed material participation) because three of the six co-trustees were full time employees of the trust-wholly owned LLC that managed the rental properties. In addition, the Tax Court also considered the activities of co-trustees that had co-ownership interests in the entities held by the trust, reasoning that the interests of the co-trustees were not majority interests, were never greater than the trust's interests in the entities, and were compatible with the trust's goals.

(3) Notwithstanding the foregoing, the IRS ruling position is that only the fiduciary's activities are relevant. The IRS reaffirmed this ruling position in TAM 201317010. The ruling explains the IRS rationale as follows:

> The focus on a trustee's activities for purposes of § 469(h) is consistent with the general policy rationale underlying the passive loss regime. As a general matter, the owner of a business may not look to the activities of the owner's employee's to satisfy the material participation requirement. *See* S. Rep. No. 99-313, at 735 (1986) ("the activities of [employees] . . . are not attributed to the taxpayer."). Indeed, because an owner's trade or business will generally involve employees or agents, a contrary approach would result in an owner invariably being treated as materially participating in the trade or business activity. A trust should be treated no differently. A trustee performs its duties on behalf of the beneficial owners. Consistent with the treatment of business owners, therefore, it is appropriate in the trust context to look only to the activities of the trustee to determine whether the trust materially participated in the activity. An interpretation that renders part of a statute inoperative or superfluous should be avoided. *Mountain States Tel. & Tel. Co. v. Pueblo of Santa Ana*, 472 U.S. 237, 249 (1985).[49]

---

[46] Treas. Reg. § 1.1411-3(b)(1)(v).

[47] 256 F. Supp.2d 536 (N.D. Tex. 2003)

[48] 142 T.C. No. 9 (March 27, 2014).

[49] TAM 201317010. *See also* TAM 200733023 and PLR 201029014.

(4) At issue in the ruling were the activities of "special trustees" who did the day-to-day operations and management of the companies in question but lacked any authority over the trust itself. The ruling states:

> The work performed by A was as an employee of Company Y and not in A's role as a fiduciary of Trust A or Trust B and, therefore, does not count for purposes of determining whether Trust A and Trust B materially participated in the trade or business activities of Company X and Company Y under § 469(h). A's time spent serving as Special Trustee voting the stock of Company X or Company Y or considering sales of stock in either company would count for purposes of determining the Trusts' material participation. However, in this case, A's time spent performing those specific functions does not rise to the level of being "regular, continuous, and substantial" within the meaning of § 469(h)(1). Trust A and Trust B represent that B, acting as Trustee, did not participate in the day-to-day operations of the relevant activities of Company X or Company Y. Accordingly, we conclude that Trust A and Trust B did not materially participate in the relevant activities of Company X or Company Y within the meaning of § 469(h) for purposes of § 56(b)(2)(D) for the tax years at issue.[50]

(5) The need for a trustee to be active may affect the organization of business entities held in trust. For instance, a member-managed LLC may be more efficient than a manager-managed LLC unless a fiduciary is the manager.

c. Pass-Through Entities

(1) The proposed Treasury Regulations issued in 2013[51] (the "2013 Proposed Regulations") provide that the exception for certain active interests in partnerships and S corporations will apply to a "Section 1411(c)(4) Disposition." A Section 1411(c)(4) Disposition is defined as the sale of an interest in any entity taxed as a partnership or an S corporation[52] (a "Pass-Through Entity") by an individual, estate, or trust if: (1) the Pass-Through Entity is engaged in one or more trades or businesses, or owns an interest (directly or indirectly) in another Pass-through Entity that is engaged in one or more trades or businesses, other than the business of trading in financial instruments or commodities; and (2) one or more of the trades or businesses of the Pass-Through Entity is not a passive activity (defined under section 469 of the Code) of the transferor.[53] Therefore, if the transferor (e.g., the trustee of a non-grantor trust) materially participates in one or more of the Pass-Through Entity's trades or businesses (other than trading in financial instruments or commodities), then some or all of the gain attributable to the sale of an interest in such entity would be exempt from the NIIT.

(2) The 2013 Proposed Regulations provide two possible methods of determining the amount of gain or loss from a Section 1411(c)(4) Disposition. The simplified method is available to a taxpayer if the gain of the transferor is $250,000 or less (including gains

---

[50] *Id.*

[51] REG-130843-13. Generally, effective for taxable years beginning after December 31, 2013.

[52] Prop. Treas. Reg. § 1.1411-7(a)(2)(i)

[53] Prop. Treas. Reg. § 1.1411-7(a)(3).

from multiple sales that were part of a plan).[54] If the gain exceeds $250,000, the transferor may use the simplified method if the sum of the transferor's share during the "Section 1411 Holding Period" (generally, the year of sale and the preceding two years) of separately stated items of income, gain, loss, and deduction of a type that the transferor would take into account in calculating NII is 5% or less than the sum of all separately stated items of income, gain, loss, and deduction allocated to the transferor over the same period of time, and the gain is $5 million or less.[55] Generally, the simplified method determines the amount gain or loss subject to NII by multiplying it by a fraction, the numerator of which is the sum of NII items over the Section 1411 Holding Period, and the denominator of which is the sum of all items of income, gain, loss, and deduction allocated to the transferor during the same period.[56]

(3) If the transferor does not qualify for the simplified method,[57] then the 2013 Proposed Regulations provides that the gain or loss that the transferor would have taken into account if the Pass-Through Entity had sold all of its "Section 1411 Property" for fair market value immediately before the disposition of the interest.[58] Section 1411 Property generally is the property owned by the Pass-Through Entity that if disposed by the entity would result in net gain or loss allocable to the transferor (partner or S corporation shareholder) that would be considered NII of the transferor (deemed sale of the activities, on an activity-by-activity basis, in which the transferor does not materially participate).[59]

(4) These rules apply in to all entities taxed as partnerships (limited liability companies, limited partnerships, general partnerships, etc.) and S corporations.

d. Qualified Subchapter S Trusts

(1) A qualified subchapter S trust (QSST)[60] is an eligible shareholder of an S corporation. Generally, a QSST may have only one beneficiary (who also must be a U.S. citizen or resident)[61] who may receive income or corpus during the beneficiary's lifetime, and all of its income[62] must be distributed (or required to be distributed) currently to that beneficiary while the trust holds S corporation stock.[63] A trust that has substantially separate and

---

[54] Prop. Treas. Reg. § 1.1411-7(c)(2)(ii) (all dispositions that occur during the taxable year are presumed to be part of a plan).

[55] Prop. Treas. Reg. § 1.1411-7(c)(2)(i).

[56] Prop. Treas. Reg. § 1.1411-7(c)(4).

[57] The 2013 Proposed Regulations provide certain exceptions for situations when a transferor will be ineligible to use the optional simplified reporting method, notwithstanding qualifying for such. Situations of exception would include if the transferor held the interest for less than 12 months or if the transferor transferred Section 1411 Property to the Passthrough Entity or received a distribution of property that is not Section 1411 property during the Section 1411 Holding Period. *See* Prop. Treas. Reg. § 1.1411-7(c)(3).

[58] Prop. Treas. Reg. § 1.1411-7(a)(1).

[59] Prop. Treas. Reg. §§ 1.1411-7(a)(2)(iv), 1.1411-7(b), 1.469-2T.

[60] § 1361(d)(1)(A) treating such QSSTs as grantor trusts of U.S. citizens or residents under § 1361(c)(2)(A)(i).

[61] § 1361(d)(3)(A).

[62] Fiduciary accounting income, not taxable income. Treas. Reg. § 1.1361-1(j)(1)(i).

[63] § 1361(d)(3)(B).

independent shares, each of which is for the sole benefit of one beneficiary, may qualify as a QSST as to each share.[64] If the trust holds other assets in addition to the S corporation stock, all of the fiduciary accounting income must be distributed, not just amounts attributable to the S corporation distributions.[65] The beneficiary of a QSST is taxed on all of the QSST's income and losses from the S corporation reported on the Schedule K-1 (as if the beneficiary was grantor of the trust for grantor trust purposes under Section 678 of the Code).[66] In contrast, when the QSST sells the S corporation stock, the QSST is taxable on any resulting gain.[67]

(2) For NIIT purposes, the material participation (or lack thereof) of the beneficiary of a QSST determines to what extent the Schedule K-1 income from the S corporation will be subject to NIIT at the beneficiary level. On the other, for sales of interests in an S corporation by the QSST, material participation (and the applicability of a Section 1411(c)(4) Disposition, as discussed above) is determined at the trust (trustee) level. The preamble to the 2013 Proposed Regulations provide, in pertinent part: [68]

> In general, if an income beneficiary of a trust that meets the QSST requirements under section 1361(d)(3) makes a QSST election, the income beneficiary is treated as the section 678 owner with respect to the S corporation stock held by the trust. Section 1.1361–1(j)(8), however, provides that the trust, rather than the income beneficiary, is treated as the owner of the S corporation stock in determining the income tax consequences of the disposition of the stock by the QSST... For purposes of section 1411, the inclusion of the operating income or loss of an S corporation in the beneficiary's net investment income is determined in a manner consistent with the treatment of a QSST beneficiary in chapter 1 (as explained in the preceding paragraph), which includes the determination of whether the S corporation is a passive activity of the beneficiary under section 469... [T]hese proposed regulations provide that, in the case of a QSST, the application of section 1411(c)(4) is made at the trust level. This treatment is consistent with the chapter 1 treatment of the QSST by reason of §1.1361–1(j)(8). However, these proposed regulations do not provide any special computational rules for QSSTs within the context of section 1411(c)(4) for two reasons. First, the treatment of the stock sale as passive or nonpassive income is determined under section 469, which involves the issue of whether there is material participation by the trust.

e. Electing Small Business Trusts

(1) An electing small business trust (ESBT) [69] is another non-grantor trust that is an eligible S corporation shareholder. Unlike a QSST, an ESBT may have multiple beneficiaries[70] who can have discretionary interests in the income and principal of the trust.[71]

---

[64] §§ 1361(d)(3) and 663(c).

[65] *See* PLR 9603007

[66] § 1361(d)(1)(B) and Treas. Reg. § 1.1361-1(j)(7)(i).

[67] Treas. Reg. § 1.1361-1(j)(8).

[68] Preamble to REG-130843-13.

[69] § 1361(c)(2)(A)(v).

[70] Must be individuals, estates, or charitable organizations described in § 170(c)(2) through (5). § 1361(e)(1)(A)(i) and Treas. Reg. § 1.1361-1(m)(1).

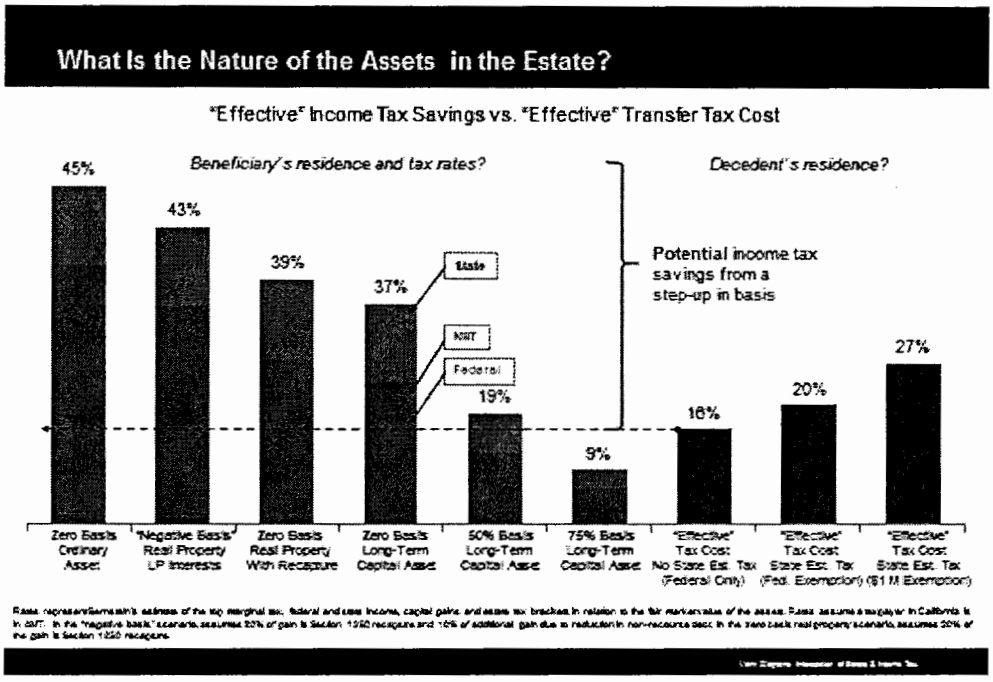
(making portability and community property issues moot), the total transfer tax cost would depend on the state in which the couple lived. The table below shows a summary of the death tax cost if the couple lived in a state with: (i) no death tax; (ii) a death tax with a rate tied to the now repealed Federal estate tax credit (maximum 16% tax above $10,040,000)[87] and an exemption equal to the Federal Applicable Exclusion Amount (e.g., Hawaii); and (iii) a death tax with a rate tied to the credit but with a $1,000,000 exemption per person (e.g., Massachusetts):

| | No State Death Tax | State Death Tax (Federal Exemption) | State Death Tax ($1 Mil. Exemption) |
|---|---|---|---|
| Joint Taxable Estates | $23 million | $23 million | $23 million |
| Transfer Tax Cost | $3.7 million | $4.6 million | $6.3 million |
| "Effective" Tax Cost | 16% | 20% | 27% |

d. To calculate the "effective" transfer tax cost, divide the total transfer tax cost by the fair market value of the assets in the estate ($23 million). In this example, that tax cost ranges from 16% up to 27%. Whether that cost is too high or too low depends, in large part, on the nature of the types of assets that are likely to be in the estate and the state of residence of the beneficiaries. If the beneficiaries live in the state of California, a comparison of the cost versus the income tax savings on different types of assets can be illustrated by the following chart:[88]

[87] § 2011(b).

[88] Assumes the top marginal tax, federal and state income and capital gains. Rates assume a taxpayer in California is in AMT. In the "negative basis" scenario, assumes 20% of gain is Section 1250 recapture and 10% of additional gain due to reduction in non-recourse debt. In the zero basis real property scenario, assumes 20% of the gain is Section 1250 recapture.




(1) As one can see, and as is discussed in more detail in the next section of this outline, if it is anticipated that many of the assets in the estate will be zero basis ordinary assets like intellectual property or zero basis real property subject to recapture, then the estate plan should be focused on liquidity planning and allowing the assets to be included in the gross estate. If the assets are high basis assets or IRD assets, then getting the assets out of the estate (and reducing the transfer tax cost) should be the strategy. The graphic also makes clear that transfer tax costs and income tax savings might change significantly if the decedents died in a state with a death tax (with different exemptions) and if the beneficiaries lived in a state with no income tax. In addition, the income tax savings would also change if the sale of the asset would not be subject to the NIIT, if, by way of example, the beneficiary is below the thresholds or if the beneficiary is materially participating in the real estate venture.

(2) This simplified example assumes away one of the most important variables in determining the transfer tax cost, spending. The example assumes a joint estate of $23 million in 10 years. Higher or lower spending rates (along with longevity), will dramatically affect the gross estate and thus the transfer tax cost.

(3) When the income tax savings from the "step-up" in basis are sufficient to justify paying the transfer tax cost, the need for ensuring liquidity to pay the transfer tax liability becomes crucial. While the general trend for the future portends increasingly less transfer tax liability, the need for life insurance (and irrevocable life insurance trusts) continues in this new planning landscape.

e. Estate planning will focus increasingly on the income tax savings resulting from the "step-up" in basis. Estate planners will seek to maximizing the "step-up" in basis by ensuring that the assets that are includible in the estate of a decedent are the type of assets that will:

(1) Benefit from a "step-up" (avoiding the inclusion cash or property that has a basis greater than fair market value)

(2) Benefit the most from the "step-up" (for example, very low basis assets, collectibles, and "negative basis" assets); and

(3) Provide significant income tax benefits to the beneficiaries (assets are likely to be sold in a taxable transaction after "step-up" or depreciable/depletable assets giving rise to ongoing income tax deductions).

f. Notwithstanding these relatively simple set of goals, tax basis management can involve a large number of strategies, some of which are relatively straightforward and are broadly applicable to all clients regardless of the size of their estates. Other strategies are more complex and are only applicable to those clients with very large estates, who are willing to take on such complexity, but the tax benefits can be quite significant.

g. In considering tax basis management in estate planning, estate planners will need to take a bifurcated approach based upon the tax nature of the assets. For clients who are likely to own primarily low-basis assets that would benefit the most from a step-up in basis (e.g., creators of intellectual property or real estate developers), the estate plan will be centered around dying with the assets and benefiting from the "step-up" in basis. To the extent the assets will be subject to Federal or state transfer taxes, then consideration must be given to ensuring that estate taxes can be paid on a timely or orderly manner. Thus, common features of the plan might include maintaining life insurance held by an irrevocable life insurance trust, qualifying for the payment of transfer taxes pursuant to the deferral provisions of section 6166, or securing a *Graegin*[89] loan.[90] For those clients who are likely to own assets that would not likely benefit from the "step-up" in basis (e.g., IRA assets, actively managed publicly-traded investment portfolios, or other high basis asset), then transferring the assets out of the estate would be paramount to the extent the assets would be subject to a significant Federal or state transfer tax liability. Finally, for those clients, who have both types of assets and whose assets would be subject to a significant transfer tax liability, the strategy would involve transferring the high basis assets out of the estate through a combination of zeroed-out transfer strategies and exercising the "swap" power proactively if the assets are held in a grantor trust, as discussed later in this article.

h. When clients are in a situation where no estate taxes will be due, referred to as a "free-base" situation, then estate planners should seek to maximize the value of certain assets because the "step-up" in basis is based on fair market value (rather than trying to reduce the value for transfer tax purposes). A "free-base" situation can arise when the assets includible in the estate are less than the decedent's remaining Applicable Exclusion Amount or a marital deduction transfer under section 2056 to the surviving spouse.[91] In these "free-basing"

---

[89] *Estate of Graegin v. Commissioner*, 56 T.C.M. (CCH) 387 (1988).

[90] *See* Stephanie Loomis-Price, Paul S. Lee, Charles E. Hodges, *Asset Rich, Cash Poor: Addressing Illiquidity with Graegin Loans, as Well as Sections 6166 and 6161*, 36 Tax Mgmt. Est. Gifts & Tr. J No. 4 (7/14/11).

[91] Another free-base situation could arise with a testamentary transfer to a zeroed-out charitable lead annuity trust. The creation of basis would significantly lower the on-going income tax liability of the non-grantor charitable lead trust. However, increasing the value would also increase the payments to charity that are required to zero-out the testamentary transfer to the trust.

situations, practitioners will need to consider when valuations discounts are warranted and when the discounts should be removed.

i. In addition to the foregoing, estate planners will increasingly seek to:

(1) Maximize the value of certain assets because the "step-up" in basis is based on fair market value (rather than trying to reduce the value for transfer tax purposes); and

(2) Intentionally create estate tax inclusion, especially if the decedent lives in a state with no state death tax and if the decedent has significant unused Available Exclusion Amount above his or her assets.

j. Valuation Discounts On or Off?

(1) A common "free-base" situation occurs when the first spouse passes away, and assets are transferred to or for the benefit of the spouse in a transfer that qualifies for the marital deduction under section 2056. In community property states, as mentioned above, the "step-up" in basis will also apply to the assets held by the surviving spouse. Clearly, for income tax purposes, a higher valuation is preferable to a lower valuation. As such, consideration should be given to when valuation discounts should be created and when they should be removed. For example, when both spouses are alive, it is sensible to avoid valuation discounts, and if the assets that would be includible in the surviving spouse's estate are significantly above the Applicable Exclusion Amount (including any ported amount), then valuation discounts will likely save more in estate taxes than the income tax savings from the subsequent "step-up" at the surviving spouse's estate. If a quick succession of deaths is a worry, practitioners should be prepared to layer valuation discounts immediately after the first death, so post-mortem estate planning might include the estate creating family limited partnerships prior to the complete settlement of the estate.

(2) Where assets have been divided among generations to create discounts, consideration should be given to undoing those arrangements if the effect is to depress the value of an estate below the amount of Available Exemption Amount in order to increase the income tax basis of the assets.

(3) Family limited partnerships or other entities that create valuation discounts could be dissolved or restated to allow the parties to the entity to withdraw for fair value or to remove restrictions on transferability.

(a) An option could be given to a parent allowing the sale of the parent's interest to a child or children for undiscounted fair market value at death. Giving such an option to a parent would be a gift unless accompanied by adequate and full consideration.

(b) If undivided interests in property are owned, family control agreements could be entered into that require all generations to consent to the sale of the property as one tract, and join in paying the expenses of a sale, if any one owner wanted to sell. Quite obviously such agreements may be contrary to other estate planning or ownership goals of the family.

(c) The ability of the IRS to ignore provisions of an agreement that increase the value of assets in the hands of a parent, but not in the hands of a child, is

uncertain. By its literal terms section 2703 applies only to provisions that reduce value and to restrictions on the right to sell or use property. To illustrate, in *Estate of James A. Elkins, Jr., et al. v. Commissioner*,[92] the Tax Court applied section 2703 to ignore a family co-tenancy agreement requiring all owners of fractional interests in art to agree before the art could be sold. The purpose of that agreement was to limit the marketability of each fractional interest. But what might the effect on value be of an agreement which provided, instead, that any fractional owner could compel the sale of the entire asset? Similarly, a provision that allows a shareholder in business to put stock to the business at death for fair market value would seem to be outside the scope of the section. In many instances amending old agreements to include such provisions will be more likely to create gifts from the younger owners to the older owners than would terminating an old agreement and creating a new one.

(4) One option for eliminating valuation discounts with family limited partnership interests is to "convert" the limited partnership (or limited liability company) to a general partnership.

(a) Section 2704(b) of the Code will disregard certain "applicable restrictions" on the ability of the partnership to liquidate. However, an exception exists for "any restriction imposed . . . by any Federal or State law."[93] Since the effective date of section 2704 of the Code, many states have amended their limited partnership and limited liability company statutes to provide for significant restrictions on an owner's ability to liquidate his or her ownership interest in those entities, thereby rendering section 2704(b) inapplicable.[94]

(b) General partnership statutes, on the other hand, provide much more liberal provisions for liquidation and dissolution of a partnership and for the withdrawal of a partner. For example: (i) section 801 of the Uniform Partnership Act (UPA)[95] provides in a partnership at will, dissolution occurs upon a person's express will to withdraw; (ii) under section 601(1) of the UPA, a person is dissociated as a partner when the partnership has notice of the person's express will to withdraw as a partner; (iii) section 602(a) of the UPA points out that a person has the power to dissociate as a partner at any time, rightfully or wrongfully; and sections 701(a) and (b) of the UPA provide, upon dissociation, the partnership is required to purchase the person's interest in the partnership for a buyout price that is the *greater* of

---

[92] 140 T.C. 86 (2013); reversed on September 15, 2014, by the Fifth Circuit _*Estate of James A. Elkins, Jr. v. Commissioner*, 13-60472.

[93] § 2704(b)(3)(B).

[94] *See, e.g.*, *Kerr v. Commissioner*, 113 T.C. 449 (1999) (The Tax Court held section 2704(b) of the Code was not applicable because the partnership agreement was no more restrictive than § 8.01 of the Texas Revised Limited Partnership Act, which generally provides for the dissolution and liquidation of a limited partnership pursuant to the occurrence of events specified in the agreement or upon the written consent of the partners.), *aff'd* 292 F.3d 490 (5th Cir. 2002) (The Fifth Circuit affirmed the decision that section 2704(b) of the Code is inapplicable under section 2704(b)(2)(B)(i) of the Code. Section 2704(b)(2)(B)(i) provides that "the transferor or any member of the transferor's family, either alone or collectively, must have the right to remove the restriction" immediately after the transfer for the restriction to be one that would be disregarded. In the case, the University of Texas was a partner in the partnership.).

[95] Uniform Partnership Act, as adopted in 2007 and last amended in 2013, by the National Conference of Commissioners on Uniform State Laws (hereinafter, UPA).

liquidation value or the value based on a sale of the entire business as a going concern without the person.[96]

(c) Furthermore, nothing under section 2704(b) of the Code prohibits being less restrictive in the partnership agreement.

(d) Where retaining limited liability of a partner is important, the partner should consider utilizing a wholly-owned limited liability company that is treated as a disregarded entity for Federal tax purposes.[97] The use of disregarded entities is discussed in more detail later in these materials. In this instance, the partner would first contribute his or her limited partnership or limited liability company interest into the disregarded entity and then the limited partnership or limited liability company would "convert" to a general partnership. The conversion can be accomplished under a conversion power,[98] interest exchange[99] and dissolution, or other merger transaction.

(e) Because all of the limited partners and limited liability company members retain the same proportionate interest in the resulting entity, there is no gift for transfer tax purposes because of the "vertical slice" exception to section 2701 of the Code.[100]

3. Section 1014

a. General Rule: The "Step-Up" in Basis to Fair Market Value

(1) Generally, under section 1014(a)(1), the "basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent" is the "fair market value of the property at the date of the decedent's death."[101] The foregoing general rule is often referred to as the "step-up" in basis at death, under the assumption that assets generally appreciate in value. However, many assets depreciate in value, and this general rule will mean a loss of tax basis to fair market value at date of death (a "step-down" in basis). For purposes of this outline, I refer to the general rule of section 1014(a)(1) as a "step-up" in basis, whether the asset is appreciated or at a loss at the time of the decedent's death.

---

[96] The comment to section 701(b) of the UPA provides, "Liquidation value is not intended to mean distress sale value. Under general principles of valuation, the hypothetical selling price in either case should be the price that a willing and informed buyer would pay a willing and informed seller, with neither being under any compulsion to deal. The notion of a minority discount in determining the buyout price is negated by valuing the business as a going concern. Other discounts, such as for a lack of marketability or the loss of a key partner, maybe appropriate, however. For a case applying the concept, see *Fotouhi v. Mansdorf*, 427 B.R. 798, 803–05 (Bankr. N.D. Cal. 2010)."

[97] A single owner entity that has not elected to be classified as an association (corporation). See § 7701 and Treas. Reg. §§ 301.7701-1(a), -2(c)(2), -3(b)(1)(ii).

[98] *See* § 1141(a)(1) of the UPA

[99] *See* § 1131(a) of the UPA.

[100] *See* Treas. Reg. § 25.2701-1(c)(4).

[101] § 1014(a)(1).

(2) The Code goes on to say that if the executor of the estate elects an alternate valuation date under section 2032 or special use valuation under section 2032A, then the basis is equal to the value prescribed under those Code sections.[102]

(3) If land or some portion of such land that is subject to a qualified conservation easement is excluded from the estate tax under section 2031(c), then "to the extent of the applicability of the exclusion," the basis will be the "basis in the hands of the decedent"[103] ("carryover basis").[104]

b. New Sections 1014(f) and 6035 of the Code

(1) On July 31, 2015, the President signed the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015[105] (commonly referred to as the "Highway Bill") into law. Among the non-expiring provisions in the Highway Bill are provisions that create new sections 1014(f) and 6035 of the Code.[106] Pursuant to these provisions, taxpayers acquiring property from a decedent whose estate was required to file a Federal estate tax return must report their adjusted tax basis consistently with the value of the property as finally determined for Federal estate tax purposes, or if not finally determined, the value as reported by the statement made under section 6035 of the Code. Specifically, beneficiaries cannot claim a higher basis than the estate tax value. Further, the executor is required to furnish the IRS and to each person acquiring any interest in property included in the gross estate a statement of value and any other information prescribed by the IRS.

(2) The text to Section 1014(f) of the Code is:

> (f) BASIS MUST BE CONSISTENT WITH ESTATE TAX RETURN.—For purposes of this section—
>
> (1) IN GENERAL.—The basis of any property to which subsection (a) applies shall not exceed—
>
> (A) in the case of property the final value of which has been determined for purposes of the tax imposed by chapter 11 on the estate of such decedent, such value, and
>
> (B) in the case of property not described in subparagraph (A) and with respect to which a statement has been furnished under section 6035(a) identifying the value of such property, such value.
>
> (2) EXCEPTION.—Paragraph (1) shall only apply to any property whose inclusion in the decedent's estate increased the liability for the tax imposed by chapter 11 (reduced by credits allowable against such tax) on such estate.
>
> (3) DETERMINATION.—For purposes of paragraph (1), the basis of property has been determined for purposes of the tax imposed by chapter 11 if—
>
> (A) the value of such property is shown on a return under section 6018 and such value is not contested by the Secretary before the expiration of the time for assessing a tax under chapter 11,

---

[102] §§ 1014(a)(2) and (3).

[103] § 1014(a)(4).

[104] § 1015.

[105] Pub. L. No. 114-41 (the "Highway Bill").

[106] § 2004 of the Highway Bill.

(B) in a case not described in subparagraph (A), the value is specified by the Secretary and such value is not timely contested by the executor of the estate, or

(C) the value is determined by a court or pursuant to a settlement agreement with the Secretary.

(4) REGULATIONS.—The Secretary may by regulations provide exceptions to the application of this subsection.

(3) The text to Section 6035 of the Code is:

**SEC. 6035. BASIS INFORMATION TO PERSONS ACQUIRING PROPERTY FROM DECEDENT.**

(a) INFORMATION WITH RESPECT TO PROPERTY ACQUIRED FROM DECEDENTS.—

(1) IN GENERAL.—The executor of any estate required to file a return under section 6018(a) shall furnish to the Secretary and to each person acquiring any interest in property included in the decedent's gross estate for Federal estate tax purposes a statement identifying the value of each interest in such property as reported on such return and such other information with respect to such interest as the Secretary may prescribe.

(2) STATEMENTS BY BENEFICIARIES.—Each person required to file a return under section 6018(b) shall furnish to the Secretary and to each other person who holds a legal or beneficial interest in the property to which such return relates a statement identifying the information described in paragraph (1).

(3) TIME FOR FURNISHING STATEMENT.—

(A) IN GENERAL.—Each statement required to be furnished under paragraph (1) or (2) shall be furnished at such time as the Secretary may prescribe, but in no case at a time later than the earlier of—

(i) the date which is 30 days after the date on which the return under section 6018 was required to be filed (including extensions, if any), or

(ii) the date which is 30 days after the date such return is filed.

(B) ADJUSTMENTS.—In any case in which there is an adjustment to the information required to be included on a statement filed under paragraph (1) or (2) after such statement has been filed, a supplemental statement under such paragraph shall be filed not later than the date which is 30 days after such adjustment is made.

(b) REGULATIONS.—The Secretary shall prescribe such regulations as necessary to carry out this section, including regulations relating to—

(1) the application of this section to property with regard to which no estate tax return is required to be filed, and

(2) situations in which the surviving joint tenant or other recipient may have better information than the executor regarding the basis or fair market value of the property.

(4) The statement must be delivered within 30 days of the earlier of the date the return is filed or the date the estate tax return was due (with extensions). If the value is subsequently adjusted (e.g., by audit or amendment), a supplemental statement must be provided within 30 days. The penalty for each failure is $250, to a maximum of $3 million, and

if the failure to report was intentional, the penalty is increased to $500, with exceptions for reasonable cause.[107]

(5) If a taxpayer claims a tax basis on his or her income tax return in excess of the basis reported under section 1014(f) of the Code, a 20% penalty[108] is applied to the underpayment arising from the "inconsistent estate basis reporting."[109] The 6-year statute of limitations applies in the case of an overstatement of basis.[110]

(6) Note that section 1014(f)(1) of the Code limits application of the section to situations where Federal estate tax values have been determined. Section 1014(f)(3) defines "determined" in such a way that ordinarily a return would need to be filed. This is a more limited application than requested by the Obama Administration in its Greenbook.[111] Treasury and the IRS can be expected to push the language of the statute to its maximum scope when writing the regulations.

(7) These new provisions apply to estate tax returns (and related income tax returns) filed after July 31, 2015.[112] The IRS has issued Temporary Regulations that provide that executors and other persons required to file or furnish a statement under 6035(a)(1) and (a)(2) before March 31, 2016 do not need to do so until March 31, 2016.[113] On January 27, 2016, the IRS posted on its website an updated draft IRS Form 8971 (Information Regarding Beneficiaries Acquiring Property from a Decedent) and instructions. On March 4, 2016, the IRS published Proposed Treasury Regulations providing guidance on the basis consistency and reporting requirements.[114]

---

[107] §§ 6721, 6724(d)(1)(D), and 6724(d)(2)(II). The penalty under section 6721 if the Code for failing to file an information return was increased from $100 to $250 by the Trade Preferences Extension Act of 2015 (P.L. 114-27) on June 29, 2015. The penalty under section 6723 of the Code for failing to comply with a "specified information reporting requirement" does not apply, because "specified information reporting requirement" is a defined term limited under sections 6724(d)(3) of the Code, applying to circumstances which do not apply here.

[108] § 6662(a) (accuracy-related penalties on underpayments).

[109] § 6662(b)(8) and 6662(k).

[110] § 2005 of the Highway Bill and re-designated § 6502(e)(1)(B)(ii).

[111] Department of Treasury, General Explanation of the Administrations Fiscal Year 2016 Revenue Proposals (Feb. 2015), *Require Consistency in Value for Transfer and Income Tax Purposes*, p. 195.

[112] §§ 2004(d) and 2005(b) of the Highway Bill.

[113] T.D. 9757.

[114] REG-127923-15.

c. Section 1014(e): The One Year Conundrum

(1) Section 1014(e) provides that if "appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent's death,[115]" and the property is "acquired from the decedent by (or passes from the decedent to) the donor of such property (or spouse of such donor),"[116] then the property will not receive a "step-up" in basis and it will have the basis in the hands of the decedent before the date of death.[117]

(2) For purposes of the foregoing, the Code provides that carryover basis shall apply to any appreciated property "sold by the estate of the donor or by a trust of which the decedent was the grantor" but only "to the extent the donor of such property (or the spouse of such donor) is entitled to the proceeds from such sale."[118]

(3) This rule does not apply if the property passes to the issue of the original donor, and it is unclear whether this rule applies if the property is placed in trust where the original donor or donor's spouse is a potential beneficiary.[119] In *Estate of Kite v. Commissioner*[120] prior to her husband's death, the surviving spouse funded an inter-vivos QTIP trust for the benefit of her husband with appreciated assets. Her husband died a week after the QTIP trust was created and funded. The surviving spouse reserved a secondary life estate for the benefit of the surviving spouse, and the inclusion in her husband's estate was offset with a QTIP election. As such, after her husband's death, the appreciated assets were held in a marital trust for the surviving spouse, the original donor of the assets. Two other marital trusts were created for the benefit of the surviving spouse. The three marital trusts engaged in a series of transactions that effectively terminated the marital trusts, with a subsequent sale of the assets by the surviving spouse to the children for a deferred annuity. These transactions were at issue in the case, and the tax court concluded that a taxable gift was deemed to occur upon the sale of the marital trust assets under section 2519. However, in a footnote, the tax court provided that all of the assets in the marital trusts, including the appreciated assets gifted to him shortly before death, received a step-up in basis under section 1014.[121] The decision and the result of the case (in particular the with respect to section 1014(e)) have been criticized by a number of commentators.[122]

---

[115] § 1014(e)(1)(A).

[116] § 1014(e)(1)(B).

[117] § 1014(e)(1) (flush language).

[118] § 1014(e)(2)(B).

[119] *See* PLRs 200210051, 200101021, 9026036, and TAM 9302002.

[120] T.C. Memo 2013-43.

[121] "All of the underlying trust assets, including the OG&E stock transferred to Mr. Kite in 1995, received a step-up in basis under sec. 1014." *Estate of Kite v. Commissioner*, T.C. Memo 2013-43, footnote 9.

[122] See Jeff Pennell, *Jeff Pennell on Estate of Kite: Will it Fly?*, LISI Estate Planning Newsletter #2062 (Feb. 11, 2013) and John J. Scroggin, *Understanding Section 1014(e)*, LISI Estate Planning Newsletter #2192 (Feb. 6, 2014).

d. Community Property and Elective/Consensual Community Property

(1) The Code provides a special rule for community property. Section 1014(b)(6) provides that "property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate"[123] shall be deemed to have been acquired from or to have passed from the decedent.

(2) There are currently nine community property states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. There are two states that are separate property states but they allow couples to convert or elect to treat their property as community property: Alaska[124] and Tennessee.[125] Generally, these elective or "consensual community property" laws allow resident and nonresident couples to classify property as community property by transferring the property to a qualifying trust, and for nonresidents, a qualifying trust requires at least one trustee who is a resident of the state or a company authorized to act as a fiduciary of such state, and specific language declaring the trust asset as community property.

(3) Clearly, for residents of separate property states, taking advantage of the "consensual community property" laws of another state has the potential for a basis adjustment under section 1014(b)(6). There has been no direct ruling on whether that would be the case under the laws of Alaska or Tennessee. However, a number of commentators have argued that assets in such "consensual community property" arrangements would, indeed, receive a full "step-up" in basis under section 1014(b)(6).[126] A professional fiduciary must be designated in Alaska or Tennessee in order to invoke the respective statutes and the administrative expense ought to be weighed against the potential benefit, taking into consideration the uncertainty.

4. The Tax Nature of Particular Assets

a. Generally

(1) Understanding how and to what extent assets will benefit from a "step-up" in basis is critical to the estate planning process. Obviously, certain assets like highly-appreciated assets will benefit more from the "step-up" in basis at death than cash (which has a basis equal to its face value which is equal to its fair market value) or property at a loss (a "step-down" in basis). Moreover, appreciated assets like gold that are considered "collectibles"[127]

---

[123] § 1014(b)(6).

[124] Alaska Stat. 34.77.010 et al. (Alaska Community Property Act).

[125] Tenn. Code Ann. § 35-17-101 et al. (Tennessee Community Property Trust Act of 2010).

[126] Jonathan G. Blattmachr, Howard M. Zaritsky and Mark L. Ascher. *Tax Planning with Consensual Community Property: Alaska's New Community Property Law*, 33 Real Prop. Probate and Tr. J. 615 (Winter 1999). *See also Commissioner v. Harmon*, 323 U. S. 44 (1944) (an Oklahoma income tax case involving elective community property), *McCollum v. U.S.*, 58-2 USTC § 9957 (N. D. Okla. 1958) (explaining what *Harmon* meant, and distinguishing it in the context of basis), and Rev. Rul. 77-359, 1977-2 C.B. 24.

[127] § 1(h)(4).

under the Code, benefit more from a step-up in basis than other appreciated capital assets because the Federal long-term capital gain tax rate for collectibles is 28%, rather than 20%.

(2) A list of asset categories or types starting with those that benefit the most from the "step-up" in basis and ending with those that benefit the least (or actually suffer a "step-down" in basis), might look like this:

(a) Creator-owned intellectual property (copyrights, patents, and trademarks), intangible assets, and artwork;

(b) "Negative basis" commercial real property limited partnership interests;

(c) Oil & gas investment assets (to be sold after date of death);

(d) Investor/collector-owned artwork, gold, and other collectibles;

(e) Low basis stock or other capital asset;

(f) Roth IRA assets;

(g) Oil & gas investment assets (to be held after date of death);

(h) High basis stock;

(i) Cash;

(j) Passive Foreign Investment Company (PFIC) Shares;

(k) Stock or other capital asset that is at a loss;

(l) Variable annuities; and

(m) Traditional IRA and qualified plan assets.

(3) A full discussion of every asset type listed above is beyond the scope of these materials, but a number of them deserve additional consideration and discussion. In addition, some assets listed above like traditional IRA, qualified plan, and Roth IRA assets cannot be owned by a partnership, so they are excluded from further discussion in this outline.

b. Creator-Owned Intellectual Property, Intangible Assets and Artwork

(1) Generally

(a) In the hands of the creator, intellectual property, intangible assets and artwork represent the type of asset that, from a tax standpoint, benefits greatly from the "step-up" in basis. For the most part, during the lifetime of the creator, these assets have little or no basis in the hands of the creator, and the sale, exchange, disposition, licensing or other exploitation of these types of assets are considered ordinary income to the creator. If the asset is transferred in a "carry-over" basis transaction like a gift, the tax attributes carry to the donee. On the other hand, if the creator of the asset dies with the asset, the asset is entitled to a "step-up" in basis and the asset becomes a long-term capital gain asset in the hands of the beneficiaries.

(b) Patents, copyrights, and trademarks are common assets, but intangible rights might also include the right of publicity, defined loosely as the right of an individual to have a monopoly on his or her own name, likeness, attributes, etc. In the case of well-known artists, actors, and celebrities, this right of publicity can be quite valuable. Some states, like New York, do not recognize a postmortem right to publicity,[128] while approximately 19 states have specifically codified the postmortem right to publicity. Notably, California[129] has codified the postmortem right to publicity, which lasts for a term of 70 years after the death of the personality. Further, the California statute specifically provides that such rights are freely transferable during lifetime or at death.

