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Introduction

The steps that partners and their advisors take in forming and operating a family limited partnership can impact a court's view on valuation to such a great extent that valuation evidence can become irrelevant. In transfer tax cases addressing legal issues such as indirect gifts and the applicability of Internal Revenue Code ("I.R.C.") § 2036, courts may conclude that the facts in a given case are such that it is a proportionate share of the assets of the partnership, rather than the transferred partnership interest, that is to be valued for transfer tax purposes. In other words, if the existence of the partnership is judicially disregarded, the question of value of the transferred partnership interest need not be reached – only the value of the underlying assets of the partnership matters. The result to the taxpayer in such a situation is that although he may have transferred a partnership interest, which interest carries with it the duties and restrictions found in the governing partnership agreement (and thus, in determining the fair market value of that interest, discounts for lack of marketability and lack of control should be

applied), for transfer tax purposes, those duties and restrictions are ignored, and the resulting discounts disregarded. Thus, when the existence of a partnership is judicially ignored, the value that is used for transfer tax purposes is the portion of the underlying assets of the partnership attributable to the transferred interest, without regard to the fact that a hypothetical buyer would take into account the terms of the partnership agreement when deciding on the price that he would be willing to pay for the interest.

In determining fair market value for transfer tax purposes, the value of a transferred interest to be transferred is determined according to the “hypothetical willing buyer/willing seller” test found in I.R.C. § 2031 (for estate tax purposes) and § 2512 (for gift tax purposes) and the related Treasury Regulations. But the fair market value of the transferred interests is not a proportionate share of the partnership’s assets, because a hypothetical willing buyer would not be willing to pay for a pro rata share of the underlying assets of the partnership, in part because the buyer would not own the underlying assets and in part because the terms of the partnership agreement burden the assets. Consequently, the fair market value of a partnership interest is almost certain to be less than the proportionate value of the assets of the partnership. And it is the fair market value *of the transferred partnership interest* that is used to determine the amount of tax due as a result of the transfer.

However, in some circumstances, the Internal Revenue Service (“the IRS”) has argued, and the courts have agreed, that the existence of a partnership should be, in essence or in fact, ignored. This article is intended to assist practitioners in advising their clients at each step of forming, operating, and defending a partnership to avoid pitfalls that the courts and the IRS are pointing to when opining that, in essence, the existence of a partnership should be disregarded for valuation purposes.

Consider Appropriateness of Partnership

Keep Potential Future Audience in Mind

Planning for the estate tax examination really begins at the estate planning level. Keep in mind that anything that you write (even if protected from discovery by one or more privileges) may later be viewed by the IRS, a judge, or even a jury. For instance, in cases where the IRS has asserted that I.R.C. § 2036 applies (and thus the client has passed away), the only evidence of non-tax reasons for forming a partnership may be found in the advisors’ files. While advisors should not shy away from explaining the tax effects of forming a limited partnership, it is preferable to have such discussions take place in the context of a discussion of the non-tax reasons, as well.

Consider Whether Clients Are Ready for Partnership

Family limited partnerships are like blowfish sushi – handled with precision and care, they can be wonderful; handled carelessly, they are downright dangerous. Family limited partnerships can be confusing, but at a minimum, they are complex. In that regard, it is important to evaluate whether the people who are considering forming a family limited partnership are up to the task. Can they get along? Are they willing to abide by the rules? Are they prepared to pay the legal and accounting fees that tend to come along with the entity? These questions and others are important to address in determining whether your clients are ready for a partnership.

Evaluate Potential Assets

The courts and the IRS have opined that partners should retain enough assets outside of the partnership to support their lifestyles. The IRS is fond of asserting that a contributing partner's failure to retain sufficient assets outside of a partnership to maintain his or her standard of living is evidence of an implied agreement of that partner to retain rights to the income from the assets contributed to the partnership. See *Estate of Stone v. Comm'r*, 86 T.C.M. (CCH) 551 (2003). In combating, for instance, an I.R.C. § 2036 argument, it is helpful to have contemporaneous documentation of the fact that a contributing partner had sufficient cash flow outside of the partnership to support his or her lifestyle without depending on extraordinary distributions from the partnership.