(c) As one can see, each of these intangible assets has its own peculiarities (for example, the duration of the intangible rights) that may affect its value at the date of transfer (whether during lifetime or at death) and that may affect whether the asset or particular rights can be transferred at all.

(2) Copyrights

(a) Under U.S. law, copyright protection extends to "original words of authorship fixed in any tangible medium of expression," which includes: "(1) literary works; (2) musical works, including any accompanying words; (3) dramatic works, including any accompanying music; (4) pantomimes and choreographic works; (5) pictorial, graphic, and sculptural works; (6) motion pictures and other audiovisual works; (7) sound recordings; and (8) architectural works."[130] The courts have ruled that computer software constitutes protected literary works.[131]

(b) Knowing the duration of an existing copyright is critical to understanding what value a copyright may have today and what value a copyright may have in the future. For works copyrighted on or after January 1, 1978, a copyright's duration is based

---

[128] *See, Milton H. Greene Archives Inc. v. Marilyn Monroe LLC*, No. 08-056471 (9th Cir. 8/30/12), *aff'g* 568 F. Supp. 2d 1152 (C.D. Cal. 2008). *See* http://rightofpublicity.com for a good discussion of statues, cases, and current controversies, maintained by Jonathan Faber of the Indiana University McKinney School of Law.

[129] Ca. Civ. Code § 3344.

[130] 17 U.S.C. § 102(a)(1)-(8).

[131] *See, e.g., Apple Computer, Inc. v. Franklin Computer Corp.*, 714 F.2d 1243 (3rd Cir. 1983).

upon the life of the author plus 70 years.[132] For works copyrighted prior to January 1, 1978, a copyright's duration was 28 years, with the author (and his or her estate) having the right to renew and extend the term for another 67 years (for a total of 95 years).[133]

(c) For works copyrighted on or after January 1, 1978, the author (or the author's surviving spouse or descendants if the author is deceased) has a right to terminate any transfer or assignment of copyright by the author 35 years after the transfer or assignment.[134] These termination rights apply "in the case of any work other than a work made for hire, the exclusive or nonexclusive grant of a transfer or license of copyright or of any right under a copyright, executed by the author on or after January 1, 1978, otherwise than by will."[135] Because only the author has the right of termination during his or her lifetime, even if a gift is made of the copyright, the author's continued right of termination calls into question how the copyright can be irrevocably transferred (especially since there seems no mechanism to waive the termination right) and appropriately valued for transfer tax purposes.

(d) Payments to the creator of a copyright on a non-exclusive license give rise to royalty income, taxable as ordinary income.[136] An exclusive license (use of substantially all of the seller's rights in a given medium) is treated as a sale or exchange. When the creator is the seller, it is deemed to be a sale of an asset that is not a capital asset,[137] so it is taxed at ordinary rates. By contrast, if the seller is not the creator, capital asset treatment under section 1221 is available if such seller is not a dealer.[138] Notwithstanding the foregoing, if the creator/author of the copyright, gifts the asset (carryover basis transaction), a sale or exchange by the donee is not afforded capital treatment either.[139] A gift for estate planning purposes, therefore, may have the unintended effect of prolonging ordinary income treatment after the death of the author/creator of the copyright.

(e) In contrast, upon the death of the author/creator who still owns the asset at death, the copyright is entitled to a "step-up" in basis to full fair market value under section 1014 and the asset is transformed into a long-term capital gain asset. Because the basis of the copyright included in the creator's estate is no longer tied to that of the creator, the asset no longer falls within the exclusion from capital asset treatment under section 1221(a)(3) and, thus, are capital assets in the hands of the creator's beneficiaries. The copyright is deemed to immediately have a long-term holding period even if it is sold within 1 year after the decedent's death.[140]

---

[132] 17 U.S.C. § 302(a).

[133] 17 U.S.C. § 304.

[134] 17 U.S.C. § 203(a).

[135] *Id.*

[136] § 61(a)(6). *See also* Treas. Reg. § 1.61-8. Rev. Proc. 2004-34, 2004-22 I.R.B. 964, allows certain taxpayers to defer to the next taxable year, certain payments advance royalty payments.

[137] § 1221(a)(3). § 1221(b)(3) provides a limited exception for copyrights in musical works, pursuant to which the taxpayer may elect to have § 1221(a)(3) not apply to a sale or exchange.

[138] It could also be afforded § 1231 treatment (asset primarily held for sale to customers in the ordinary course of a trade or business).

[139] § 1221(a)(3)(C).

[140] § 1223(9).

(3) Patents

(a) Individuals who patent qualifying inventions are granted the "right to exclude others from making, using, offering for sale, or selling"[141] such invention for a specified term. The term for a utility or plant patent is 20 years, beginning on the earlier of the date on which the application for the patent was filed.[142] The term for a design patent is 14 years from the date of grant.[143]

(b) Similar to the taxation of copyrights, payments received for a transaction that is not considered a sale or exchange or payments received for a license will be considered royalty income, taxable as ordinary income.[144]

(c) A sale or exchange of a patent that does not qualify under section 1235 (discussed below), may qualify for capital gain treatment because the Treasury regulations specifically provide that a patent or invention are not considered "similar property"[145] to a copyright, which is excluded from capital gain treatment. However, for the sale of a patent to qualify for capital gain treatment under section 1221, the individual generally must be considered a non-professional inventor (otherwise the patent would be considered stock in trade or inventory in the hands of a professional inventor). Capital gain treatment under section 1231 is possible but only if the patent is considered to have been "used in a trade or business."[146] Often, however, patents held by individuals will not qualify as such. By consequence, generally, for individuals selling or exchanging a patent, the only avenue for capital gain treatment is under section 1235.

(d) Like the tax treatment of the creator of a copyright, if the creator dies with a patent, the asset is entitled to a "step-up" in basis to full fair market value under section 1014, and the asset is transformed into a long-term capital gain asset.

(e) Section 1235 provides that a "transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 1 year."[147]

(f) Only an individual may qualify as a holder, regardless of whether he or she is in the business of making inventions or in the business of buying and selling

---

[141] 35 U.S.C. § 154(a)(1).

[142] 35 U.S.C. § 154(a)(2).

[143] 35 U.S.C. § 173.

[144] § 61(a)(6). *See also* Treas. Reg. § 1.61-8.

[145] "For purposes of this subparagraph, the phrase "similar property" includes for example, such property as a theatrical production, a radio program, a newspaper cartoon strip, or any other property eligible for copyright protection (whether under statute or common law), but does not include a patent or an invention, or a design which may be protected only under the patent law and not under the copyright law." Treas. Reg. § 1.1221-1(c)(1).

[146] § 1231(a)(3)(A)(i). The holding period is deemed to start when the patent is reduced to practice. *Kuzmick v. Commissioner*, 11 T.C. 288 (1948).

[147] § 1235(a).

patents.[148] Specifically, a qualified "holder" includes (i) the creator of the patent,[149] or (ii) "any other individual who has acquired his interest in such property in exchange for consideration in money or money's worth paid to such creator prior to actual reduction to practice of the invention covered by the patent,"[150] provided that in such instance, the individual is not an employer of the creator or related to the creator.[151] As such, a trust, estate, or corporation will not qualify as a holder under section 1235, although a transfer to a grantor trust would not likely disqualify a subsequent sale or exchange to capital gain treatment.[152] An entity taxable as a partnership does not qualify as a holder, but each individual in the partnership may qualify separately as such.[153]

(g) A sale or exchange by a qualified holder to a "related person" will not qualify for capital-gain treatment under section 1235.[154] A "related person" is generally defined by reference to section 267(b) and includes (i) the holder's spouse, ancestors, and lineal descendants (but not siblings);[155] (ii) a fiduciary of any trust of which the holder is the grantor; (iii) any corporation, partnership, or other entity in which the holder (and other related persons) own 25% or more of the ownership interests.[156]

(h) Because of the foregoing limitations of who can qualify as a holder and the related person limitations on who can be the transferee, many estate planning techniques involving patents are limited if capital gain treatment is to be retained.

(i) If a qualified holder sells his or her interest in a patent under section 1235 and later dies before all payments are received, the estate and/or beneficiary of the deceased reports the payments as long-term capital gain as IRD.[157]

---

[148] § 1235(a)(2) and Treas. Reg. § 1.1235-2(d)(3).

[149] § 1235(b)(1).

[150] § 1235(b)(2).

[151] § 1235(b)(2)(A)-(B).

[152] *See* Treas. Reg. § 1.671-2(c). If a holder sells his or her interest in a transfer qualifying under section 1235 and later dies before all payments are received, the estate and/or beneficiary of the deceased reports the payments as long-term capital gain as income in respect of a decedent.

[153] Treas. Reg. § 1.1235-2(d)(2). *See also*, PLRs 200135015, 200219017, 200219019, 200219020, 200219021, 200219026, 200506008, 200506009, and 200506019.

[154] § 1235(d).

[155] § 1235(d)(2)

[156] § 1235(d)(1).

[157] § 691 and Treas. Reg. § 1.691(a)(3).

(4) Artwork

(a) The taxation of artwork in the hands of the artist is the same as it would be for the creator of a copyright, as discussed above. Generally, all payments pursuant to a license and a taxable sale or exchange of the artwork give rise to ordinary income.[158] A third-party collector or investor in the artwork might qualify for capital gain treatment or section 1231 treatment, as long as the property is not held out for sale in the ordinary course of a trade or business (inventory).[159] Similarly, capital gain treatment is not available to a donee of the artist because the donee's basis is determined by reference to the artist's basis.[160]

(b) Artwork in the hands of a collector or investor (third-party other than the creator or a donee of the creator) is considered a collectible under the Code and would be subject to the 28% long-term capital gain tax, rather than 20%.[161] Under the Code, a "collectible" is any work of art, rug, antique, metal, gem, stamp, coin, alcoholic beverage, or any other tangible personal property designated by the IRS as such.[162]

(c) As with copyrights and patents, the basis of property in the hands of a person acquiring property from a deceased artist is the fair market value of the property at the date of the artist's death or on the alternate valuation date, if so elected.[163] The artwork in the hands of the estate or the artist's beneficiaries becomes a capital asset, qualifying for long-term capital gain treatment.[164]

c. "Negative Basis"/"Negative Capital Account" Real Property Interests

(1) "Negative basis" is the colloquial phrase used to describe a situation where the liabilities in a partnership (as also shared by the partners) are in excess of the tax basis of the partnership assets (and in the basis of the partners' interests in the partnership). Note, the basis of an asset may not go below zero, so the phrase "negative basis" is technically incorrect. Even successful real property investment partnerships may have "negative basis" assets where the underlying developed real property has been fully depreciated and cash from refinancings has been distributed to the owners or partners.

(2) The following example illustrates how this "negative basis" problem can arise and how costly a taxable event would be from an income tax standpoint:

(a) Taxpayer buys an office building in 1983 for $10,000,000 (assume for purposes of this example, the entire purchase price is properly allocated to the office building, which is depreciable). Over the next 30 years, the property appreciates in value, the

---

[158] §§ 1221(a)(3) and 61(a)(6). § 1221(b)(3) provides a limited exception for copyrights in musical works, pursuant to which the taxpayer may elect to have § 1221(a)(3) not apply to a sale or exchange.

[159] § 1221(a)(1).

[160] §§ 1221(a)(5)(B) and 1015.

[161] § 1(h)(4).

[162] §§ 1(h)(5)(A) and 408(m)(2).

[163] § 1014(a).

[164] *See* §§ 1221(a)(3) and 1223(9).

taxpayer fully depreciates the original basis of $10 million in the building to zero,[165] borrows against the property, and takes the loaned funds tax free. As a result in 2014, the office building is now worth $20 million, has zero adjusted tax basis, and has a mortgage on the building of $15 million ($5 million of net equity in the property).

(b) Note, because the property was placed in service in 1983, an accelerated method of depreciation was allowable on the property.[166] As such, a taxable sale of the property will be subject to recapture under the Code. Because the property was placed in service prior to 1986, recapture is under section 1245 (rather than section 1250, which generally applies to real property).[167] As such, the total amount of the depreciation deductions is subject to recapture as ordinary income.[168]

(c) If the building is sold for $20 million in a taxable transaction, the gain would break down as follows:

| | |
|---|---|
| Amount Recognized: | $20,000,000 |
| Adjusted Basis: | $ ------ |
| Recapture: | $10,000,000 ordinary income |
| Long-Term Capital Gain: | $10,000,000 long-term capital gain |

Assuming the taxpayer is in the highest income tax bracket and in a relatively high income tax state, like a New York City taxpayer, the ordinary rate would be approximately 45% and the long-term capital gain rate would be approximately 37%. The total tax liability would be $8.2 million. After repayment of the $15 million of debt, the taxpayer (who would net $5 million in cash from the transaction before taxes) would actually be in deficit by approximately -$3.2 million after the payment of income taxes.

---

[165] §§ 1016(a)(2), 168(a), and Treas. Reg. § 1.1016-3(a)(1)(i).

[166] Accelerated Cost Recovery System ("ACRS") was enacted in 1981 under the Economic Recovery Tax Act of 1982 ("ERTA"), P.L. 97-34. ACRS was later modified by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), P.L. 97-248, and the Tax Reform Act of 1984, P.L. 98-369, when the recovery period for most real property was extended from 15 to 18 years. In 1985, the real property recover period was extended from 18 to 19 years, P.L. 99-121, § 103. ACRS generally applies to property placed in service after December 31, 1980, and before December 31, 1986. Prop. Treas. Reg. § 1.168-4(a). The Tax Reform Act of 1986, P.L. 99-514, ("TRA 1986") dramatically changed the applicability of ACRS to real property investments and instituted the modified ACRS ("MACRS"). Notably, the "applicable recovery period" for most real property assets like buildings are placed in 27.5 or 39-year recovery periods, while land improvements fall within 15 or 20-year recovery periods. § 168(c). In this example, because it was placed in service before 1984, the building would be considered 15-year real property, pursuant to which the applicable percentage of depreciation was 12% in the first year, reducing to 5% in from 11 to 15 years.

[167] § 1245(a)(5) before being amended by TRA 1986, defines "§1245 recovery property" to include all recovery property under ACRS, real or personal, other than certain types of 19-year (18-year for property placed in service after March 15, 1984, and before May 9, 1985; and 15-year for property placed in service before March 16, 1984) real property and low-income housing: residential rental property, property used "predominantly" outside the United States, property as to which an election to use straight-line recovery is in effect, and certain low-income and Federally insured residential property. The foregoing types of property are subject to recapture under Section 1250. In this example, the office building does not fall within the listed categories, and as such is subject to recapture under Section 1245.

[168] *See* § 1245(a)(2).

(d) Compare the result if the taxpayer died owning the building (assume for simplicity's sake, the building no longer has a mortgage). The building would get a "step-up" in basis under section 1014(a) to fair market value, the recapture and long-term capital gain tax problem would be eliminated. If the taxpayer has $5.34 million of Applicable Exclusion available, the maximum estate tax liability (assuming a top state death tax rate of 16% and state death tax exemption equal to the federal exclusion amount) is approximately $7.3 million (maximum blended rate of 49.6%). If the Applicable Exclusion Amount grows to $8 million for example, then the estate tax liability falls to a bit less than $6.0 million. If the foregoing building was in California, the income tax liability would be greater, and the estate tax cost would be even less because California does not have a death tax. With an Applicable Exclusion Amount of $5.34, the estate tax liability is less than $5.9 million.

(e) Property placed in service after 1986 will not have as egregious of an income tax problem because the gain would not have recapture calculated under section 1245. Rather, section 1250 would be the applicable recapture provision. "Section 1250 property" means any real property, with certain exceptions that are not applicable,[169] that is or has been property of a character subject to the allowance for depreciation.[170] Section 1250(a)(1)(A) provides that if section 1250 property is disposed of, the "applicable percentage" of the lower of the "additional depreciation" in respect of the property or the gain realized with respect to the disposition of the property shall be treated as ordinary income. In short, section 1250 provides that all or part of any depreciation deduction in excess of straight-line depreciation is recaptured as ordinary income. [171] Under the current depreciation system, straight-line depreciation is required for all residential rental and nonresidential real property.[172] As such, section 1250 recapture is typically not a problem for property placed in service after 1986. The Code does, however, tax "unrecaptured section 1250 gain" at a 25% tax rate. Unrecaptured section 1250 gain is essentially the lesser of all depreciation on the property or the net gain realized (after certain losses) to the extent not treated as ordinary income under section 1250.[173]

(f) From an estate planning perspective, it is important to remember that even if recapture is inherent in an appreciated property, it does not apply to a disposition by gift or to a transfer at death, unless the recapture would be considered income in respect of a decedent.[174]

(3) Today, most real property investments are not held individually, but are held typically in an entity taxable as a partnership (for example, a limited liability company or limited partnership). When real property investments are subject to refinancing followed by a distribution of the loan proceeds, the partnership debt rules under section 752 must be considered when determining the income tax cost of selling such property. Any increase in a partner's share of partnership liabilities (whether recourse or nonrecourse to such partner) is treated as a contribution of money by the partner to the partnership, resulting in an increase in the

---

[169] § 1245(a)(3).

[170] § 1250(c).

[171] § 1250(b)(1), (3), (5).

[172] § 168(b)(3)(A)-(B).

[173] § 1(h)(6).

[174] § 1250(d)(1) and (2).

partner's basis in his or her partnership interest ("outside basis").[175] Any decrease in a partner's share of partnership liabilities is treated as a distribution of money by the partnership to the partner, resulting in a decrease in the partner's outside basis.[176] A partner's outside basis may not be reduced below zero, so a deemed distribution of money that arises from a decrease in a partner's share of liabilities will give rise to gain recognition.[177]

(4) In the example described above, consider if a partnership owned a fully depreciated $20 million building. The partnership has $15 million of debt which is in excess of the basis in the building and in excess of the taxpayer's outside basis. Assume for this example that we can ignore other partners because they have relatively insubstantial interests in the partnership. When a partner has a negative capital account, so that the outside basis is less that the partner's share of partnership liabilities, it is also colloquially called "negative basis." As discussed, this is a misnomer because basis can never go below zero. [178] A transfer by the taxpayer, whether a taxable sale or a gift to a non-grantor trust, creates what is often referred to as "phantom gain" because the transferee takes over the transferor partner's negative capital account. It should also be noted that a partner who sells his or her partnership interest must include in income his or her allocable share of the partnership's recapture from depreciated partnership property.[179] The transfer results in a decrease in the transferor partner's share of liabilities, which in turn is treated as a distribution of money to the partner when the partner has an outside basis of zero, resulting in gain in a donative transfer or additional gain in the case of taxable sale.[180]

(5) When dealing with highly appreciated, depreciable assets like real property and partnership debt, taxable sales of the property and inter-vivos transfers of partnership interests can be problematic. [181] In many cases, given reduced transfer tax rates and growing Applicable Exclusion Amounts, it will make more economic sense to die owning these assets, than to transfer them during the partner's lifetime. The transfer of a partner's interest on death is a disposition that does not result in gain or loss recognition, even if the liability share exceeds outside basis.[182] The outside basis of the decedent receives a "step-up" in basis to fair market value (net of liabilities) but is also increased by the estate's share of partnership

---

[175] §§ 752(a) and 722. Treas. Reg. § 1.752-1(b).

[176] §§ 752(b) and 733. Treas. Reg. § 1.752-1(c).

[177] § 731(a) or 751.

[178] Partnership borrowings and payments of liabilities do not affect the capital accounts, because the asset and liability changes offset each other. See Treas. Reg. § 1.704-1(b)(2)(iv)*(c)*.

[179] §§ 751 and 453(i)(2). Under § 751, unrealized receivables are deemed to include recapture property, but only to the extent the unrealized gain is ordinary income. Treas. Reg. § 1.751-1(e) and (g).

[180] Rev. Rul. 84-53, 1984-1 C.B. 159, Situation 4.

[181] *See* Steve Breitstone and Jerome M. Hesch, *Income Tax Planning and Estate Planning for Negative Capital Accounts: The Entity Freeze Solution*, 53 Tax Mgmt. Memo. 311 (08/13/12).

[182] *See* Elliott Manning and Jerome M. Hesch, *Sale or Exchange of Business Assets: Economic Performance, Contingent Liabilities and Nonrecourse Liabilities (Part Four)*, 11 Tax Mgmt. Real Est. J. 263, 272 (1995), and Louis A. del Cotto and Kenneth A. Joyce, *Inherited Excess Mortgage Property: Death and the Inherited Tax Shelter*, 34 Tax L. Rev. 569 (1979).

liabilities.[183] Further, if the partnership makes an election under section 754, the underlying assets in the partnership will also receive a "step-up" in basis.[184]

(6) Even if a section 754 election is not made, the estate or the successor beneficiaries of the partnership interest can get the benefit of a "step-up" in the underlying assets if the successor partner makes an election under section 732(d) and if the partnership distributes the assets for which there would have been a basis adjustment.[185] The election must be made in the year of the distribution if the distribution includes property that is depreciable, depletable, or amortizable. If it does not include such property, the election can wait until the first year basis has tax significance.[186]

d. Passive Foreign Investment Company (PFIC) Shares

(1) A PFIC is a foreign corporation, 75% or more of the gross of which is "passive,"[187] or the average percentage of assets that produce passive income of which is at least 50%.[188] The PFIC rules do not apply to any U.S. taxpayer who is a 10% shareholder of a controlled foreign corporation.[189]

(2) The PFIC rules generally provide that when a U.S. shareholder receives a distribution from a PFIC, rather than treating them under the normal rules of U.S. taxation (e.g., dividend treatment), a special tax regime applies. Under the PFIC tax regime, distributions from a PFIC will be treated either as "excess" or "nonexcess" distributions.

(a) An excess distribution is any portion that exceeds 125% of the average distributions made to the shareholder with respect to the shareholder's shares within the 3 preceding years (or shorter if the shareholder has held the shares for less than 3 years).[190] All other distributions or portions thereof are treated as nonexcess distributions.

(b) With respect to nonexcess distributions, the normal rules of U.S. taxation apply, which generally results in dividend treatment.[191] However, the dividend

---

[183] §§ 1014(a), 1014(b), 742; Treas. Reg. §§ 1.1014-1(a), (b), and 1.742-1. The election is made by the distributee partner's attaching a schedule to the income tax return setting out (i) the election to adjust the basis of distributed property under Section 732(d), and (ii) the computation of the basis adjustment to the distributed properties. Treas. Reg. § 1.732-1(d)(3).

[184] § 743(a).

[185] § 732(d) and Treas. Reg. §1.732-1(d)(1)(i)-(iii). The election is made by the distributee partner's attaching a schedule to the income tax return setting out (i) the election to adjust the basis of distributed property under Section 732(d), and (ii) the computation of the basis adjustment to the distributed properties. Treas. Reg. § 1.732-1(d)(3).

[186] Treas. Reg. § 1.732-1(d)(2).

[187] § 1297(a)(1). Generally, "passive income" is foreign personal holding company income, as provided in § 954(c). § 1297(b).

[188] § 1297(a)(2).

[189] § 1297(e).

[190] § 1291(b)(2)(A).

[191] Prop. Treas. Reg. § 1.1291-2(e)(1).

will not be considered a qualified dividend taxable at 20% because a PFIC will never be a "qualified foreign corporation."[192]

(3) The portion of any distribution that is considered an excess distribution will first be allocated to each day in the shareholder's holding period for the shares.[193] Any portion so allocated to the current year and the non-PFIC years will be included in the year of receipt as ordinary income (not qualified dividends).[194]

(4) The portion of the excess distribution that is allocated to other years (the "PFIC years") is not included in the shareholders income, but is subject to a "deferred tax."[195] The deferred tax is added to the tax that is otherwise due. In computing the "deferred tax" the shareholder multiplies the distribution allocated to each PFIC year by the top marginal tax rate in effect for that year.[196] The shareholder then adds all of the "unpaid" tax amounts for all of the PFIC years, and then computes interest on those unpaid tax amounts as if the shareholder had not paid the tax for the PFIC years when due using the applicable federal underpayment rate.[197] The deferred tax and interest are separate line items on the individual shareholder's income tax return.[198]

(5) The sale of PFIC shares are considered excess distributions to the extent the consideration for the sale is in excess of the shareholder's tax basis in the PFIC shares.[199] Thus, effectively the gain is treated as ordinary income, which is treated as realized ratable over the seller's holding period for purposes of determining the deferred tax and interest for prior years.

(6) U.S. shareholders of a PFIC may make a "qualified elective fund" (QEF) election to avoid the excess distribution regime. If the shareholder makes a QEF election, the shareholder must include in gross income a pro rata share of the PFIC's ordinary income and net capital gain each taxable year.[200] If a shareholder makes this election, he or she must have access to the PFIC's books and records so the allocable share of the PFIC's income and gain can be calculated.

(7) The death of a U.S. shareholder is not a taxable disposition of the PFIC shares if the death results in a transfer to a domestic U.S. estate or directly to another U.S. taxpayer.[201] By contrast, a transfer upon the death of a U.S. shareholder to a testamentary trust or to a foreign person will be considered at taxable disposition.[202] The proposed Treasury

---

[192] *See* § 1(h)(11)(C)(iii).

[193] § 1291(a)(1)(A).

[194] § 1291(a)(1)(B).

[195] § 1291(c).

[196] § 1291(c)(1).

[197] § 1291(c)(1), (2) & (3).

[198] § 1291(a)(1)(C).

[199] § 1291(a)(2).

[200] § 1293(a).

[201] Prop. Treas. Reg. § 1.1291-6(c)(2)(iii)(A).

[202] Prop. Treas. Reg. § 1.1291-6(c)(2)(iii)(B).

Regulations treat a transfer upon death as a transfer by the shareholder immediately prior to death and thus reportable in the decedent's last tax return.[203]

(8) If the PFIC shares are held in a grantor trust, the grantor's death is a taxable disposition unless one of the exceptions applies.[204]

(9) PFIC shares are nominally eligible for a "step-up" in basis. However, section 1291(e)(1) provides that a succeeding shareholder's basis in PFIC shares is the fair market value of the shares on date of death but then reduced by the difference between the new basis under section 1014 and the decedent's adjusted basis immediately before date of death.[205] Thus, a succeeding shareholder's basis in PFIC shares received from a decedent is limited to the adjusted basis of the decedent prior to death.

(10) The foregoing basis reduction rule does not apply to PFIC shares received by a succeeding U.S. shareholder upon the death of a nonresident alien decedent if the decedent was a nonresident alien during his or her entire holding period.[206]

e. Qualified Small Business Stock (QSBS)

(1) Section 1202 provides that a portion or all of the gain from the sale or exchange of "Qualified Small Business Stock" (QSBS) will be excluded from gross income, provided the QSBS has been held for more than 5 years.[207] The exclusion is generally 50% of the gain.[208] The exclusion is increased to 75% for QSBS acquired after February 17, 2009 and before September 28, 2010, and to 100% for QSBS acquired after September 27, 2010, and before January 1, 2014.[209]

(2) In addition to the gain exclusion provisions above, section 1045 allows a taxpayer who realizes gain on the sale of QSBS to rollover the gain, without gain recognition, into new QSBS within a 60-day period beginning on the date of the sale.[210] To qualify for non-recognition, the taxpayer may not be a corporation, must have held the stock for six months at the time of the sale, and must affirmatively elect to apply section 1045. If the taxpayer so qualifies, the taxpayer will only recognize gain from the sale to the extent the amount realized on the sale of the QSBS exceeds the cost basis of any QSBS purchased during the 60-day period beginning on the date of sale, less any portion of the cost already used to shelter the amount realized with respect to the sale of other QSBS.[211]

---

[203] Prop. Treas. Reg. § 1.1291-6(d)(2).

[204] Prop. Treas. Reg. § 1.1291-6(c)(3)(iv).

[205] § 1291(e)(1).

[206] § 1291(e)(2).

[207] § 1202(a)(1).

[208] *Id.*

[209] §§ 1202(a)(3) and (a)(4). There is also an exclusion of 60% with respect to QSBS of certain empowerment zone businesses. *See* §§ 1202(a)(2)(A) and 1397C(b).

[210] § 1045(a).

[211] § 1045(a)(1).

(3) Because of the gain exclusion and gain rollover aspects of QSBS, most taxpayers should seek to make inter-vivos transfers of these assets out of their gross estates to the extent they exceed their transfer tax exclusions (both state and Federal). Simply put, heirs will not benefit as much from a "step-up" in basis because of the gain exclusion features of QSBS, and as discussed below, QSBS status can be retained and transferred through donative transfers to donees.

(4) QSBS is stock of a C corporation that is a Qualified Small Business (QSB) in an active business, issued after August 10, 1993 (the date section 1202 was enacted by the Revenue Reconciliation Act of 1993), and that satisfies the original issuance requirement.[212] In order to be considered a QSB, the aggregate gross assets of the corporation must not have exceeded $50,000,000 after August 10, 1993, before the issuance of the stock, and immediately after the issuance of the stock.[213] Only U.S. corporations can qualify for QSB status.[214]

(5) A corporation will meet the active business requirement if the corporation uses at least 80% of its assets (measured by fair market value) in the active conduct of one or more qualified trades or businesses.[215] A qualified trade or business is any trade or business other than:

(a) Any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees;

(b) Any banking, insurance, financing, leasing, investment or similar business;

(c) Any farming business;

(d) Any business involving the production or extraction of products that would provide depletion deductions under sections 613 and 613A (e.g., oil, natural gas, minerals, etc.); and

(e) Any business operating a hotel, motel, restaurant, or other similar businesses.

(6) The original issuance requirement is met if the taxpayer acquired the stock at its original issuance for money, property, or services provided to the issuing corporation.[216]

---

[212] § 1202(c).

[213] § 1202(d).

[214] § 1202(d)(1).

[215] § 1202(e). Also, the U.S. corporation may not be a DISC, a corporation for which a Section 936 election is in effect, a regulated investment company, real estate investment trust, or real estate mortgage investment conduit, or a cooperative. § 1202(e)(4).

[216] § 1202(c)(1)(B).

f. A taxpayer that receives QSBS as a gift or by death retains its character as QSBS, and the taxpayer is treated as having acquired the stock in the same manner as the transferor with a tacking of the transferor's holding period.[217] If the transfer is by death, the QSBS receives a "step-up" in basis under section 1014, but appreciation after date of death would continue to be eligible for gain exclusion under section 1202.

g. If a partnership transfers stock to a partner, the partner is treated as having acquired the stock in the same manner as the partnership did.[218] As such, if the partnership met all of the QSBS stock eligibility requirements, the stock will be considered QSBS in the hands of the partner, and the partner's holding period will be deemed to include any time held by the partnership.[219]

h. As one might expect, the Code and the Treasury Regulations are silent as to whether stock retains its character as QSBS if it is transferred in an installment sale to an IDGT. Presumably, because the sale is ignored for income tax purposes and losing grantor trust status (whether due to death or otherwise) is akin to a donative transfer at that time, as discussed in more detail below, QSBS status passes to the IDGT.

C. Why Partnerships?

1. For many years the one of the primary reasons entities taxed as partnerships (general partnerships, limited partnerships, limited liability companies, etc.) were used in estate planning was to take advantage of valuation discounts. With the ascension of income tax planning, estate planning will become increasingly focused on: proactive tax basis management (maximizing the step-up in basis) and income tax deferral and avoidance.

2. Entities taxed as partnerships are the only vehicles flexible enough to allow families to change the basis of assets without death or a taxable event and also shift income among family taxpayers (including trusts and other business entities) without requiring a taxable gift. The hurdle that practitioners must overcome is the complexity of subchapter K, which can be daunting.

3. The remainder of this outline is focused on how partnerships can be used in the new estate planning landscape. It will discuss different partnership designs, elections, and provisions for estate planners to consider.

---

[217] §§ 1202(h)(1), (2)(A) and (B).

[218] § 1202(h)(2)(C).

[219] § 1202(h)(1). *See* Treas. Reg. § 1.1045-1(e)(3)(i).

## II. TAX BASIS MANAGEMENT AND THE FLEXIBILITY OF PARTNERSHIPS

### A. Generally

1. There are limited ways of changing the basis of an asset without having a recognition event for income tax purposes. The donee of a gift generally acquires "carryover" basis[220] increased by any Federal gift tax paid attributable to any appreciation in the property transferred.[221] Moreover, if the fair market value of the gift is less than the donor's basis, the donee's basis on a subsequent sale of the property will depend on whether the sale creates a gain or a loss. If the donee recognizes a loss, the donee's basis for purposes of determining the recognizable amount of such loss is the fair market value of the property at the time of the gift. If the donee recognizes a gain, the donee's basis for purposes of determining the recognizable amount of such gain is the donor's basis at the time of the gift. A sale at an amount somewhere in between the basis for determining loss and the basis for determining gain results in no gain or loss recognized. [222] As discussed above, the basis of most assets will get a "step-up" in basis if acquired from a decedent under section 1014(a).

2. Estate planners should consider using entities treated as partnerships for tax purposes to proactively manage the tax basis of the assets of families. The partnership rules provide sufficient planning flexibility to shift and change the basis of property through distributions (both non-liquidating and liquidating distributions) and the use of certain elections like the section 754 election. For example, a partnership could distribute a high basis asset into the hands of a partner with zero outside basis. The basis of the property in the hands of the partner generally would become a zero basis asset eligible for a "step-up" in basis on the subsequent death of the partner.[223] With a section 754 election, the "stripped" basis (i.e., the partnership's basis in the asset immediately prior to the distribution) would allow an upward basis adjustment to the other assets remaining inside the partnership.[224] Furthermore, because partnership debt can create tax basis to certain partners, the careful management of each partner's allocable share of that debt can increase or decrease basis.[225] Notwithstanding the general rules above, other provisions of subchapter K must be considered, including the "mixing bowl" transaction and disguised sale rules.[226]

3. Understanding and proactively using the subchapter K rules concerning the basis of assets inside a partnership and the outside basis that the partners have in their partnership interests thus can become a valuable tax-saving tool for the estate planner. In particular, estate planners should have a working knowledge of the following subjects pertaining to subchapter K and the income tax treatment of partnerships:

a. Unitary basis rules;

---

[220] § 1015(a).

[221] § 1015(d).

[222] § 1015(a) and Treas. Reg. § 1.1015-1(a)(1) & (2).

[223] §§ 732(a)(2) and 1014(a).

[224] § 734(b).

[225] § 752.

[226] §§ 704(c)(1)(B), 707(a)(2)(B), 731(c), 737, and 751(b).

b. Non-liquidating "current" distributions of partnership property;

c. Liquidating distributions of partnership property;

d. "Mixing Bowl" transactions;

e. Partnership liabilities and basis;

f. Section 754 election and inside basis adjustments;

g. Partnership divisions; and

h. Anti-abuse rules.

B. Anti-Abuse Rules

1. In 1995, the IRS issued "anti-abuse" Treasury Regulations[227] that permit the IRS to recharacterize any transaction that involves a partnership if a principal purpose of the transaction is to reduce the present value of the partners' "aggregate Federal tax liability" in a manner inconsistent with the intent of subchapter K.[228] The breadth of these provisions are potentially infinite, but generally apply to artificial arrangements. The discussion herein focuses on only those arrangements that result in changes in tax basis in light of attempting to maximize the "step-up" in basis.

2. The Treasury Regulations provide that the following requirements are implicit in the "intent" of subchapter K:

a. The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose;[229]

b. The form of each partnership transaction must be respected under substance over form principles;[230] and

c. The tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income (collectively, proper reflection of income) or "the application of such a provision [of subchapter K] to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision."[231]

3. The Treasury Regulations provide that certain of the factors that may be taken into account in determining whether a partnership was formed or availed of with a principal

---

[227] Treas. Reg. § 1.701-2.

[228] Treas. Reg. § 1.701-2(b).

[229] Treas. Reg. § 1.701-2(a)(1).

[230] Treas. Reg. § 1.701-2(a)(2).

[231] Treas. Reg. § 1.701-2(a)(3).

purpose to reduce substantially the present value of the partners' aggregate Federal tax liability in a manner inconsistent with the intent of subchapter K. Some of those factors are:

a. The fact that substantially all of the partners (measured by number or interests in the partnership) are related (directly or indirectly) to one another;

b. The present value of the partners' aggregate Federal tax liability is substantially less than it would have been had the partners owned the partnership's assets and conducted the partnership's activities directly;

c. The benefits and burdens of ownership of contributed property are retained by the contributing partner, or the benefits and burdens of ownership of partnership property are shifted to the distributee partner, before and after the property actually distributed;

d. The present value of the partners' aggregate Federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction; and

e. Partners who are necessary to claiming a certain tax position but who have a nominal interest in the partnership, are substantially protected from any risk of loss, or have little or no participation in profits other than a preferred return that is a payment for the use of capital.[232]

4. Pertinent to the concept of changing the tax basis of property, the Treasury Regulations provide 2 examples of situations that generally indicate that basis shifts resulting from property distributions are allowable under the anti-abuse provisions:

a. The first example involves a liquidating distribution of appreciated, nonmarketable securities from a partnership without a section 754 election in place. The distribution resulted in a stepped-up basis in the securities. Because no section 754 was in place, there was no downward basis adjustment by the amount of untaxed appreciation in the asset distributed. The example acknowledges that the remaining partners will enjoy a timing advantage because the adjusted bases of the remaining assets were not adjusted downward. Further, the example provides that the partnership and the liquidating partner had as a principal purpose to take advantage of the basis shift. Notwithstanding the foregoing, the Treasury Regulations conclude this does not violate the anti-abuse provisions.[233]

b. The second example involves a liquidating distribution of an appreciated, non-depreciable asset, and depreciable property with a basis equal to its fair market value. The distribution resulted in a shift of basis from the non-depreciable asset to the depreciable asset (adding basis in excess of fair market value). This resulted in additional depreciation deductions and tax benefits to the liquidated partner. The example provides that the partnership and the liquidating partner had as a principal purpose the foregoing tax advantage to the liquidating partner. Notwithstanding the foregoing, the Treasury Regulations conclude this does not violate the anti-abuse provisions.[234]

---

[232] Treas. Reg. § 1.701-2(c).

[233] Treas. Reg. § 1.701-2(d), Ex. 9.

[234] Treas. Reg. § 1.701-2(d), Ex. 10.

5. The Treasury Regulations do provide an example of an abusive situation. In that example, a partner contributes property with inherent loss to a partnership formed for the purpose by related parties, who contribute cash, used to purchase a nonmarketable security with a value and inside basis equal to the value of the contributed property. The contributor will have a section 704(c) allocation of the inherent loss and an outside basis equal to the value of the contributed loss property. The property is leased for three years to a prospective purchaser, who has an option to purchase at the value at the time of the contribution. Three years later, but before the sale under the option, the contributor receives a liquidating distribution of the other property with an inside basis equal to the value of the contributed property,[235] but that will have a distributed transferred basis equal to the basis of the contributed property, so that the contributor still has the original inherent loss. The sale by the partnership of the contributed loss property, recognizing the loss after the contributor has withdrawn from the partnership, results in a partnership loss that is allocated to the related partners since the loss that would have been allocated under section 704(c) to the contributor is no longer a partner. The Treasury Regulations conclude that this situation is abusive.[236]

6. Notwithstanding the existence of these anti-abuse rules, the IRS may also rely on non-statutory principles like substance-over-form, step-transaction, and sham-transaction doctrines to recast certain partnership transactions.[237]

7. In addition to the anti-abuse rules, some mention should be made about the codification of the economic substance doctrine under section 7701(o) of the Code.[238] It provides, in pertinent part, "In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if— the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction."[239] However, the Code provides an exception for "personal transactions of individuals" and "shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income."[240] It is unclear to what extent this provision could apply to the planning techniques discussed in this outline, particularly since this new paradigm in estate planning combines both transfer tax and income tax planning.

---

[235] This transaction might have a different result today. Section 704(c)(1)(C), enacted in the American Jobs Creation Act of 2004, P.L. 108-357, provides that contributed property has a "built-in loss," for purposes of allocating income to other partners, the inside basis will be treated as being equal to its fair market value at the time of contribution.

[236] Treas. Reg. § 1.701-2(d), Ex. 8. *See also* FSA 200242004 (Transfer of loss property to tax partnership, a sale of the partnership interest to unrelated party with no Section §754 election in effect, followed by sale of loss property by the partnership. The transaction was recharacterized under Treas. Reg. § 1.701-2 as sale of assets).

[237] Treas. Reg. § 1.701-2(i).

[238] Health Care and Education Reconciliation Act of 2010, P.L. 111-152, § 1409 (Mar. 30, 2010).

[239] § 7701(o)(1).

[240] § 7701(o)(5)(B).

C. Unitary Basis Rules

1. A partner has a "unitary basis" in his or her partnership interest, even if the partner has different classes of partnership interest (general and limited, preferred and common, etc.) and even if the partner acquired the partnership interests in different transactions.[241] This is in contrast to the "separate lot" rules applicable to shares of corporate stock when such separate lots can be "adequately identified."[242]

2. Under this unitary basis concept, basis is generally allocated in property to the relative fair market value of different interests when determining such basis allocation is relevant (for example, the sale of a partnership interest or a distribution of property in redemption of a partnership interest). When, however, partnership liabilities exist, changes in a partner's share of debt must be taken into account (deemed distributions and contributions of cash under section 752) in determining basis (corresponding additions or reductions of outside basis under sections 722 and 733).[243]

3. A partner will have a split holding period in his or her partnership interest if the partner acquires his or her partnership interest by contributing assets with different holding periods or by subsequent contributions. The split holding periods are allocated generally in proportion to the fair market value of the property in question.[244]

4. Unitary basis is determined on a partnership by partnership basis even, so it seems, if a partner has an interest in 2 or more partnerships that are identical in all respects (including the interests of other partners) except, perhaps the assets in the partnership, there does not seem to be a statutory rule that the unitary basis of the partner must be aggregated. This may have important planning implications in estate planning as it bears to reason that it might make sense for taxpayers to segregate low basis and high basis assets into different partnerships.

5. In estate planning, it is common for grantors to simultaneously own interests in FLPs individually and deem to own, for income tax purposes, FLP interests in an IDGT due to grantor trust status. This assumes that grantor trust status equates to the IDGT being disregarded or ignored for income tax purposes, and thus, the grantor will be treated for all income tax purposes as the owner of the trust assets. This apparently is the position of the government. Revenue Ruling 85-13[245] provides that a "defective grantor trust" will be "ignored" for income tax purposes. As discussed later in this outline regarding the use of disregarded entities in transfer tax planning, however, the cases, Code, and Treasury Regulations are not necessarily consistent with this interpretation.

6. In any case, assuming an IDGT may be "ignored" for income tax purposes, because of the unitary basis rule, subsequent contributions of high basis property by the grantor will result in proportional increases (in a pro rata FLP) to the outside basis of the IDGT

---

[241] Rev. Rul. 84-53, 1984-1 C.B. 159. *Cf.* PLR 200909001 (the unitary basis rule does not apply to publicly-traded partnership interests).

[242] *See* Treas. Reg. § 1.1012-1(c). Even if lots cannot be identified, then a first-in, first-out accounting convention is used to determine gain or loss.

[243] *See* Treas. Reg. 1.752-1.

[244] *See* Treas. Reg. § 1.1223-3.

[245] Rev. Rul. 85-13, 1985-1 C.B. 184.

partnership interests. Given that the FLP interests held by the IDGT will generally not benefit from a "step-up" in basis at the death of the grantor, this can have the advantage of increasing the basis of the FLP interests without requiring an additional transfer to the trust or estate tax inclusion. Of course, if the grantor has a power to swap assets of equivalent value, exchanging high basis assets for the FLP interests is likely to be more advantageous from a basis increase standpoint.

D. Current and Liquidating Distributions

1. Non-Liquidating "Current" Distributions

a. Cash Distributions

(1) Unless a distribution (or a series of distributions) results in a termination of a partner's interest in a partnership, it will be considered a non-liquidating or "current" distribution.[246] Since most FLPs are structured as "pro rata" partnerships,[247] it is important to recognize that, generally, there is no gain or loss on pro rata current distributions regardless of the type of asset being distributed,[248] unless cash distributed exceeds the outside basis of the partnership interest of any of the partners.[249]

(2) Distributions of cash (including a reduction in a partner's share of liabilities and distributions of marketable securities[250]) to a partner reduces the partner's outside basis, with gain recognized to the extent the cash distributed exceeds outside basis.[251] No loss is ever recognized on a current distribution.[252] Any gain resulting from a current distribution of cash is considered capital gain that would result from a sale of the partner's interest.[253] The gain may be ordinary income if the distribution results in a disproportionate sharing of certain "unrealized receivables" and "inventory items" of the partnership (section 751 assets).[254] The definitions of these types of assets (sometimes referred to as "hot assets") include more things than might be obvious. Unrealized receivables include rights to payment for goods or services not previously included in income,[255] and recapture property, but only to the extent unrealized gain is ordinary income (as discussed above). "Inventory items" include any property described in

---

[246] Treas. Reg. § 1.761-1(d).

[247] This is generally due to the "same class" exception under § 2701(a)(2)(B). With respect to this exception, the Treasury Regulations provides, "[a] class is the same class as is (or is proportional to the class of) the transferred interest if the rights are identical (or proportional) to the rights of the transferred interest, except for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability)." Treas. Reg. § 25.2701-1(c)(3).

[248] § 731(a)(1) and Treas. Reg. §§ 1.731-1 and 1.732-1(b).

[249] § 731(a)(1) and Treas. Reg. § 1.731-1(a).

[250] § 731(c) and Treas. Reg. § 1.731-2.

[251] § 733(a) and Treas. Reg. § 1.733-1.

[252] §§ 731(a)(2) and 731(b). A loss may only occur with a liquidating distribution. Treas. Reg. §1.731-1(a)(2).

[253] § 731(a).

[254] § 751.

[255] § 751(b) and Treas. Reg. § 1.751-1(b)(2), (d)(1).

section 1221(a)(1) (inventory or other property held for sale to customers in the ordinary course of business and any other property that would not result in capital gain or gain under section 1231 (accounts receivables).

(3) The holding period of any gain from the distribution of cash is determined by the partner's holding period in his or her partnership interest.[256] If the partner acquired his or her partnership interest by contributing property to the partnership (typically in a non-recognition[257] transaction), the holding period of the property transferred is added to the partnership interest's holding period.[258] If the partner acquires the partnership interest at different times, the partnership interest will have different holding periods, allocated in proportion to the fair market value of the contributed property.[259]

(4) It should be noted that if a partner transferred his or her partnership interest in exchange for cash (or other property), the tax rate on capital gain may be different than if the partner received cash from the partnership in liquidation/redemption of the partnership interest. The planning opportunities that might arise as a result of this anomaly is discussed in more detail later in this outline.

(a) Upon a sale or exchange, the transferor recognizes gain under rules similar to section 1001.[260] The transferee of the partnership interest takes a cost basis in the partnership interest equal to the consideration paid,[261] and carries over the transferor's capital account and share of forward and reverse section 704(c) gain in the partnership assets, if any.[262]

(b) The character of the gain is capital subject to recharacterization under section 751(a). The transferor partner recognizes ordinary income or loss in an amount equal the income or loss that would be allocated to the partner if the partnership sold all of the partnership assets at fair market value.[263] Capital gain or loss is recognized in an amount equal to the gain or loss that would be calculated under section 1001 minus the ordinary income (or plus the ordinary loss) computed under section 751(a).[264]

(c) All of the foregoing provides for similar results to a cash distribution to a partner. For determining the rate of tax on the capital gain, on the other hand, one looks through to the underlying partnership assets.[265] Thus, depending on the assets held by

---

[256] *See* GCM 36196 and *Commissioner v. Lehman*, 165 F.2d 383 (2d Cir. 1948), *aff'g* 7 T.C. 1088 (1946), *cert. denied*, 334 U.S. 819 (1948).

[257] § 721.

[258] §§ 1223(1), 1223(2) and 723; Treas. Reg. §§ 1.1223-1(b) and 1.723-1.

[259] Treas. Reg. § 1.1223-3(a), (b) and (f), Ex. 1; *See* T.D. 8902, *Capital Gains, Partnership, Subchapter S, and Trust Provisions*, 65 Fed. Reg. 57092 (9/21/00).

[260] *See* § 741.

[261] Treas. Reg. § 1.704-1(b)(2)(iv)(b).

[262] Treas. Reg. § 1.704-3(a)(7).

[263] Treas. Reg. § 1.751-1(a)(2).

[264] *Id.*

[265] *See* § 1(h)(5)(B), (h)(9), and (h)(10). Treas. Reg. § 1.1(h)-1(a).

the partnership, the transferor partner may recognize capital gain at a 20%, 25%, and 28% federal rate.

b. Property Distributions

(1) Neither the partner nor the partnership will recognize any gain or loss upon a distribution of property,[266] unless the property is a marketable security (treated as cash)[267] or is a "hot asset" under section 751 (mentioned above). If the distributed property is subject to indebtedness, any net change (typically an increase) in the partner's share of liability is treated as a contribution (in most cases) or a distribution of cash by the partner, and the distributed property is distributed without recognizing any gain.[268]

(2) The basis of the distributed property in the hands of the partner is based on the tax basis that the partnership had in the property prior to the distribution (the "inside basis").[269] The basis of the distributed property will, however, be limited to the outside basis of the partner's partnership interest, as adjusted for cash distributions (reduction) and changes in liabilities because the distributed property is encumbered with debt.[270] This limitation, effectively, transfers the inherent gain in the partnership interest (outside basis) to the distributed property. When multiple properties are distributed and the outside basis limitation is triggered, the outside basis is allocated first to section 752 property and any excess to other property.[271] All other distributed property once all outside basis has been exhausted will have a zero basis.

(3) Generally speaking, the character of the distributed property in the hands of the partner will be determined at the partner level, with the exception of unrealized receivables and inventory items, as defined in section 751.[272] This provision prevents a partner from converting an ordinary income item, like inventory in the partnership's hands, into a capital asset. The holding period of the distributed property includes the holding period of the partnership.[273]

---

[266] § 731(a)-(b) and Treas. Reg. § 1.731-1(a)-(b). Although the "mixing bowl" rules may apply to trigger gain to a partner who contributed the distributed property. §§ 704(c)(2)(B) and 737.

[267] § 731(c) and Treas. Reg. § 1.731-2.

[268] Treas. Reg. § 1.752-1(e) and (g).

[269] § 732(a)(1) and Treas. Reg. § 1.732-1(a). Note, that if a Section 754 election is in place or if the partnership had a substantial built-in loss under Section 743(d), the inside basis includes any basis adjustment allocable to the partner under Section 743(b) but only as they relate to the partner. If the distributed property is not the property that was the subject of the basis adjustment under Section 743(b), the adjustment is transferred to the distributed property in the same class (capital gain or ordinary property). Treas. Reg. § 1.755-1(a).

[270] *See* Treas. Reg. §§ 1.732-1, 1.736-1(b)(1), and 1.743-1(d)(1).

[271] § 732(c)(1)(A)(i) and Treas. Reg. § 1.732-1(c)(1)(i).

[272] § 735(a).

[273] § 735(b). Note, the holding period of the partner's interest in the partnership is generally irrelevant when determining the holding period of distributed property.

c. Partnership Inside Basis

(1) When gain is recognized on a distribution (cash in excess of outside basis) or when the basis of the distributed property is reduced because outside basis is less than the basis of the property prior to the distribution, absent a section 754 election, there is no adjustment to the partnership's inside basis. This gives may give rise to a temporary duplication of gain or to a loss of basis to the partnership (and to the partners).

(2) If a section 754 election is made, an adjustment of basis under section 734(b) occurs when a partner recognizes gain due to a distribution (or deemed distribution) of cash in excess of outside basis, or property is distributed that results in a reduction of basis on the distributed property.[274] The adjustment results in an increase to the inside basis of the partnership assets. The basis increase is allocated among two different classes of assets: (i) capital and section 1231 assets, and (ii) ordinary income property.[275] Any basis adjustment due to gain from a distribution of cash must be allocated to capital assets.[276] Any increased basis adjustment is allocated first to appreciated property in proportion to the amount of unrealized appreciation, with any remaining increase allocated to all of the properties within the same class in proportion to fair market values.[277] Thus, there is a possibility of allocating basis to an asset above its fair market value, creating the possibility of a recognizable loss to the partners. Adjustments under section 734(b) are discussed in more detail later in this outline.

2. Liquidating Distributions

a. Liquidating distributions (whether in one distribution or a series of distributions) terminate the liquidated partner's entire interest in a partnership.[278] Liquidating distributions are treated the same as current distributions except a loss may be recognized,[279] and the basis of property distributed to a partner may be increased (discussed below).[280] The only way to recognize a loss upon a liquidating transfer is if the distribution consists only of cash (but not including marketable securities[281]) and section 751 assets (hot assets).[282]

b. In the estate planning context, most partnerships are structured as "pro rata" or single class share partnerships because of the "same class" exception under section 2701(a)(2)(B). With respect to this exception, the Treasury Regulations provides, "[a] class is the same class as is (or is proportional to the class of) the transferred interest if the rights are identical (or proportional) to the rights of the transferred interest, except for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to

---

[274] § 734(b)(1).

[275] Treas. Reg. §§ 1.755-1(a)(1) and 1.755-1(c)(1).

[276] Treas. Reg. § 1.755-1(c)(1)(ii).

[277] Treas. Reg. § 1.755-1(c)(1)(i).

[278] § 761(d).

[279] § 731(a)(2) and Treas. Reg. § 1.731-1(a)(2).

[280] § 732(b), 732(c), and Treas. Reg. § 1.732-1(b).

[281] § 731(c)(1) refers to § 731(a)(1), the gain provision, not § 731(a)(2), the loss provision.

[282] § 731(a)(2). Treas. Reg. §§ 1.731-1(a)(2) and 1.732-1(c)(3).

management and limitations on liability)."[283] In order to qualify for this exception, it generally requires that distributions must be made proportionately and at the same time (and perhaps with the same assets). In order to effectuate a disproportionate distribution of property to, for example, an older partner with limited outside basis (trying to maximize the benefit of the "step-up"), one would need to redeem a portion of the partner's interest (lower the percentage ownership), which would be considered a current distribution, or liquidate the partner.

c. When property is distributed in liquidation of a partner's interest, for purposes of determining the basis in the hands of the former partner, the Code provides the basis in section 751 assets cannot exceed the transferred basis.[284] However, basis of other property distributed can be increased if the liquidated partner's outside basis (reduced by cash distributed and adjusted for any change in the partner's share of liabilities as a result of the distribution) is greater than the inside basis of the assets distributed.[285] If the transferred basis is in excess of the fair market value of the distributed asset, then a loss can be recognized on a subsequent sale or, if the property is depreciable, depletable or amortizable, the added basis can provide tax benefits in the form of ongoing deductions.

d. The basis adjustments to the partnership are the same as discussed with current distributions, in particular, if there is a section 754 election in place. With respect to liquidating distributions, the inside basis adjustments may be increased or decreased (rather than only increased in a current distribution). This is because a liquidating distribution may result in a loss to the withdrawing partner,[286] and a property distribution may result an increased tax basis.[287] Another difference with liquidating distributions exists when there is a substantial basis reduction. Under section 734(a), an inside basis adjustment is not required upon a distribution of property to a partner, unless a section 754 election is in place or unless "there is a substantial basis reduction with respect to such distribution,"[288] which will exist if the amount exceeds $250,000.[289] There will be a substantial basis reduction when the sum of: (i) any loss recognized by the liquidating partner, and (ii) the excess of the basis of distributed property to the liquidated partner over the partnership's transferred inside basis, exceeds $250,000. For example, if a partner with an outside basis of $2 million is distributed an asset with an inside basis of $1 million in full liquidation of his or her interest, then under section 732(b) of the Code, the partner's basis in the distributed asset is now $2 million. Because the partner's basis in the asset now exceeds the partnership's basis in the asset by more than $250,000, there is a substantial basis reduction. Consequently, the partnership must reduce the basis of its remaining assets by $1 million as if a section 754 election were in effect.[290]

---

[283] Treas. Reg. § 25.2701-1(c)(3).

[284] § 732(c)(1)(A) and Treas. Reg. § 1.732-1(c)(1)(i).

[285] § 732(b) and Treas. Reg. § 1.732-1(b).

[286] § 734(b)(2)(A) and Treas. Reg. §1.734-1(b).

[287] § 734(b)(2)(B) and Treas. Reg. §1.734-1(b).

[288] § 734(a).

[289] § 734(d). The subsection refers to § 734(b)(2)(A), which in turn refers to §731(a)(2) relating to liquidating distributions, and § 734(b)(2)(B), which refers to § 732(b) also relating to liquidating distribution.

[290] *See* IRS Notice 2005-32, 2005-1 C.B. 895.

e. Adjustments for the gain or loss on the partnership interest, or for distributed capital or section 1231 assets may be made only to the inside basis of capital or section 1231 assets, while adjustments to reflect a limitation on the basis of ordinary income property are allocated only to partnership ordinary income property. There may be a positive adjustment for ordinary income assets, and a negative adjustment for capital assets, or the reverse, but no positive adjustment for one capital or ordinary income asset, and negative adjustment for another.[291] Like the adjustments for current distributions, positive adjustments for a class are allocated to appreciated properties, first, in proportion to unrealized gain, and then to all properties in proportion to fair market value.[292] Similarly, reductions in partnership assets are allocated first to property that has declined in value in proportion to the unrealized loss, then to all properties in proportion to their adjusted basis.[293]

3. Distributions and "Hot Assets"

a. Section 751 was enacted to prevent partners from converting ordinary income to capital gain through sales or exchanges of their partnership interests or through distributions of partnership property. Generally, the Code provides that any consideration received by a partnership in exchange for his or her partnership interest that is attributable to unrealized receivables or inventory items ( "hot assets") shall be treated as an amount realized in exchange for property other than a capital assets.[294] In other words, to the extent applicable, it converts what otherwise would be considered capital gain (sale of a partnership interest) to ordinary income.

b. Section 751(b) provides that if a partner receives a distribution of hot assets (sometimes referred to as "section 751(b) property") in exchange for all or part of his or her partnership interest,[295] or receives other partnership property (not hot assets) in exchange for all or part of his or her interest in such hot assets,[296] then the transaction will be considered a sale or exchange between the distributee partner and the partnership (as constituted after the distribution). Section 751(b) applies to both non-liquidating distributions as well as liquidating distributions.[297] In effect, section 751(b) only applies to distributions involving an exchange of interests in one class of property for another class of property (ordinary for capital/capital for ordinary). As such, section 751(b) does not apply to distributions of one partner's share of both section 751(b) property and other property.[298] Furthermore, if a partnership has only one class of property (e.g., no hot assets), then section 751(b) will never apply. Thus, any disproportionate distribution of partnership property that results in any partner receiving more or less than his or her proportionate share of the hot assets will trigger section 751(b).

c. If section 751(b) applies to a distribution, then income inclusion is required. If, by way of example, a partner receives a disproportionate distribution of section

---

[291] Treas. Reg. § 1.755-1(c)(2).

[292] Treas. Reg. § 1.755-1(c)(2)(i).

[293] Treas. Reg. § 1.755-1(c)(2)(ii).

[294] § 751(a).

[295] § 751(b)(1)(A).

[296] § 751(b)(1)(B).

[297] *See* Treas. Reg. § 1.751-1(b)(1).

[298] *See* Rev. Rul. 57-68, 1957-1 C.B. 207.

751(b) (hot assets), then the partner will realize capital gain. If, on the other hand, the partner a disproportionate distribution of other property, then the partner will realize ordinary income.

d. In determining whether there has been a disproportionate shift of hot assets or other property, the Treasury Regulations provide for a hypothetical transaction involving:

(1) Current distribution of partnership property relinquished by the distributee partner (the partner's decreased interest in section 751(b) property or other property) in order to determine the partner's tax basis in the relinquished property;[299] and

(2) Partnership sale of the increased share in the other section 751(b) property in exchange for the property relinquished by the partner.[300]

e. The Code provides two specific exceptions to section 751(b). It does not apply to distributions of property to a partner who contributed the property to the partnership.[301] Section 751(b) also does not apply to section 736(a) payments made to a retiring partner or a successor in interest of a deceased partner.[302]

f. Originally, the definition of "unrealized receivables" under section 751(c) only included rights to payments for services and rights to payments for goods. Since its enactment, 751(c) property has been expanded to include many additional types of property, the sale of which would result in the realization of ordinary income.[303] In particular, the following types of assets have been added as "unrealized receivables" for purposes of section 751:

(1) Section 1245 property, but only to the extent that ordinary income would be recognized under section 1245(a) if a partnership were to sell the property at its fair market value.[304] The amount is treated as an unrealized receivable with a zero basis. Section 1245 property includes property which allows for depreciation other than buildings or their structural components.[305]

(2) Section 1250 property but only to the extent that ordinary income would be recognized under section 1240(a) if a partnership were to sell the property at its fair market value.[306] Section 1250 property is any depreciable property other than section 1245 property.[307] Generally, gain which is treated as ordinary income under section 1250(a) is the

---

[299] *See* Treas. Reg. §§ 1.751-1(b)(1)(iii), 2(iii), and 3(iii).

[300] *See* Treas. Reg. §§ 1.751-1(b)(1)(iii), 2(ii), and 3(ii).

[301] § 751(b)(2)(A).

[302] § 751(b)(2)(B).

[303] One court ruled that section 751(c) "invites a liberal construction by stating that the phrase 'unrealized receivables' *includes* certain specified rights, thereby implying that the statutory definition of term is not necessarily self-limiting." *Logan v. Commissioner*, 51 T.C. 482, 486 (1968).

[304] § 704(c) and Treas. Reg. §§ 1.751-1(c)(4)(iii), -1(c)(5).

[305] § 1245(a)(3).

[306] Treas. Reg. §§ 1.751-1(c)(4)(v), -1(c)(5), -1(a)(1)(i) and -1(a)(2)(ii).

[307] § 1250(c).

lower of: (a)" additional depreciation" taken after 1975, and (b) the gain realized on the disposition of the property.[308] "Additional depreciation" generally refers to section 1250 property held for one year or less, all depreciation taken (in that one year or less), and for section 1250 property held for more than one year, the excess of the depreciation taken over the amount of depreciation which would have been taken if the straight-line method of depreciation had been used. Since TRA 1986, the "applicable recovery period" for most commercial real property assets are placed in 27.5 or 39-year recovery periods, while land improvements fall within 15 or 20-year recovery periods.[309] Most importantly, the depreciation method for nonresidential and residential real property is straight line.[310] Thus, most commercial real property assets would fall out of the definition of "unrealized receivables" and would not be considered a "hot" section 751(b) asset.

(3) Amortizable section 197 intangibles (patents, copyrights, goodwill, going concern value, etc.), which by definition are held in connection with a trade or business or an activity described in section 212.[311] Amortizable section 197 intangibles are treated as property which is of the character subject to the allowance for depreciation,[312] and these assets are subject to section 1245 recapture.[313] Generally, this does not include self-created intangibles,[314] so intangible assets in the hands of the creator (or held by a donee of such intangible) would fall out of the definition of "unrealized receivables" and would not be considered a "hot" section 751(b) asset.

(4) Section 1248 stock of a controlled foreign corporation (CFC) to the extent that ordinary income would be recognized under section 1248(a) if a partnership were to sell the CFC stock at its fair market value.[315] The amount is treated as an unrealized receivable with a zero basis. The ordinary income under these circumstances is generally the "dividend," which is determined, in part, by the additional corporate income tax that would have been paid by the CFC if it had been taxed as a domestic corporation plus the tax which would have been paid by the taxpayer by including in gross income (as long-term capital gain).[316]

(5) Section 1254 property, which includes oil, gas, geothermal, or other mineral property, to the extent that ordinary income would be recognized under section 1254(a) if a partnership were to sell the property at its fair market value.[317] The amount is treated as an unrealized receivable with a zero basis. Section 1254 recaptures certain previously expensed amounts as ordinary income to the extent of gain realized on the disposition of section 1254 property. Amounts deducted under sections 263 (capital expenditures), 616 (development expenditures with respect to a mine or other natural deposit other than an oil or gas well), and

---

[308] § 1250(a)(1)(A).

[309] § 168(c).

[310] § 168(b).

[311] *See* §§ 197(c) and (d)(1).

[312] § 197(f)(7) and Treas. Reg. § 1.197-2(g)(8).

[313] *See* Treas. Reg. § 1.197-2(g)(8).

[314] § 197(c)(2).

[315] *See* § 751(c) and Treas. Reg. §§ 1.751-1(c)(4)(iv), -1(c)(5).

[316] § 1248(b) and Treas. Reg. § 1.1248-4.

[317] § 751(c) and Treas. Reg. §§ 1.751-1(c)(4)(ix), -1(c)(5).

617 (mining exploration expenditures), which otherwise would have been included in the property's adjusted tax basis, must be recaptured as ordinary income.[318] In addition, any amount deducted under section 611 (deduction for depletion) must be recaptured to the extent it reduced the tax basis (e.g., cost depletion) of the section 1254 property.[319] The calculation for section 1254 property is determined at the partner level, not at the partnership.[320]

(6) Section 617(f)(2) mining property to the extent of the amount that would be treated as ordinary income under section 617(d)(1) if a partnership were to sell the mining property at its fair market value.[321] The amount is treated as an unrealized receivable with a zero basis. Pursuant to section 617(a), a taxpayer can elect to deduct, as ordinary and necessary business expenses, expenditures paid or incurred during the taxable year and prior to the beginning of the development stage of the mine, for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral. In general, under section 617(d)(1), a portion of the gain recognized on the sale or other disposition of mining property is treated as ordinary income (the deducted exploration expenditures).

(7) Section 1252(a)(2) farm land to the extent that ordinary income would be recognized under section 1252(a)(1) if a partnership were to sell the property at its fair market value.[322] The amount is treated as an unrealized receivable with a zero basis. Section 1252 generally provides that, if a taxpayer has held farm land for less than 10 years and has elected to deduct soil and water conservation expenditures under section 175, then upon disposition of the land, the taxpayer is required to treat a portion of the gain as ordinary income.[323]

(8) Section 1253 property, to the extent that ordinary income would be recognized under section 1253(a) if the partnership were to sell the property at its fair market value. The amount is treated as an unrealized receivable with a zero basis. Under §1253(a), the transfer of a franchise, trademark, or trade name is not treated as a sale or exchange of a capital asset if the transferor retains any "significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark or trade name."[324]

(9) Partnership property subject to basis reduction under section 1017, relating to income from discharge of indebtedness that is excluded from income under section 108(a). These are reductions are treated as depreciation subject to section 1245 or section 1250 recapture.

(10) Market discount bonds to the extent that ordinary income would be recognized under section 1276(a) if a partnership were to sell the bonds at fair market value.[325] The amount is treated as an unrealized receivable with a zero basis. Section 1276(a) provides

---

[318] *See* § 1254(a)(1)(A)(i) and Treas. Reg. § 1.1254-1(b)(1)(i)(A).

[319] *See* § 1254(a)(1)(A)(ii) and Treas. Reg. § 1.1254-1(b)(1)(i)(B).

[320] *See* Treas. Reg. § 1.1254-5(b)(1).

[321] *See* Treas. Reg. §§ 1.751-1(c)(4)(i) and -1(c)(5).

[322] *See* Treas. Reg. §§ 1.1252-1(a), 1.751-1(c)(4)(vii), and -1(c)(5).

[323] § 1252(a).

[324] § 751(c) and Treas. Reg. §§ 1.751-1(c)(4)(viii), -1(c)(5).

[325] § 751(c) and Treas. Reg. § 1.751-1(c)(5).

that gain recognized upon the disposition of any market discount bond[326] is treated as ordinary income to the extent of "accrued market discount" on the bond. The term "market discount bond" means any bond having "market discount."[327] The term "market discount" means the excess of the stated redemption price of the bond over the basis of the bond immediately after its acquisition by the taxpayer.[328]

4. Mixing Bowl Transactions

a. Because both property contributions to and distributions from a partnership are generally non-recognition events, partnerships could be used to exchange property without recognizing income despite the fact that the properties would not have qualified as a like-kind exchange under section 1031. The partnership would be treated as a "mixing bowl" where assets are commingled and then the partnership is dissolved, each partner walking away with a different mixture of assets. As a result of this perceived abuse, Congress enacted the "mixing bowl transaction" provisions of sections 704(c)(1)(B) and 737. These provisions can be triggered when contributed property is distributed to another partner or if other property is distributed to a contributing partner.

b. Contributed Property to Another Partner-Section 704(c)(1)(B)

(1) If contributed property is distributed within 7 years of the date of contribution to any partner other than the partner who contributed such property, the contributing partner must generally recognize a taxable gain or loss in the year of distribution.[329]

(2) The amount of such gain or loss will generally equal the lesser of (a) the difference between the fair market value of the contributed at the time the property was contributed and the contributing partner's basis in the contributed property, or (b) the difference between the fair market value of the contributed property and the inside basis of the partnership at the time of the distribution.[330] The reason for the latter limitation is the gain or loss is meant to be limited to the amount that would have been allocated to the contributing partner under section 704(c) had the partnership sold the asset.

(3) The character of any such gain or loss is determined by the character of the contributed securities in the hands of the partnership.[331]

(4) If the contributed property is exchanged for other property in a tax free exchange, the property received will be treated as the contributed property for the application of section 704(c)(1)(B).[332]

---

[326] *See* § 1278(a)(1).

[327] § 1278(a)(1)(A).

[328] § 1278(a)(2).

[329] § 704(c)(1)(B).

[330] § 704(c)(2)(B)(i) and Treas. Reg. § 1.704-4(a).

[331] Treas. Reg. § 1.704-4(b).

[332] Treas. Reg. § 1.704-4(d)(1)(i).

(5) The outside basis of the contributing partner and the inside basis of the contributed property and the "non-contributing" partner (distributee) are adjusted for any gain or loss without the need for a section 754 election.[333]

(6) Similar to the general anti-abuse provisions mentioned above, the Treasury Regulations provides that "if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 704(c)(1)(B),"[334] based on all the facts and circumstances, the IRS can recast the transaction appropriately. One example given in the Treasury Regulations deals with a partnership having a nominal outside partner for a number of years, and then prior to the expiration of the (now 7 years) section 704(c)(1)(B) period, adding a partner to whom it is intended the contributed property will be distributed. When the contributed property is distributed after the "mixing bowl" period has expired, the example provides that a taxable transfer is deemed to have occurred because the "mixing bowl" period is deemed to have been tolled until the admission of the intended recipient partner of the contributed property.[335]

c. Other Property Distributed to Contributing Partner- Section 737

(1) If a partner contributes appreciated property to the partnership and, within 7 years of the date of contribution, that partner receives a distribution of any property other than the contributed property, such partner generally will be required to recognize gain upon the receipt of such other property.[336] The reason for this provision is to avoid deferral of the gain that would have been allocated to the contributing partner under section 704(c) because such gain would not be triggered unless the partnership actually sold the property in a taxable transaction. If section 737 is triggered, to avoid a doubling of the gain, the subsequent distribution of the property previously contributed by the same partner does not trigger gain.[337]

(2) Unlike section 704(c)(1)(B), this provision only applies to gain, not loss. As a result, in order to recognize any loss under section 704(c), the partnership would need to sell the asset in a taxable transaction.

(3) The amount of the gain is equal to the lesser of (a) "net precontribution gain"[338] (aggregate net gain, as reduced by any loss property, that would be realized under section 704(c)(1)(B) if all of the property contributed by the contributor within 7 years of the distribution (and still owned by the partnership) had been distributed to another partner;[339] (b) the excess of the fair market value of the distributed property over the outside basis of the partnership interest, determined with adjustments resulting from the distribution without regard to the gain triggered by section 737.[340]

---

[333] § 704(c)(1)(B)(iii) and Treas. Reg. § 1.704-4(e).

[334] Treas. Reg. § 1.704-4(f)(1).

[335] Treas. Reg. § 1.704-4(f)(2), Ex. 2.

[336] §§ 704(c)(1)(B) and 737.

[337] § 737(d)(1) and Treas. Reg. § 1.737-3(d).

[338] § 737(b).

[339] *See* Treas. Reg. §§ 1.737-1(c)(1)(iv) and 1.737-1( e), Ex. 2.

[340] §§ 737(a)(1) and (2).

(4) The character of the gain is determined by reference to the "proportionate character of the net precontribution gain,"[341] which is to say, it is generally determined by its character in the hands of the partnership.

(5) The partner's outside basis and the partnership's inside basis in the contributed property are automatically adjusted without the need for a section 754 election.[342] Further, the basis of the distributed property is adjusted to reflect the recognized gain on the partner's outside basis.[343]

(6) Marketable securities are generally treated as cash for purposes of section 737.[344] In determining "net precontribution gain" under section 737, however, marketable securities contributed to the partnership are treated as contributed property.[345]

(7) Similar to the anti-abuse guidelines under section 704(c)(1)(B), the Treasury Regulations provide that transactions can be recast if, based on all the facts and circumstances, they are "inconsistent with the purposes of section 737."[346] The deemed abusive example provided in the Treasury Regulations involves a transaction, in an intentional plan to avoid section 737, where there is a contribution of property to a partnership (under section 721) immediately before a distribution of other property to the contributing partner (who also made a previous contribution of appreciated property). Gain under section 737 would be avoided because the contribution increased the outside basis of the contributing partner. Then the partnership liquidates the contributing partner's interest in a nontaxable distribution, returning the contributed property (temporarily parked in the partnership to avoid gain on the distribution of other property prior to the liquidation of the partner's interest).[347]

5. Disguised Sale Rules

a. If a partner who has contributed appreciated property to a partnership receives a distribution of any other property or cash within 2 years of the contribution, based on the applicable facts and circumstances, the distribution may cause the partner to recognize gain as of the original date of contribution with respect to his or her contributed property under the "disguised sale" rules.[348]

b. Distributions within two years are presumed to be part of a disguised sale, and those more than two years are presumed not to be part of a disguised sale.[349]

---

[341] § 737(a) [flush language] and Treas. Reg. § 1.737-1(d).

[342] § 737(c) and Treas. Reg. § 1.737-3. The increase in inside basis is allocated to property with unrealized gain of the same character as the gain recognized. *See* Treas. Reg. §§ 1.737-3(c)(3) and 1.737-3(e), Ex. 3.

[343] § 737(c)(1) and Treas. Reg. § 1.737-3(b)(1).

[344] §§ 737(c)(1), 737(e), and Treas. Reg. § 1.731-2(a).

[345] Treas. Reg. § 1.731-2(g)(i)-(iii).

[346] Treas. Reg. § 1.731-4(a).

[347] Treas. Reg. § 1.731-4(b), Ex. 1.

[348] § 707(a)(2)(B).

[349] Treas. Reg. § 1.707-3.

c. Distributions in a transaction determined to be a disguised sale are treated as payments by the partnership to the disguised seller-partner, acting in an independent capacity, and not as a partner.[350]

6. Distributions of Securities

a. A distribution consisting of marketable securities generally is treated as a distribution of cash (rather than property).[351] For these purposes, marketable securities includes financial instruments (stocks, equity interests, debt, options, forward or futures contracts, notional principal contracts and other derivatives) and foreign currencies which are actively traded.[352]

b. There are a number of applicable exceptions to the foregoing treatment of distributions of marketable securities, including: (1) distributions of contributed securities to the partner who contributed them;[353] (2) distributions of securities that were not marketable when acquired by the partnership;[354] and (3) distributions of securities from an "investment partnership" to an "eligible partner."[355]

c. An "investment partnership" is defined as a partnership substantially all of whose assets consist of specified investment-type assets and has never been engaged in a trade or business.[356] Specified investment-type assets include (1) money, (2) stock in a corporation, (3) notes, bonds, debentures, or other evidences of indebtedness, (4) interest rate, currency, or equity notional principal contracts, (5) foreign currencies, and (6) derivative financial instruments (including options, forward or futures contracts and short positions).[357] A partnership will not be considered engaged in a trade or business by reason of any activity undertaken as an investor, trader, or dealer in such specified investments.[358]

d. An "eligible partner" is one who, before the date of distribution, did not contribute to the partnership any property other than specified investment-type assets permitted to be held by an investment partnership.[359]

---

[350] § 707(a)(2) and Treas. Reg. § 1.707-3.

[351] § 731(c).

[352] § 731(c)(2)(A) and (C).

[353] § 731(c)(3)(A) and Treas. Reg. § 1.731-2(d)(1).

[354] § 731(c)(3)(A)(ii) and Treas. Reg. § 1.731-2(d)(1)(iii). To qualify for this exception, the security must not have been marketable on the date acquired and the entity to which the security relates must not have had any outstanding marketable securities on that date. Further, the partnership must have held the security for at least 6 months prior to the security becoming marketable, and the partnership must distribute the security within 5 years from the date the security became marketable.

[355] §§ 731(c)(3)(C)(i) and 731(c)(3)(A)(iii).

[356] § 731(c)(3)(C)(i).

[357] § 731(c)(3)(C)(i)(I) through (VIII).

[358] § 731(c)(3)(C)(ii)(I) and Treas. Reg. § 1.731-2(e)(3)(i).

[359] § 731(c)(3)(C)(iii)(I).

e. If one of these exceptions do not apply and a distribution of marketable securities my result in gain to the distribute partner to the extent the value of the marketable securities exceeds outside basis.[360] The amount of marketable securities treated as cash is reduced (and the potential recognized gain is reduced) by:

(1) "such partner's distributive share of the net gain which would be recognized if all of the marketable securities of the same class and issuer as the distributed securities held by the partnership were sold (immediately before the transaction to which the distribution relates) by the partnership for fair market value, over;"[361]

(2) "such partner's distributive share of the net gain which is attributable to the marketable securities of the same class and issuer as the distributed securities held by the partnership immediately after the transaction, determined by using the same fair market value."[362]

f. Any unrealized loss in the marketable securities is not recognized, either by the partnership or the partner.[363]

g. If gain is recognized on the distribution of marketable securities under section 731(c), the tax basis of the distributed securities is increased by the amount of such gain, allocated to the distributed securities in proportion to unrealized appreciation.[364] If no gain is recognized, the basis of the marketable securities in the hands of the partner is the inside basis under the general rule of section 732. It's important to keep in mind that section 731(c) applies only for purposes of determining gain to the partner. The partner's outside basis is still determined under the general rules of section 733. As such, when gain is recognized upon a distribution of marketable securities, the partner's outside basis, by definition, is reduced to zero. Any gain recognized by the partner is not reflected in the partner's outside basis, rather it is reflected in the securities received.

h. If the partner receives other property in addition to marketable securities in the same distribution, the reduction in outside basis due to the marketable securities (cash) is taken into account first, with any remaining basis applied against the other property distributed.[365]

i. Even if a section 754 election is in place, any gain triggered from a distribution of marketable securities will not be reflected in the inside basis of any other partnership property. However, if a section 754 election is in place, the inside basis of partnership can be adjusted for any lost basis resulting from the limitation of the basis of the marketable securities in the partner's hands to the partner's outside basis (because outside basis is not adjusted to reflect the gain, as mentioned above).[366]

---

[360] § 731(c)(3)(B) and Treas. Reg. § 1.731-2(a) and (j), Ex. 1.

[361] § 731(c)(3)(B)(i).

[362] § 731(c)(3)(B)(ii),

[363] § 731(b).

[364] § 731(c)(4) and Treas. Reg. § 1.731-2(f)(1)(i).

[365] § 731(a)(1) and Treas. Reg. § 1.731-2(f)(1)(ii), (j), Ex. 5.

[366] Treas. Reg. § 1.731-2(j), Ex. 6(iv).

E. Partnership Liabilities and Basis

1. The partnership rules make an important distinction between recourse and nonrecourse liabilities. In this context, generally, recourse liabilities increase basis only as to the partner who bears economic risk of loss, whereas nonrecourse liabilities increase basis proportionately among all of the partners. A partnership liability is considered recourse if any partner or "related person" bear the economic risk of loss for the liability.[367] Conversely, a liability is considered nonrecourse to the extent no person or "related person" bears such risk of loss.[368]

2. Any increase in a partner's share of liabilities (including any assumption by a partner of any partnership liabilities) is treated as contribution of cash by the partner in the partnership, thereby increasing basis.[369] Any decrease is treated as a distribution of cash to the partner, thereby reducing basis and possibly resulting in the recognition of gain if the amount of the deemed distribution exceeds available outside basis.[370] If property that is subject to a liability is contributed to or distributed from a partnership, the transferee is deemed to assume the liability but only to the extent the liability is not in excess of the fair market value.[371]

3. A partner or related person will be deemed to bear the economic risk of loss for a partnership liability if the partner or related person would be obligated to make a payment to any person (like a third-party lender) or a contribution to the partnership upon a constructive liquidation of the partnership.[372] Whether such payment or contribution obligation exists (and the extent of such obligation) depends on all the facts and circumstances, like the existence of the following:

a. Contractual obligations like "guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors or to other partners, or to the partnership;"[373]

b. Partnership obligations including "obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership;"[374]

c. Payment obligations "imposed by state law, including the governing state partnership statute;"[375] and

---

[367] Treas. Reg. § 1.752-1(a)(1).

[368] Treas. Reg. § 1.752-1(a)(2).

[369] § 722 and Treas. Reg. § 1.752-1(b).

[370] §§ 733, 731(a), 751 and Treas. Reg. § 1.752-1(c).

[371] Treas. Reg. § 1.752-1(e).

[372] Treas. Reg. § 1.752-2(b)(1)

[373] Treas. Reg. § 1.752-2(b)(3)(i).