In determining whether formation of a partnership is appropriate, partners should consider the nature of the assets to be contributed to the partnership. For instance, the IRS and the courts have, in their consideration of whether a partnership is to be respected, considered as a negative factor the contribution of "personal use" assets to partnerships. See, e.g., *Estate of Harper v. Comm'r*, 83 T.C.M. (CCH) 1641 (2002); *Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000); *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331 (2003). Such assets include personal residences, vacation homes, and recreational equipment. If the partners feel strongly about contributing such assets to the partnership, care should be taken to avoid IRS attack by ensuring that the partnership is compensated for individuals' (including and perhaps most importantly, partners') use of those assets, i.e., rent should be paid to the partnership for use of the partnership's assets. Failure to do so may lead the IRS to assert, for instance, that I.R.C. § 2036 should apply at death, in light of the fact that a contributing partner maintained the right to use partnership property without paying for it.

In recent cases, the courts have examined the propriety of partners' capital accounts on formation as a factor in whether I.R.C. § 2036 should be applied to various partnership interest transfers. In that regard, advisors should keep the full and adequate consideration element of the exception to I.R.C. § 2036 in mind and ensure that capital accounts of all partners are properly created, credited, and maintained. Consequently, if partners intend to contribute assets to the partnership that are hard to value (i.e., real estate, oil and gas interests, interests in closely held entities), it is advisable to obtain appraisals of the fair market value of those assets so that the calculation of initial ownership interests in the partnership is as accurate as possible.

Likewise, if assets subject to debt or non-liquid assets (such as real estate) are to be contributed to the partnership, the partners should make sure to fund the partnership with sufficient cash to support those assets, such that the partnership can service its debt and pay real estate taxes related to its property. Doing so may help to minimize fuel for an IRS argument that a contributing partner's debt service or payment of maintenance costs related to assets contributed to the partnership evidences an implied agreement under I.R.C. § 2036 of that partner's right to use those partnership assets.

Finally, when determining which assets are to be contributed to the partnership, it is important to review any transfer restrictions that might be applicable to those assets. If the documents governing a particular asset do not permit transfer of that asset without, for instance, written authorization of a certain person or entity, it is important to begin that authorization process sooner rather than later (or to avoid contributing that asset to the partnership, if it is determined that that transfer restrictions are too onerous).

Evaluate Potential Partners

First, potential partners should consider with whom they wish to be partners. Family limited partnerships often have long terms of existence. It is a good idea to consider whether partners think that they will be able to work together throughout the term of the partnership. Evidence of discussion of such considerations is helpful in establishing that the terms of the partnership agreement were negotiated, a factor that is considered, for instance, in determining whether the bona fide sale element of the exception to I.R.C. § 2036 is applicable.

On a similar note, participants should consider the health of their proposed partners. The IRS likes to point to “deathbed partnerships” as evidence of its assertion that the only reason for forming the partnership was tax avoidance. If one or more of the potential partners is seriously ill, the partners might reconsider whether to include her. *See, e.g., Estate of Strangi v. Comm’r*, 115 T.C. 478 (2000) (bad health); *Estate of Strangi v. Comm’r*, 85 T.C.M. (CCH) 1331 (2003) (bad health); *Estate of Stone v. Comm’r*, 86 T.C.M. (CCH) 551 (2003) (good health). And beware forming a partnership with a person who is not competent to execute the partnership agreement himself; when determining whether partnerships were formed for bona fide, non-tax reasons, the IRS and the courts have taken into account the fact that an agent, rather than the partner, executed the formation documents. *See, e.g., Estate of Strangi v. Comm’r*, 115 T.C. 478 (2000); *Estate of Strangi v. Comm’r*, 85 T.C.M. (CCH) 1331 (2003); *Estate of Stone v. Comm’r*, 86 T.C.M. (CCH) 551 (2003).