[374] Treas. Reg. § 1.752-2(b)(3)(ii).

[375] Treas. Reg. § 1.752-2(b)(3)(iii).

d. Reimbursement rights a partner or related person may have from another partner or a person who is related to such other partner.[376]

4. In making a determination of whether a partner or related person has a payment obligation on a partnership liability and bears the economic risk of loss, it is assumed the partner or related person will be able to pay the obligations "irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation."[377]

5. The Treasury Regulations state that a person will be a "related person" to a partner if they have a relationship that is specified in sections 267(b) and 707(b)(1) but with a few modifications.[378] Including those modifications, a person is related to a partner if they are (in part):

a. Members of the same family (spouse, ancestors and lineal descendants);

b. An individual and a corporation if more than 80% of the value of the outstanding stock of the corporation is owned, directly or indirectly, by or for such individual;

c. A grantor and a fiduciary of any trust;

d. A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;

e. A fiduciary of a trust and a beneficiary of such trust;

f. A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;

g. A fiduciary of a trust and a corporation if more than 80% of the value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;

h. A person and a charitable organization if the organization is controlled directly or indirectly by such person or, if the person is an individual, by members of the individual's family;

i. A corporation and a partnership if the same persons own more than 80% in value of the outstanding stock of the corporation and more than 80% of the capital interest or the profits interest in the partnership;

j. An S corporation and another S corporation (or C corporation) if the same persons own more than 80% in value of the outstanding stock of each corporation;

---

[376] Treas. Reg. § 1.752-2(b)(5).

[377] Treas. Reg. § 1.752-2(b)(6).

[378] Treas. Reg. § 1.752-4(b)(1).

k. Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of that estate;

l. A partnership and a person owning, directly or indirectly, more than 80% of the capital interest, or the profits interest, in such partnership; or

m. Two partnerships in which the same persons own, directly or indirectly, more than 80% of the capital interests or profits interests.

6. To avoid double counting, the Treasury Regulations provide that persons owning interests (directly or indirectly) in the same partnership are not treated as related persons for purposes of determining their share of partnership loss.[379]

7. The Treasury Regulations further provide that if (i) a partnership liability is held or guaranteed by another entity that is a partnership, S corporation, C corporation, or trust; (ii) a partner or related person (directly or indirectly) owns 20% or more in such other entity, and (iii) a principal purpose of having such other entity act as a lender or guarantor is to avoid having the partner bears the risk of loss for all or part of the liability, then the partner is treated as holding the other entity's interest as a creditor or guarantor to the extent of that partner's or related person's ownership interest in such other entity.[380] The ownership interest of the partner and related person are determined according to each entity in the following manner:

a. Partnership: highest percentage interest in any partnership loss or deduction for any taxable year;[381]

b. S corporation: percentage of outstanding stock owned by the shareholder;[382]

c. C corporation: percentage of the issued and outstanding stock owned by the shareholder based upon fair market value;[383] and

d. Trust: actuarial percentage interest owned beneficially.[384]

8. An otherwise nonrecourse partnership liability is treated as a recourse liability to the extent that a partner or a related person holds an interest in the liability, referred to as "partner nonrecourse debt" in the Treasury Regulations.[385] In such case, the economic risk of loss is allocated to such partner (or related person) to the extent not otherwise allocated to another partner.[386]

---

[379] Treas. Reg. § 1.752-4(b)(2)(iii).

[380] Treas. Reg. § 1.752-4(b)(2)(iv)(A).

[381] Treas. Reg. § 1.752-4(b)(2)(iv)(B)(1)

[382] Treas. Reg. § 1.752-4(b)(2)(iv)(B)(2).

[383] Treas. Reg. § 1.752-4(b)(2)(iv)(B)(3).

[384] Treas. Reg. § 1.752-4(b)(2)(iv)(B)(4).

[385] *See* Treas. Reg. § 1.704-2(b)(4).

[386] Treas. Reg. § 1.752-2(c)(1).

9. If a partner (or related person) pledges property outside the partnership (a direct pledge) as security for a partnership liability, the partner is deemed to bear the risk of loss to the extent of the "net fair market value" of the pledged property.[387] If a partner contributes property to a partnership solely for the purpose of securing a partnership liability (an indirect pledge), the partner is deemed to bear the risk of loss to the extent of the "net fair market value" of the pledged property.[388] Contributed property will not be deemed indirectly pledged unless "substantially all of the items of income, gain, loss, and deduction attributable to the contributed property are allocated to the contributing partner, and this allocation is generally greater than the partner's share of other significant items of partnership income, gain, loss, or deduction."[389]

10. As with other partnership provisions, the Treasury Regulations contain anti-abuse rules that would disregard the form of the situation "if facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's economic risk of loss with respect to that obligation or create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise."[390] The Treasury Regulations discuss 2 situations:

a. Arrangements tantamount to a guarantee:[391]

(1) Partner or related person undertakes one or more contractual obligations so the partnership may obtain a loan;

(2) Contractual obligations of the partner or related person eliminate substantially all the risk to the lender that the partnership will not satisfy its obligations under the loan; and

(3) One of the principal purposes is to attempt to permit partners (other than those who are directly or indirectly liable for the obligation) to include a portion of the loan in the basis of their partnership interests.

b. A plan to circumvent or avoid the obligation, based on the facts and circumstances, of a partner (or related person).[392]

11. A complete discussion of how nonrecourse liabilities are shared by partners is beyond the scope of this outline, but the Treasury Regulations generally provide that a partner's share of such liabilities are the sum of:[393]

---

[387] Treas. Reg. § 1.752-2(h)(1).

[388] Treas. Reg. § 1.752-2(h)(2).

[389] *Id.*

[390] Treas. Reg. § 1.752-2(j)(1).

[391] Treas. Reg. § 1.752-2(j)(2). *See* CCA 200246014 (a guarantee was disregarded due to a number of facts including sever undercapitalization and the provisions of the guarantee set forth many waivers and defenses for the benefit of the purported guarantor).

[392] Treas. Reg. § 1.752-2(j)(3). An example is provided that involved a general partnership, minimally capitalized corporation as a partner and a deficit capital account restoration obligation. The obligations of the corporate partner and the capital account restoration obligation are ignored for purposes of Section 752.

[393] Sometimes referred to as the sum of tier one, tier two, and tier three allocations.

a. The partner's share of "partnership minimum gain"[394] (gain that would be realized if all property subject to nonrecourse liability is sold in full satisfaction of the liabilities and for no other consideration);[395]

b. Amount of taxable gain that would be allocated to the partner under section 704(c) (arising because the partner contributed property to the partnership and the partnership still holds the property) if the partnership disposed of all partnership property subject to nonrecourse liabilities in a taxable transaction in full satisfaction of the liabilities and for no other consideration;[396] and

c. The partner's share of "excess nonrecourse liabilities" (liabilities not allocated above).[397]

12. A partner's share of "excess nonrecourse liabilities" is "determined in accordance with the partner's share of partnership profits" under all of the "facts and circumstances relating to the economic arrangement of the partners."[398] As a result, if an FLP has pro rata shares (as is common), and no partner has made a contribution of property to the partnership, then nonrecourse debt will also be shared pro rata.

F. Loss of Grantor Trust Status with Partnership Liabilities

1. Because grantor trust status will be terminated on the death of the grantor or "turned off" by the release of the power causing grantor trust status, [399] changing trustees,[400] or repayment of borrowed trust assets,[401] taxpayers must deal with having a trust that will ultimately be considered a separate taxable entity, a non-grantor trust. In the context of partnerships, this normally does not cause adverse tax consequences, but if there is partnership debt, it can, under certain circumstances, trigger gain.

2. When grantor trust is terminated during the lifetime of the grantor, a transfer is deemed to occur and the grantor may recognize gain to the extent the amount owed to the grantor exceeds the grantor's basis in the assets. This is one of the most problematic features of selling "negative basis" real property partnership interests to IDGTs. For this reason, practitioners advise against terminating grantor trust status while the debt is still outstanding and advise clients to pay off the debt prior to the death of the grantor if at all possible.

3. Gain can also result if grantor trust status is renounced and, due to the creation of a new taxpayer (the trust), it results in a reduction of partnership liabilities of the grantor or the IDGT. Outside basis of the partnership would no longer be calculated across all of the

---

[394] Treas. Reg. § 1.752-2(d)(1).

[395] Treas. Reg. § 1.752-3(a)(1).

[396] Treas. Reg. § 1.752-3(a)(2).

[397] Treas. Reg. § 1.752-3(a)(3).

[398] *Id.*

[399] *E.g.*, § 675(4)(C) power.

[400] *E.g.*, § 674(c) power.

[401] *See* § 675(c).

partnership interests and would thus be determined separately. If all of the partnership liabilities are nonrecourse, then no net reduction should occur to either the grantor or the trust. However, if the grantor had guaranteed some partnership debt thereby making such debt recourse as to the grantor, then the loss of grantor trust status would result in a net reduction of partnership liabilities with respect to the trust partner and a deemed distribution on the partnership shares owned by the trust. If there is insufficient outside basis in the trust shares, capital gain would be recognized by the trust.

4. The IRS has ruled that when the grantor of a grantor trust that holds a partnership interest that is subject to liabilities renounces grantor trust status, the grantor is treated as transferring the partnership interest to the trust. When the interest transferred is a partnership interest and the grantor's share of the partnership liabilities is reduced, the grantor is treated as having sold the partnership interest for an amount equal to the grantor's share of the reduced liabilities.[402]

5. The Treasury Regulations also provide that if a taxpayer creates a grantor trust which purchases a partnership interest and the grantor later renounces grantor trust status, then the taxpayer is considered to have transferred the partnership interest to the trust. The taxpayer's share of liabilities that are eliminated as a result of the transfer are considered part of the amount realized for income tax purposes.[403]

6. The loss of grantor trust status due to the death of the grantor should not result in a reduction of partnership liabilities with respect to the IDGT. If anything, it may result in an increase of such liabilities and an increase in basis if the partnership had recourse debt as to the grantor.

G. Basis Issues with Transfers of Partnership Interests

1. Generally

a. When a donor makes a gratuitous transfer of a partnership interest to a donee and the donee is not a deemed to be the donor for income tax purposes (e.g., the donee is a grantor trust), then generally no gain or loss is recognized on the transfer,[404] and the donee has a transferred basis in the interest received, increased by any gift tax paid.[405] The transferred basis is, however, limited to fair market value of the partnership interest, for purposes of determining a loss.[406] Given the foregoing limitation with respect to losses, valuation discounts could, in fact, limit the ability of the donee to recognize a portion of a subsequent. In such cases, the partner

---

[402] Rev. Rul. 77-401, 1977-2 C.B. 122

[403] Treas. Reg. § 1.1007-2(c), Ex. 5. *See also* TAM 200011005.

[404] This assumes that the transfer is not considered a part sale/part gift transfer. Gain, possibly ordinary income under section 751(a) of the Code, but not loss, may be recognized with a part sale/part gift, but only when the sale price exceeds the outside basis of the partnership interest. *See* § 751(a) and Rev. Rul. 60-351, 1960-2 C.B. 208 (gift accelerated gain on an installment obligation). The sale price would be deemed to include any partnership liabilities deemed to have been transferred. *See* § 752(d), Rev. Rul. 77-402, 1977-2 C.B. 222 (grantor trust converting to a taxable trust), and *Madorin v. Commissioner*, 84 T.C. 667 (1985).

[405] § 1015(d).

[406] § 1015(a).

might be better off having received distributions of partnership assets in-kind and selling such assets, rather than selling the partnership interest itself. The tax difference between selling a partnership interest and selling distributed assets is discussed in more detail later in this outline.

b. If the donor transfers only a portion of his or her partnership interest, it bears to reason that only a portion of the donor's unitary outside basis is transferred. One would assume that a pro rata portion of the donor's outside basis would also be transferred to the donee. In other words, if a donor owns a partnership interest having an outside basis of $100 and the donor gifts 55% to a donee (who is not a grantor trust), then the donee will now own a partnership interest with an outside basis of $55. Surprisingly, that does not seem to be the case.

c. In Revenue Ruling 84-53,[407] the IRS ruled in the context of calculating outside basis of a transferred partnership interest, "the basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market value of the entire interest."[408] Under this calculation, if the gift of the 55% partnership interest carries a valuation discount (which it should since that reflects fair market value), then the 55% interest would actually transfer less than $55 of basis.

d. For example, assume a donor has a partnership interest that has a fair market value of $200 (the value represents a controlling interest in the partnership but reflects some discounts for lack of marketability) and an outside basis of $100. The donor gifts 45% of his or her partnership interest to a donee. Assume further that 45% transfer carries a valuation discount of 30%. As a result the gift tax value (fair market value) of the transfer is $63 (reflecting a 30% discount on an interest which has a value before the discount of $90). Under the formula of Revenue Ruling 85-53, the transferred interest has a fair market value of $63, and the fair market value of the entire interest is $200, resulting in only 31.5% of the donor's original basis having been transferred ($63/$200). After the transfer, the donee owns 45% of the partnership interest with an outside basis of $31.50, and the donor retains 55% of the partnership interest but has an outside basis of $68.50.

2. Estate Planning Implications

a. The income and estate planning implications are significant. In the example above, the result is the donor retains a disproportionate amount of the basis, and the donee receives less. If the donee is in a lower income tax bracket or resides in a state (or is a resident non-grantor trust of such state) that has no state income tax and if the donor is in a higher income tax situation, a taxable event like the sale of the partnership interests (or the sale of the assets of the partnership followed by a distribution of the assets) would generally result in less taxes to be paid when compared to having the donor be the sole taxpayer. In addition, if the donee is near death, then holding a lower basis asset provides more potential for a "step-up" in basis.

b. Often, however, the donor is in the senior generation and is wealthier than the donee. Under those circumstances, how can this distortion in basis be used, assuming it

---

[407] Rev. Rul. 84-53, 1984-1 C.B. 159.

[408] *Id.* The ruling relies Treasury Regulation § 1.61-6(a) which provides that when a part of a larger property is sold, the basis of the entire property shall be equitably apportioned among the several parts for purposes of determining gain or loss on the part sold.

would be preferred that the donor retain less basis (for a potential "step-up" in basis) and the donee receive more basis. Consider the following:

(1) As in the above example, donor owns a partnership interest that has a fair market value of $200 and an outside basis of $100. Donor gifts 55% of his or her partnership interest to an IDGT. No basis allocation is actually required because the unitary basis rules provide that the donor continues to own the basis in all of the partnership interests owned by the donor and the IDGT.

(2) The donor then transfers a 45% interest to a non-grantor trust that provides features that make it an "incomplete gift, non-grantor trust." Most prevalently, practitioners have taken advantage of the laws of Delaware (Delaware incomplete non-grantor trust or "DING") and Nevada (Nevada incomplete non-grantor trust or "NING")[409] to eliminate state income tax on the assets in the trust. Putting aside the potential state income tax savings, a properly structured "incomplete gift, non-grantor trust" results in the following:[410]

(a) The trust not a grantor trust (although the grantor is a permissible beneficiary of the trust);

(b) Contributions to the trust by the grantor are not completed gifts for Federal gif tax purposes; and

(c) The assets of the trust are includible in the grantor's gross estate upon the grantor's death, although the corpus is subject to a testamentary special power of appointment held by the grantor.

(3) For basis purposes, based on Revenue Ruling 84-53, the non-grantor trust (the assets of which will be includible in the estate of the donor at death) has a partnership interest with an outside basis of $31.50 (although representing 45% of the donor's interest). The IDGT (the assets of which are not includible in the donor's estate), on the other hand, has a partnership interest with an outside basis of $68.50 (representing 55% of the donor's interest). Thus, a disproportionate amount of basis ends up passing with the partnership interest that is out of the donor's estate, while the partnership interest that remains in the estate is poised to get a disproportionately large "step-up" in basis (particularly, if as discussed above, certain measures are taken to reduce or eliminate the valuation discounts attributable to the partnership interest in the non-grantor trust).

---

[409] For a more complete discussion of NINGs and DINGs, *see* Peter Melcher and Steven J. Oshins, *New Private Letter Ruling Breathes Life into Nevada Incomplete Gift Non-Grantor Trusts*, Wealthmanagement.com, the digital resource of REP. and Trusts & Estates (Apr. 16, 2013), and Steven J. Oshins, *NING Trusts Provide Tax and Asset Protection Benefits*, CCH Estate Planning Review - The Journal, Page 150 (Aug. 20, 2013).

[410] *See* PLRs 201310002, 201310003, 201310004, 201310005, 201310006, 201410001-201410010, 201426014, 201430003–201430007, 201436008, 201436012, 201436013-201436014, 201436018, 201436024-201436027, 201436028-36032, and 201440008-201440012.

H. Section 754 Election and Inside Basis Adjustments

1. Generally

a. As discussed above, whether a partnership has a section 754 election in place has a direct bearing on the inside basis of the assets held by a partnership. Those adjustments to basis are made pursuant to section 743, when there is a sale or exchange of a partnership interest or a death of a partner occurs, and section 734, when there is a distribution to a partner.

b. Generally, the inside basis of partnership assets are not adjusted when a partnership interest is sold or exchanged, when a partner dies or when there is a distribution of property to a partners. These transactions can create discrepancies between inside and outside basis, which in turn can create distortions in the amount of income recognized and the timing of the income. For example, if a partner dies or a partner sells his or her partnership interest, the transferee partner will have a basis in the partnership interest equal to fair market value or the cost of the sale. If that basis is greater than the inside basis of the assets, when the partnership sells those assets, additional gain will be allocated to the transferee partner. Similarly, if a partnership makes a liquidating distribution to a partner for cash, and the partner recognizes gain as a result of that distribution because the partner's outside basis is less than the cash distributed, that gain essentially represents the liquidated partner's share of appreciation in the partnership. Absent an adjustment to inside basis, a subsequent sale of the partnership assets will result in that gain being allocated to the remaining partners. The adjustments under sections 743 and 734 attempt to adjust for those types of discrepancies. Adjustments can increase or decrease the inside basis of partnership property.

2. A section 754 election is generally made by the partnership in a written statement filed with the partnership return for the taxable year during which the transfer in question (sale, exchange, death or distribution) occurs.[411] Once the election is made, it applies to the year for which it is filed as well as all subsequent taxable years until and unless it is formally revoked.[412]

3. The adjustments under sections 743(b) are mandatory even in the absence of a section 754 election if the partnership has a substantial built-in loss immediately after the sale or exchange or upon death (adjustment under section 743(b)) or there is a substantial basis reduction with respect to a distribution (adjustment under section 734(b)).

(1) There is a substantial built-in loss if the partnership's inside basis on all partnership property exceeds the fair market value by more than $250,000.[413]

---

[411] Treas. Reg. § 1.754-1(b)(1). Under certain circumstances, there is a 12-month extension past the original deadline. Treas. Reg. § 301.9100-2.

[412] § 754 and Treas. Reg. § 1.754-1(a). An election may be revoked if there exists: (i) a change in the nature of the partnership business; (ii) a substantial increase in or a change in the character of the partnership's assets; and (iii) an increase in the frequency of partner retirements or shifts in partnership interests (resulting in increased administrative costs attributable to the § 754 election). Treas. Reg. § 1.754-1(c)(1).

[413] § 743(d)(1).

(2) There is a substantial basis reduction resulting from a distribution of property if the sum of the following exceeds $250,000: (i) a loss to the partner (only upon a liquidating transfer, as discussed above); and (ii) excess basis of the distributed property in the hands of the partner over the inside basis prior to the distribution.[414]

4. Adjustments under section 743(b) result in either:

a. An increase in the transferee's share of partnership inside basis "by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property"[415] or

b. A decrease in the transferee's share of partnership inside basis "by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership."[416]

5. A transferee partner's proportionate share of the basis of the partnership property is the sum of the partner's previously taxed capital, plus the partner's share of partnership liabilities.[417] The partner's previously taxed capital is:[418]

a. The amount of cash the partner would receive upon a hypothetical sale of all of the partnership assets (immediately after the transfer or death, as the case may be) in a fully taxable transaction for cash equal to the fair market value of the assets[419]; increased by

b. The amount of tax loss that would be allocated to the partner on the hypothetical transaction; and decreased by

c. The amount of tax gain that would be allocated to the partner on the hypothetical transaction.

6. The inside basis adjustment under section 743(b) is then allocated among the partnership property under the rules set out in section 755.

a. Generally, section 755 seeks to reduce the difference between the fair market value of partnership assets and the adjusted tax basis of the partnership in such assets.[420]

b. In allocating the adjustment, to the extent the adjustment is attributable to property consisting of (i) capital assets and section 1231(b) property (capital gain property) and (ii) any other property, the adjustment must be allocated to partnership property of a like character (ordinary income property).[421]

---

[414] § 734(b)(2) and (d).

[415] § 734(b)(1).

[416] § 734(b)(2).

[417] Treas. Reg. § 1.743-1(d)(1).

[418] Treas. Reg. § 1.743-1(d)(1)(i)-(iii).

[419] Treas. Reg. § 1.743-1(d)(2).

[420] § 755(a).

[421] § 755(b).

c. The adjustment is allocated first between the capital gain property and ordinary income property, and then is allocated among the assets within these two asset categories.[422]

7. Unlike adjustments under section 743(b), adjustments under section 734(b) (upon a distribution of partnership property to a partner) are made to the common inside basis of the partnership assets, so the basis adjustment is made in favor of all of the partners in the partnership (not just for the benefit of a transferee). Section 734(b)(1) and (2) provides that increases or decreases are made to "partnership property."[423] In contrast, adjustments under section 743(b) "shall constitute an adjustment to the basis of partnership property with respect to the transferee partner only."[424]

I. Partnership Divisions

1. Generally

a. Divisions of partnerships are generally not specifically defined in the Code or under state law. A partnership division is any transaction that converts a single partnership into two or more resulting partnerships. A division of a partnership can be accomplished in a number of different ways, sometimes referred to as, "assets-over, assets-up, and interests-over."[425]

(1) Assets-Over: Divided partnership contributes some of its assets (and perhaps liabilities) to a recipient partnership in exchange for an interest in the recipient partnership, followed by a distribution of the interests in the recipient partnership to the partners.

(2) Assets-Up: Divided partnership contributes some of its assets (and perhaps liabilities) to some or all of its partners, and the partners then contribute those assets (and liabilities, if any) to the recipient partnership for interests in the recipient partnership.

(3) Interests-Over: Some or all of the partners in the divided partnership contribute a portion of their interest in the divided partnership to the recipient partnership in exchange for interests in the recipient partnership, followed by a liquidating distribution of assets (and perhaps liabilities) into the recipient partnership.

b. To avoid unintended transfer tax consequences, tax planners must be wary of the special valuation rules of Chapter 14, in particular, section 2701.

(1) Section 2701 includes a "transfer" of an interest in a family-controlled partnership to a member of the transferor's family, pursuant to which the transferor keeps an applicable retained interest.[426] "Transfer" is broadly defined and is deemed to include

---

[422] Treas. Reg. § 1.755-1(a)(1).

[423] § 734(b)(1) and (2).

[424] § 743(b) (flush language).

[425] Cassady V. Brewer, *Coming Together and Breaking Apart: Planning and Pitfalls in Partnership Mergers and Divisions*, 43rd Annual Southern Federal Tax Institute (2008), Outline F, F-13.

[426] § 2701.

"a contribution to capital or a redemption, recapitalization, or other change in the capital structure of a corporation or partnership."[427]

(2) Importantly in this context, section 2701 does not apply to a transfer "to the extent the transfer by the individual results in a proportionate reduction of each class of equity interest held by the individual and all applicable family members in the aggregate immediately before the transfer."[428] The Treasury Regulations provide the following example: "Section 2701 does not apply if P owns 50 percent of each class of equity interest in a corporation and transfers a portion of each class to P's child in a manner that reduces each interest held by P and any applicable family members, in the aggregate by 10 percent even if the transfer does not proportionately reduce P's interest in each class."[429] This exception is often referred to as the "vertical slice exception."

(3) In addition, section 2701 does not apply to any right with respect to an applicable retained interest if such interest is the same class as the transferred interest,[430] or the same as the transferred interest, without regard to non-lapsing differences in voting power (or, for a partnership, non-lapsing differences with respect to management and limitations on liability).[431]

(4) Consequently, most divisions of partnerships for estate planning purposes (assuming no gifts are intended as a result of the division) will result in the partners in the divided partnership being the same partners in the recipient partners and retaining the same pro rata interest in both the divided and the recipient partnership.

2. Tax Treatment of Partnership Divisions

a. Partnership divisions are governed by section 708(b)(2)(B). The Treasury Regulations issued in 2001,[432] provide that the IRS will not respect the "interests-over" form of partnership division described above. In addition, while both an assets-over and assets-up method will be respected under the Treasury Regulations, there is a preference to treat the transaction as an assets-over transaction.[433]

b. In the assets-over form, the divided partnership transfers assets to the recipient partnership in exchange for interest in the recipient partnership, followed by a distribution of the recipient partnership interests to the partners.[434] Parity of ownership interests will likely exist between the divided partnership and the recipient partnership because of the

---

[427] § 2701(e)(5).

[428] Treas. Reg. § 25.2701-1(c)(4).

[429] *Id.*

[430] § 2701(a)(2)(B).

[431] § 2701(a)(2)(C). Non-lapsing provisions that are necessary to comply with the partnership allocation requirements will be treated as non-lapsing differences with respect to limitations on liability. Treas. Reg. § 25.2701-1(c)(3).

[432] T.D. 8925, 66 Fed. Reg. 715 (1/4/01).

[433] *See* Treas. Reg. § 1.708-1(d)(3).

[434] Treas. Reg. § 1.708-1(d)(3)(i)(A). The transitory ownership by the divided partnership of all the interests in the recipient partnership is ignored. Treas. Reg. § 1.708-1(d)(5) Ex. 3-6.

Chapter 14 considerations mentioned above. As such, the distribution of the recipient partnership interest to the partners will be current distributions rather than liquidating distribution because no partner is terminating his or her interest in the divided partnership. Because of this parity of ownership, it is unlikely that the "mixing bowl" transaction (as discussed above) will trigger any gain or loss.[435] Furthermore the preamble to the Treasury Regulations point out that when a division results in a pro rata division, there are no section 704(c) implications.[436] Similarly, given the parity of ownership before and after the division, there should be no gain resulting from a deemed distribution of cash under section 752 because the division will not result in a change in the share of the liabilities of the partners.

c. The resulting basis that the partners have in their respective interests in the divided partnership and the recipient partnership depend on what assets and liabilities are contributed and distributed as a result of the division.

d. In a division, the Treasury Regulations provide that a "resulting partnership"[437] (a partnership that has at least 2 partners from the prior partnership) will be considered a continuation of the prior partnership if the partners in the resulting partnership had an interest of more than 50 percent in the capital and profits of the prior partnership.[438] All resulting partnerships that are considered a continuation of the prior partnership are subject to all preexisting tax elections (for example, a section 754 election) that were made by the prior partnership.[439] Thus, in pro rata divisions where all of the partners retain the same ownership in the resulting partnerships, all of the resulting partnerships will be considered continuing partnerships, retaining all prior tax elections of the divided partnership.[440]

e. There is a narrow anti-abuse provision in the Treasury Regulations with respect to partnership divisions. It provides that if a partnership division is "part of a larger series of transactions, and the substance of the larger series of transactions is inconsistent"[441] with the form, the IRS may recast the larger series of transactions in accordance with their substance.

3. Partnership Divisions in Tax Basis Management

a. The importance of tax-free partnership divisions in the new paradigm of estate planning cannot be overstated. The unitary basis rules applicable to partnership interests do not allow taxpayers to differentiate between low or high basis lots of partnership interests. The partnership division rules effectively allow taxpayers to segregate particular assets within a partnership into a new partnership and provide a separate outside basis in those assets through the new partnership. Because the basis of partnership property distributed in-kind to a partner is determined by the outside basis of the partner's interest, careful partnership divisions allow

---

[435] §§ 704(c)(1)(B), 737 and Treas. Reg. §§ 1.704-4(c)(4), 1.737-2(b)(2).

[436] T.D. 8925, 66 Fed. Reg. 715 (1/4/01). Non-pro rata divisions are still being reviewed.

[437] Treas. Reg. § 1.708-1(d)(4)(iv)

[438] Treas. Reg. § 1.708-1(d)(1).

[439] Treas. Reg. § 1.708-1(d)(2)(ii).

[440] *See* PLR 9015016 (seven continuing partnerships with same owners in the same proportions).

[441] Treas. Reg. § 1.708-1(d)(6). *See also* Treas. Reg. § 1.708-1(c)(6)(ii) for an example of an abusive series of transactions that involved a partnership division and merger.

taxpayers to determine what the tax basis of the in-kind property will be upon distribution (rather than determined by an aggregate basis under the unitary basis rule).

b. Furthermore, divisions allow taxpayers to isolate the particular assets that they wish to benefit from an inside basis adjustment under sections 743 and 734, as the case may be. As mentioned above, the inside basis adjustments under section 755 are made at an entity level and apply across all of the assets within the partnership. Careful partnership divisions would allow taxpayers to determine what assets would be the subject of the inside basis adjustment and perhaps separately choose to make a section 754 election for the new partnership, rather than the original partnership.

J. Death of a Partner

1. Generally

a. The transfer of a deceased partner's interest in a partnership will not result in gain or loss, even if the deceased partner's share of liabilities exceeds outside basis.[442]

b. The estate's outside basis in the partnership will equal the fair market value of the partnership interest for estate tax purposes (which is net of partnership liabilities), plus the estate's share of partnership liabilities, minus any value attributed to items of IRD owned by the partnership. The Treasury Regulations provide, "The basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of his death or at the alternate valuation date, increased by his estate's or other successor's share of partnership liabilities, if any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent (see section 753 and paragraph (c)(3)(v) of § 1.706-1 and paragraph (b) of § 1.753-1) under section 691."[443]

c. Unless a section 754 election applies, no adjustment is made to the tax basis of the partnership property as a result of the partner's death. The lack of an inside basis adjustment puts the estate (or the successor in interest) at risk of being taxed on unrealized gain in the partnership at the time of the decedent's death.

2. Inside Basis Adjustments at Death

a. If a section 754 election is timely made or in place at the time of a partner's death, the estate or successor to the partnership interest gets the benefit of an inside basis adjustment over the partnership's assets under section 743.

(1) The inside basis adjustment will not, however, "step-up" the basis of partnership assets that would be considered IRD if held by the deceased partner individually and unrealized receivables of the partnership.[444]

---

[442] *See* Elliott Manning and Jerome M. Hesch, *Sale or Exchange of Business Assets: Economic Performance, Contingent Liabilities and Nonrecourse Liabilities (Part Four)*, 11 Tax Mgmt. Real Est. J. 263, 272 (1995).

[443] Treas. Reg. § 1.742-1.

[444] §§ 1014(c), 691(a)(1), Treas. Reg. § 1.691(a)(1)-1(b), and *Woodhall v. Commissioner*, 454 F.2d 226 (9th Cir. 1972).

(2) The IRS has affirmatively ruled that the inside basis adjustment applies to the entire partnership interest that is considered community property upon the death of the deceased spouse/partner.[445]

(3) The inside basis adjustment is limited by the fair market value of the deceased partner's interest in the partnership. As such, to the extent that valuation discounts are applicable to the partnership interest, the inside basis adjustment will be limited to the extent of such discounts. To the extent little or no transfer taxes would be payable upon the death of a partner, practitioners may want to reduce or eliminate such valuation discounts, thereby maximizing the inside basis adjustment with a section 754 election. Further, because the inside basis adjustment under section 743 is applied to all of the assets in the partnership at the time of the death of the partner, the adjustment does not allow tax practitioner to proactively choose which asset will get the benefit of the "step-up" in basis. For this reason, practitioners may want to consider distributing certain property in-kind to the partner prior to the partner's death and allowing the partner to own the property outside the partnership at the time of death. Valuation discounts will not apply, and if the partner's outside basis is very low, the distributed property will have a very low basis in the hands of the partner. In this manner, practitioners can maximize the size of the "step-up" in basis and also choose the asset that they wish to receive the basis adjustment at death.

(4) As mentioned above, the adjustment under section 743(b) is the difference between the successor partner's tax basis in partnership interest (generally, fair market value at the date of death under section 1014(a), increased by the partner's share of partnership liabilities and reduced by items of IRD) and the successor partner's proportionate share of the basis of the partnership property. In calculating the partner's proportionate share of the partnership's tax basis, the Treasury Regulations assume a fully taxable hypothetical sale of the partnership's assets. This taxable sale is deemed to occur immediately after the transfer that triggers the inside basis adjustment. The IRS has ruled that the transfer in question, for purposes of section 743(b), is the date of the decedent partner's death.[446] As such, practitioners should consider what effect the death of the partner might have on the value of the partnership assets in determining the inside basis adjustment.

b. Even in the absence of a section 754 election, there is a mandatory downward inside basis adjustment if, at the time of death, the partnership has a substantial built-in loss (more than $250,000).[447] For example, if A owns 90% of a partnership. At the time of A's death, if the partnership owns property worth $9 million but with a tax basis of $10 million, then the partnership will be required to make a mandatory downward basis adjustment of $900,000 (assuming A's share the partnership's basis is 90% of the total basis).[448]

---

[445] Rev. Rul. 79-124, 1979-1 C.B. 224.

[446] Rev. Rul. 79-84, 1979-1 C.B. 223 (partnership interest owned by grantor trust).

[447] § 743(b).

[448] *See* IRS Notice 2005-32, 2005-1 C.B. 895.

3. Section 732(d) Election: Avoiding the Section 754 Election

a. As mentioned above, even with no section 754 election, the estate or successor in interest can achieve the same benefits of an inside basis adjustment if the partnership makes a liquidating distribution of property within 2 years of the date of death and if the successor partner makes an election under section 732(d).[449] The election must be made in the year of the distribution if the distribution includes property that is depreciable, depletable, or amortizable. If it does not include such property, the election can wait until the first year basis has tax significance.[450]

b. The basis adjustment is computed under section 743(b), which relates the basis adjustments due to sales or transfer of partnership interest (during lifetime, or more notably for this discussion, at death). The inside basis adjustment is made artificially to all of the partnership property owned on the date of death (for purposes of determining the transferred inside basis to the distributee with respect to the property distributed). In other words, it is allocated to all of the partnership property whether actually distributed or not.[451] If any property for which the distributee/transferee would have had an inside basis adjustment is distributed to another partner, the adjustment for such distributed property is reallocated to remaining partnership property.[452]

c. The election under section 732(d) can be a significant planning opportunity especially when planners would like to avoid having a section 754 election in place. As mentioned above, once the section 754 election is made, it is irrevocable unless the IRS gives permission to revoke the election. Because the inside basis adjustments under section 743(b) only apply to the transferees of the partnership interests (not to the partnership as a whole), having a section 754 election in place requires having a different set of basis calculations for the transferees of the interest. The book keeping requirements become quite onerous as partnership interests are often distributed at death to multiple trusts or beneficiaries and become even more so as additional partners pass away.

d. If the distribution of property is made pursuant to provision in the partnership agreement that requires a mandatory in-kind liquidation of the deceased partner's interest based on the partner's positive capital account balance, then the estate would have a good argument to say that the value of the partner's interest for purposes of section 1014(a) should not entail valuation discounts. This would, in turn, increase the inside basis adjustment on the assets claimed with the section 732(d) election. Giving the manager of the LLC or general partner of the partnership the discretion to determine what assets to distribute in liquidation of the partnership interest could give considerable planning opportunities to pick and choose which assets to receive the inside basis adjustment based on the needs of the distributee partner. While the assets received would likely not receive full fair market value (because, as mentioned above, the inside basis adjustment is artificially allocated across all of the partnership assets whether distributed or not), some planning opportunities could exist by distributing assets to other partners prior to the liquidation because the nominal inside basis adjustment that would have been allocated to those assets would be adjusted to the remaining partnership property.

---

[449] Treas. Reg. § 1.732-1(d)(1)(iii).

[450] Treas. Reg. § 1.732-1(d)(2).

[451] Treas. Reg. §§ 1.732-1(d)(1)(vi), 1.743-1(g)(1) and (5), Ex. (ii).

[452] Treas. Reg. §§ 1.743-1(g)(2) and (5), Ex. (iv).

K. Maximizing the "Step-Up" and Shifting Basis

1. Given the limitations of the basis adjustment at death, practitioners may want to consider distributing certain property in-kind to the partner prior to the partner's death and allowing the partner to own the property outside the partnership at the time of death. Valuation discounts will not apply, and if the partner's outside basis is very low, the distributed property will have a very low basis in the hands of the partner. In this manner, practitioners can maximize the size of the "step-up" in basis and also choose the asset that they wish to receive the basis adjustment at death.

2. Consider the following scenario: FLP owns 2 assets, one with very high basis and one with very low basis, neither of which is a marketable security. The assets have been in the FLP for more than 7 years. The partners consist of younger family members and a parent. Assume that the parent's outside basis in the FLP is zero. As discussed above, the traditional advice of allowing the parent to die with the FLP interest and making a section 754 election after death will likely create an inside basis adjustment that is limited by a significant valuation discount under section 743. Assume further that the partnership intends on selling the very low basis asset relatively soon. What might be a way to maximize the "step-up" in basis that will occur at the parent's death and also create tax basis for the low basis asset that will be sold? The partnership should make a section 754 election and distribute the high basis asset, in-kind, to the parent in full or partial liquidation/redemption of the parent's interest in the partnership. What is the result of this distribution?

3. Because the distribution is not cash or marketable securities, neither the partner nor the partnership will recognize any gain or loss upon a distribution of the property.[453] In addition, because the assets have been in the partnership for more than 7 years, there are no concerns about triggering any gain to another partner under the "mixing bowl" or the "disguised sale" rules. The basis of the distributed property in the hands of the parent is based on the tax basis that the partnership had in the property prior to the distribution. The basis of the distributed property will, however, be limited to the outside basis of the partner's partnership interest, as adjusted for cash distributions (reduction in basis) and changes in liabilities because the distributed property is encumbered with debt. This limitation, effectively, transfers the inherent gain in the partnership interest (outside basis) to the distributed property. In other words, the basis of the asset now held by the parent is zero. Because the parent now owns the property individually and outside of the partnership, upon the parent's death, the property will get a full "step-up" in basis to fair market value, free of any valuation discounts.

4. Because a section 754 election was made, an adjustment of inside basis under section 734(b) occurs. The adjustment results in an increase to the inside basis of the partnership assets. The increased basis adjustment is allocated first to appreciated property in proportion to the amount of unrealized appreciation, with any remaining increase allocated to all of the properties within the same class (capital gain or ordinary) in proportion to fair market values. Thus, there is a possibility of allocating basis to an asset above its fair market value, creating the possibility of a recognizable loss to the partners. The result, in this case, is the tax basis that was "stripped" from the high basis asset when it was distributed to the parent (and became a zero basis asset) is allocated to the only other remaining asset in the partnership (the low basis asset

[453] § 731(a)-(b) and Treas. Reg. § 1.731-1(a)-(b). This assumes the property distributed is not a "hot asset" under Section 751.

that will be sold). Thus, the low basis asset becomes a high basis asset, reducing or eliminating the gain to be recognized when it is sold. Unlike adjustments under section 743(b), adjustments under section 734(b) (upon a distribution of partnership property to a partner) are made to the common inside basis of the partnership assets, so the basis adjustment is made in favor of all of the partners in the partnership (not just for the benefit of a transferee).

5. The type of basis management discussed above is predicated upon a number of factors that must be that must orchestrated well in advance of the actual transaction. In particular, the movement of tax basis and the maximization of the "step-up" is predicated upon: (i) the selective use of the section 754 election (not necessarily at death but certainly upon distribution of assets in-kind); (ii) the isolation of the assets to be used in the basis shift; (iii) the avoidance of the triggering gain under the "mixing bowl" and "disguised sale" rules; and (iv) the manipulation of outside basis, so that the partner to receive the property has zero or very low basis in his or her partnership interest. As such, planners should consider evolving the partnership over time to put the taxpayers in the best position to take advantage of the type of flexibility that the partnership rules allow.

6. By way of example, practitioners should consider setting up a partnership that is funded with all manner of assets that might be used in this type of planning (high and low basis assets, depreciable and non-depreciable assets, closely held company interests, cash, etc.). The more assets the taxpayers contribute, the more options will be available in the future. The only type of asset planners should consider avoiding is marketable securities. This is because, generally, a distribution consisting of marketable securities generally is treated as a distribution of cash (rather than property).[454] Thus, regardless of the basis in the marketable securities, a distribution may cause the distributee partner to recognize gain because of insufficient outside basis. However, as discussed later, there is an important exception to this rule that might allow practitioners to create a separate partnership holding only marketable securities and still allow the types of tax basis management discussed herein. Once the assets have been contributed, it is critical that the assets remain in the partnership for at least 7 years to avoid the "mixing bowl" and "disguised sale rule" problems.

7. As discussed in more detail above, distributions of marketable securities are generally treated as cash. There is, however, an important exception to this rule for distributions of securities from an "investment partnership" to an "eligible partner."[455] An "investment partnership" is defined as a partnership substantially all of whose assets consist of specified investment-type assets and has never been engaged in a trade or business.[456] Specified investment-type assets include (1) money, (2) stock in a corporation, (3) notes, bonds, debentures, or other evidences of indebtedness, (4) interest rate, currency, or equity notional principal contracts, (5) foreign currencies, and (6) derivative financial instruments (including options, forward or futures contracts and short positions).[457] An "eligible partner" is one who, before the date of distribution, did not contribute to the partnership any property other than specified investment-type assets permitted to be held by an investment partnership.[458] As such, if taxpayers wish to proactively manage the basis of marketable securities in the manner discussed

---

[454] § 731(c).

[455] §§ 731(c)(3)(C)(i) and 731(c)(3)(A)(iii).

[456] § 731(c)(3)(C)(i).

[457] § 731(c)(3)(C)(i)(I) through (VIII).

[458] § 731(c)(3)(C)(iii)(I).

in this article, taxpayers must have a partnership that *from inception* has essentially only held marketable securities and has never engaged in a trade or business. Hence, practitioners should consider having taxpayers create partnerships that only hold marketable securities and having it hold the securities for at least 7 years.

8. During the 7 year period, if at all possible, the partnership should avoid making a section 754 election because of the limitations of the inside basis adjustment at death and the onerous record keeping requirements discussed above. Once the 7 year period has expired, then the assets of the partnership (that is hopefully free of a section 754 election) are ripe for proactive tax basis management. Once an opportunity arises for the type of planning discussed above (e.g., a potential sale of a low basis asset or the failing health of a partner), then the partnership can then proceed to isolate the appropriate assets in tax free "vertical slice" division. The assets to be carved out of the larger partnership into a smaller partnership would be those assets selected to receive the basis and those that would have their basis reduced upon distribution. Careful consideration should be given to reducing the outside basis of the distributee partner through disproportionate distributions of cash or shifting basis to other partners by changing the allocable share of partnership debt under section 752 (e.g., by converting nonrecourse debt to recourse debt through a guarantee by the other partners).[459]

9. Upon distribution of the higher basis assets to the distributee partner, the inside basis adjustment would be applied across all of the remaining assets in the partnership, but only those assets that have been spun off the larger partnership are in this partnership. Thus, allowing for a larger basis increase to those assets (rather than having the basis increase apply to all of the assets of the larger partnership and never creating an asset fully flush with tax basis). A section 754 election is required to effectuate the inside basis shift under section 734, but the election would only apply to the smaller, isolated partnership. As such, the record keeping requirements are kept to a minimum and are totally eliminated when and if the smaller partnership is dissolved and liquidated. Remember, in a vertical slice division, the isolated partnership is considered a continuation of the larger partnership, and the elections of the previous partnership follow to the new partnership. By keeping the larger partnership free of a section 754 election, it allows practitioners to selectively choose when and over what assets it would apply to in the future.

L. Family Partnership Examples

1. Example 1: Indemnifications and Divisions

a. The following hypothetical illustrates how easily partnerships can facilitate tax basis management in fairly typical estate-planning scenarios. The facts are as follows:

(1) Assume that Mr. and Mrs. Developer are married with three adult children. Exclusive of their home, vacation home, and other personal use assets, Mr. and Mrs. Developer have a net worth of approximately $25 million. Most of Mr. and Mrs. Developer's wealth derives from constructing, owning, and leasing "General Dollar" stores across Georgia, a state that does not have a state death tax. All of the General Dollar store properties are held by General Dollar Lessor, LLC, which is a wholly owned subsidiary of Mr. and Mrs. Developer's family partnership, "Developer Family Partnership, LLLP" (hereinafter "FLLLP"). Assume

[459] *See* Treas. Reg. § 1.752-2(b).

General Dollar Lessor, LLC has no assets other than the General Dollar stores that it owns and leases. FLLLP was formed many years ago to be the family "holding company."[460]

(2) General Dollar Lessor, LLC has a gross fair market value of approximately $31 million subject to recourse debt of $10 million which is secured by all of its assets (for a net value of $21 million). The debt also is personally guaranteed by Mr. Developer. Due to depreciation and past like-kind exchanges, the adjusted basis of the assets held by General Dollar Lessor, LLC is only $10 million.

(3) FLLLP owns $9 million in publicly-traded securities in addition to its ownership of 100% of General Dollar Lessor, LLC. Essentially, the $9 million in publicly traded securities was accumulated by investing cash flow and earnings distributed to FLLLP from General Dollar Lessor, LLC. In turn, FLLLP would distribute some of the cash flow and earnings to its partners (especially for them to pay taxes), but FLLLP would retain and invest any amounts not distributed to its partners. The aggregate adjusted basis of the FLLLP in the publicly-traded securities is $6 million. A significant portion of the securities have bases equal to their face values (e.g., bonds).

(4) The aggregate outside bases of the partners of FLLLP in their partnership interests is $16 million. The ownership of FLLLP is split roughly 70% to Mr. Developer and 30% to his three adult children as follows:

(a) Mr. and Mrs. Developer own 50% each in FLLLP GP, LLC, which in turn owns a 1% general partner interest in FLLLP. The outside basis of FLLLP GP, LLC in its GP interest in FLLLP is $203,000 (rounded). The non-discounted value of FLLLP GP, LLC's 1% GP interest in FLLLP is $300,000.

(b) Mr. Developer owns 69 limited partner "LP Units." These LP Units correspond to an aggregate 69% interest in FLLLP (1% per LP Unit). Mr. Developer's LP Units have a total outside basis of $13,997,000 (rounded) and a non-discounted value of $20,700,000.

(c) Each adult child owns 10 LP Units (corresponding to a 10% interest in FLLLP for each child). Each child's outside basis in his/her LP Units is $600,000 and the non-discounted value of each child's 10 LP Units is $3 million, respectively.

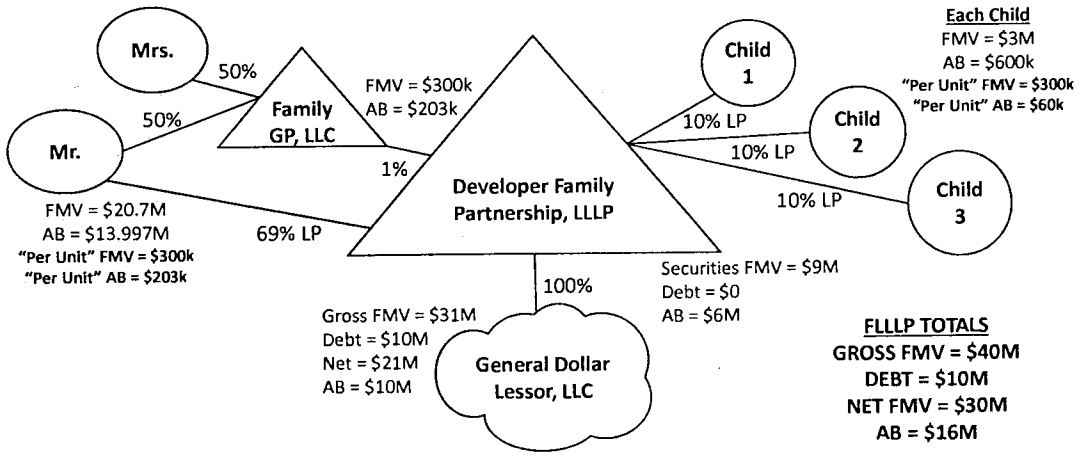
(d) Mr. and Mrs. Developer have their full $10.68 million applicable credit available and have a basic estate plan that leaves all of their assets to their three adult children and their families.

(5) A diagram of the FLLLP ownership structure is set forth below. In the diagram, individuals are represented by circles, partnerships (including entities treated as partnerships for income tax purposes) are represented by triangles, and disregarded entities are represented as clouds:

---

[460] If FLLLP has been in existence for more than seven years, and no appreciated or depreciated property has been contributed to the FLLLP by the partners within the past seven years, then the FLLLP will avoid the "mixing bowl" and "disguised sale" rules of §§ 704(c)(1)(B), 707(a)(2)(B), 731(c), 737, and 751(b). *See* above for further discussion of these rules.

## Family Partnership Hypothetical




(6) Based upon the foregoing facts, the capital accounts and bases of Mr. and Mrs. Developer and their children in their partnership interests (their "outside bases") in FLLLP are as follows:[461]

| | Developer (Includes Family GP, LLC) | | | Children | | |
|---|---|---|---|---|---|---|
| | Capital Accounts | Outside Basis | Fair Market Value | Capital Acounts | Outside Basis | Fair Market Value |
| Initial Balances | $4,200,000 | $14,200,000 | $21,000,000 | $1,800,000 | $1,800,000 | $9,000,000 |

b. Pursuant to the Treasury Regulations,[462] the $10 million debt of General Dollar Lessor, LLC is treated as "partner nonrecourse debt" with respect to Mr. Developer. The debt is treated as "partner nonrecourse debt" because it is guaranteed by Mr. Developer, and he therefore bears the economic risk of loss with respect to the loan if (as one is required to assume under the Treasury Regulations) General Dollar Lessor, LLC's assets became worthless and the liability became due. Accordingly, the debt of General Dollar Lessor, LLC is treated as recourse to Mr. Developer.[463] Therefore, the entire $10 million of the liability is allocated to Mr. Developer for purposes of determining his outside basis in FLLLP.[464] This is why Mr. Developer's aggregate outside basis in FLLLP ($14.2 million) is disproportionately higher than the aggregate outside basis ($1.8 million) of the children in FLLLP.

---

[461] *See* Treas. Reg. § 1.704-1(b)(2)(iv) for the rules regarding the maintenance of capital accounts for partners in a partnership. *See* § 705 and the Treasury Regulations thereunder for the rules regarding the determination of a partner's basis in his or her partnership interest. For the sake of simplicity, the capital accounts and outside bases of Mr. and Mrs. Developer and the children are aggregated here (including, of course, the capital accounts and outside bases of Mr. and Mrs. Developer held through Family GP, LLC).

[462] Treas. Reg. § 1.704-2(b)(4).

[463] Treas. Reg. § 1.752-1(a)(1).

[464] *See* Treas. Reg. § 1.752-2.

c. Assume that Mrs. Developer predeceases Mr. Developer and leaves all of her assets to him. Next, Mr. Developer dies leaving all of his partnership interests in FLLLP to his three adult children in equal shares. Further assume for this purpose that Mr. Developer's combined[465] partnership interests in FLLLP have a non-discounted value of $20 million. If Mr. Developer's combined partnership interests in FLLLP are discounted by 25% for estate tax purposes, then their value will be $15 million (75% of $20 million). This discounted estate-tax value results in very little step-up in outside basis in the FLLLP as compared to Mr. Developer pre-death outside basis of $14.2 million.

d. On the other hand, if prior to his death Mr. Developer's children had indemnified Mr. Developer for 30% (i.e., their combined percentage share of FLLLP) of any liability on the $10 million debt of General Dollar Lessor, LLC, then the outside bases of Mr. Developer and his children in FLLLP would have been as reflected in the table below:

| | Developer (Includes Family GP, LLC) | | | Children | | |
|---|---|---|---|---|---|---|
| | Capital Accounts | Outside Basis | Fair Market Value | Capital Acounts | Outside Basis | Fair Market Value |
| Initial Balances | $4,200,000 | $14,200,000 | $21,000,000 | $1,800,000 | $1,800,000 | $9,000,000 |
| Children Indemnify 30% Debt | | ($3,000,000) | | | $3,000,000 | |
| TOTALS | $4,200,000 | $11,200,000 | $21,000,000 | $1,800,000 | $4,800,000 | $9,000,000 |

(1) Under the Treasury Regulations,[466] this simple step of indemnifying Mr. Developer for 30% of the $10 million debt—a step contemplated by the Treasury Regulations[467]—would shift a debt allocation of $3 million of the $10 million General Dollar Lessor, LLC debt to the children.[468]

(2) This shift would not change the percentage interests of the partners or the values of their partnership interests. As noted above, though, it clearly would increase by $3 million the amount of the potential basis step-up to Mr. Developer's estate upon his death even after taking into account the estate-tax valuation discount on Mr. Developer's partnership interests in FLLLP.

e. Moreover, proactive tax basis management could be taken a step further if, prior to Mr. Developer's death, the FLLLP implemented a "vertical slice" partnership division under section 708(b)(2)(B) (an "assets-over" transaction, as discussed above). Specifically, a "vertical slice" division of FLLLP would involve a pro rata distribution by the FLLLP of the

---

[465] That is, his 69% limited partner interest held directly in FLLLP and his 1% general partner interest held through Family GP, LLC.

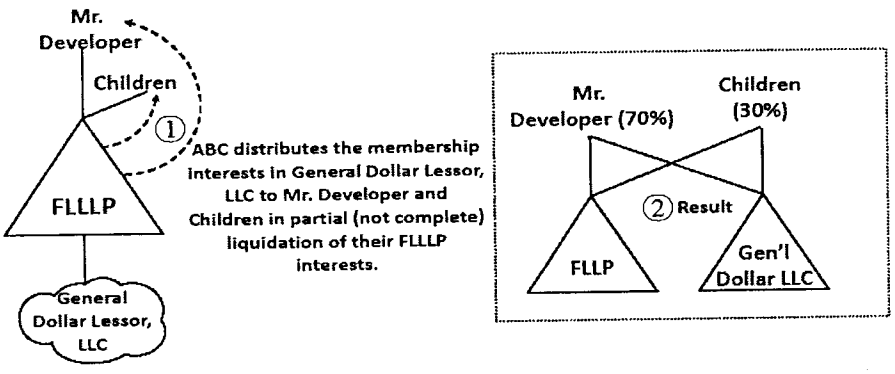
[466] Treas. Reg. §§ 1.752-1(a)(1) and 1.752-2.

[467] *See* Treas. Reg. § 1.752-2(b)(3) (stating that contractual obligations "such as . . . indemnifications" outside the partnership agreement are to be taken into account in determining the partners' economic risk of loss and shares of liabilities for outside basis purposes).

[468] Technically, under §§ 752(a) and (b), this shift in the allocation of the $10 million debt of General Dollar Lessor, LLC is treated as a constructive distribution of cash to Mr. Developer and a constructive contribution of cash by the children thereby decreasing and increasing, respectively, their outside bases. Because the shift is treated as a constructive distribution of cash to Mr. Developer, the advisor must keep in mind § 731(a)(1), which provides that a distribution of cash (constructive or otherwise) from a partnership to a partner that exceeds the partner's outside basis results in gain to that partner. Here, though, the $3 million constructive distribution is far less than Mr. Developer's outside basis.

membership interests in General Dollar Lessor, LLC to Mr. Developer and his children. The marketable securities would remain within the FLLLP while the real estate assets would remain within General Dollar Lessor, LLC. The diagram below illustrates such a division.

Family LLLP: "Vertical Slice" Division




(1) Thus, as a result of a "vertical slice" division of FLLLP, Mr. Developer and his children would own 70%/30%, respectively, of two separate partnerships: the FLLLP (which would own $9 million in securities) and General Dollar Lessor, LLC (which would own $31 million in real estate subject to debt of $10 million). As discussed above, this type of "vertical slice" division of FLLLP would not run afoul of the "mixing bowl" or "disguised sale" rules.

(2) Significantly, the partnership division would also avoid the special rule of section 731(c) that treats a distribution of marketable securities as a distribution of cash. This is because the division does not involve a distribution of the securities. Otherwise, under section § 731(c), a distribution of marketable securities with a fair market value in excess of a partner's outside basis can trigger gain to the partner.[469]

(3) The effect of a "vertical slice" division on the capital accounts and outside bases of Mr. Developer and his children with respect to FLLLP and General Dollar Lessor, LLC are set forth below:

[469] § 731(a)(1).

| | Developer (Includes Family GP, LLC) | | | Children | | |
|---|---|---|---|---|---|---|
| P'ship Division--FLLLP | Capital Accounts | Outside Basis | Fair Market Value | Capital Accounts | Outside Basis | Fair Market Value |
| Initial Balances | $4,200,000 | $14,200,000 | $21,000,000 | $1,800,000 | $1,800,000 | $9,000,000 |
| Spin Out Gen'l Dollar Lessor | $0 | ($10,000,000) | ($14,700,000) | $0 | $0 | ($6,300,000) |
| TOTALS | $4,200,000 | $4,200,000 | $6,300,000 | $1,800,000 | $1,800,000 | $2,700,000 |
| General Dollar Lessor, LLC | Capital Accounts | Outside Basis | Fair Market Value | Capital Accounts | Outside Basis | Fair Market Value |
| Initial Balances | $0 | $10,000,000 | $14,700,000 | $0 | $0 | $6,300,000 |
| Children Indemnify 30% Debt | | ($3,000,000) | | | $3,000,000 | |
| TOTALS | $0 | $7,000,000 | $14,700,000 | $0 | $3,000,000 | $6,300,000 |

f. With the marketable securities and real estate assets now segregated, upon Mr. Developer's death the discount taken with respect to the estate's partnership interest in FLLLP might be less, thus facilitating a higher step-up in basis in the securities. The estate's partnership interest in General Dollar Lessor, LLC would be subject to a significant discounting, but indemnification of Mr. Developer by the children (as discussed above) could prevent the discount from effectively nullifying the benefit of the basis step-up.

2. Example 2: In-Kind Distributions and Section 754 Election

a. Partner indemnification of debt is not the only means to engage in tax basis management with partnerships. In the right circumstances, the estate-planning advisor should consider in-kind distributions of property from a family partnership to one or more partners.

b. Consider the following hypothetical situation:

(1) Assume that ABC Family LLC owns raw land held for long-term investment. A has a 33.34% interest in ABC Family LLC, while each of A's adult children, B and C, have a 33.33% interest in ABC Family LLC. Each member of ABC Family LLC has an outside basis in his membership interest of $1.5 million.

(2) Assume further that the raw land held by ABC Family LLC is unencumbered and consists of the following three parcels of land: Parcel 1 has an adjusted basis of $4 million but a value of only $2 million; Parcels 2 and 3 each have an adjusted basis of $250,000 and a value of $5 million. Thus, ABC Family LLC is worth a total of $12 million and has an aggregate adjusted basis of $4.5 million in the land. Each member's interest in ABC Family LLC therefore is worth $4 million before taking into account any valuation discounts. Notice as well that the aggregate inside basis of ABC Family LLC in the raw land ($4.5 million) is equal to the aggregate outside basis (3 x $1.5 million = $4.5 million) of the members of ABC Family LLC.[470] Further assume that all capital contributions to ABC Family LLC are outside the seven year prohibition such that the "mixing bowl" and "disguised sale" rules are not implicated.[471]

[470] Typically, absent the death of a partner or a sale or exchange of a partner's partnership interest, the aggregate inside basis of a partnership in its property will equal the aggregate outside basis of the partners in their partnership interests.

[471] If ABC Family LLC has been in existence for at least seven years, and no appreciated or depreciated property has been contributed to the ABC Family LLC by the partners within the past seven years, then the ABC Family LLC will avoid the "mixing bowl" and "disguised sale" rules of Sections 704(c)(1)(B), 707(a)(2)(B), 731(c), 737, and 751(b).

c. Section 754 Election and Tax Basis Management

(1) Assume that A dies leaving his entire 33.34% membership interest in ABC Family LLC to his children, B and C. Assume that A's membership interest has an outside basis of $1.5 million and a value of $4 million at the time of A's death.[472] ABC Family LLC typically would make a section 754 election to optimize the estate's step-up in basis in A's membership interest. Pursuant to section 743(b), the election allows A's estate (which ultimately benefits B and C) to adjust its proportionate share of ABC Family LLC's inside basis in the land by a net amount of $2.5 million (i.e., an amount equal to the outside basis step-up in A's membership interest from $1.5 million to $4 million).[473]

(2) It is important to understand that the adjustment under section 743(b) is personal to the transferee partner (A's estate, and ultimately B and C). The adjustment is thus made to the transferee's (the estate's) *share of the inside basis* of the partnership in its property, not the partnership's basis in the property itself.[474] In the case of ABC Family LLC, the estate's share (as well as B's and C's respective shares) of the inside basis of the partnership in the land is as follows: Parcel 1 equals $1.334 million (one-third of inside basis of $4 million) and Parcels 2 and 3 equal $83,334 (one-third of inside basis of $250,000 in each parcel).

(3) Next, under section 755, the amount of the adjustment under section 743(b) ($2.5 million) must be allocated among the individual items of ABC Family LLC's property. The adjustment to the basis of items of partnership property is determined by reference to what would be the allocation of gains and losses to the transferee partner (A's estate) from a hypothetical sale of the partnership's property.[475] Moreover, the allocation of the adjustment across items of partnership property is made by reference to the net amount of the adjustment. Therefore, some items of partnership property (such as built-in loss property) may be subject to a negative adjustment while other items of partnership property (such as built-in gain property) are subject to a positive adjustment.[476]

(4) If, on a hypothetical sale, after A's death ABC Family LLC sold all of its property for its then fair market value, the gain and loss from such a sale would be allocated to A's estate as follows: $1.583 million gain [one-third of the built-in gain of $4.75 million ($5 million less adjusted basis of $.25 million)] from each of Parcels 2 and 3; and $.667 million loss (one-third of the $2 million built-in loss) from Parcel 1. Accordingly, the $2.5 million net adjustment under section 743(b) for the estate with respect to ABC Family LLC is allocated as follows:

(a) decrease the estate's share of inside basis in Parcel 1 to $.667 million (i.e., the estate's pre-adjustment share of inside basis of $1.334 million attributable to Parcel 1 less the estate's $.667 million allocable share of loss on a hypothetical sale); and

---

[472] For the sake of simplicity, this example assumes no discounted value on the 33.34% membership interest held by A's estate. Even if A's membership interest is subject to a valuation discount, however, the same principles illustrated here apply.

[473] *See* Treas. Reg. § 1.743-1(b).

[474] *See* § 743(b) (flush language).

[475] Treas. Reg. § 1.755-1(b)(1)(ii).

[476] Treas. Reg. § 1.755-1(b)(1).

(b) increase the estate's share of inside basis in Parcels 2 and 3 to $1.667 million each (i.e., the estate's pre-adjustment share of inside basis of $83,334 per parcel plus the estate's $1.583 million per parcel allocable share of gain from a hypothetical sale).

(5) The ultimate goal of these complicated adjustments is to ensure that if ABC Family LLC sold all of its assets for their fair market values at the time of A's death, the estate would benefit from the step-up in basis and (on a net basis) would not be allocated gain or loss from the sale. And, if we re-examine the facts of our hypothetical, we see that by virtue of the adjustments under section 743(b) this result is, in fact, produced. In particular, the estate's inside share of basis with respect to Parcels 1 and 2 has been adjusted to $1.667 million each. Thus, if Parcels 1 and 2 sell for their respective fair market values of $5 million each, the estate's one-third share of the proceeds from each parcel would be $1.667 million (one-third of $5 million), exactly equal to the estate's adjusted share of inside basis per parcel. Thus, no gain or loss with respect to the sale of either Parcel 1 or 2 will be recognized by the estate. Likewise, if Parcel 1 sold for its fair market value of $2 million, the estate's share of the proceeds would be $.667 million (one-third of $2 million), exactly equal to the estate's adjusted share of inside basis with respect to Parcel 1. Again, no gain or loss will be recognized by the estate with respect to the sale of Parcel 1.

d. Benefits to B and C as A's Heirs

(1) If we now examine ABC Family LLC from the perspective of B and C, the heirs to A's estate, we see that on balance the step-up in basis, the section 754 election, and the corresponding adjustments under section 743(b) benefit B and C. B and C benefit because $2.5 million of built-in gain within ABC Family LLC that would have been allocable to A prior to his death is now offset by the net $2.5 million adjustments made to Parcels 1, 2, and 3.[477]

(2) Upon closer examination, however, we also see that the result of the $2.5 million net adjustment is not entirely beneficial to B and C. First, there is no question that B and C benefit from the positive adjustment attributable to the estate's share of inside basis in Parcels 2 and 3. The adjustment reduces the taxable gain that B and C will report from a sale of either Parcel 2 or 3 by ABC Family LLC. On the other hand, though, the negative adjustment to the estate's share of inside basis in Parcel 1 is unfavorable. This negative adjustment reduces

[477] More specifically, B's and C's shares of inside basis in ABC Family LLC's property were $1.334 million each in Parcel 1 and $83,334 each in Parcels 2 and 3 prior to A's death. Without the Section 754 election and the corresponding adjustments under Section 743(b), B's and C's shares of inside basis simply would have reflected their inherited portions of A's inside basis prior to his death: B's and C's share of inside basis in Parcel 1 would have been $2 million each [$1.334 million plus $.666 million, which is one-half of A's former share ($1.334 million) of inside basis in Parcel 1]; and B's and C's respective shares of inside basis in Parcels 2 and 3 would have been $.125 million each [$83,334 plus $41,666, one-half of A's former share ($83,334) of inside basis in each of Parcels 2 and 3].

By virtue of Sections 754 and 743(b), however, B's and C's shares of inside basis in Parcels 1, 2, and 3 are as follows: B's and C's respective shares of inside basis in Parcel 1 are lower--$1.667 million each [$1.334 million plus $.3335 million, one-half of the estate's adjusted share ($.667 million) of inside basis in Parcel 1]; B's and C's respective shares of inside basis in Parcels 2 and 3 are higher--$.9175 million each [$83,334 plus $.834 million, one-half of the estate's adjusted share ($1.667 million) of inside basis in each of Parcels 2 and 3].

the amount of loss that B and C would report from a sale of Parcel 1 by ABC Family LLC had the section 754 election not been made.

(3) Put differently, the section 754 election and corresponding adjustments apply across every item of partnership property. There is no ability to pick and choose which assets to adjust so that built-in gain is reduced while built-in loss is preserved. Nonetheless, ABC Family LLC perhaps could have distributed the built-in loss property, Parcel 1, to A in partial redemption of A's 33.34% membership interest in order to better optimize the favorable aspects of the section 754 election.

e. Distributing Loss Property to Optimize Section 754 Election

(1) Under section 731, a current (i.e., non-liquidating) in-kind distribution of property (other than money) to a partner generally does not result in the recognition of gain or loss to the partnership or to the distributee partner.[478] Instead, the distributee partner takes a basis in the property equal to but not in excess of the distributing partnership's basis, and the distributee partner reduces his outside basis in his partnership interest by an amount equal to his basis in the distributed property.[479] Moreover, if the distributing partnership makes (or has in effect) a section 754 election and the distributed property had a basis in the partnership's hands higher than the distributee partner's outside basis in his partnership interest, then the excess results in a positive adjustment under section 734(b) to the distributing partnership's basis in its remaining assets.[480] Unlike the adjustments under section 743(b) (e.g., arising upon the death of partner), the adjustment under 734(b) is not personal to the distributee partner. Instead, where it applies, section 734(b) creates an upward or downward adjustment in the partnership's basis in its remaining property. Then, under section 755, the adjustment under section 734(b) is allocated across the partnership's remaining property according to unrealized appreciation or depreciation among classes and items of property (in accordance with the methodology set forth in the Treasury Regulations).[481]

(2) If we apply these rules in the context of ABC Family LLC, and assume that Parcel 1 (the built-in loss property) is distributed to A prior to his death, then we can produce a more favorable result to B and C (A's heirs) than is produced if Parcel 1 is not distributed and ABC Family LLC makes a section 754 election upon A's death.

(3) To wit, recall that ABC Family LLC is worth $12 million and that A, B, and C own membership interests in ABC Family LLC worth $4 million each (assuming no valuation discount).[482] A, B, and C have an outside basis of $1.5 million each in their membership interests. Parcel 1 is a built-in loss property with a basis of $4 million and a value of $2 million. Parcels 2 and 3 are each built-in gain properties with adjusted bases of $20,000 each and values of $5 million each.

---

[478] § 731(a)-(b). Under Section 731(c), though, an in-kind distribution of marketable securities can be treated as a distribution of money triggering gain (but not loss) to the distributee partner.

[479] §§ 732(a) and 733.

[480] *See* § 734(b).

[481] *See* Treas. Reg. § 1.755-1(c).

[482] Again, for the sake of simplicity, this example assumes no discounted value.

(4) Assume that ABC Family LLC distributes Parcel 1 to A prior to his death in partial redemption of his membership interest and also makes a section 754 election. Under the rules of subchapter K, the following results obtain:

(a) Under sections 731 and 732, A takes Parcel 1 with a value of $2 million and a basis of $1.5 million (exactly equal to A's outside basis in his partnership interest).

(b) Under section 733, A's outside basis in his interest in ABC Family LLC is reduced to zero.

(c) A's percentage interest in ABC Family LLC is reduced to 20% (because A is left with a membership interest worth $2 million in a partnership worth $10 million).[483]

(d) B's and C's percentage interests in ABC Family LLC increase to 40% each (because they each have membership interests worth $4 million in a partnership worth $10 million).

(e) *Most importantly*, an adjustment under section 734(b) in the amount of $2.5 million arises from the distribution of Parcel 1 to A (e.g., $4 million inside basis in Parcel 1 less A's $1.5 million outside basis in his membership interest immediately prior to the distribution).

(5) Then, under section 755, the $2.5 million adjustment under section 734(b) must be allocated across Parcels 2 and 3 in proportion to the unrealized gain in each parcel. The unrealized gain in each of Parcels 2 and 3 is the same: $4.75 million. ABC Family LLC therefore increases its inside basis in Parcels 2 and 3 by $1.25 million each. This leaves ABC Family LLC holding Parcels 2 and 3 worth $5 million each with an inside adjusted basis of $1.5 million each ($.25 million plus $1.25 million).

(6) Next, assume that A dies holding his 20% membership interest in ABC Family LLC and Parcel 1. A's membership interest had a non-discounted value of $2 million and a basis of zero. Parcel 1 had a value of $2 million and a basis of $1.5 million. A's estate steps up its basis in the ABC Family LLC membership interest from zero to $2 million. A's estate steps up its basis in Parcel 1 from $1.5 million to $2 million. Furthermore, under section 754, the $2 million step-up in the estate's outside basis in its membership interest in ABC Family LLC gives rise to a $2 million adjustment under section 743(b). That $2 million positive adjustment increases the estate's (and ultimately B's and C's) share of inside basis in Parcels 2 and 3 by $1 million each. This $1 million positive adjustment under section 743(b) is in addition to the $1.25 million positive adjustment under section 734(b) that previously had been made to Parcels 2 and 3 as result of the distribution of Parcel 1 to A.

(7) B and C thus inherit from A Parcel 1 with a value of $2 million and a basis of $2 million. There is no longer a trapped, built-in loss in Parcel 1. B and C also inherit from A his 20% interest in ABC Family LLC, leaving B and C owning 50% each of ABC

[483] As discussed above, non-pro-rata distributions of property in family partnerships almost always should result in adjustment of the partners percentage interests in the partnership. Otherwise, the special valuation rules of Chapter 14 will come into play.

Family LLC. Due to the combination of the adjustments under sections 734(b) and 743(b) though, Parcels 2 and 3 effectively have an adjusted basis to B and C of $2.5 million each determined as follows:

(a) Parcels 2 and 3 each had $1.5 million basis after the IRC § 734(b) inside basis adjustments (described above) upon the distribution of Parcel 1 to A.

(b) A's death gives rise to a $2 million adjustment under section 734(b) to the estate's share of inside basis in Parcels 2 and 3 which remain held by ABC Family LLC.

(c) Under section 755, this $2 million positive adjustment must be allocated across Parcels 2 and 3 to increase the estate's share of inside basis attributable to Parcels 2 and 3.

(d) The Treasury Regulations under section 755 allocate the $2 million adjustment in proportion to relative fair market values of assets inside ABC Family LLC.

(e) Because Parcels 2 and 3 have the same value ($5 million each), the estate's $2 million adjustment under section 743(b) is allocated equally between Parcels 2 and 3.

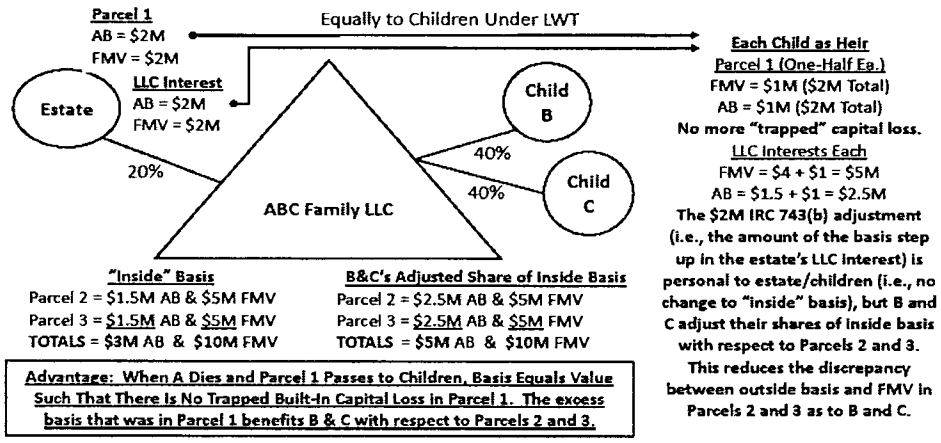
(f) Therefore, the estate's share of the inside basis of ABC Family LLC in Parcels 2 and 3 is $1 million each.

(g) B and C then inherit the estate's share of ABC Family LLC's $1 million inside basis in Parcels 2 and 3.

(h) When combined with ABC Family LLC's existing inside basis of $1.5 million each in Parcels 2 and 3, B's and C's inside shares of basis in Parcels 2 and 3 are now $2.5 million each.

(8) A diagram illustrating the ultimate results to A's estate and to B and C is set forth below:

ABC Family LLC Alternative Two: Step-Up at Death in Parcel 1 and LLC Interest




(9) As can be seen from the foregoing analysis and the diagram, the carefully planned distribution of Parcel 1 optimizes the results of the section 754 election. In other words, the basis and value of Parcel 1 in B's and C's hands is equal, avoiding receipt of property with built-in loss that can be realized only upon sale. Further, B's and C's inside shares of basis in Parcels 2 and 3 within ABC Family LLC are higher ($2.5 million each versus $1.835 each) than where Parcel 1 is not distributed and A dies holding a 33.34% interest in ABC Family LLC.

(10) In short, the carefully planned distribution of Parcel 1 re-allocated $2 million of excess basis to Parcels 2 and 3 to reduce their built-in gain, rather than trapping a large portion of that excess basis as built-in loss in Parcel 1.

M. Basis Planning with Charitable Entities

1. One of the tax benefits of having a partner that is a charitable entity is its tax-exempt status. When a charitable entity holds a partnership interest, however, due regard should be given to unrelated business taxable income[484] and excess benefit transactions.[485] Further, if the charitable entity is a private foundation, planners should consider the rules relating to self-dealing transactions[486] and excess business holdings.[487] A full discussion of these and other related rules is beyond the scope of these materials. For purposes of these materials, it is assumed that the charitable partner is a public charity, and the assets in the partnership do not give rise to unrelated business taxable income, excess benefit transactions, or private inurement issues.

---

[484] § 511.

[485] § 4958.

[486] § 4941

[487] § 4943.

2. As discussed above, Revenue Ruling 84-53 provides that when a partner transfers (gratuitous or taxable) a partnership interest and the interest carries a valuation discount, a disproportionately smaller amount of basis is transferred to the transferee. Further, as discussed in these materials, a tax basis "shift" is predicated upon the partnership distributing a higher inside basis asset (in-kind) to a partner whose outside basis in the partnership is lower than the distributed asset. With these rules in mind, a gift of a non-controlling partnership interest to a charitable entity may provide significant tax basis planning opportunities.

3. Consider the following highly simplified hypothetical:

a. Taxpayer creates a limited partnership and contributes to the partnership the following assets:

(1) Asset A with a zero basis and fair market value of $100; and

(2) Asset B with $100 basis and fair market value of $100.

b. As a result of the contribution, the taxpayer takes back a 1% general partnership interest and 99% limited partnership interest. Assume another person contributes and owns a nominal interest in the partnership to ensure that the entity is a partnership for income tax purposes, rather than a disregarded entity (see the discussion later in these materials). For purposes of this hypothetical, ignore the existence of this nominal partner. Outside basis in the taxpayers partnership interest is $100 and his capital account is $200. Assume for purposes of this example that the taxpayer's interest (prior to any transfer) in the partnership remains at $200 (no valuation discounts).

c. Taxpayer donates 50% of the limited partnership interest to charity (retaining the 1% general partnership interest and a 49% limited partnership interest). Assume the value of the limited partnership interest carries a 50% valuation discount. In other words, the value for income and gift tax purposes is $50.[488]

d. Under Revenue Ruling 84-53, the basis of charity's partnership interest is only $25, and taxpayer's outside basis is $75:

$$\frac{\text{Transferor's Adjusted Basis}}{\$100} \times \frac{\text{Fair Market Value (Discounted) Transferred Portion}}{\text{Fair Market Value Transferor's Entire Portion}} = \frac{\$50}{\$200} \qquad \frac{\text{Transferee's Adjusted Basis}}{\$25}$$

e. Notwithstanding the foregoing, charity's capital account, under the Treasury Regulations,[489] is $100.

[488] Assuming the charitable entity is a public charity and the partnership does not have any "hot asset" under section 751 of the Code, the taxpayer will receive a $50 income tax deduction. *See* § 170(e)(1)(A).

[489] Treas. Reg. §§ 1.704-1(b)(2)(iv)(l) and 1.704-1(b)(5), ex. 13.

| Transferor's Capital Account | x | Percentage Transferred | = | Transferee's Capital Account |
|---|---|---|---|---|
| $200 | | 50% | | $100 |

f. At least 7 years after the contribution of the assets, assuming the assets remain in the partnership and there has been no change in the values, the partnership liquidates charity's interest (according to its capital account balance) and distributes Asset B ($100 basis and fair market value of $100) to charity. Assume the LLC has a section 754 election in place at the time of the distribution of Asset B.

g. The basis of Asset B owned by charity has its basis replaced by charity's outside basis in the partnership. As a result, Asset B's basis is $25. Charity can then sell the Asset B and recognize the gain in a tax-exempt environment.

h. With the section 754 election, the $75 of basis reduction (basis strip) results in an increase in the basis to Asset A under section 734(b) of the Code. Asset A's basis goes from zero to $75. As discussed in in more detail above, the basis adjustment under section 734(b) is to partnership property, so if the partnership sells Asset A, the basis increase will benefit all of the remaining partners (the taxpayer and any transferees of the taxpayer's retained interest).

## III. INCOME TAX AVOIDANCE AND DEFERRAL WITH PARTNERSHIPS

### A. Generally

1. With the higher income tax rates, progressivity in the marginal income tax brackets provides an opportunity for taxpayers to take advantage of "running the brackets" and taxing income at lower effective tax rates. With the highest income tax rates becoming effective at $466,950 of taxable income for joint filers and the NIIT being applied when MAGI exceeds $250,000, the tax savings can be quite significant. At ordinary rates, "running the bracket" provides approximately $43,830 of tax savings (the difference between being taxed at the highest rate of 39.6% and the actual tax liability) for single filers and $54,333 for joint filers, and at long-term capital gain tax rates, the tax savings are $30,235 and $36,612, respectively:[490]

[490] Rev. Proc. 2015-53, 2015-44 I.R.B. 615.

| *STCG/Ordinary Rate* | Single ($43,830 in savings) | Joint ($54,333 in savings) |
|---|---|---|
| *10%* | $0-$9,275 | $0-$18,550 |
| *15%* | $9,276-$37,650 | $18,551-$75,300 |
| *25%* | $37,651-$91,150 | $75,301-$151,900 |
| *28% / 31.8%* | $91,151-$190,150 | $151,901-$231,450 |
| *33% / 36.8%* | $191,151-$412,350 | $231,451-$413,350 |
| *35% / 38.8%* | $413,351-$415,050 | $412,351-$466,950 |
| *39.6% / 43.4%* | $415,051 and above | $466,951 and above |

| LTCG/QD Rate | Single ($30,235 in savings) | Joint ($36,612 in savings) |
|---|---|---|
| 0% | $0-37,650 | $0-$75,300 |
| 15% | $37,651-*$200,000 MAGI* | $75,301-*$250,000 MAGI* |
| 18.8% | *$200,001 MAGI*-$415,050 | *$250,001 MAGI*-$466,950 |
| 23.8% | $415,051 and above | $466,951 and above |

2. As a result, taxpayers will increasingly look for opportunities to not only defer the payment of income taxes (which provides a present value economic benefit) but to have the income spread out over many taxable years and over multiples of taxpayers. This will provide the benefit of having the income taxed at a lower tax rate by running the brackets, and to also fully avoid the imposition of certain taxes like the NIIT (for such annual amounts that remain below $200,000 to $250,000 of MAGI).