Second participants should consider whether the partners will be individual family members, trustees of trusts for family members, entities formed by family members (such as a limited liability company, or “LLC”), or some combination of any or all of the above.

In choosing partners, the participants should consider who will be able to make meaningful capital contributions to the partnership. *See Estate of Bongard v. Comm’r*, 124 T.C. 95 (2005). To the extent possible, it is preferable to have each partner make a meaningful contribution to the partnership so as to establish that a real pooling of assets and services occurred and to avoid the IRS’s argument that, for instance, a child’s proportionately small contribution had no real impact – that creation of the partnership was a “mere recycling of value,” as that term is used in *Estate of Harper v. Comm’r*, 83 T.C.M. (CCH) 1641 (2002). (Beware, though, the implications of the investment company rules when determining the nature and amount of the assets to be contributed to a partnership.) *See, e.g.,* I.R.C. §§ 721, 351, 368.

Finally, in determining who the partners will be, forming partners should consider what roles each of the partners will play, if any, in partnership management. Do the partners intend to have the parent manage the partnership? Is the partnership to be used as a tool to progressively teach the next generation? Or is management to be passed immediately to the children? A parent’s considerations in this regard and a written record of those considerations can play a pivotal role in later establishing the non-tax reasons for which a partnership was formed.

Engage/Consult with Experienced Advisors

It is important to hire an attorney and an accountant who are experienced in family limited partnership issues to assist in the decision-making processes, and hiring such advisors should happen sooner rather than later. The earlier that experienced advisors are involved, the less likely the partners are to make

a misstep in what can be a convoluted process. Beware simplified “kit” partnerships that do not take into account the partners’ individual reasons for and goals in forming the partnership. *See, e.g., Estate of Strangi v. Comm’r*, 115 T.C. 478 (2000); *Estate of Strangi v. Comm’r*, 85 T.C.M. (CCH) 1331 (2003); *Estate of Thompson v. Comm’r*, 84 T.C.M. (CCH) 374 (2002).

Partnership Formation

In the IRS’s view, and more importantly, that of the courts, it is critical that partners in a partnership respect the entity as an entity (*i.e.*, comply with the terms of the governing partnership agreement, treat assets of the partnership as partnership assets, etc.). If the partners fail to do so, it is highly unlikely that the IRS or a court will. In that regard, it is important to dot all of the Is and cross all of the Ts. Some suggestions follow:

Consider Separate Counsel for Participants

Although implementation of this suggestion can be expensive, having each partner represented by separate counsel goes a long way toward ensuring that the interests of each partner are considered when forming the partnership and that the terms of the partnership agreement will be reviewed by and discussed among the partners at that time. It also serves to evidence the arm’s-length nature of the creation of the partnership. *See Estate of Stone v. Comm’r*, 86 T.C.M (CCH) 551 (2003).

Discuss Partnership Terms

In establishing that the creation of the partnership is a bona fide sale as that term is used in I.R.C. § 2036, it is important to document any facts evidencing the arm’s-length nature of the transaction. Negotiation of the terms of the partnership agreement by the intended partners is precisely the type of evidence that can be used to establish that the bona fide sale element of the I.R.C. § 2036 exception is met, as was the case in *Estate of Stone v. Comm’r*, 86 T.C.M (CCH) 551 (2003). (Using a “kit” partnership may play into the hands of the IRS, as such pre-formulated documents rarely leave room for the tailoring that an attorney with experience in family partnerships can provide. *See, e.g., Estate of Strangi v. Comm’r*, 417 F.3d 468 (5th Cir. 2005); *Estate of Thompson v. Comm’r*, 84 T.C.M. (CCH) 374 (2002).