A. "Splitting" Income with Partnerships

1. The most flexible vehicle available to practitioners to "split" income among taxpayers are entities taxed as partnerships. While an S corporation will spread the entity's income across the shareholders, the capital structure of an S corporation investment is limited to one class of stock so there is no ability to disproportionately allocate income to certain shareholders (who are taxed at lower marginal income tax brackets and who may not be subject to state income tax) to the exclusion of other shareholders (who are already at the highest income tax brackets and who may be residents of a high income tax state like California).[491]

2. Unlike S corporations, partnerships can be structured to provide different classes of ownership interests. In the family-owned entity context, if different ownership

[491] § 1361(b)(1)(D).

interests are utilized, careful consideration must be given to section 2701 because the "same class"[492] exception will not be available. Notwithstanding the foregoing, "preferred" partnership interests can be created that avoid the punitive effects of section 2701, namely the "zero valuation" rule.[493] These types of "preferred" interests include:

a. A "qualified payment"[494] interest (discussed in more detail later in the following article of this outline), which is an exception to the zero valuation rule;

b. A "deemed" or "electing" qualified payment, which is an exception to zero valuation rule;[495]

c. A "guaranteed payment" right under section 707(c), which is an exception to section 2701;[496] and

d. A "mandatory payment right," which is an exception to section 2701.[497]

3. Generally, the Code and the IRS take the position that if a partner holds a preferred interest in a partnership, taxable income should follow with the preferred interest payment.

a. For guaranteed payment rights, the taxation to the partnership and the partners is relatively straightforward. A partnership that makes a guaranteed payment to partner is entitled to either deduct the payment as an ordinary and necessary business expense[498] of the partnership or capitalize[499] the expense as a capital expenditure, depending on the nature of the payment.[500] The partner receiving the guaranteed payment must include the payment as ordinary

---

[492] § 2701(a)(2)(B).

[493] § 2701(a)(3)(A).

[494] § 2701(c)(3)(A).

[495] These are specified amounts to be paid at specified times that nonetheless do not qualify as a "qualified payment" but which the taxpayer elects to treat as such. § 2701(c)(3)(C)(ii).

[496] Excluded from the definition of "distribution right" is "any right to receive any guaranteed payment described in section 707(c) of a fixed amount." § 2701(c)(1)(B)(iii). The Code defines guaranteed payments as "payments to a partner . . . for the use of capital" but only "to the extent determined without regard to the income of the partnership to a partner for . . . the use of capital." § 707(c). The Treasury Regulations go on to explain that a guaranteed payment is meant to provide the partner with a return on the partner's investment of capital (as opposed to payments designed to liquidate the partner's interest in the partnership). Treas. Reg. § 1.707-4(a)(1)(i).

[497] A "mandatory payment right" is a right to a required payment at a specified time. For purposes of Section 2701 it is considered neither an extraordinary payment right nor a distribution right. It includes a right in preferred stock requiring that the stock be redeemed at its par value on a date certain and it also includes a right to receive specific amount on the death of the holder. Treas. Reg. § 25.2701-2(b)(4)(i). The Service has also ruled that a mandatory payment right includes the right to redeem preferred stock at a stated value plus any accrued and unpaid dividends on the earlier to occur of a certain date or change in control of the company. PLR 9848006.

[498] § 162(a).

[499] § 263.

[500] § 707(c).

income[501] in the year in which the partnership paid or accrued the payment under its method of accounting.[502]

b. For the other types of preferred interests, the allocation of income is a bit more convoluted. Generally, the income allocated to the preferred payment depends on the distributive share of the partnership. The McKee, Nelson and Whitmire treatise provides that the Service expects a preferred return to be matched by a corresponding allocation of available income or gain.[503] The Treasury Regulations, in the context of the disguised sale rules, provide that a preferred return means "a preferential distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of gain."[504]

4. With the goal of disproportionately allocating income to lower taxed individuals, practitioners should make note of the "junior equity" exception to section 2701.

a. The Code provides that a distribution right does not include a right to distributions with respect to any interest which is junior to the rights of the transferred interest.[505]

b. The Treasury Regulations also exempt an interest that is of the same class, or a class that is subordinate to, the transferred interest.[506]

c. This is one of the most significant exceptions to section 2701 from a tax planning standpoint. Essentially, it is an exception for the transfer of the preferred or senior equity interest (with the retention of the junior equity or common interest by the transferor). As an exception to section 2701, normal gift tax rules apply to such transfer of the preferred interest, along with any applicable valuation discounts for lack of marketability and minority interest discount. Equally as important, as mentioned above, the preferred return will carry a preferred allocation of the tax items of the partnership.

B. Non-Grantor Trusts: Distributions and Partnerships

1. As mentioned above, non-grantor trusts are taxed at the highest rates once taxable income exceeds $12,400. As such, non-grantor trusts carry an inherent income tax disadvantage when compared to how those same assets would grow if they were held by an individual or group of individual taxpayers. Trustee should consider whether making distributions to trust income might better serve the overall purposes of the grantor and the grantor's family, in terms of total wealth accumulation.

2. Even with trusts where the primary objective is to accumulate as much wealth in the trust as possible (for example, a "dynasty trust" or GST tax exempt trust), trustees may be

---

[501] *See* 61(a).

[502] § 706(a) and Treas. Reg. §§ 1.706-1(a)(1) and 1.707-1(c).

[503] McKee, Nelson and Whitmire, *Federal Taxation of Partnerships and Partners*, ¶ 13.02[3][b][iii], at 3-19 (3d ed. 1997).

[504] Treas. Reg. § 1.707-4(a)(2).

[505] § 2701(c)(1)(B)(i).

[506] Treas. Reg. § 25.2701-2(b)(3)(i).

able to produce more total wealth by distributing trust income out to the trust beneficiaries, especially if the trust beneficiaries would be taxed at lower income tax rates, would not be subject to state income tax, and have sufficient Applicable Exemption Amount and GST exemption available to shelter whatever assets may accumulate in the gross estates of the beneficiaries. Given the potential number of taxpayers or beneficiaries a trust could spread the income across, the savings could be significant.

3. Trust distributions that carry out distributable net income ("DNI")[507] of the trust would effectively ensure taxation of the income to the beneficiaries. DNI determines the amount of income that may be deducted by the trust resulting from distributions and determines the character of the income items taxable to the beneficiaries.[508] Determining DNI for a trust requires first determining the taxable income of the trust and modifying that figure in a number of ways. With respect to capital gain, the Code provides, "[g]ains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not . . . paid, credited or required to be distributed to any beneficiary during the taxable year."[509] In other words, absent certain circumstances, capital gain is excluded from DNI and is taxable to the trust, rather than to the beneficiary receiving the distributions.

4. Often the governing instrument will give the trustee the authority to allocate gains between income and principal. Under the Treasury Regulations, however, "Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized."[510] The Treasury Regulations provide that capital gain is ordinarily excluded from DNI, with a number of notable exceptions:[511]

> *Capital gains included in distributable net income.* Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law)—
>
> (1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of the distributable net income determined without regard to this subparagraph 1.643(a)-3(b));
>
> (2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or

---

[507] § 643.

[508] §§ 651(b), 652(a), 652(b), 661(a), 662(a) and 662(b).

[509] I.R.C. § 643(a)(3). *See* Treas. Reg. § 1.643(a)-3(a) regarding the treatment of capital gains and losses in the taxable year in which the trust or estate terminates.

[510] Treas. Reg. § 1.643(b)-1.

[511] Treas. Reg. § 1.643(a)-3(a).

(3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.[512]

5. Notwithstanding the limited discretion granted to fiduciaries under the foregoing provisions, given the potential limitations of including capital gain in DNI and the fact that many clients would prefer not to have the asset held personally by the beneficiaries, practitioners may be able to accomplish the same types of tax savings by utilizing a partnership structure where the beneficiary is a partner along with the trust. By way of example, the trust could from an entity taxable as a partnership like a limited partnership or limited liability company and distribute an interest in the entity to the beneficiary. Whether such distribution carries out DNI to the beneficiary is secondary to the fact that on an ongoing basis a proportionate amount of partnership income will be allocated to the beneficiary. While a preferred interest partnership structure can be utilized, as discussed above, and practitioners should be aware of the implications under section 2701 upon the creation of the preferred partnership with the beneficiary or the distribution of a preferred interest in the partnership to the beneficiary.

6. Given that any partnership interest held by a trust beneficiary will be in his or her gross estate for estate tax purposes, practitioners will want to consider utilizing IDGTs to minimize the estate tax impact but still retain the income tax benefits of having the partnership income taxed to the beneficiary-grantor. For example, the beneficiary may want to sell his or her partnership interest to an IDGT created by the beneficiary, as the grantor for grantor trust purposes.

C. Trust to Trust Preferred Partnership

1. Consider the following hypothetical situation:

a. Trust A is an irrevocable resident trust of State A, which is a no or low income tax state. Trust B is an irrevocable resident trust of State B, which is a high income tax state. Trust A and Trust B were created many years ago by grantors who are now deceased, and both trusts are held for benefit of the same beneficiaries. The terms of both trusts, particularly the provisions describing the beneficial interests of the beneficiaries, are substantially similar to each other. Trust A and Trust B each hold $10 million in publicly-traded securities.

b. Trust A and Trust B consolidate their assets by contributing them to a limited liability company (now holding $20 million), with Trust A receiving preferred interests in the LLC, and with Trust B receiving common interests in the LLC, as follows:

(1) The preferred interest held by A is structured as follows:

(a) $10 million liquidation preference (upon dissolution of the LLC, this amount will be paid to the preferred partner in cash or in-kind before any liquidating distributions are made to the common holder); and

[512]Treas. Reg. § 1.643(a)-3(b). Since the issuance of the final regulations, the service has ruled that the exclusion and inclusion of capital gains in determining DNI was a reasonable exercise of discretion. *See* PLRs 200617004 and 200448001.

(b) An annual, cumulative preferential right to partnership cash flow equal to 10% of the liquidation preference ($1,000,000 annually).

(2) The common interest held by B retains all of the residual interest in any annual cash flow, liquidation proceeds, and earnings of the LLC after the preferred interest holders have been paid.

2. Each year, the LLC pays $1,000,000 of cash flow to Trust A. The portfolio of the LLC generates $1,000,000 or less of taxable income (capital gain and portfolio income). Assuming no tax items need to be allocated to Trust B under section 704(c) of the Code, all of the taxable income will be allocated to Trust A, the low or no state income tax Resident Trust. No income will be allocated to Trust B.

3. There are strong arguments to support the conclusion that when Trust A and Trust B create the preferred LLC described above, section 2701 of the Code either does not apply or at worst has no transfer tax consequences:

a. Section 2701 of the Code is gift tax provision. For it to apply, Trust A or Trust B must be making a gift to the other. For example, as a result of the formation of the LLC, Trust B is deemed to make a gift to Trust A. It is unclear whether an irrevocable trust can even make a gift like that. The original transfer to Trust B was made by a grantor or testator who is now deceased.

b. Perhaps, there is a deemed gift from the beneficiaries of Trust B to the beneficiaries of Trust A. As mentioned above, section 2701 of the Code provides that in determining whether a gift has been made and the value of such gift, when a person transfers an interest in a partnership to a "member of the transferor's family"[513] the value of certain "applicable retained interests" will be treated as zero.[514] "Transfer" is broadly defined and is deemed to include "a contribution to capital or a redemption, recapitalization, or other change in the capital structure of a corporation or partnership."[515] A "member of the transferor's family" means: (a) the transferor's spouse, (b) a lineal descendant of the transferor or the transferor's spouse, or (c) the spouse of any such lineal descendant.[516] For these purposes, an individual is treated as holding any interest to the extent held indirectly through a trust.[517] If the beneficiaries of Trust A are making a gift to the beneficiaries of Trust B, aren't they making a gift to themselves because they have the same beneficial interests in both trusts? For a taxable gift to occur, property must be transferred for less than adequate and full consideration in money or money's worth.[518]

c. Section 2701 of the Code does not apply to a transfer "to the extent the transfer by the individual results in a proportionate reduction of each class of equity interest held by the individual and all applicable family members in the aggregate immediately before the

---

[513] § 2701(a).

[514] § 2701(a)(1)(3)(A).

[515] § 2701(e)(5).

[516] § 2701(e)(1).

[517] § 2701(e)(3).

[518] § 2512(b).

transfer."[519] This is often referred to as the vertical slice exception. The Treasury Regulations provide, for interests held in trust:

> A person is considered to hold an equity interest held by or for an estate or trust to the extent the person's beneficial interest therein may be satisfied by the equity interest held by the estate or trust, or the income or proceeds thereof, assuming the maximum exercise of discretion in favor of the person. A beneficiary of an estate or trust who cannot receive any distribution with respect to an equity interest held by the estate or trust, including the income therefrom or the proceeds from the disposition thereof, is not considered the holder of the equity interest.

d. In our hypothetical, the beneficial interest of the beneficiaries of Trusts A and Trust B are substantially similar. It would seem that even if Section 2701 of the Code applied, the vertical slice exception would also apply.

4. Out of an abundance of caution, practitioners should structure the preferred interest as a "qualified payment" interest (which is discussed in more detail later in this outline). A qualified payment "means any dividend payable on a periodic basis under any cumulative preferred stock (or a comparable payment under any partnership interest) to the extent that such dividend (or comparable payment) is determined at a fixed rate."[520] A payment will be treated as a "fixed rate" if the payment is "determined at a rate which bears a fixed relationship to a specified market interest rate."[521] The Treasury Regulations provides that a qualified payment is:

a. "A dividend payable on a periodic basis (at least annually) under any cumulative preferred stock, to the extent such dividend is determined at a fixed rate."[522]

b. Any other cumulative distribution payable on a periodic basis (at least annually) with respect to an equity interest, to the extent determined at a fixed rate or as a fixed amount."[523]

5. The preferred interest held by Trust A provides for a cumulative fixed annual payment of $1 million to Trust A, so it is considered a qualified payment interest. This avoids the risk of the zero valuation rule applying and reduces the value of any deemed gift from Trust A to Trust B under the subtraction method (as discussed in more detail later in this outline). When one runs through the attribution rules, given that the beneficiaries have substantially similar beneficial interests in both trusts, it is likely any net gift would be nominal (if section 2701 of the Code actually applied to this hypothetical).

6. Generally, the Code and the IRS take the position that if a partner holds a preferred interest in a partnership, taxable income should follow with the preferred interest payment.

---

[519] Treas. Reg. § 25.2701-1(c)(4).

[520] § 2701(c)(3)(A).

[521] § 2701(c)(3)(B). *See* Treas. Reg. § 25.2701-2(b)(6)(ii).

[522] Treas. Reg. § 25.2701-2(b)(6)(i)(A).

[523] Treas. Reg. § 25.2701-2(b)(6)(i)(B).

a. As mentioned above, a partnership that makes a guaranteed payment to a partner is entitled to either deduct the payment as an ordinary and necessary business expense[524] of the partnership or capitalize[525] the expense as a capital expenditure, depending on the nature of the payment.[526] The partner receiving the guaranteed payment must include the payment as ordinary income[527] in the year in which the partnership paid or accrued the payment under its method of accounting.[528] If the preferred interest is structured as a guaranteed payment, then the partnership (and consequently Trust B as part of its distributive share as a partner), in the hypothetical above, is entitled to a deduction that can reduce other taxable income.

b. As mentioned above, for the other types of preferred interests, generally, a preferred return to be matched by a corresponding allocation of available income or gain.

D. Sale of Partnership Interests vs. Distributions In-Kind

1. Taxable Sale of Partnership Interests

a. If a partner sells his or her partnership interest in a taxable transaction, the transferor recognizes gain or loss in accordance with the rules of section 1001.[529] The transferee takes a cost basis in the acquired partnership interest,[530] but the transferee's capital account is not based on the consideration tendered. The capital account of the transferee carries over from the transferor partner.[531] The purchased partnership interest carries with it the transferor's share of section 704(c) gain (both forward and reverse) in the partnership's assets.[532]

b. The character of the gain recognized by the selling partner is capital subject to recharacterization under section 751(a) for "hot assets," as discussed in more detail above.[533] Capital gain or loss is recognized as it would be under section 1001 less the amount of ordinary income (or plus the amount of ordinary loss) recharacterized under section 751(a).[534]

c. Section 1(h) provides that the tax rate on the capital gain portion of the sale is determined by looking through to the partnership assets at the time of the sale.[535] As a result, the transferor partner may recognize capital gain at a 20%, 25%, and 28% rate (along with the NIIT, if applicable to the taxpayer) depending on the nature of the assets in the partnership.

---

[524] § 162(a).

[525] § 263.

[526] § 707(c).

[527] *See* 61(a).

[528] § 706(a) and Treas. Reg. §§ 1.706-1(a)(1) and 1.707-1(c).

[529] § 741.

[530] § 742.

[531] Treas. Reg. § 1.704-1(b)(2)(iv).

[532] Treas. Reg. § 1.704-3(a)(7).

[533] § 741.

[534] Treas. Reg. § 1.751-1(a)(2).

[535] § 1(h)(5)(B), (h)(9), (h)(10) and Treas. Reg. § 1.1(h)-1(a).

The capital gain will be short-term or long-term depending on the transferor partner's holding period in the partnership interest. Notwithstanding the unitary basis requirement for partnership interests, as discussed above, the Treasury Regulations provide that a partner can have multiple holding periods for a single partnership interest.[536] As a result, the sale of a partnership interest can result in ordinary income, short-term capital gain, and long-term capital gain at a multitude of different rates.

d. As discussed below, a distribution of assets, rather than a sale of the partnership interest (particularly when the partner is exiting the partnership) may result in much better results for the exiting partner. The distribution is not subject to the look-through rule of section 1(h).

e. As discussed above, if the partnership has a section 754 election in place, the inside basis of the partnership's assets will be adjusted based upon the value of the consideration furnished by the purchasing partner. This will essentially give the income purchasing partner a fair market value basis in each of the partnership assets (assuming no valuation discount), so that if the partnership were to sell the assets at that time, no additional gain or loss would be borne by the incoming partner.[537]

f. A partnership terminates for tax purposes (i) on the sale or exchange of 50% or more interests in the capital and profits of the partnership within any consecutive 12 month period,[538] or (ii) sale of all other partnership interests to one remaining partner or a single new partner.[539] When a partnership is terminated, there is a deemed transfer of the assets from the old partnership to a new partnership, followed by a transfer of the interests in the new partnership to the partners of the old partnership (exactly like the "assets-over" transaction described above for partnership divisions).[540] The primary downside of a technical termination is that the partnership's depreciable tangible assets (but not for section 197 intangibles) is treated as newly placed in service as of the date of the technical termination.[541] The successor partnership must depreciate the adjusted basis of tangible assets as newly acquired assets placed in service on the termination date. On the other hand, qualified property placed in service by the terminated partnership during the taxable year of termination may be eligible for the first year "bonus" depreciation under §168(k), as mentioned above.

g. Importantly, despite the foregoing downside, a technical termination does not create any new section 704(c) amounts,[542] and does not start a new 7 year period for purposes of the mixing bowl provisions.[543] The termination does not trigger application of

---

[536] Treas. Reg. § 1.1223-3.

[537] In fact, in this instance, the gain or loss would be allocated to the purchasing partner in an amount equal to the gain or loss that would have been allocated to the transferor partner had there been no taxable sale of the interest, and then the inside basis adjustment under section 743(b) then offsets the gain or loss allocated. The effect is the same. *See* Treas. Reg. § 1.743-1(j)(3)(ii), Ex. 2.

[538] § 708(b)(1)(B) and Treas. Reg. § 1.708-1(b)(2).

[539] § 708(b)(1)(A), Treas. Reg. § 1.708-1(b)(1) and Rev. Rul. 99-6, 1991-1 C.B. 432.

[540] Treas. Reg. § 1.708-1(b)(4).

[541] Treas. Reg. § 1.708-1(b)(4), § 168(i)(7)(B) (final flush language), and § 197(f)(2).

[542] Treas. Reg. §§ 1.704-3(a)(3)(i), 1.704-4(c)(3), and 1.708-1(b)(4), Ex. (iii).

[543] Treas. Reg. §§ 1.704-4(a)(4)(ii) and 1.737-2(a),

section 731(c) (distributions of marketable securities),[544] allows carryover of the inside basis adjustment under section 743(b) in assets of the terminated partnership.[545]

2. Liquidating Distributions

a. The treatment of distribution (both current and liquidating) is discussed in more detail above.

b. As mentioned above, if the liquidating distribution includes cash, then gain or loss is recognized based on the amount of outside basis on the partnership interest prior to the distribution. Ordinary income will be generated under Section 751(b) to the extent that certain "hot assets" are in the partnership.[546] To the extent the distributee partner recognizes capital gain, the gain will be taxed at 20% (never 25% or 28%) because there is no look-through rule under section 1(h).[547] As one author points out, "While there is no obvious reason why the higher capital gain rates can apply to dispositions of partnership interests but not to distributions, that is the way the statute is written."[548] If a section 754 election is in place, any gain recognized by a distributee will not be also be allocated to the remaining partners (thereby avoiding the higher capital gain tax rates in the future for the remaining partners). If the liquidating distribution does not include cash in excess of outside basis, no gain will be recognized but ordinary income may be generated under section 751(b).

c. If property in-kind is distributed, the outside basis of the partnership interest replaces the basis of the distributed assets.[549] Ordinary income assets take a carryover basis, with any outside basis remaining going to the capital gain and section 1231 assets distributed.[550] Assuming a section 754 election, if the distributed capital assets receive additional basis after the distribution (or if there is a substantial basis reduction with respect to such distribution exceeding $250,000), then the partnership must adjust the inside basis of the remaining assets downward by that amount.[551] If the distributed capital asset results in a basis reduction, the partnership will receive an upward inside basis adjustment if a section 754 election is in place.[552] All of these adjustments are made pursuant to section 734(b) and are therefore for the benefit of the partnership and the remaining partners. If the distribution in-kind is not in

---

[544] Treas. Reg. § 1.731-2(g).

[545] Former Treas. Reg. § 1.743-2, T.D. 8717, 62 Fed. Reg. 25498 (3/9/97). The provision was omitted when the Treasury Regulations were rewritten by T.C. 8747, 64 Fed. Reg. 69903 (12/15/99).

[546] One thing to note, however, section 751(b) only applies to "substantially appreciated" inventory. *See* §§ 751(b)(1)(A)(ii) and 751(a)(2). To the extent that inventory exists but is not substantially appreciated, a distribution of cash in liquidation of a partnership interest will be considered capital gain, but a taxable sale of such interest would generate ordinary income under section 751(a). "Substantial appreciation" is defined in section 751(b)(3).

[547] The rule only applies to the sale or exchange of an interest. *See* § 1(h)(9) and Treas. Reg. § 1.1(h)-1(a).

[548] Howard E. Abrams, Now You See It; Now You Don't: Exiting a Partnership and Making Gain Disappear, 50 Tax Mgmt. Mem. No. 4 (2/16/09).

[549] § 732(b).

[550] § 732(c).

[551] § 734(b)(2)(B).

[552] § 734(b)(1)(B).

liquidation of the distributee partner's interest, the inside basis adjustment shifts results in a basis shift from the distributee partner to the non-distributee partners.[553]

3. Planning for FLPs: Sales vs. Distributions

a. Given the disparate treatment of taxable sales of partnership interests and distributions of partnership property, families in FLPs will often find distributions of assets in-kind more advantageous than a taxable sale of a partnership interest.

b. A number of strategies can be devised to take advantage of lower income tax bracket partners (including individuals or non-grantor trusts residing in no income tax states or private foundations). By way of example, one strategy might be distributing appreciated property to the lower income tax rate partner (not in liquidation of the partnership) prior to a taxable sale of the assets. This puts the appreciated property in hands of the lower income tax bracket partner

c. Another strategy might include a non-liquidating distribution of cash[554] in partial redemption of most of the departing partner's interest in the partnership (triggering gain), followed then by a taxable sale of the remaining partnership interest to another family taxpayer. This takes advantage of the no look-through feature of distributions, and with a section 754 election in place, a common inside basis adjustment in favor of the partnership under section 734(b) for the cash distribution, and then an inside basis adjustment in favor of the purchasing partner under section 743.

## IV. CREATIVE USES OF THE APPLICABLE EXCLUSION WITH PARTNERSHIPS

### A. Qualified "Cost-of-Living" Preferred Interests

1. As mentioned above, there are very good reasons for trying to retain as much Applicable Exclusion Amount as possible, even for very wealthy clients who have significant estate tax exposure. One technique that may be appealing is a traditional preferred freeze partnership, where the grantor retains a preferred interest in the partnership and gifts, or more likely, sells to an IDGT, a common interest in the partnership. The twist would be that the retained preferred interest would be adjusted for inflation to provide inflation-adjusted cash flow and ensure that the retained preferred interest in the gross estate would equal the grantor's Applicable Exclusion Amount on the grantor's death. Pursuant to this technique:

a. The retained preferred interest would be structured as a "qualified payment" interest under section 2701, so the zero valuation rule would not be applicable.

b. The liquidation preference of the preferred interest would be adjusted to provide for a cost-of-living increase, calculated in the same manner as the Applicable Exclusion Amount.

---

[553] *See* Howard E. Abrams, *The Section 734(b) Basis Adjustment Needs Repair*, 57 Tax Law. 343 (2004).

[554] The partnership could borrow the proceeds to effectuate the cash distribution. Care should be given to ensure that undesirable partnership liability shifts do not occur in the transaction. Thus, taxpayers should consider borrowing on a nonrecourse basis but having certain remaining partners guarantee the debt.

c. The retained preferred interest would be structured so that the preferred holder would have the right to put the interest to the partnership for the liquidation preference (as adjusted for the cost-of-living increase) and at death, the partnership has the right to liquidate the preferred interest at the liquidation preference.

d. The gift or sale of the common interest would qualify for significant valuation discounts, in excess of those that would typically apply to a traditional single class or pro rata family limited partnership.

2. A qualified payment "means any dividend payable on a periodic basis under any cumulative preferred stock (or a comparable payment under any partnership interest) to the extent that such dividend (or comparable payment) is determined at a fixed rate."[555] A payment will be treated as a "fixed rate" if the payment is "determined at a rate which bears a fixed relationship to a specified market interest rate."[556] The Treasury Regulations provides that a qualified payment is:

a. "A dividend payable on a periodic basis (at least annually) under any cumulative preferred stock, to the extent such dividend is determined at a fixed rate."[557]

b. Any other cumulative distribution payable on a periodic basis (at least annually) with respect to an equity interest, to the extent determined at a fixed rate or as a fixed amount."[558]

3. A common inflation-sensitive interest rate investment is a Treasury Inflation-Protected Security (TIPS). TIPS, unlike certain U.S. savings bonds, adjust for inflation by providing inflation adjustments to the underlying principal amount and keeping the yield fixed. For example, if a $100,000 TIPS is issued with a 4% yield, then $4,000 of interest will be paid in the first year. Assume inflation is 3% in the ensuing year. The TIPS adjusted principal amount will be $103,000 but the yield remains at 4%. As a result, the ensuing year's interest payment will be $4,120. TIPS are an example of a larger category of investments under the Code, called inflation-indexed debt instrument ("IIDI").[559] An IIDI is defined as a debt instrument that has the following features:[560]

a. It is issued for U.S. dollars and all payments are denominated in the same;

b. Except for a minimum guarantee,[561] each payment is indexed for inflation or deflation; and

---

[555] § 2701(c)(3)(A).

[556] § 2701(c)(3)(B). *See* Treas. Reg. § 25.2701-2(b)(6)(ii).

[557] Treas. Reg. § 25.2701-2(b)(6)(i)(A).

[558] Treas. Reg. § 25.2701-2(b)(6)(i)(B).

[559] *See* Treas. Reg. § 1.1275-7.

[560] Treas. Reg. § 1.1275-7(c)(1).

[561] An additional payment made at maturity if the total inflation-adjusted principal paid on the IIDI is less than the IIDI's stated principal amount. Treas. Reg. § 1.1275-7(c)(5).

c. No payments are subject to any contingencies other than inflation or deflation.[562]

4. Terms of the Qualified "Cost-of-Living" Preferred Interests

a. The partnership will provide a cumulative preferential right to partnership cash flow. Typically, this preferential right will be a percentage of a stated liquidation preference amount (for example, 6% of $5.45 million-the current Available Exclusion Amount). In this instance, the liquidation preference would be structured similarly to take into account future inflation or deflation as TIPS would be adjusted.

b. The preferred payment will accrue annually and will be cumulative to the extent payments are not made in any given year. The payment is accrued and payable regardless of partnership profits. As such, while it is normally paid from net cash flow of the partnership, the lack of net cash flow in any given year will not affect the total amount that is due.

c. The preferred payment will go into arrears for up to 4 years after the due date without interest being due on the unpaid preference. After the 4 year period, the unpaid payments will accrue interest at the specified preferred rate (for example, 6%).

d. The partnership agreement will provide that payments may be paid from available cash, first, and, at the discretion of the general partner, with in-kind distributions of partnership property.

e. Upon dissolution, the preferred interest will receive liquidating distributions equal to the liquidation preference amount ($5.45 million as adjusted for inflation) before any distributions are made to non-preferred interest holders.

f. The partnership agreement will provide the partnership the right to call the preferred interest at the liquidation preference amount upon the death of the preferred holder. This effectively freezes the value for transfer tax purposes at the liquidation preference amount and at the taxpayers Applicable Exclusion Amount.

5. Chapter 14 Implications

a. Valuation of the preferred interest in the Subtraction Method under section 2701, because it is a "qualified payment," will be according to regular gift tax rules. It is unclear, however, what standard should be used in valuing the preferred interest. Or, said another way, how does one determine the appropriate preferred annual payment to minimize the gift tax consequences, if any, under section 2701?

b. As discussed above, to be a "qualified payment" the preferred interest must generally provide for a cumulative and annual payment that is determined at a fixed rate. While certain "bells and whistles" must be ignored, no other requirements are set out in the Code or the Treasury Regulations.

---

[562] A qualified inflation index is any general price or wage index that is updated and published at least monthly by an agency of the U.S. Government. The Treasury Regulations specifically mentioned the non-seasonally adjusted U.S. City Average All Items Consumer Price Index for All Urban Consumers (CPI-U). Treas. Reg. § 1.1275-7(c)(3).

6. Revenue Ruling 83-120

a. Many commentators[563] and the IRS in rulings[564] have asserted that the appropriate standard for valuing the preferred interest is under Revenue Ruling 83-120,[565] pertaining to preferred corporate stock. The Revenue Ruling provides a methodology for valuing preferred interests, based upon 3 primary factors:[566] yield, preferred payment coverage and protection of the liquidation preference.

(1) Yield of the preferred interest is compared with the dividend yield of "high-grade, publicly traded preferred stock." The required credit rating is not explicitly stated in the ruling. The ruling does point out, however, that "If the rate of interest charged by independent creditors to the [entity] on loans is higher than the rate such independent creditors charge their most credit worthy borrowers, then the yield on the preferred [interest] should be correspondingly higher than the yield on the high quality preferred stock."[567]

(2) The ruling provides that "Coverage of the dividend is measured by the ratio of the sum of the pre-tax and pre-interest earnings to the sum of the total interest to be paid and the pre-tax earnings needed to pay the after-tax dividends."[568] Obviously, in the partnership context, due to pass-thru taxation under Subchapter K, concerns about pre-tax earnings and after-tax dividends are not relevant. Coverage is further supported if the partnership agreement provides that the preferred payment can be satisfied from both cash flow of the partnership and distributions in-kind of partnership assets.

(3) Protection of the liquidation preference is determined by comparing the value of the partnerships assets (net of liabilities) to the liquidation preference amount. In other words, what is the ratio of preferred interests in comparison to non-preferred interests?

b. From a planning perspective, dividend (preferred payment) coverage and liquidation protection are within the control of the planner (whereas the yield on publicly-traded preferred stocks is determined by the vagaries of the market at the time of the purported transfer). In other words, if a FLP is being recapitalized into a qualified payment preferred FLP, then how much dividend coverage or liquidation protection is a function of the sizing between the preferred and common interests. For example, dividend coverage and liquidation protection would be quite different if AB partnership, which holds $10,000,000 of assets is structured, as follows: (i) A holding a 7% preferred on a $5,000,000 liquidation preference amount and B holding the common shares, and (ii) A holding a 7% preferred on a $9,000,000 liquidation preference amount and B holding the common shares. In the first instance, the effective yield

---

[563] *See, e.g.,* Milford B. Hatcher, Jr. and Edward M. Manigault, *Warming Up to the Freeze Partnership*, Estate & Personal Financial Planning (June 2000).

[564] *See, e.g.,* PLR 9324018.

[565] Rev. Rul. 83-120, 1983-2 C.B. 170.

[566] The ruling also indicates that voting rights and lack of marketability are secondary factors, but these may cancel each other out in many instances. Rev. Rul. 83-120, 1983-2 C.B. 170 at Sections 4.01, 4.05 and 4.06.

[567] Rev. Rul. 83-120, 1983-2 C.B. 170 at Section 4.02.

[568] Rev. Rul. 83-120, 1983-2 C.B. 170 at Section 4.03.

that must be paid from the portfolio is 3.5% per year and there is 2:1 ratio of liquidation protection ($10,000,000 of assets to satisfy a $5,000,000 liquidation preference), and in the second instance, the effective yield is 6.3% and there is a 10:9 ratio of liquidation protection ($10,000,000 of assets to satisfy a $5,000,000 liquidation preference). In the latter instance, the value of the preferred interest would most likely be much less than the liquidation preference of $9,000,000 because the required yield from the partnership is considerably higher (less dividend coverage) and there is very little cushion of liquidation protection.

7. The yield on a qualified "cost-of-living" preferred interest will be less than the yield on a liquidation preference that is fixed, just as the yield on TIPS is less than the yield on bonds that are not inflation-adjusted. This difference is referred to as "breakeven inflation." Breakeven inflation is the difference between the nominal yield on a fixed rate investment and the "real yield" on an inflation-adjusted investment of similar maturity and credit quality.

8. Practitioners may want to consider including a provision in the partnership or membership agreement providing that upon liquidation of the preferred holder's interest at death (equal to the liquidation preference), the liquidation distribution shall be satisfied, to the extent possible, with assets that are most appreciated at the time of death. Whether a section 754 election is in place or not, these assets should be received without any tax consequences and with a full step-up in basis.[569]

B. "Busted" Section 2701 Preferred Interests

1. A "busted" section 2701 preferred interest involves the creation of a preferred interest in a partnership or limited liability company that is not a "qualified payment" under section 2701(c)(3) and gifting the common interest in a manner that mandates the "zero valuation" rule under the "subtraction method." Typically, the preferred interest payment is non-cumulative.

2. For example, taxpayer owns an LLC that holds $5 million in assets. Taxpayer recapitalizes the LLC into preferred and common interests. The preferred interests have a $5 million liquidation preference and an 8% non-cumulative preferred annual payment ($400,000). The preferred holder has the right to put the preferred interest to the LLC at any time for the liquidation preference. The LLC has the right to liquidate the preferred interest for $5 million at the death of the preferred holder. The taxpayer gifts the common interests to an IDGT.

a. The preferred interest is not a "qualified payment" under section 2701(c)(3). As such, the value of the gifted common interest will be determined using the "subtraction method" described in the Treasury Regulations,[570] with the preferred interest (family-held senior equity[571] interest) being assigned a value of zero in step 2 of the subtraction method.

b. The value attributed (with the preferred interest having a zero value) to transferred common interest may be entitled to valuation discounts. The Treasury Regulations provide if the value of the transferred interest would have been determined (but for section 2701)

---

[569] *See* § 736(b).

[570] Treas. Reg. § 25.2701-3.

[571] Senior equity interest is "an equity interest in the entity that carries a right to distribution of income or capital that is preferred as to the rights of the transferred interest." Treas. Reg. § 25.2701-3(a)(2)(ii).

with a "minority or similar discount," the amount of the gift is reduced by the excess of a "pro rata portion of the fair market value[572] of the family-held interests of the same class" over "the value of the transferred interest (without regard to section 2701)."[573] The Service has ruled that "minority or similar discount" includes a "discount for lack of marketability" with respect to the transferred interest (when the preferred interest was valued at zero).[574]

3. If, for the sake of simplicity, we assume in this example, the gift of the common is calculated to be exactly $5 million. Why would a taxpayer consider making this gift? The answer lies in the calculation of the estate tax upon the taxpayer's death. The tentative federal estate tax (before credits) is essentially computed against the sum of the decedent's taxable estate,[575] and the "amount of adjusted taxable gifts."[576] The Treasury Regulations provide that if an individual (referred to as the "initial transferor") makes a transfer subject to section 2701, "in determining the Federal estate tax with respect to an initial transferor, the executor of the initial transferor's estate may reduce the amount on which the decedent's tentative tax is computed under section 2001(b)... by the amount of the reduction."[577]

a. Assuming there has been no subsequent transfer of the retained preferred interest, the amount of the reduction is the "amount by which the initial transferor's taxable gifts were increased as a result of the application of section 2701 to the initial transfer."[578]

b. In other words, in our simple example, the amount of the reduction is exactly $5 million (the increase of the gift of the common). However, because the non-cumulative preferred can be liquidated at $5 million, the amount includible is also $5 million. As such, these two amounts should cancel each other out.

c. The Treasury Regulations provide the following example that makes it clear that the reduction in adjusted taxable gifts is frozen in value:

> P, an individual, holds 1,500 shares of $1,000 par value preferred stock of X corporation (bearing an annual noncumulative dividend of $100 per share that may be put to X at any time for par value) and 1,000 shares of voting common stock of X. There is no other outstanding common stock of X.[579]
>
> P continues to hold the preferred stock until P's death. The chapter 11 value of the preferred stock at the date of P's death is the same as the fair market value of the preferred stock at the time of the initial transfer. In computing the Federal

---

[572] The Treasury Regulations provide, the value is "determined as if all voting rights conferred by family-held equity interests were held by one person who had no interest in the entity other than the family-held interests of the same class, but otherwise without regard to section 2701." Treas. Reg. § 25.2701-3(b)(4)(ii)(A).

[573] Treas. Reg. § 25.2701-3(b)(4)(ii).

[574] Tech. Adv. Mem. 9447004.

[575] § 2001(b)(1)(A).

[576] § 2001(b)(1)(B).

[577] Treas. Reg. § 25.2701-5(a)(3).

[578] Treas. Reg. § 25.2701-5(b)(2).

[579] Treas. Reg. § 25.2701-5(d)(1)(i).

estate tax with respect to P's estate, P's executor is entitled to a reduction of $1,500,000 under paragraph (a)(3) of this section.[580]

4. The benefit to the taxpayer is that for as long as the taxpayer holds the preferred interest, the taxpayer presumably can choose to receive the preferred payment or not. If no preferred payment is received, all of the appreciation effectively passes to the common interests. The preferred interest is frozen in value with a reduction for estate tax purposes that essentially "zeroes-out" the estate tax liability attributable to the preferred.

5. The benefit to the taxpayer is that for as long as the taxpayer holds the preferred interest, the taxpayer presumably can choose to receive the preferred payment or not. If no preferred payment is received, all of the appreciation effectively passes to the common interests. The preferred interest is frozen in value with a reduction for estate tax purposes that essentially "zeroes-out" the estate tax liability attributable to the preferred.

6. Practitioners may want to consider providing for a provision in the partnership or membership agreement that provides upon liquidation of the preferred holder's interest at death (equal to the liquidation preference), it shall be satisfied, to the extent possible, with assets that are most appreciated at the time of death. Whether a section 754 election is in place or not, these assets should be received without any tax consequences and with a full step-up in basis.[581]

## V. PARTNERSHIP ELECTIONS

### A. Section 754 Election

1. There is significant discussion of the Section 754 election earlier in the outline. In particular, practitioners should be aware of the economic and practical implications of the election and the corresponding inside basis adjustments under Sections 734 and 743. It seems clear that to take full advantage of the flexibility that partnerships can provide from a tax planning standpoint, a section 754 election is necessary (particularly when distributing assets in-kind). However, the record-keeping requirements on an ongoing basis can be quite burdensome.

2. To reduce such burden, practitioners might consider using the partnership division rules to isolate the partnership assets that would be the subject of the planning and thereby limiting the assets over which the section 754 election would be applicable.

3. Practitioners should also consider the use of the election under Section 732(d), which might provide some of the same inside basis adjustments under the right circumstances, but without the requirement of a Section 754 election.

---

[580] Treas. Reg. § 25.2701-5(d)(3), Ex. 2.

[581] *See* § 736(b).

B. Section 704(c) Election

1. A full discussion of section 704(c) is beyond the scope of this outline, but estate planners should be aware of certain elections under section 704(c) that can be used under the correct circumstances that could shift income tax liabilities among different taxpayers.[582]

2. When a partner contributes property to a partnership that has a fair market value different (more or less) than its tax basis, section 704(c)(1)(A) ensures that the inherent tax characteristics associated with such difference will ultimately be allocated to the contributing partner. Upon contribution, the contributing partner's capital account is credited with an amount equal to the fair market value of the property, and when the contributed property is sold by the partnership, any inherent gain or loss (as calculated at the time of contribution) will be allocated to the contributing partner.[583] In that manner, section 704(c) ensures that the inherent gain or loss is not allocated to the non-contributing partners. As the Treasury Regulations provide, "The purpose of section 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. Under section 704(c), a partnership must allocate income, gain, loss, and deduction with respect to property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution."[584]

3. When the contributed property is depreciable property (e.g., commercial real estate or equipment), section 704(c) attempts to put the non-contributing partners in the same position they would be if the depreciable property had been contributed when the tax basis was equal to the fair market value.

a. By way of example, partner A contributes depreciable property worth $1,000,000 and with a tax basis equal to $400,000. Assume, the property has a remaining depreciable life of 5 years. Partner B contributes $1,000,000 of cash. Partner A and B are equal 50% partners.

(1) For book purposes, the depreciable property is depreciated over the remaining 5 years based on the $1,000,000 book value. Assuming straight line depreciation that would be $200,000 per year.[585] For tax purposes, because the property only has $400,000 of tax basis, the partnership only has $80,000 of depreciation per year.

(2) Absent section 704(c), A and B would be allocated $40,000 each of depreciation per year. This would be $60,000 less depreciation than B would have been allocated had the property actually had a tax basis of $1 million (as assumed for book purposes). Said another way, for the same equal contribution to become an equal partner, B will have

---

[582] For an excellent article on using section 704(c) allocation in the family partnership context, see Thomas N. Lawson, *Using Curative and Remedial Allocations to Enhance the Tax Benefits of FLPs*, 9 Est. Plan. No. 8, pg. 12 (Aug. 2009).

[583] *See* Treas. Reg. § 1.704-1(b)(2)(iv)(d)(1).

[584] Treas. Reg. § 1.704-3(a)(1).

[585] Treas. Reg. § 1.704-1(b)(2)(iv)(g)(3) provides that book depreciation must bear the same relationship to book value that tax depreciation bears to adjusted tax basis. If adjusted tax basis is zero, book depreciation can be any reasonable method.

$60,000 more taxable income per year. In theory, A is effectively shifting taxable income to B because A has already enjoyed more of the depreciation previously.

(3) Section 704(c) attempts to cure this anomaly. The Treasury Regulations provide, "For section 704(c) property subject to amortization, depletion, depreciation, or other cost recovery, the allocation of deductions attributable to these items takes into account built-in gain or loss on the property. For example, tax allocations to the noncontributing partners of cost recovery deductions with respect to section 704(c) property generally must, to the extent possible, equal book allocations to those partners."[586] As such, all of the tax depreciation must be allocated to B until B has received tax depreciation equal to his share of the book depreciation. In other words, all $80,000 of depreciation will be allocated to B each year.[587] As a result, A has more taxable income and is effectively "recapturing" the depreciation taken prior to the contribution.

(4) This method of allocation is sometimes referred to as the "traditional method."

b. As a result, in the family context, when dealing with depreciable property, under the "traditional method," section 704(c) serves to disproportionately allocate depreciation deductions to the non-contributing partner. Thus, families could form a partnership and use the traditional method of allocations under section 704(c) to their advantage particularly if the non-contributing partner is:

(1) A high income taxpayer (including a non-grantor taxable trust),

(2) Holding property that has basis and that is not depreciable (e.g., cash or marketable securities); or

(3) Has an investment that generates significant passive income each year.

4. You will note, in the previous example, B will be allocated $80,000 of tax depreciation per year, not the $100,000 that B would have received if the depreciable property had a tax basis of $1 million at the time of the contribution. Over the remaining 5 years, B will be allocated, in aggregate, $400,000 of depreciation deductions (which is $100,000 less than the $500,000 B would have received if the property had $1 million of tax basis). This result is due to what is referred to as the "ceiling rule."[588] The ceiling rule mandates that the partnership cannot allocate more depreciation than it actually has for tax purposes. The Treasury Regulations provide that partnerships can override the effect of the ceiling rule by making "curative" allocations or, alternatively, "remedial" allocations, as discussed in more detail below.

---

[586] Treas. Reg. § 1.704-1(b)(1).

[587] *See* Treas. Reg. § 1.704-3(b)(2), Ex. 1.

[588] Treas. Reg. § 1.704-3(a)(1). "The total income, gain, loss, or deduction allocated to the partners for a taxable year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the taxable year (the ceiling rule)."

5. A partnership may elect to make "reasonable" [589] curative allocations to correct distortions created by the ceiling rule. This is often referred to as the "traditional method with curative allocations."

a. Pursuant to this election, the partnership may allocate other tax items (not related to the contributed property) of income, gain, or deduction.[590] Thus, because B in the traditional method above will be allocated $20,000 less depreciation each year, if the partnership has other depreciable property, it could allocate $20,000 of other depreciation to B.

b. Alternatively, if the partnership does not have other depreciable property, it could allocate $20,000 of ordinary income to A, which has the same effect as an allocation of depreciation to B.[591]

c. Note, however, in the family context, whether an allocation of depreciation to B or ordinary income to A is economically holistically better to the family is dependent upon their individual circumstances of the taxpayers. What if A has significant net operating losses? What if B is a non-grantor trust subject to very high state income taxes?

d. There is no requirement that curative allocations must offset the entire distortion created by the ceiling rule, and curative allocations can be limited to taking depreciation from a specific set of assets or to specific items of income.[592]

e. Generally, curative allocations must be made over the remaining depreciation life of the asset, [593] but if the remaining depreciation life is very short in comparison to its actual economic life, under certain circumstances, the IRS could invoke the anti-abuse rule and invalidate the curative allocation.

6. The Treasury Regulations allow a third allocation method, often referred to as the "remedial allocation."[594]

a. Unlike curative allocations which are made from actual partnership tax items, remedial allocations involve the creation of notional tax items by the partnership (not dependent upon the actual tax items recognized by the partnership).[595] Furthermore, unlike curative allocations, remedial allocations must fully offset the disparity created by the ceiling rule.[596]

b. Under the remedial allocation method, if the ceiling rule results in a book allocation to a non-contributing partner different from the corresponding tax allocation, the partnership makes a remedial allocation of tax items to the non-contributing partner equal to the

---

[589] *See* Treas. Reg. § 1.704-3(c)(3).

[590] Treas. Reg. § 1.704-3(c)(1).

[591] *Id.*

[592] Treas. Reg. § 1.704-3(c)(1).

[593] *See* Treas. Reg. § 1.704-3(c)(4), Ex. 2.

[594] *See* Treas. Reg. § 1.704-3(d).

[595] *See* Treas. Reg. § 1.704-3(d)(4).

[596] Treas. Reg. § 1.704-3(d).

full amount of the limitation caused by the ceiling rule, and a simultaneous, offsetting remedial allocation of tax items to the contributing partner.[597]

c. From the partner's standpoint, remedial allocations have the same effect as other tax items actually recognized by the partnership from both a tax liability and outside basis standpoint.[598]

d. Unlike curative allocation, when it comes to depreciable property, the time period is different for remedial allocations. As discussed above, curative allocations are generally made over the remaining depreciable life of the property.[599] Under the remedial allocation method, a partnership must bifurcate its book basis in the contributed property for purposes of calculating depreciation.

e. The portion of book basis in the property equal to the tax basis in the property at the time of contribution is recovered generally over the property's remaining depreciable life of the property (under section 168(i)(7) or other applicable part of the Code).[600] With respect to the portion of the book value (fair market value at the time of contribution) in excess of the tax basis (the partnership's remaining book basis in the property), it is recovered using any applicable recovery period and depreciation (or other cost recovery) method, including first-year conventions, available to the partnership as if newly purchased property of the same type as the contributed property that is placed in service at the time of contribution.[601] As discussed above, for residential real property that would generally be 27.5 years. However, for certain types of qualified property (e.g., certain leasehold improvements), it could mean 50% bonus depreciation under section 168(k) in the first year.[602]

7. Generally, curative allocations will be more desirable than remedial allocations for families because curative allocations will be taken over the life of the remaining depreciable life of the contributed property. Furthermore, curative allocations do not have to fully negate the disparity in the ceiling rule. As such, families have the flexibility to tailor the use of curative allocations to the tax situation of the partners.

8. Anti-Abuse Rule for Allocation Methods

a. Echoing the general anti-abuse provisions discussed above, the Treasury Regulations provide that any "allocation method (or combination of methods) is not reasonable if the contribution of property (or event that results in reverse section 704(c) allocations) and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability."[603] It

---

[597] Treas. Reg. § 1.704-3(d)(1).

[598] Treas. Reg. § 1.704-3(d)(4)(ii).

[599] *See* Treas. Reg. § 1.704-1(b)(2)(iv)(g)(3).

[600] Treas. Reg. § 1.704-3(d)(2).

[601] *Id.*

[602] This provision currently requires extension each year and was recently extended by the Tax Increase Prevention Act of 2014, P.L. 113-295 (December 19, 2014) to include certain property placed in service through 2014.

[603] Treas. Reg. § 1.704-3(a)(10)(i).

also provides that any reference to partners above includes both "direct and indirect" partners, and an "indirect partner" is "any direct or indirect owner of a partnership, S corporation, or controlled foreign corporation ... or direct or indirect beneficiary of a trust or estate, that is a partner in the partnership."[604]

b. Example 3 in the Treasury Regulations describes a situation where the contributed property only has one year remaining in its depreciable life (although the economic life is 10 years) and the contributing partner has an expiring net operating loss.[605] The proposed curative allocation is to offset the entire disparity between book value and tax basis in the first year. The example concludes that the curative allocation is unreasonable because income would be allocated to a partner with a low marginal tax rate from a partner with a high marginal tax rate "within a period of time significantly shorter than the economic life of the property." However, the example goes on, if the partnership makes curative allocations over the economic life of the property (10 years) then the allocation would be deemed reasonable.[606]

c. It should be noted that the anti-abuse rules do not necessarily apply for state income tax purposes (although most state income tax regimes are tied to the Federal tax liability). When the anti-abuse rules refer to the present value of aggregate tax liability, it refers only to the Federal income tax. Therefore, there are likely allocations that would not result in any Federal income tax savings that would be deemed reasonable, but could result in significant state income tax savings (e.g., partners in high and low income tax states).

9. The Treasury Regulations do not require a particular election to apply curative or remedial allocations. However, the partnership agreement needs to reflect the allocation chosen by the partnership.

## VI. PLANNING WITH DISREGARDED ENTITIES

### A. Generally

1. A "disregarded entity" has come to mean an entity that is ignored for Federal income tax purposes (but is legally recognized for other purposes as a separate entity for state law purposes).[607] As the Treasury Regulations provide, "if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner." [608] Effectively, the entity is "disregarded as an entity separate from its owner if it has a single owner," [609] and this applies for "federal tax purposes."[610]Generally, there are three types of entities that are considered "disregarded" for tax purposes: (a) single-owner entities (like wholly-

---

[604] Treas. Reg. § 1.704-3(a)(10)(ii).

[605] Treas. Reg. § 1.704-3(c)(4), Ex. 3.

[606] *See also* Treas. Reg. § 1.704-3(b)(2), Ex. 2 for an example of an unreasonable use of the traditional method involving the contribution of property having on year of remaining depreciable life.

[607] Generally, a business entity that is not classified as a corporation (eligible entity), that has a single owner, and that has not elected to be taxed as an association taxed as a corporation. See Treas. Reg. § 301.7701-3(a) and -3(b)(1)(ii).

[608] Treas. Reg. § 301.7701-2(a).

[609] Treas. Reg. § 301.7701-3(b)(1)(ii).

[610] Treas. Reg. §§ 301.7701-1(a) and -2(c)(2).

owned LLCs) that have not elected corporate treatment, (b) qualified subchapter S corporation subsidiaries, and (b) qualified real estate investment trust subsidiaries. For purposes of these materials, only LLCs are discussed.

2. Despite the single owner requirement, the IRS has ruled that if an entity is wholly owned by two spouses as community property, it will nevertheless be considered a disregarded entity, provided the spouses report the entity as such.[611] The ruling does not require that the parties file a joint return. It further provides that a change in reporting position (presumably by either spouse) will be treated as a conversion of the entity (e.g., to a partnership). The ruling provides that the business entity must be "wholly owned" by the spouses as community property and "no person other than one or both spouses would be considered an owner for federal tax purposes."[612]

3. Further, the IRS has ruled that a state law partnership formed between an entity disregarded under the elective classification (wholly owned LLC of a corporation) regime and its owner (the corporation) is itself disregarded because it only has one owner for tax purposes.[613]

B. Are Grantor Trusts Disregarded Entities?

1. While many practitioners believe a grantor trust (grantor trust as to both the income and the corpus and over the entire trust[614]) is treated like a disregarded entity, the law is not clear.[615] In *Rothstein v. Commissioner*,[616] the taxpayer purchased property from his grantor trust with an installment note. The taxpayer then resold the property to a third party, computing the resulting gain using a cost basis arising from the original purchase from the grantor trust. While the IRS argued that the trust should be treated as a disregarded entity, the court held for the taxpayer. In coming to its conclusion, the court interpreted the phrase "shall be treated as the owner of the trust assets"[617] as applying only for purposes of including the trust's income and deductions.

2. Echoing the *Rothstein* ruling, Professor Jeffrey N. Pennell writes, as to grantor trusts being disregarded for tax purposes:[618]

> The Code and Regs, however, are not entirely consistent with that treatment. Instead, every grantor trust rule (§§673-677) begins by saying "The grantor shall be treated as the owner of any portion of a trust . . . ." The significance of this is found in §671:

---

[611] Rev. Proc. 2002-69, 2002-45 I.R.B. 831.

[612] *Id.*

[613] Rev. Rul. 2004-77, 2004-31 I.R.B. 119.

[614] See Treas. Reg. § 1.671-3.

[615] *See* Mark L. Asher, *When to Ignore Grantor Trusts: The Precedents, a Proposal, and a Prediction*, 41 Tax. L. Rev. 253 (1986).

[616] 735 F.2d 704 (2nd Cir. 1984).

[617] § 671.

[618] *Jeffrey N. Pennell*, (Mis)Conceptions about Grantor Trusts, 50th Annual Southern Federal Tax Institute, Outline V, p. 1-2 (Oct. 2015).

> Where it is specified . . . that the grantor . . . shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor . . . those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust.

Notice that this does not mention losses, which are considered along with gains only in determining the trust's income. This also does not say that an exchange with a grantor trust is not recognized, or that the trust is ignored...

In a nutshell, then, the tax attributes of a grantor trust are reported by the grantor on the grantor's income tax return, as if the trust's income (which includes net gain in excess of any offsetting losses), deductions, and credits belonged to the grantor.

The actual treatment, however, is as if the trust's DNI was entirely taxable to the grantor. Losses would offset gains in the trust for this purpose, and gain that is attributed out to the grantor thus would be less. But excess losses are trapped in the trust by virtue of the rule in §642(h) ... And these results apply only to the extent the grantor is treated as the owner of the trust. It is not necessarily true for the entire trust, depending upon application of the portion rules.

As a result, the conclusion articulated by various authorities that the trust is "ignored" is not what either the Code or Regulations themselves actually specify. Yet the government itself makes pronouncements that are interpreted by taxpayers in a vast number of different situations to mean that a grantor trust is treated as if it did not exist. This especially is true involving transfers by a grantor into an intentionally defective grantor trust, based on the government's ruling position that the grantor can have no gain or loss on a transfer involving the grantor trust — that an exchange between the grantor and the trust is not a gain or loss realization event

3. Notwithstanding the foregoing, the IRS has ruled in Revenue Ruling 85-13,[619] on facts similar to *Rothstein*, that the taxpayer in question did not obtain cost basis when he purchased the assets from the grantor trust. Specifically, the ruling provides:[620]

> In Rothstein, as in this case, section 671 of the Code requires that the grantor includes in computing the grantor's tax liability all items of income, deduction, and credit of the trust as though the trust were not in existence during the period

[619] Rev. Rul. 85-13, 1985-1 C.B. 184.

[620] *Id. See also* Rev. Rul. 88-103, 1988-2 C.B. 304 and PLR 8729023 (grantor and grantor trust will be treated as a single taxpayer for purposes of qualifying for involuntary conversion treatment under section 1033 of the Code), and Rev. Rul. 2004-86, 2004-33 I.R.B. 191 (a taxpayer may exchange interests in a grantor trust—a Delaware statutory trust—for real property and qualify for like-kind treatment under section 1031 of the Code). *But see* Rev. Rul. 2004-88, 2004-32 I.R.B. 165 (disregarded entity will be treated as an entity separate from its owner for purposes of the TEFRA unified audit rules), Treas. Reg. § 1.001-2(c), Ex. 5 (if a grantor trust holds a partnership interest and the trust ceases to be a grantor trust, then it is treated as a disposition of the partnership interest, and Prop. Treas. Reg. § 1.108-9(c)(1), (2) (cancellation of indebtedness rules only apply if the grantor, not the grantor trust, is bankrupt or insolvent)

the grantor is treated as the owner. Section 1.671-3(a)(1) of the regulations. It is anomalous to suggest that Congress, in enacting the grantor trust provisions of the Code, intended that the existence of a trust would be ignored for purposes of attribution of income, deduction, and credit, and yet, retain its vitality as a separate entity capable of entering into a sales transaction with the grantor. The reason for attributing items of income, deduction, and credit to the grantor under section 671 is that, by exercising dominion and control over a trust, either by retaining a power over or an interest in the trust, or, as in this case, by dealing with the trust property for the grantor's benefit, the grantor has treated the trust property as though it were the grantor's property. The Service position of treating the owner of an entire trust as the owner of the trust's assets is, therefore, consistent with and supported by the rationale for attributing items of income, deduction, and credit to the grantor.

The court's decision in Rothstein, insofar as it holds that a trust owned by a grantor must be regarded as a separate taxpayer capable of engaging in sales transactions with the grantor, is not in accord with the views of the Service.

4. Consistent with Revenue Ruling 85-13, the IRS has ruled that an LLC created by the taxpayer and the taxpayer's grantor trust will be treated as a disregarded entity because the LLC is deemed to have only one taxpayer-owner.[621]

5. For purposes of this outline and the discussion herein, the government's position under Revenue Ruling 85-13 (grantor trusts are ignored for income tax purposes) is assumed to be correct. In reality, the vast majority of practitioners treat grantor trusts as disregarded entities for all income tax purpose, having all tax items (including losses) reported by the grantor and ignoring all transactions between the grantor and his or her grantor trust. As such, it is assumed if all interests in an LLC are owned by a grantor and grantor trusts, the LLC is treated, at least for Federal income tax purposes, as a disregarded entity.

C. May Discounts Be Used When Valuing Interests in Disregarded Entities?

1. The critical issue for estate planning purposes is whether valuation discounts must be disregarded when valuing transfers (gifts, bequests, sales, and exchanges) of interests in disregarded entities to and among the grantor and grantor trusts. Does the "willing buyer/willing seller" standard[622] apply to transfers of interests in disregarded entities? In other words, just as transfers between a grantor and grantor trust are ignored for Federal income tax purposes, are they also ignored for Federal transfer tax purposes?

2. In *Pierre v. Commissioner*,[623] the Tax Court held the transfers of interests in a disregarded entity should be valued for gift tax purposes as transfers of interests in the entity, rather than transfers of the underlying assets of the entity. The Tax Court pointed out, "[s]tate law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed." As such, the transferred interests in the disregarded entity would qualify for marketability and minority interest discounts. In the case at issue, however, the court

---

[621] PLR 200102037.

[622] *See generally* Treas. Reg. §§ 20.2031-1(b) and 25.2512-1 and Rev. Rul. 59-60, 1959-1 C.B. 237.

[623] *Pierre v Commissioner*, 133 T.C. 24 (2009).

concluded that the step transaction applied, in part, because the entity was funded (cash and marketable securities) by the taxpayer less than two weeks prior to the transfers of the entity interests. The taxpayer transferred her entire interest in the wholly-owned LLC to two trusts (9.5% gift and 40.5% sale to each trust).

3. Importantly, the Tax Court in *Pierre* wrote:[624]

> While we accept that the check-the-box regulations govern how a *single-member LLC* will be taxed for Federal tax purposes, i.e., as an association taxed as a corporation or as a disregarded entity, we do not agree that the check-the-box regulations apply to disregard the LLC in determining how a *donor* must be taxed under the Federal gift tax provisions on a transfer of an ownership interest in the LLC. If the check-the-box regulations are interpreted and applied as respondent contends, they go far beyond *classifying* the LLC for tax purposes. The regulations would require that Federal law, not State law, apply to define the property rights and interests transferred by a donor for valuation purposes under the Federal gift tax regime. We do not accept that the check-the-box regulations apply to define the property interest that is transferred for such purposes. The question before us (i.e., how a transfer of an ownership interest in a validly formed LLC should be valued under the Federal gift tax provisions) is not the question addressed by the check-the-box regulations (i.e., whether an LLC should be taxed as a separate entity or disregarded so that the tax on its operations is borne by its owner). To conclude that because an entity elected the *classification* rules set forth in the check-the-box regulations, the long-established Federal gift tax valuation regime is overturned as to single-member LLCs would be "manifestly incompatible" with the Federal estate and gift tax statutes as interpreted by the Supreme Court.

4. In other cases, courts have generally supported the position that transfers of interests in disregarded entities are entitled to valuation discounts based on the rights of the transferee under applicable state law and under the LLC operating agreement.[625]

D. Conversion of Disregarded Entity to Partnership

1. Given that grantor trust status must necessarily terminate with the death of the grantor, all disregarded entities owned by a grantor and one or more grantor trusts will be converted to another type of entity upon the death of the grantor (unless, in theory, the grantor's interest is transferred to the trust and the trust is the only other member of the LLC). It is important then to understand the tax consequences of the conversion of the disregarded entity to (most likely) a partnership.

2. In Revenue Ruling 99-5,[626] the IRS provided guidance on the tax issues involved in a conversion of a disregarded entity to a partnership. The ruling addresses 2

---

[624] *Id.*

[625] *See e.g., Estate of Mirowski v. Commissioner*, 95 T.C. Memo 2008-74 (Mar. 26, 2008). *But see Pope & Talbot Inc., et al. v. Commissioner*, 105 T.C. 574 (1995) (The court ignored the existence of a newly created partnership in valuing the tax paid upon a distribution of the interests to its shareholders under section 311 of the Code).

[626] Rev. Rul. 99-5, 1999-6 I.R.B. 8.

situations with respect to a wholly-owned LLC that is disregarded for tax purposes and that is initially owned by a single member A. The ruling assumes that the LLC has no liabilities, the assets are not subject to any indebtedness, and all of the assets are capital assets or property described in section 1231 of the Code.

a. In situation 1, B purchases 50% of A's ownership in the LLC for $5,000. The ruling concludes that the LLC is converted to a partnership when B purchases the interest in the LLC from A. The purchase of the LLC interest is treated for tax purposes as if B purchased 50% of each of the LLC's assets (which are, in turn, treated as if held by A for tax purposes). Immediately thereafter, A and B are deemed to contribute their respective interests in those assets to a newly formed partnership. Under such treatment, the ruling further provides:

(1) Member A recognizes gain or loss on the deemed sale under section 1001 of the Code. However, there is no further gain or loss under section 721(a) of the Code for the contribution of asset to the partnership in exchange for partnership interests in the newly formed entity.

(2) Under section 722 of the Code, B's outside basis in the partnership is $5,000, and A's outside basis is equal to A's basis in A's 50% share of the assets in the LLC. Under section 723 of the Code, the partnership's tax basis in the assets is the adjusted basis of the property in A and B's hands immediately after the deemed sale.

(3) Under section 1223(1) of the Code, A's holding period for the partnership interest includes his or her holding period in the assets held by the LLC, and B's holding period for the partnership interests begins on the day following the date of B's purchase of the LLC interest from A.[627] Under section 1223(2) of the Code, the partnership's holding period for the assets deemed transferred to it includes A's and B's holding periods for such assets.

b. In situation 2, B contributes $10,000 in the LLC for a 50% ownership interest in the LLC. In this instance, as in the previous situation, the ruling concludes that the LLC is converted to a partnership when B contributes the cash to the LLC in exchange for an ownership interest in the partnership. A is treated as contributing all of the assets of the LLC to a newly formed partnership. Under such treatment and facts, the ruling provides:

(1) There is no gain or loss to A or B under section 721(a) of the Code.

(2) Under section 722 of the Code, B's outside basis is equal to $10,000, and A's outside basis is his or her basis in the assets of the LLC which A is treated as contributing to the new partnership. Under section 723 of the Code, the basis of the property contributed to the partnership by A is the adjusted basis of that property in A 's hands. The basis of the property contributed to the partnership by B is $10,000, the amount of cash contributed to the partnership.

(3) Under section 1223(1) of the Code, A 's holding period for the partnership interest includes A 's holding period in the LLC assets deemed contributed when the disregarded entity converted to a partnership. B's holding period for the partnership interest begins on the day following the date of B's contribution of money to the LLC. Under section

[627] The ruling cites Rev. Rul. 66-7, 1966-1 C.B. 188.

1223(2), the partnership's holding period for the assets transferred to it includes A 's holding period.

3. Unfortunately, the foregoing ruling does not address (i) non-taxable transactions like sales or exchanges of a disregarded entity interests between a grantor and his or her grantor trust (situation 1 is a taxable sale) or (ii) contributions of assets to a disregarded entity by a grantor or grantor trust. Under those circumstances, how should the tax basis be allocated among the grantor and the grantor trust? It seems that given the IRS's position in Revenue Ruling 85-13 that grantor trusts are "ignored" or also disregarded, that the unitary basis rules would apply in such a way that if B was a grantor trust in the situations described in Revenue Ruling 99-5, B's outside would not be $5,000/$10,000 respectively. Rather, the aggregate basis of A (the grantor) and B (the grantor trust) would be allocated pursuant to the unitary basis rules, as discussed in more detail above (essentially B would receive a portion of A's basis in the transferred asset).

4. Further, the ruling does not address the conversion of a disregarded entity to a partnership when grantor trust status is lost and the trust holds only a portion of the entities interest.

E. Conversion of Partnership to Disregarded Entity

1. In Revenue Ruling 99-6,[628] the IRS provided guidance on the tax issues involved in a conversion of partnership to a disregarded entity. The ruling addresses 2 situations with respect to an LLC that is classified as a partnership but becomes a disregarded entity when a transaction consolidates all of the ownership with a single member. The ruling provides that the LLC has no liabilities, and the assets are not subject to any indebtedness.

a. In situation 1, A and B are equal partners in an LLC taxed as a partnership. A sell's his or her entire interest in the LLC to B for $10,000. The ruling concludes the partnership terminates under section 708(b)(1)(A) when B purchases A's entire interest. A must treat the transaction as a sale of A's partnership interests, and with respect to the treatment of B, there is a deemed liquidating distribution of all of the assets to A and B, followed by B treated as acquiring the assets deemed to have been distributed to A in liquidation of A's interests. Under such treatment:

(1) A has gain or loss resulting from the sale of the partnership interest under section 741 of the Code. As discussed above, section 741 of the Code provides that gain or loss resulting from the sale or exchange of an interest in a partnership shall be recognized by the transferor partner, and that the gain or loss shall be considered as gain or loss from a capital asset, except as provided in section 751 of Code (relating to "hot assets," unrealized receivables and inventory items).

(2) B's basis in the assets attributable to A's one-half interest in the partnership is $10,000 under section 1012 of the Code. B does not get to retain the holding period of the partnership on such assets deemed liquidated and distributed to A under section 735(b) of the Code. Rather, these are newly acquired assets, and B's holding period for these assets begins on the day immediately following the date of the sale.

[628] Rev. Rul. 99-6, 1999-6 I.R.B. 6.

(3) With respect to B's portion of the deemed liquidation, B will recognize gain or loss (if any) under section 731(a) of the Code (generally, no gain or loss except to the extent that any money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution, assuming there are no "hot assets" in the partnership). B's basis in the assets received in the deemed liquidation of B's interest is determined under section 732(b) of the Code (generally, the adjusted basis of B's interest in the partnership, reduced by any money distributed in the same transaction). Under section 735(b) of the Code, B's holding period for the assets includes the partnership's holding period for such assets.[629]

b. In situation 2, C and D are equal partners in an LLC taxed as a partnership. C and D sell their entire interests in the LLC to E, an unrelated person, for $20,000 ($10,000 each). As under the previous situation, the ruling concludes the partnership terminates under section 708(b)(1)(A) when E purchases all of the LLC interests. C and D must treat the transaction as a sale of their respective partnership interests, and with respect to E, there is a deemed liquidating distribution of all of the assets to C and D, followed by E treated as acquiring all of the former assets of the partnership from C and D.

(1) C and D have gain or loss under section 741 of the Code.

(2) E's basis in the assets in the partnership is $20,000 under section 1012 of the Code, and E's holding period begins on the day immediately following the date of the sale.

2. In typical estate planning transactions, a conversion from a partnership to a disregarded entity could occur in a taxable transaction (e.g., sale of a partnership interest from a non-grantor trust to another partner) or in a non-taxable transfer (e.g., the distribution of a partnership interest from a non-grantor trust to a beneficiary that is the only other partner or in a gratuitous transfer of the partnership interest (subject to gift or estate tax) to the only other partner. Presumably, the Revenue Ruling 99-6 would apply to the taxable transactions, but it's unclear how they might apply to the non-taxable transactions.

F. Disregarded Entities: Subchapter K and Capital Accounts

1. One of the practical benefits of utilizing disregarded entities with grantor trusts is that the income tax consequences of every transaction (transfers of partnership interests, contributions of capital, distributions, etc.) can be essentially ignored until there is a conversion event, whether that occurs because of the death of the grantor, relinquishing grantor trust status, or admitting a partner that is not the grantor for tax purposes. As long as 100% of the ownership interest is held by the grantor or grantor trusts, there are no complications relating to the allocation of built-in gains and losses under section 704(c) of the Code (or "reverse 704(c)" due to the admission of new partners), no recognition events due to the sale or exchange of a partnership interest, and no need to account for inside or outside basis.

2. Even if a partner has more than one interest in a partnership (held individually or through grantor trusts, presumably) that partner is deemed to have a single capital account. Maintaining capital accounts only becomes important when the disregarded entity is converted to a partnership or if there is a liquidation of the disregarded entity among the members. Keep in

[629] Except for inventory items. *See* §735(a)(2).

mind, the safe harbor Treasury Regulations provide that an allocation will have "economic effect" if, in part, the partnership maintains capital accounts under the Treasury Regulations,[630] and the partnership makes liquidating distributions in accordance with the partners' positive capital account balances.[631]

3. The Treasury Regulations provide that upon a transfer of all or a part of a partnership interest, the transferor's capital account "that is attributable to the transferred interest carries over to the transferee partner."[632] The Treasury Regulations contain a simple example[633] pursuant to which a partner sells half of the partner's interest in a general partnership (representing a 25% interest in the partnership) for $10,000. At the time of the transfer, the general partnership held $40,000 in cash and securities, and the transferring partner's capital account prior to the transfer was $11,000. The example provides, in accordance with the Treasury Regulations "the partnership agreement provides" the transferee "inherits 50 percent of"[634] the transferor's capital account balance. Thus, the transferee inherits a capital account of $5,500. In other words, the Treasury Regulations seem to take the position that the portion of the transferor's capital account that carries over to the transferee equals the percentage of the transferor's total interest that is sold. This is straightforward and logical when dealing with pro rata, single class partnership and with transfers that do not reflect valuation discounts. However, it is not as straightforward when one is dealing with different classes of partnership interests (preferred and common, by way of example), and the methodology set out above is not how tax basis is allocated.

4. As discussed above, in Revenue Ruling 84-53,[635] the IRS ruled in the context of calculating outside basis of a transferred partnership interest, "the basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market value of the entire interest."[636]

5. As discussed in more detail above, each partner is deemed to have a single unitary basis for all interests held in a partnership. Similarly, each partner has a single capital account for all interests in the same partnership. The Treasury Regulations provide, "a partner who has more than one interest in a partnership shall have a single capital account that reflects all such interests, regardless of the class of interests owned by such partner (e.g., general or limited) and regardless of the time or manner in which such interests were acquired." [637] If the methodology set forth in Revenue Ruling 84-53 would also apply to calculating capital accounts of transferred partnership interests, then some unusual capital account distortions would occur.

---

[630] Treas. Reg. § 1.704-1(b)(2)(iv).

[631] Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2).

[632] Treas. Reg. § 1.704-1(b)(2)(iv)(l).

[633] Treas. Reg. § 1.704-1(b)(5), Ex. 13.

[634] *Id.*

[635] Rev. Rul. 84-53, 1984-1 C.B. 159.

[636] *Id.* The ruling relies Treasury Regulation § 1.61-6(a) which provides that when a part of a larger property is sold, the basis of the entire property shall be equitably apportioned among the several parts for purposes of determining gain or loss on the part sold.

[637] Treas. Reg. § 1.704-1(b)(2)(iv)(b).

6. If the fair market value of the transferred portion (in relation to the entire interest) is the appropriate formula, then the "willing buyer/willing seller" value used for transfer tax purposes would seem to be the appropriate value in calculating the transferred capital account. If that is the case, consider the following scenarios:

a. A owns a partnership interest, and has a capital account of 100. A gifts 30% of A's interest to a B. Assume, (i) the gift tax value of the 30% that A transferred is $20 (representing a 1/3 valuation discount); and (ii) A's entire interest before the transfer had a fair market value of $90 (10% discount for lack of marketability). Rev. Rul. 84-53 would seem to say, after the transfer, B's capital account is $22.22 ($20/$90x$100), and A's capital account is $77.78, even though B owns 30% of the partnership (the ruling compares the value transferred against the total value prior to the transfer). What if the partnership agreement allocates distributive share of profits according to capital accounts? Does that mean B only gets 22.22% of the profits moving forward and upon liquidation, presumably less than 30% of the partnership assets?

b. Same as above but, A gifts A's entire interest simultaneously to 4 transferees, 30% each to B, C, and D, 10% to E. Assume, the transfers all carried a 1/3 valuation discount each. Because the transfer is simultaneous and all of them have the same valuation discount, doesn't that mean B, C, D, and E a percentage of A's total capital account (30% each to B, C, and D, and 10% to E)? If the discounted values are strictly used against each transfer, then a portion of A's original capital account would not carry over to the transferees and would theoretically disappear (creating a capital shift to other partners).

7. In the disregarded entity context, consider the following related scenarios:

a. What if in the first scenario (A transfers to B a 30% interest), B is a grantor trust as to A, and the entity in question is initially a wholly owned LLC taxed as a disregarded entity. The "unitary" capital account rule would seem to imply that A, after the transfer, continues to have a capital account of 100, in some way allocated among A and B (the grantor trust, which owns 30%). After the transfer, B becomes a non-grantor trust. The IRS has taken the position that when grantor trust status is lost, it will be treated as if the grantor transferred the interest to the trust at that time. If that is the case, is the value of the deemed transfer at that time used to determine how capital account will now be allocated between A and B? Alternatively, does one follow Revenue Ruling 99-5 as a conversion from a disregarded entity to a partnership (the deemed transfer) which would treat B as having purchased 30% of the LLC's assets and then contributed them to the new partnership? Do you end up in the same place because the "purchase" price would be deemed to be a discounted value?

b. What if one is dealing with a wholly-owned LLC of A that is recapitalized into preferred and common shares? A transfers/gifts the preferred and common in separate transactions or simultaneously? What values does one use to allocate capital account? Certainly, Chapter 14 value under section 2701 of the Code can't be the answer because what if the preferred shares are deemed to have a zero value under section 2701 of the Code because they do not fall under the qualified payment interest exception? Does that mean the common shares get 100% of the capital account? What if the common is retained and the preferred is transferred under a reverse freeze (junior equity exception)?

8. Thus, due to the unusual results caused by using fair market value Revenue Ruling 84-53, the appropriate answer seems to be that capital accounts should be allocated according to a hypothetical liquidation after each transfer. This would be similar to an approach

that some partnerships employ called targeted allocations. Targeted allocations assume a hypothetical liquidation at the end of each accounting period where it is determined what each partner would receive if all of the partnership assets are sold for cash as each asset is valued under section 704(b) of the Code. The hypothetical cash proceeds are distributed in liquidation of the partnership under the distribution provisions of the partnership agreement. Once that amount is determined, each partner is allocated section 704(b) profits and losses so that the partner's capital account balance at the end of the period is equal to the amount of cash the partner would have received in the hypothetical liquidation. The IRS has not formally blessed targeted capital account allocations as qualifying under the economic effect equivalence rule.[638] Notwithstanding, this type of approach would solve many of the capital account distortions described above, but no direct guidance seems to exist on this issue.

G. Planning Opportunities with Disregarded Entities[639]

1. Inherent Leverage with No Income Tax Consequences

a. Because transfers of less than 100% of a disregarded entity to a grantor trust (another disregarded entity) will likely carry valuation discounts (see the discussion above), but liquidations must occur according to positive capital accounts, there is inherent wealth transfer leverage in any zeroed-out transfer to an IDGT or GRAT (if and when the disregarded entity or converted entity is finally liquidated). This assumes that the contribution or transfer to the trust carries a valuation discount, but the liquidation will occur on basis that does not include the discount. It further assumes the transfer and the ultimate liquidation is not subject to recharacterization under the economic substance doctrine under section 7701(o) of the Code or non-statutory doctrines like substance-over-form, step-transaction, or sham-transaction.

b. While grantor trust status is retained, the grantor will continue to be treated as if the grantor owned all of the assets for income tax purposes. This allows the assets in the IDGT or GRAT to grow without the burden of paying income tax, which is borne by the grantor. If the grantor also has a power to exchange assets of equivalent value under section 675(4)(C) of the Code, assets that carry a valuation discount can be exchanged to further increase the wealth transfer. For example, if the IDGT directly holds assets that have been liquidated from a disregarded entity, then those assets could be reacquired with shares in another disregarded entity but the value of which carries a discount. All of these transactions can be consummated without recognizing any gain or loss.

2. Disregarded Entities and S Corporations

a. S corporations cannot have more than one class of stock, which generally requires that all of the outstanding stock must have identical rights to distributions and

---

[638] *See* Treas. Reg. § 1.704-1(b)(2)(ii)*(i)* and Proposed Treasury Regulations under section 707(a)(2)(A) of the Code, REG-11452-14, 80 Fed. Reg. 43,652 (July 23, 2015). The preamble requests comments on the impact of targeted allocations on certain allocations but then provides "[n]o inference is intended as to whether and when targeted capital account agreements could satisfy the economic effect equivalence rule."

[639] *See* Richard A. Oshins and David A. Handler, *Estate Planning with Disregarded Entities*, presented at the Society of Trust and Estates Practitioners Institute on Tax Estate Planning and the Economy (Jan. 2014) for an excellent discussion of the topic and additional planning opportunities including using a disregarded entity with a residence in lieu of a qualified personal residence trust and a tiered LLC strategy to maximize the leverage of an installment sale.

liquidation proceeds, but the S corporation may have voting and non-voting shares.[640] In addition, partnerships are not eligible S corporation shareholders.[641] Because of the single class of stock requirement, S corporation shareholders are not able bifurcate their economic interests into preferred and common interests and effectuate transactions similar to a preferred partnership freeze or reverse freeze.

b. S corporation shareholders may be able to create preferred and commons interests through a disregarded entity. Pursuant to this idea, S corporation shareholder would create a wholly-owned LLC that is treated as a disregarded entity and contribute his or her S corporation shares to the entity. The disregarded entity would then recapitalize its shares into preferred and common shares, thereby allowing the taxpayer to do a forward or reverse freeze transaction with his or her IDGT. While the taxpayer is alive and the trust remains a grantor trust, the individual taxpayer should continue to be deemed the eligible S corporation shareholder.[642] The IRS has ruled that an S corporation may be owned by a partnership or a limited liability company (or a combination of them) as long as the partnership and limited liability company are disregarded for income tax purposes.[643] If the disregarded entity is liquidated during the life of the grantor, then the S corporation shares will be distributed among the grantor and the trust, which will either remain a grantor trust or become either an electing small business trust[644] or a qualified subchapter S trust.[645]

3. If, however, the grantor dies prior to the liquidation of the disregarded entity, then an issue arises as to whether the entity will be deemed to have converted to a partnership (as an entity owned by a non-grantor trust and the estate of the taxpayer), thereby terminating the S corporation status of the corporation. This termination might be avoided, as follows:

a. If the operating agreement of the disregarded entity requires an immediate termination and liquidation upon the death of the grantor, then the LLC would, in theory, cease to exist and the assets (the S corporation shares) would immediately be divided among the estate of the decedent and the trust (that must also qualify as an ESBT or QSST).[646] In most forward freeze transactions, the grantor would hold a preferred interest that had a fixed liquidation amount, and the trust would hold any excess value. The value of the S corporation shares would need to be determined in allocating the fixed liquidation amount to the estate, with any excess shares passing to the trust.

b. Another possible way of avoiding S corporation termination is to ensure that upon the death of the taxpayer, the LLC shares held by the decedent would pass directly to

---

[640] *See* § 1361(b)(1)(D), Treas. Reg. § 1.1361-1(l)(1).