Some of the partnership agreement terms that family members might consider important to negotiate and discuss in this regard are:

Purpose – what are the family-specific reasons that this taxpayer and her family have for forming the partnership?;

Management structure – who will serve as general partner(s)? Will there be a managing partner(s)? Will unanimity be required for management decision-making if more than one person or entity is managing the partnership?;

Management powers – what actions may partnership management take without the approval or input of the other partners?;

Compensation to managers – will the general partners/managing partners be

compensated? If so, at what level?;

Investment policy – what will the partnership’s investment policy be?;

Distribution policy – will the partnership make regular distributions? Will it make distributions sufficient to cover each partner’s income tax liability attributable to his partnership interest?;

Transfer restrictions – what transfer restrictions should be included in the partnership agreement? How will those transfer restrictions impact each partner?;

Partnership term – how long should the partnership stay in existence?; and

Use of partnership assets – under what terms may a partner or third party rent a partnership asset?

Ensure Agreement’s Schedules Are Complete

Most partnership agreements refer to an attachment, schedule, or exhibit that is intended to list all of the assets that the partners agree to contribute to the partnership at formation and the resulting partnership interests to be received by the partners in return. In some states, such attachments are required by statute; and in some of those states, the attachments must also detail the fair market value of the assets to be contributed. In combating IRS arguments that the formalities of a partnership were not respected, it is important that any such attachments to a partnership agreement be complete at the time that the partnership agreement is signed. And in order to best anticipate questions in audit, such attachments should accurately set forth the assets contributed to the partnership, the fair market value of those assets, and the resulting ownership interests of each partner of the partnership.

Sometimes it is impossible to know the fair market value of contributed assets – and thus the amount of the resulting percentage interests – at the time that the partnership agreement is signed. This situation can occur if, for instance, there are hard-to-value assets such as real estate for which an appraisal as of the formation date is being obtained. This can also occur with regard to securities, for which the value cannot be known until the close of business on the day of formation. If necessary, an amendment to the partnership agreement can be executed once accurate fair market values are known.

Prepare Transfer Documents in Advance and File with Relevant State Authorities

As referenced above, in disputing the IRS’s assertions that a partnership should not be respected, it is important to establish that the formalities surrounding formation (and operation) of a partnership are respected. One of those formalities is the transferring of assets to the partnership that the partners agreed to contribute when creating the partnership. In that regard, it is most efficient to have the transfer documents ready at the time that the partnership agreement is signed, so that partners can sign all of the relevant documents necessary to form the partnership agreement and transfer title to the assets into the partnership’s name all at once. Doing so also ensures that this very important step does not get overlooked.

Typically, a limited partnership is not formed until a Certificate of Limited Partnership or similar document is filed with the relevant state authority (often, the Secretary of State). Be sure to file such required documentation with the state (and obtain any state licenses or registrations) timely. Delays between the date that a partnership agreement is executed and the date that the partnership is actually formed under state law can be problematic when the IRS gets involved. *See, e.g., Senda v. Comm'r*, 88 T.C.M. (CCH) 8 (2004), *aff'd*, 433 F.3d 1044 (8th Cir. 2006); *Shepherd v. Comm'r*, 115 T.C. 376 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002); *Estate of Erickson v. Comm'r*, 93 T.C.M. (CCH) 1175 (2007); *Estate of Harper v. Comm'r*, 83 T.C.M. (CCH) 1641 (2002).

File for Employer Identification Number

Likewise, in order to avoid IRS attack, once a partnership is formed, it is important to apply to the IRS for a federal employer identification number ("EIN") as quickly as possible, *e.g.*, as soon as the certificate of limited partnership is filed and returned by the relevant state authority. *See Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), *aff'd*, *Turner v. Comm'r*, 382 F.3d 367 (3rd Cir. 2004). As with the failure to timely file certificates of limited partnership, the IRS has pointed to delays in obtaining EINs as evidence that partnership formalities were not respected.

Create Partnership Accounts Timely

It is important to set up partnership bank and brokerage accounts and transfer contributed assets to those accounts as soon as possible after formation for two reasons: first, to establish that the partnership entity is being respected by its partners and the partners understand that the partnership's assets are just that – partnership assets; second, to ensure that any income earned on partnership assets is credited to the partnership – not to the contributing partner. Otherwise, the door is left open for the IRS to assert the applicability of I.R.C. § 2036, on the grounds that the contributing partner had an implied agreement to retain the income from the assets contributed to the partnership. *See Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), *aff'd* *Turner v. Comm'r*, 382 F.2d 367 (3rd Cir. 2004).

Engage Partnership Accountant

Accounting issues can make or break a court's view of whether to respect the existence of a partnership. In that regard, it is important to hire an experienced partnership accountant who has knowledge of, among others, such partnership issues as capital accounts, the impact of distributions on partners' basis in their partnership interests, the impact of additional capital contributions, redemptions, and sales on ownership interests, I.R.C. § 754 elections, protective claims, and audit procedures, etc.

Reflect Contributions in Capital Accounts in Proportion to Fair Market Value of Assets Contributed

This step is critical in establishing the existence of proof that a transfer of assets in exchange for partnership interests was for full and adequate consideration, as that term is used in the exception to the application of I.R.C. § 2036, or was not an indirect gift of the assets contributed to the partnership. To avoid IRS attack, each partner's capital account should reflect the value of the assets that he contributed to the partnership and the percentage interest received by the partner in return. In order to refute the application of, among other theories, I.R.C. § 2036, the percentage interests received by the

partners should be proportionate to the fair market value of the assets that each contributed.

Consider Deducting Partnership Set-Up Fees

The IRS consistently examines the identity of the payor of partnership set-up fees. If a partner has paid the legal and accounting fees related to creation of the entity and has not been repaid by the partnership, the IRS typically asserts that the partnership has not been respected; that, if it were truly a business entity (and not merely an entity created for tax avoidance purposes), the paying partner would have sought reimbursement by the partnership. Keep in mind that a partnership that pays for (or reimburses) set-up fees may, in most cases, deduct those fees for income tax purposes, although, depending on the amount, it may have to do so by way of amortizing them.

If Necessary, Amend Partnership Percentages as Quickly as Possible After Formation

In order to minimize IRS attack, if assets were contributed to the partnership but the precise fair market value of some or all of those assets was not known on the date of formation (as is likely to be the case with hard-to-value assets such as real estate or mineral interests), the partnership agreement (or its attachments) should be amended as soon as information on all contributed assets becomes available. If such amendments are not made, the IRS is likely to assert that the capital accounts of the contributing partners are not proportionate to the fair market value of the assets contributed and, as a result, the exception to I.R.C. § 2036 cannot apply.

Be Prepared to Produce Documents in Your File to the IRS, If Necessary

The best evidence of a taxpayer's rationale for forming a partnership often comes from the correspondence prepared in connection with the decision to create the entity. In that regard, it is important always to keep the potential audience in mind as communications among the partners and their advisors occur. In attempting to establish the non-tax reasons for forming a partnership, it is helpful if the documentation is such that the taxpayer feels comfortable waiving the attorney-client privilege and producing requested communications that would otherwise be protected from discovery under the attorney-client privilege. Further, keep in mind that assertion of privileges may lead to negative inferences by the IRS.

Partnership Maintenance

Consider Filing Tax Returns for Each Year in Existence

It seems common sense – a legal entity has been established; thus, at the appropriate time, a tax return for the partnership must be filed, right? But what if the entity is formed on December 27? Should a tax return for those 4 days be filed? And what if the entity has no income for the first two or three years that it exists (perhaps it holds only cash and non-income producing real estate, or non-dividend paying stock)? What then?