[641] *See* § 1361(b)(1)(B).

[642] *See* § 1361(c)(2)(A)(i) allowing grantor trusts of U.S. citizens and residents to be S corporation shareholders.

[643] PLR 200513001.

[644] § 1361(c)(2)(A)(v).

[645] § 1361(d)(1)(A) treating such qualified subchapter S trusts as grantor trusts of U.S. citizens or residents under § 1361(c)(2)(A)(i).

[646] *See Guzowski v. Commissioner*, T.C. Memo 1967-145. A partnership that ceased to exist based on the stated term in the partnership agreement was not deemed to be the shareholder. The partners were deemed to be the shareholders.

the trust, thereby unifying 100% of the LLC ownership in the trust (which is either an ESBT or QSST). It appears that bequeathing the shares under the decedent's Will may still cause termination of S status. The IRS has ruled that if a corporation's stock is subject to the possession of the executor or administrator of the decedent's estate, the estate is considered a shareholder as of the date of death, notwithstanding the fact that applicable state law provides that legal title to the stock passes directly to the heirs under the Will.[647] However, termination might still nonetheless be avoided by providing that the LLC interests pass directly to the trust outside of probate. The operating agreement could provide an immediate transfer of the grantor's interest in the LLC to the trust, similar to a transfer on death provision or beneficiary designation. Whether a transfer on death provision in a revocable living trust (as opposed to under the Will) would also be effective is unclear.

c. Even if there is a deemed termination of S corporation status, The IRS has granted relief in circumstances where the S corporation stock was held by disregarded entities and the death of the grantor caused the termination. In PLR 200841007, the IRS concluded that a termination of S corporation status caused by the death of the grantor—during life the taxpayer had created grantor trusts that held shares in a disregarded entity that, in turn, owned S corporation shares—was inadvertent within the meaning of section 1362(f) of the Code. In the ruling, the taxpayer granted relief and S corporation status was maintained after the death of the taxpayer.[648] Of course, private letter rulings have no precedential value, so practitioners are advised to obtain a ruling in advance to ensure that S corporation status will not be terminated.

## VII. CONCLUSION

The new tax environment has catapulted income tax planning, the "step-up" in basis, and tax basis management to the center of estate planning. Entities taxed as partnerships (including disregarded entities that become partnerships) are the most flexible planning tool available, allowing taxpayers to shift income, to take full advantage of the "step-up" in basis both inside and outside of the partnership, to change the basis of assets, and to move tax liability to different partners without requiring a gift. If practitioners are willing to take on the added complexity of subchapter K, the advantages to their wealthy clients can be significant.

---

[647] Rev. Rul. 62-116, 1982-2 C.B. 207.

[648] *See also* PLRs 200237014, 200237011, 9010042, and 8934020 where the IRS ignored momentary ownership of a newly formed corporation's stock by a partnership during the process of incorporating the partnership or taking remedial measures.

# 6

# DEVELOPMENTS IN INCOME TAXATION OF REAL ESTATE, CAPITAL GAINS TAXATION AND 1031 EXCHANGES

# Developments in Income Taxation of Real Estate, Capital Gains Taxation and 1031 Exchanges

**Private Wealth & Taxation Institute**28, 2015
November 18, 2015

**Bradley T. Borden**
**Professor of Law**
**Brooklyn Law School, Brooklyn, New York**
**Email: brad.borden@brooklaw.edu**

**Glenn M. Johnson**
**Principal, U.S. National Tax Department**
**Ernst & Young LLP, Washington, DC**
**Email: glenn.johnson@ey.com**

**Mark E. Wilensky**
**Partner, Tax Department**
**Meltzer, Lippe, Goldstein & Breitstone, LLP, Mineola, New York**
**Email: mwilensky@meltzerlippe.com**

# 1031 Exchanges of Fee Ownership for Condo Units

- Fact Pattern:
  - Taxpayer owns fee ownership to a land and building either held for investment or used in Taxpayer's trade or business
  - Developer proposes to demolish Taxpayer's building and build new condominium building on the site
  - Taxpayer would like to do a 1031 exchange of its fee interest for specified condominium units constructed by Developer
    - Taxpayer will hold condo units for investment or in Taxpayer's trade or business

2

## 1031 Exchanges of Fee Ownership for Condo Units

- Taxpayer and Developer agree to the following steps:
  - Taxpayer will lease the property to Developer
  - Taxpayer will grant Developer option to purchase fee interest, exercisable no earlier than receipt by Developer of permanent Certificate of Occupancy ("CO")
  - Developer will demolish the existing structure and construct a new building
    - Construction lender may require a lien on Taxpayer's fee interest during construction, with lien released as units are sold
  - Contract for sales of units to the public will provide that closing is contingent on exercise of purchase option and effectiveness of offering plan

3

## 1031 Exchanges of Fee Ownership for Condo Units

- Upon completion of construction, Developer will file for permanent CO
- Developer will exercise Purchase Option in exchange for promise to pay Taxpayer previously selected condominium units within 180 days
- Within 180 days thereafter:
  - Developer will have the Offering Plan declared effective with Attorney General
  - Developer will record the Declaration of Condominium with the County Clerk to create separate tax lots
  - Developer will transfer to Taxpayer selected condominium units
- Tax Issue: Minimizing the risk of installment sale treatment

4

## Dealer vs. Investor Issues

5

## Dealer vs. Investor Issues

- Dealer Property—Tax Consequences:
  - 1. Gain from sale is ordinary income
  - 2. Gain cannot be reported under installment method
  - 3. Section 1031 not available to defer gain

6

## Dealer vs. Investor Issues

- Recent cases
  - *Evans v. Commissioner*, T.C. Memo. 2016-7
  - *Fargo v. Commissioner,* T.C. Memo. 2015-96
  - *Allen v. United States,* 2014-1 USTC Para. 50,300 (N.D. Ca.)
  - *SI Boo, LLC v. Commissioner,* T.C. Memo. 2015-19
  - *Pool v. Commissioner*, T.C. Memo. 2014-3

7

## Dealer vs. Investor Issues

- What is "dealer property"?
- Different definitions depending on context
  - For purposes of whether gain from sale is capital or ordinary:
    - "Property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." IRC § 1221(a)(1); 1231(b)(1)(B).
  - For purposes of whether sale is a "dealer disposition" of real property:
    - "Real property which is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business." IRC § 453(l)(1)(B).
  - For purposes of whether IRC section 1031 applies:
    - Property "held primarily for sale." IRC § 1031(a)(2)(A)
    - IRC section 1031 definition is broader

8

## Dealer Status

- The issue in the case of real estate is whether the property sold is held by the taxpayer "primarily for sale to customers in the ordinary course of his trade or business." That is, real estate generally will not constitute inventory or stock in trade.
- There are a great number of cases that address the Dealer Property question.
- The following slides identify certain of the significant cases cited by courts and commentators, and then apply the authority to various common scenarios.

9

## Selected Dealer Property Cases

*Malat v. Riddell* [383 US 569 (1966)].

- Partnership purchased unimproved property, subdivided a portion into lots and constructed subdivision improvements on such portion. Lots distributed to partners. Following unsuccessful attempts to develop balance of property, after 8-9 month hold, remaining property was sold in two sales.
- Court concluded that "primarily" meant "principally" or "of first importance." Accordingly, it should not be enough that a substantial purpose of the taxpayer is the sale of the property.
- A question to address: Does profit arise from everyday operation of business or long-term appreciation?

10

## Selected Dealer Property Cases

*Biedenharn Realty Co. v. US* [526 F.2d 409 (5th Cir. 1976) ), cert. den. 429 US 819 (1976)]

- Land that had been held for investment was subdivided, improved and sold in numerous lot sales. Court concludes not a mere liquidation of investment but a change of purpose to dealer status.
  - Frequency and substantiality of sales is the most important factor in determining holding purpose, existence of trade or business and "ordinariness" of sales.
  - There is no exception for liquidating a prior investment – same analysis applies, particularly where decision to sell is not compelled but events outside TP's control.
  - Solicitation activities and development can suggest dealer status but absence of such activities are not necessarily determinative.

11

## Dealer Factors

Certain courts have identified factors to consider, including:

(1) Acquisition purpose
(2) Purpose during course of ownership
(3) Purpose at time of sale
(4) Extent of improvements
(5) Frequency, number and continuity of sales
(6) Nature and substantiality of transactions
(7) Dealings in similar property
(8) Advertising, listing with brokers and other sales efforts
(9) Duration of ownership
(10) Ordinary business of TP

*See, e.g., Maddux Contr. Co. v. Commissioner* [54 TC 1278 (1970)], *Case v. US* [633 F.2d 1240 (1980)]; *Winthrop v. US* [417 F.2d 910 (5th Cir. 1969)].

12

## Dealer Factors

- "Over the past 40 years, this case by case approach with its concentration on the facts of each suit has resulted in a collection of decisions not always reconcilable.... [S]pecific factors, or combinations of them are not necessarily controlling....'[The factors are not] the equivalent of the philosopher's stone, separating 'sellers garlanded with capital gains from those beflowered in the garden of ordinary income.' " [citations omitted].

*Biedenharn Realty Co. v. U.S.* [526 F.2d at 414-415].

13

## When To Determine If Property Is Held For Sale

- While purpose for acquiring and purpose during course of ownership are relevant, the Tax Court has noted that the purpose can change and purpose at time of sale is most relevant.
- Compare how this test is applied in *Maddux Constr. Co. v. Commissioner* [54 TC at 1278] (noting that original purpose to develop and sell raw land changed two years prior to sale) with *Fargo v. Commissioner* [TC Memo 2015-96] (noting that despite lengthy holding of property for rental, original purpose to develop property for sale never changed.) See also *Cottle v. Commissioner* [89 TC 467 (1989)] (Tax Court stated that the purpose for holding property may change and the purpose at the time of sale generally determines tax treatment.)
- The court in *Suburban Realty Co. v. US* [615 F.2d 171 (5th Cir. 1980)], stated that the focus should be on the holding purpose over the entire course of ownership not the moment of sale, but acknowledged that the holding purpose can change.

14

## Entity v. Aggregate Issues

- Where a partnership/LLC sells property, the analysis of whether the property is held for sale should not be dependent on the businesses separately engaged in by partners. *See, e.g., Phelan v. Commissioner,* TC Memo 2004-206.
- Character of gain determined at the partnership level. IRC § 702(b).
  - Note: If property is contributed to the partnership by a partner in whose hands the property was an "inventory item," gain on sale is ordinary for 5-year period after contribution. IRC § 724(b).
- Similarly, for S corporations, character of gain determined at the entity level. IRC § 1366(b); Treas. Reg. § 1.1366-1(b)(1).
- Similarly, partners generally should not be tainted by dealer activities of partnerships of which they are partners.

15

## "One Off" Sales

More than one court has stated that the frequency and substantiality of sales is the most important factor to be considered. *See, e.g., Biedenharn Realty v. US*, 526 F.2d at 409; *Buono v. Commissioner* [74 TC 187 (1980), acq., 1981-2 CB 1] ; *Phelan v. Commissioner* [TC Memo 2004-206].

However, compare results in the following cases:

*Buono v. Commissioner*. TP purchased undeveloped land with intent to subdivide and then, about 18 months later, sell to one purchaser. Later, a portion of property was subdivided into residential lots and was sold to single buyer (about 5 years after purchase due to subdivision issues) following an unsolicitied offer. No sales activity or improvements and only sale during the year. Held, not a dealer. Although planned to sell, not in the business of selling property. Court acknowledges that intent at all times was to sell the single tract. Focus is on lack of sales.

16

## "One Off" Sales

- *S&H, Inc. v. Commissioner*, 78 TC 234 (1982). TP held several properties for investment. Following acquisition of undeveloped land, it sold small portions in 3 unrelated sales following receipt of unsolicited offers. TP engaged in a transaction in which it agreed to construct and lease facility to third party coupled with purchase option. Held, transaction was a sale and TP was a dealer and sale was part of new business of constructing and selling real estate. Court stated that *Buono* did not create a one sale safe harbor – there is no "one bite rule."

17

## "One Off" Sales

- *Fargo v. Commissioner* [TC Memo 2015-96]. Partnership acquired leasehold of building (which was leased to tenants) and surrounding land in 1988 with plans to develop townhouse/retail complex. (Presumably, it was intended that the townhouses would be developed for sale.) Plans later suspended but in order to facilitate obtaining financing, p'ship acquired fee in 1997. Soft development costs incurred in 1999-2001, and received unsolicited offer in 2001, which it accepted (its only sale). Notwithstanding single sale resulting from unsolicited offer and generation of rental income throughout holding period, p'ship held to be a dealer in that it never abandoned its development objective. (Court doesn't seek to distinguish *Buono* but might argue that in *Buono* there was never an intent to engage in more than one sale.)

18

## Can One TP Hold Different Properties For Different Purposes?

- Yes. A single taxpayer may be treated as holding certain properties for investment while holding other properties for sale to customers in the ordinary course of his business. *See, e.g., Rouse v. Commissioner* [39 TC 70 (1962)]; *Cottle v. Commissioner* [89 TC at 467]; *Gardner v. Commissioner* [TC Memo 2011-37].

19

## Liquidation Exception?

*Heller Trust v. Commissioner* [382 F.2d 675 (9th Cir. 1967)]

Corporations created to develop rental housing (duplexes). Duplexes later distributed to shareholders. Related party engaged to undertake significant sales activity, selling 169 units individual units over multiple years. TP a dealer with respect to other property. Held, not a dealer. This was a separate rental business that continued until shortly before sale. [Court does not appear to distinguish corporate holding purpose from TP's purpose.]

*Parkside v. Commissioner*, [571 F.2d 1092 (9th Cir. 1977)].

Corporation developed rental housing and four years later began to undertake sales activity to sell individual units. Issue was application of personal holding company tax. Held, dealer. Liquidation of investment does not compel a result. Here, improvements to properties, significant sales activity and a large number of sales were determinative.

20

## Liquidation Exception?

*Gangi v. Commissioner* [TC Memo 1987-561]

Relying on *Heller Trust* (case was appealable to 9th Cir.), court held that partnership was not a dealer where it held 36-unit apartment bldg. for rental for 8 years but then converted units to condos and sold individual units over 2 years. Court focused on the fact that this was a liquidation of an investment due to various factors. Court distinguished *Parkside* on basis that Parkside engaged to a greater extent in sales activities.

*Cottle v. Commissioner* [89 TC at 467].

Changed circumstances and no negative factors point to liquidation of investment.

21

## Out Parcels

Sale of "out parcels" shortly following acquisition?

*Ayling v. Commissioner* [32 TC 704 (1959)]; *M.S. Doss v. U.S.* [54-1 USTC ¶ 9413 (D.C. Texas)]; *Toll v. Commissioner* [TC Memo 1961-301]; *Metz v. Commissioner* [TC Memo 1955-303]. *Compare Wibbelsman v. Commissioner* [12 TC 1022 (1949)]; *DeMars v. US*, [71-1 USTC ¶9288 (DC S.D. Ind.) (1968)]; *Klarkowski v. Commissioner* [385 F.2d 398 (7th Cir. 1967)].

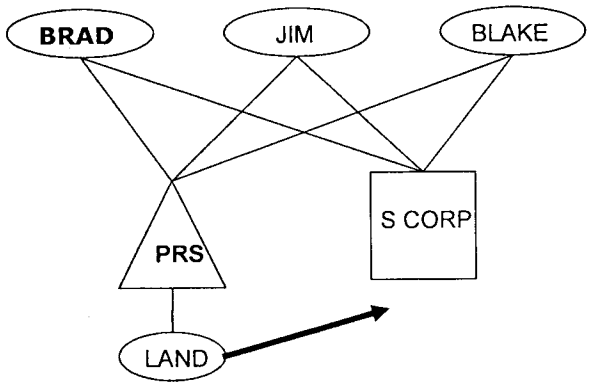
22

# Planning

- LLC/PRS agreement, tax returns and financial statements should all indicate that business is holding for investment (assuming that's the case).
- Consider ability to minimize advertising and other sales-related activity.
- Hold investment assets in different entity.
- Divide separate assets into separate entities to limit "frequent sales" argument

23

# *Bradshaw/Bramblett/Phelan*




1. Can Land be sold pre-development to related corp?
2. What if property is apt bldg. to be converted to condos?

24

## *Bradshaw/Bramblett/Phelan*

- Gain from the sale of land not held for sale to a related partnership that will hold the property for sale to customers is treated as ordinary income. IRC § 707(b)(2). However, can a taxpayer sell to a related C or S corporation?
- *Bradshaw v. US*, 683 F.2d 365 (Ct.Cl. 1982), TP sold property to his wholly-owned S corporation in exchange for notes. S Corp intended to subdivide, develop and sell property. Held, transaction respected as a sale. No attempt to treat TP as a dealer.

25

## *Bradshaw/Bramblett/Phelan*

- *Bramblett v. Commissioner*, 960 F.2d 526 (5th Cir. 1992). Partnership sold land to commonly-owned S corporation, which held land as a dealer and resold in 8 transactions. Corp tendered notes. Held, p'ship not in the business of selling land and corp is not the p'ship's agent. Court noted that 5 sales over 3 years by p'ship did not rise to the level of frequency to cause p'ship to be a dealer.
- Property was held for 3 years without development activity or sales-related activity. Intent of partnership was to hold for investment.
- Under *National Carbide* and *Bollinger* standards, the Corp was not the P'ship's agent. (Did not use P'ship's employees or assets; did not have authority to bind P'ship; did not engage in normal agency activities, etc.)
- Court noted that separate business purpose of Corp was to protect P'ship from unlimited liability.

26

## *Bradshaw/Bramblett/Phelan*

- *Phelan v. Commissioner* [TC Memo 2004-206]. Similar to *Bramblett*. Regarding business purpose, court noted that no unlimited liability concern for transferring LLC but limiting liability (but having related corporation make sales) did protect LLC's retained asset
- Various issues to consider
  - Is transfer to corp a § 351 transaction or contribution to a JV? Will installment debt be recognized as such?
    - See *Burr Oaks Corp. v. Commissioner*, 365 F2d 24 (7th Cir. 1966); *Aqualane Shores, Inc. v. Commissioner*, 269 F2d 116 (5th Cir. 1959).
    - Debt must be adequately secured, bear interest, and have limited term.
  - Is there a business purpose for the transfer?
  - Application of various § 453 & § 453A provisions.
  - Calculation of sales price. Is it FMV? Avoid participations in resales?
  - Liabilities in excess of basis?

27

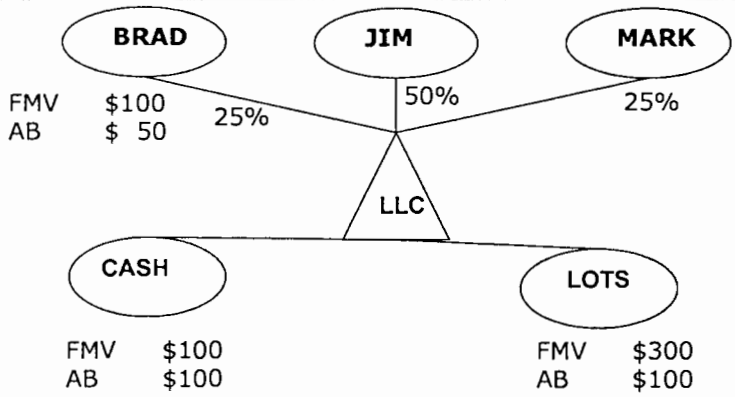
## *Bradshaw/Bramblett/Phelan*

Condo conversion

- Strategy won't work due to § 1239 if property is still in service at time of sale (sale to related party of property that is (temporarily) depreciable by buyer)
- Similarly, installment method not applicable if property is depreciable in the hands of the S corporation purchaser. IRC § 453(g).
  - Consider whether purchaser can take the position that it is holding property for sale beginning on date of acquisition.
- Can objective be accomplished by selling [90+]% of partnership interests to the corporation?

28

## Withdrawal From Dealer Partnership




Brad wants to cash out of homebuilding LLC.

Any planning opportunities?

29

## Withdrawal From Dealer Partnership

- If Brad receives liquidating distribution of $100, it appears that § 751(b) would apply, causing him to recognize $50 of ordinary income. Similar consequence under § 751(a) if he sells interest.
- Can LLC use cash to purchase rental property and within one year distribute property to Brad?
  - Prior to one year, rental property is neither capital asset nor 1231 Property; should be treated as "hot asset" under IRC § 751(d) and Treas. Reg. § 1.751-1(d)(2)(ii) (i.e., a "substantially appreciated inventory item" by virtue of the fact that all inventory items in the aggregate are substantially appreciated). Thus, distribution does not result in a 751(b) exchange.
  - Brad takes substituted basis in property (i.e., step down to $50) and LLC gets a corresponding step up in basis of lots if § 754 election is in effect.

30

## Withdrawal From Dealer Partnership

- Consider substance of purchase of rental property followed by distribution. See *Countryside L.P. v. Commissioner* [TC Memo 2008-3]; ILM 200650014.
- Consider impact of proposed § 751(b) regulations

31

# 7

# RECENT CHANGES IN THE REGULATION OF TAX PRACTICE AND ETHICS

# PRIVATE WEALTH & TAXATION INSTITUTE

Continuing Professional Education Series

## RECENT CHANGES IN THE REGULATION OF TAX PRACTITIONERS

**Professor Linda Galler**
**Maurice A. Deane School of Law**

## Topics

- Loving, Ridgely, Sexton: changes in the scope of IRS authority to regulate
- Schaeffler, AD Investment, Eaton: changes in discovery rules for client-practitioner communications
- Circular 230: changes to regulations governing practice before the IRS

2

# Changes in the Scope of IRS Authority to Regulate

Sources of Professional Regulation: What Rules Apply to Me?

- State Courts/Bar Associations – Rules of Professional Conduct, ethics opinions (applicable to attorneys)
- AICPA Code of Professional Conduct and Statements on Standards for Tax Services (applicable to CPAs)
- IRC provisions – e.g., Section 6694
- Circular 230 – Regulations governing practice before the IRS (applicable to all practitioners)

3

# Sources of Professional Regulation: Uncertain which applies?

- Suppose you're trained as a lawyer, working in an accounting firm?
  - "Some" of the ABA Model Rules may still apply. *See* Preamble [3] to Model Rules; ABA Formal Op. 336 (1974)
- Suppose you're not actively "representing" a client before the IRS (i.e. not in Exam, Appeals, seeking a ruling, etc.), but advising on returns and transactions?
  - This is the Ridgely issue, discussed below

4

## Sources of Professional Regulation: What to do when the rules conflict?

- Follow the "most restrictive" rule
- Example: conflicts that can be "waived" (consented to by the clients)
  - ABA Model Rule 1.7(b) requires "informed consent, confirmed in writing" – with no temporal restrictions
  - Most states follow that; but some (e.g., D.C.) don't technically require a writing
  - Circular 230 § 10.29: consent at the time conflict becomes known, confirmed in writing within 30 days; copies retained for at least 36 months after conclusion of representation; must be provided to IRS on request

5

## Circular 230 – Loving, Ridgely, and aftermath

- There are two sources of IRS's authority to regulate practitioners.
- 5 U.S.C. § 500 broadly authorizes attorneys to practice before all Federal agencies and CPAs to practice before the IRS.
- 31 U.S.C. § 330 specifically deals with the regulation of practice before the Department of the Treasury.

6

7

## Points to notice about 5 U.S.C. § 500

- Any licensed attorney or CPA may represent a taxpayer before the IRS, subject to getting a power of attorney.
- Attorneys can represent before any "agency" (Treasury or other), but CPAs only before the IRS.
- This section does *not* authorize the practice of law or of accounting. Those are still matters of state licensing.

7

8

## 31 U.S.C. § 330

**Section 330. Practice before the Department.**

a) Subject to section 500 of title 5, the Secretary of the Treasury may –
   1) regulate the practice of representatives of persons before the Department of the Treasury; and
   2) before admitting a representative to practice, require that the representative demonstrate –
      A. good character;
      B. good reputation;
      C. necessary qualifications to enable the representative to provide to persons valuable service; and
      D. competency to advise and assist persons in presenting their cases.

8

9

## Loving v. IRS, 742 F.3d 1013 (D.C. Cir. 2014)

- Loving and other plaintiffs were returns preparers – not CPAs, attorneys, or enrolled agents.
- They sued to enjoin application to them of the return preparer testing, CPE, and competency requirements that IRS had promulgated in Circular 230 as part of their new return preparer regulation program ("the Regulations").
- Theory: "return preparation" isn't "practice before the Treasury," and "preparers" aren't "representatives."
- The D.C. Circuit described six reasons why the Regulations failed to satisfy step 1 (and step 2) of the *Chevron* test.

10

## Loving (cont'd)

1. Tax return preparers are not "representatives." Representatives have authority to bind their principal, like an "agent."
2. Preparing tax returns does not constitute "practice" before the Treasury Department. The statute suggests that Congress intended "practice" to mean adversarial proceedings.
3. The history of the statute indicates that Congress intended the statute to cover representation in contested proceedings. Originally enacted in 1884 as part of legislation relating to property lost in military service.

11

## Loving (cont'd)

4. The broader statutory framework suggests that the statute should be read narrowly. Congress has adopted a number of statutes covering the conduct of tax return preparers. These would be superfluous if IRS could already regulate them.

5. It should not be presumed that Congress intended a broad delegation of authority to regulate tax return preparers. The regulations would have affected hundreds of thousands of preparers in a multi-billion dollar industry.

6. The IRS had not previously interpreted the statute as granting authority to regulate tax return preparers. In fact, several IRS representatives previously stated that the IRS did not possess such authority.

12

## Ridgely v. Lew, 55 F.Supp.3d 89 (D.D.C. 2014)

- Ridgely and his accounting firm (Ryan LLC) prepare "ordinary" refund claims (claims not on original returns, but before any IRS audit notice).
- They argued that preparing such claims is not "practice before the IRS," and thus that the IRS could not regulate the kind of fees they charged, in particular the Cir. 230 § 10.27 restriction on "contingent" fees.

13

## Ridgely (cont'd)

- The District Court followed Loving and held that preparation of "ordinary refund claims" is not "practice before the IRS" either.
- This ruling was practically compelled by the logic of Loving.
- Ergo, the Court concluded, the IRS cannot regulate Ridgely's contingent fee arrangement with his client either.

14

## Aftermath

- Sexton v. Hawkins, No. 2:13-cv-00893-RFB-VCF (D. Nev. 2014).
  - Sexton is a former practitioner (lawyer), suspended by OPR, who now prepares returns.
  - He argued that OPR has no authority to investigate him, since his work is outside the (post-Loving) scope of OPR's regulatory authority.
  - OPR was enjoined from requiring production of documents to investigate whether he was engaged in practice. And IRS was further prohibited from suspending Sexton's ability to e-file because he failed to produce documents.

15

## Aftermath (cont'd)

- Davis v. IRS, No. 1:14-cv-00261 (N.D. Ohio 2014).
  - Davis is a (formerly) suspended CPA who prepares returns. He argued that the IRS abused its discretion by refusing to let him use the e-filing system, even after OPR and the Ohio Board of Accountancy determined he was fit to continue practice.
  - The IRS relented and the case was settled in December, 2014.

## Observations and... what happens next?

- Did the Loving court get it right?
- Each of its 6 reasons is at least debatable – esp. that "representatives" are "agents" or that IRS had not previously said it could regulate submitters of returns.
- But most importantly for the long run of OPR and Cir. 230, Loving held that return preparation is not within the group of activities constituting "practice before" the IRS.
- Ridgely is even more restrictive.

16

## Observations and...(cont'd)

- If "practice before" the IRS means only actual representation of taxpayers in controversies (audits, rulings, collection, appeals, etc.), even by persons (CPAs and attorneys) who are otherwise practitioners, then what happens to rules (and OPR's authority) re:
  - Contingent fees on original returns (Cir. 230 § 10.27)?
  - Return positions ( § 10.34)?
  - Written advice ( § 10.37)?
  - Conflicts ( § 10.29)?
  - Negotiating taxpayer checks ( § 10.31)?

17

## Observations and...(cont'd)

- Everyone appears to have concluded that new legislative authority is therefore required.
  - How likely is that?
  - Will it be another tweak to § 330 or a complete overhaul?
- In the meantime, return preparers are subject only to "regulation" pursuant to certain provisions of the IRC (e.g., § § 6109, 6694-95, 6700, 7206(2), etc.).

18

# Work Product Protection

Fed. R. Civ. Pro. 26(b)(3):

(A) *Documents and Tangible Things*. Ordinarily, a party may not discover documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representative (including the other party's attorney, consultant, surety, indemnitor, insurer, or agent). But, subject to Rule 26(b)(4), those materials may be discovered if:

(i) they are otherwise discoverable under Rule 26(b)(1); and

(ii) the party shows that it has substantial need for the materials to prepare its case and cannot, without undue hardship, obtain their substantial equivalent by other means.

- Limited protection against discovery
- Applies to materials prepared "in anticipation of litigation"

19

# Hickman v. Taylor, 329 U.S. 495, 510-11 (1947)

"In performing his various duties, . . . it is essential that a lawyer work with a certain degree of privacy, free from unnecessary intrusion by opposing parties and their counsel. Proper preparation of a client's case demands that he assemble information, sift what he considers to be the relevant from the irrelevant facts, prepare his legal theories and plan his strategy without undue and needless interference. This work is reflected, of course, in interviews, statements, memoranda, correspondence, briefs, mental impressions, personal beliefs, and countless other tangible and intangible ways—aptly though roughly termed . . . as the 'Work product of the lawyer.' Were such materials open to opposing counsel on mere demand, much of what is now put down in writing would remain unwritten. An attorney's thoughts, heretofore inviolate, would not be his own. Inefficiency, unfairness and sharp practices would inevitably develop in the giving of legal advice and in the preparation of cases for trial. The effect on the legal profession would be demoralizing. And the interests of the clients and the cause of justice would be poorly served."

20

## Work Product Protection: Circuit Split

When is a document prepared "in anticipation of litigation?

Majority view (1st, 2d, 3d, 4th, 6th, 7th, 8th, 9th, DC Circuits): "because of" existing or expected litigation – would include pretransactional documents.

- *But see* Textron, 577 F.3d 21 (1st Cir. 2009)

Minority view (5th Circuit): "primarily or exclusively to assist in litigation" – could potentially exclude pretransactional documents.

21

## United States v. Adlman, 134 F.3d 1194 (2d Cir. 1998)

Memo written prior to a corporate restructuring contained detailed legal analysis of likely IRS challenges to the transaction, analyzed relevant law, proposed legal theories or strategies for taxpayer's response, recommended methods of structuring the transaction and made predictions on likely outcome of litigation.

Test: was the document prepared *because of* the prospect of litigation, i.e., would the document have been prepared in essentially the same form had litigation not been anticipated?

Court held that the memo was prepared in anticipation of litigation and therefore was protected by work product doctrine.

22

## Side Note on Adlman

- Court said "because of" test does not protect documents prepared in the ordinary course of business, or that would have been created in essentially the same form irrespective of the litigation.
- Raises question of application of work product doctrine to tax accrual workpapers Litigation (e.g., Textron) may be mooted by Schedule UTP.

23

## Schaeffler v. United States, 22 F.Supp.3d 319 (SDNY 2014), vacated and remanded, 806 F.3d 34 (2d Cir. 11/10/2015)

Substantially similar facts to Adlman: memos written prior to corporate restructuring contained analysis and advice on tax treatment of restructuring and refinancing, including analysis of possible challenges by the IRS and assessment of IRS's likely arguments, and discussion of potential risks taxpayer would face if transactions were challenged or litigated.

Taxpayer asserted that but for its expectation that IRS would examine its restructuring carefully, it would not have engaged outside lawyers and accountants.

District court held that memo was not protected by work product doctrine.

24

## Schaeffler (D. Ct.), continued

"While there is copious citation to relevant legal authority, the memorandum does not specifically refer to litigation – for example, by discussing what actions peculiar to the litigation process Schaeffler or the IRS might take or what settlement strategies might be considered."

Court found that taxpayer would have sought out the same sort of advice had it not been concerned with audit or litigation despite taxpayer's assertions to the contrary because transactions were so complex. In other words, complexity of transactions compelled hiring outside advisers, whether or not litigation was anticipated.

25

## Schaeffler (D. Ct.), continued

Schaeffer (D. Ct.) conflicted with Adlman. Raised questions:

Does Schaeffler effectively eliminate work product protection for tax opinions in complex transactions?

- Schaeffler might reflect the same suspicion of work product protection that the Textron court had.

Is anticipation of litigation irrelevant where a taxpayer otherwise has an interest in complying with tax laws?

Would result have been different if memorandum had been peppered with references to litigation?

26

## Schaeffler (2d Cir.)

Second Circuit vacated. Followed Adlman. So, in Second Circuit (at least):

Work product may protect tax opinions in complex transactions

Anticipation of litigation is relevant even where a taxpayer otherwise has an interest in complying with tax laws

Should memoranda nonetheless contain references to anticipated litigation?

Memo at issue was prepared by Big Four accounting firm. Extent of lawyers' involvement (if any) was not addressed. Thus, not clear whether involvement of counsel was a component of court's analysis.

27

## A cautionary note

- Asserting that a taxpayer was "in anticipation of litigation" early in the planning process could have unintended consequences
- For instance, even normal, scheduled document destruction might be considered spoliation of evidence
- Cf. Prop. Rule 37(a) to Fed. R. Civ. P. (potential sanctions for failure to preserve documents once litigation is anticipated (eff. 12/1/2015)

28

# Privilege

Attorney client privilege:

"(1) Where legal advice of any kind is sought (2) from a professional legal adviser in his capacity as such, (3) the communications relating to that purpose, (4) made in confidence (5) by the client, (6) are at his instance permanently protected (7) from disclosure by himself or by the legal adviser, (8) except the protection be waived." John Henry Wigmore, 8 Wigmore on Evidence § 2292 (McNaughton rev. 1961).

IRC § 7525(a):

(1) *General rule.* With respect to tax advice, the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney shall also apply to a communication between a taxpayer and any federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney.

(2) *Limitations.* Paragraph (1) may only be asserted in—
(A) any noncriminal tax matter before the Internal Revenue Service; and
(B) any noncriminal tax proceeding in Federal court brought by or against the United States.

29

# Does Raising a Reasonable Cause and Good Faith Defense Waive Privilege?

"When a person puts into issue his subjective intent in deciding how to comply with the law, he may forfeit the privilege afforded attorney-client communications."

"Most courts considering the matter have concluded that a party waives the protection of the attorney-client privilege when he voluntarily injects into the suit the question of his state of mind."

- Affirmative use of privileged information (e.g., receipt of an opinion) could result in *subject matter* waiver – i.e., privilege is totally waived and all communications become discoverable.

"The most common situation in which courts have found waiver is where the client claims that he acted on the 'good faith' belief that his conduct was reasonable and legal."

30

## Ad Investment 2000 Fund v. Commissioner, 142 TC 248 (2014)

Court held that attorney-client privilege was waived with respect to tax opinion letters because taxpayer raised reasonable cause and good faith defense to penalties. Taxpayer did not base its defense on opinion letters; claimed to have formed its own belief based on its own review and analysis of relevant legal authorities.

- On one hand, case could be read as saying that putting the taxpayer's state of mind at issue enables discovery of any and all otherwise privileged materials that could have contributed to taxpayer's reasons for taking a return position.
- Any and all advice from counsel would be discoverable, whether or not that advice supports taxpayer's position.
- On the other hand, case could be limited to a narrow set of circumstances: penalty defense in context of a reportable (tax shelter) transaction under a prior version of IRC § 6664. Under this reading, case could be relatively unimportant.

31

## Eaton Corp. v. Commissioner, TC Order (May 11, 2015)

Court held IRS was entitled to review six tax opinion letters written by Eaton's lawyers even though taxpayer said it relied on self-determination to meet the reasonable basis exception to penalties.

Simply by asserting a reasonable cause defense, the taxpayer put at issue all of its experience and state of mind.

32

## Navigating Privilege Waiver

- Control information. Assume that tax opinions or written advice will not be privileged in the event of litigation. Be aware of who is receiving copies of drafts and emails.
  - If there is subject matter waiver, all communications (drafts, research notes, changes made to accommodate technical concerns, emails with offhand comments, etc.) would be affected!
- Due diligence. Before asserting a defense that implicates taxpayer's state of mind, examine all relevant documents to see what information would have to be produced.
- Consider other defenses that do not implicate taxpayer's state of mind. E.g.: "There was substantial authority for the position," "There was a reasonable basis for the position and the relevant facts were disclosed on the return," etc.

33

## Changes in Cir. 230

- Last year the IRS finalized amendments to Circular 230 that had been proposed in 2012.
- Generally, these changes involve
  - Eliminating the "covered opinion" rules
  - Substituting a general "competence" rule,
  - Clarifying "due diligence" requirements for written advice
  - Expanding required compliance programs
  - Changing rules re negotiation of taxpayer checks
  - And some procedural provisions

34

## New § 10.35: "competence"

A practitioner must possess the necessary competence to engage in practice before the Internal Revenue Service. Competent practice requires the appropriate level of knowledge, skill, thoroughness, and preparation necessary for the matter for which the practitioner is engaged. A practitioner may become competent for the matter for which the practitioner has been engaged through various methods, such as consulting with experts in the relevant area or studying the relevant law.

35

## New § 10.37: written advice (or, be careful what you ask for...)

- This now applies to "all" written advice, not just written advice "other than" covered opinions
- Most of the language, however, comes from
  - Old § 10.37, plus
  - Lots of language from old § 10.35, PLUS
  - "Reasonable"!

36

## New § 10.37 (cont'd)

- Para. (a)(1): written advice must meet (a)(2)
- (a)(2): six requirements
  - Based on reasonable factual and legal assumptions
  - Reasonably consider all relevant facts and circumstances that the practitioner knows or reasonably should know
  - Use reasonable efforts to ascertain the facts
  - Not rely upon representations, statements, etc. if reliance on them would be unreasonable
  - Relate applicable law and authorities to facts
  - Not, take into account the "audit lottery"

37

## New § 10.37 (cont'd)

- Para. (b): when can you rely on others? It's reasonable to do so, UNLESS
  - The practitioner knows or reasonably should know that the opinion of the other person should not be relied on
  - The practitioner knows or reasonably should know that the other person is not competent or lacks the necessary qualifications to provide the advice; or
  - The practitioner knows or reasonably should know that the other person has a conflict of interest in violation of the rules described in this part

38

## New § 10.37 (cont'd)

- Para. (c): standard of review.
- (c)(1): "reasonable practitioner" standard for most cases – which includes limits on the scope of the engagement
- (c)(2): if an opinion is being marketed, it's a "reasonable practitioner" standard, BUT taking into account "the additional risk caused by the practitioner's lack of knowledge of the taxpayer's particular circumstances"
- Huh?

39

## New § 10.36: Procedures to ensure compliance

- Previously applied just to
  - Covered opinion rules
  - Return preparation
- Now applies to all of Cir. 230
- Applies to individual(s) who have or share overall compliance responsibility – AND the IRS will find someone!

40

## New § 10.36 (cont'd)

- Para. (b) – can be disciplined IF
  - The individual through "willfulness, recklessness or gross incompetence" fails to have adequate procedures to comply with Circular 230 – AND there exists a pattern or practice of non-compliance
  - The individual through "willfulness, recklessness or gross incompetence" fails to ensure the procedures to comply with Circular 230 are followed – AND there's a pattern or practice of non-compliance
  - The individual knows or should know of a pattern of non-compliance and fails to take "prompt action to correct the noncompliance

41

## Other changes to Cir. 230

- Amendment to § 10.31, negotiation of taxpayer checks, to make it clear it applies to any kind of payment (electronic, etc.)
- Amendment to § 10.82, expedited suspension procedures
- Numerous clerical amendments

42

# DISCLAIMER

## Note to Readers

- This Presentation is not intended to be legal advice.
- Reading the materials does not create an attorney-client relationship.
- The outcome of each case stands on its own merits
- Pursuant to I.R.S. regulations, any conclusions, or comments contained herein is not intended or written to be used, and cannot be used by the reader, for the purpose of avoiding tax penalties.