In both examples, it may be tempting to forgo filing an income tax return. However, to minimize avenues of IRS attack, it is advantageous to file, despite the apparent lack of necessity to do so. First, partnerships often rely on the information contained in the partnership income tax return to document

partners' capital accounts. If no partnership income tax return is filed in the partnership's first year of existence, it may be difficult to evidence that the capital accounts were properly created, reflecting the proportionate exchange of assets for partnership interests. Second, even if the partnership has no income, the IRS has been known to assert that the failure to file an income tax return reflects the partners' intent in forming the partnership only as a transfer tax device. Consequently, despite the fact that doing so may seem unnecessary, it is advisable to file income tax returns for partnerships consistently from inception.

File Any Required Annual/Bi-Annual Registration Statements

It is important to maintain the partnership in good standing with the relevant state authorities. It is not uncommon for IRS litigators, as their first step in reviewing a transfer tax case, to check with the state authorities for all documents on file for the relevant partnership. It is often at this stage that it is first discovered that an entity's good standing has been revoked for the simple failure to send in annual updates or confirmations of the partnership's address. When such revocations occur, even if for very short periods, the IRS likes to argue that such lapses indicate that the entity is an entity without any purpose other than transfer tax avoidance.

Comply with Terms of Partnership Agreement

This suggestion seems only common sense. However, the IRS likes to go through partnership agreements with a fine-toothed comb. If the partners have not themselves done so, they may have neglected to comply with some of the more straightforward requirements of the partnership agreement. Consider reading the partnership agreement with a fresh eye and making a list of all periodic administrative requirements. For instance, are regular meetings required? If so, in light of the IRS's frequent assertions that partnerships are nothing other than transfer tax avoidance devices, partners might choose to take minutes, even if not required (although continuing to keep in mind the eventual potential audience), to establish the business approach taken by the partnership. Are annual statements (other than tax returns) required? Are annual distributions required? Are payments on preferred interests required? Is documentation of the partners of the partnership required to be kept in a certain manner? In order to avoid IRS attack, it is important to ensure that partners treat the entity as a business entity and comply with the terms governing that entity.

Comply with Loan Terms, If Loans Are Made

Beware of lending from the partnership to family members. The IRS and the courts have not looked kindly on partnerships where such loans were made, particularly where the terms of the loans were either undocumented or, where documented, were not complied with. To minimize IRS attacks, any loans made by the partnership should be properly documented and should comply with the terms of the governing partnership agreement. See *Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), *aff'd*, *Turner v. Comm'r*, 382 F.3d 367 (3rd Cir. 2004). Loan terms should be reasonable, and payments should be made timely. In addition, both the partnership and the debtor should comply with the terms of the loans, including foreclosure, if necessary. As noted in various discussions in this chapter, it is important to treat the partnership for what it is – a separate, legal entity.

Distributions, If Made, Should Be Pro Rata

In order to minimize avenues of IRS attack, and assuming that the partnership agreement requires pro rata distributions (as most do), make sure that any distributions made by the partnership are proportionate to the percentage interests held by the partners in the partnership. In cases under IRS scrutiny where non-pro rata distributions have been made (typically to the parent partner), the IRS has typically argued that the partner receiving distributions retained rights to the assets contributed to the partnership such that I.R.C. § 2036 applies. If a non-pro rata distribution has been made, consider making “make-up” distributions to the remaining partners, perhaps with interest at a reasonable rate.

Refrain from Use of Partnership Assets for Partners’ Personal Obligations

Once contributed to the partnership, partnership assets belong to the partnership – not to the contributing partner and not to any of the other partners. Consequently, in order to avoid IRS scrutiny, it is important that partnership assets be treated as such. Where partners may have used partnership funds to pay for their individual expenses or used partnership real estate without contemporaneously paying rent, the IRS has often asserted the application of I.R.C. § 2036, on the grounds that there was, at a minimum, an implied agreement that the contributing partner retained the right to use the assets contributed. As discussed above, where I.R.C. § 2036 is held to apply, the existence of the partnership is essentially disregarded, and evidence as to the value of a transferred partnership interest becomes irrelevant, as it is the value of the underlying assets, rather than the partnership interest itself, on which the transfer tax is imposed.

As indicated above, it is important to keep the partnership’s assets separate from the partners’ assets. This suggestion applies as well at the death of any of the partners. Often, death causes financial hardship, in that a decedent’s assets may be frozen for the time between date of death and the date that a personal representative for the estate is appointed. If expenses of the decedent must be paid in the interim, and no one has access to the decedent’s assets, the partnership’s checking account should not be used to pay those expenses. (In such cases, despite objections that post-death facts are irrelevant to valuation of the decedent’s partnership interests, the IRS has argued that the fact that partnership funds were used to pay a decedent taxpayer’s debts is evidence of an implied agreement by the decedent to retain the right to use assets contributed to the partnership, such that I.R.C. § 2036 should apply.) If absolutely necessary, the partnership may wish to make a loan to the estate of the decedent so that the estate’s representative can take care of business. Alternatively, perhaps beneficiaries of the estate or a third-party lending institution could loan funds to the estate.

Upon Transfers, Consider Whether to Make Section 754 Election

Many factors should be taken into account when determining whether an I.R.C. § 754 election should be made when an interest in a partnership is transferred (whether by sale, by gift, or by transfer at death). One such consideration, however, is whether any transfer tax return related to the transfer may be audited by the IRS. If the return is audited, to the extent that it is finally determined that the value of any partnership interest is greater than the value reported on the estate tax return, an election by the partnership under I.R.C. § 754 may be advantageous, as it could apply to cause a step-up in the partnership’s inside basis in the decedent’s proportionate share of the partnership’s assets. Thus, any finally determined increase in value of the decedent partner’s partnership interest, where such an election has been made, may allow the partnership to seek an income tax refund related to sales of partnership assets since date of death, as any capital gains related to such sales will have been reduced. (Keep in mind that protective claims may need to be filed if the statute of limitations is close to running

on the income tax returns but the examination of the transfer tax return has not been completed.)

Avoid Irregular Transactions Between Partners and Partnership

When asserting that I.R.C. § 2036 should apply, the IRS looks for any facts that it can find to indicate an implied agreement that a taxpayer retained rights related to assets transferred to a partnership. For example, where a partnership has redeemed numerous partnership interests held by a partner, or made multiple loans, non-regular distributions, or non-pro rata distributions to that partner, the IRS may argue that the facts indicate an implied agreement that the taxpayer retained rights to the assets that he transferred to the partnership, such that I.R.C. § 2036 should apply to, in effect, disregard the existence of the partnership for valuation purposes. In order to avoid such arguments by the IRS, numerous transactions of this type between the partnership and its partners should be avoided.

Keep in Mind Non-Tax Reasons Stated for Forming Partnership

As the partnership grows and the partners develop a working relationship, keep in mind the non-tax reasons that were given for forming the partnership at the outset. To the extent possible, try to implement them. Doing so can help undercut an IRS attack that the partnership was formed only for tax savings.

TRANSFERS OF PARTNERSHIP INTERESTS

Generally

When partnership interests are transferred, it is a good time to review the books and records of the partnership to ensure that they are in order. Due diligence at this stage (and at all others) bolsters the position that the partnership is a respected, stand-alone entity.

Regardless of the nature of the transfer, it is also important to consider whether a transfer of a partnership interest triggers any rights of first refusal; if so, it is important in warding off IRS attacks to comply with any such transfer restrictions.

In general, it is helpful at the audit stage in particular if partnership management (and its accountants) have kept careful track of changes in partnership interests (perhaps through keeping a historical spreadsheet outlining each transfer of partnership interests) and to update the partnership books and records to reflect any such changes. Doing so concurrently with transfers assists at the audit level, as such a record provides contemporaneous evidence of the transfers and can, again, bolster the position that the partnership is an entity separate from its partners. If necessary, consider restating the applicable schedule or exhibit to the governing partnership agreement to reflect the change.

Regardless of the nature of the transfer, it is important to document the transfer of partnership interests. In order to minimize IRS attacks, such transfer documents should be executed by transferor and transferee, and the document should be dated on the date that they are signed (though the effective date may be different).

Finally, ensure that the Certificate of Limited Partnership for the partnership is amended, if necessary, and filed with the relevant state authority. Failure to do so may give the IRS room to argue that the

entity was not respected by its partners.

By Gift

In addition to the considerations discussed in paragraph A above, when the transfer is to occur by gift, it is important to refrain from gift planning until the partnership is formed and operating in order to avoid the indirect gift theory discussed above. *See, e.g., Senda v. Comm'r*, 88 T.C.M. (CCH) 8 (2004), *aff'd*, 433 F.3d 1044 (8th Cir. 2006); *Shepherd v. Comm'r*, 115 T.C. 376 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002).

By Sale

When a transfer occurs by sale, be sure to consider the income tax implications of such a transfer.

At Death

When the transfer of partnership interests occurs as a result of a partner's death, it is especially important to review the transfer to determine whether a lapse occurs under Chapter 14 of the Internal Revenue Code and to report the interest transferred accordingly. While many partnership agreements are written with an eye toward avoiding the application of Chapter 14, not all have incorporated this concept.

Further, in order to simplify estate administration and potential audit, consider maintaining the partnership interest in the hands of the Executor, subject to estate administration, until a closing letter is received from the IRS. Once an IRS closing letter is received and the partnership interest is to be transferred into the hands of the appropriate beneficiary, document the transfer from the estate to the beneficiary, and that transfer document should be executed by both the executor and the recipient beneficiary.

By Redemption

When a partnership interest is transferred by way of redemption from a partner by the partnership, be sure to review the partnership agreement to ensure that the partnership is not prohibited from redeeming the interest from the interest holder. Next, be sure to document the redemption, to be executed by partnership management and the transferring partner. Finally, be sure that the books and records of the partnership reflect a decrease in the transferring partner's interest and a corresponding proportionate increase to all remaining partners' interests. Taking these steps will help avoid IRS attack.

TRANSFER TAX REPORTING

In order to ensure that any transfer tax return, whether Form 706 or Form 709, is prepared in a manner that is most defensible in audit, the taxpayer should engage an experienced attorney or accountant to prepare such returns.

Obtain Appraisal from Independent, Qualified Appraiser

To minimize IRS attack, the taxpayer should select an appraiser who will provide an independent and

qualified appraisal of fair market value of the transferred interest. In that regard, consider whether the selected appraiser is independent from the taxpayer, is credible, is experienced in the area of partnership valuation, and has the appropriate certifications. Perhaps most importantly, the appraiser should not act as an advocate for the taxpayer.

Confirm with the Appraiser the Interest to Be Valued

Depending on the terms of the partnership agreement and the identity of the transferee, the interest transferred by the taxpayer may be a general partnership interest, a limited partnership interest, or an assignee interest in a limited partnership interest (and, depending on the terms of the partnership agreement, there may be classes within one or more of these types). It is important to identify the nature of the interest transferred, as each type carries with it specific rights and responsibilities that are likely to impact value.

Consider Whether to Aggregate Interests

If the transferred partnership interests include more than one class (*i.e.*, general partnership interests *and* limited partnership interests), be sure to clarify with the appraiser as to whether those interests should be aggregated for valuation purposes. For instance, if a general partnership interest and a limited partnership interest are transferred by the decedent, it is likely that the interests should be aggregated. If, however, the general partnership interest is held by the decedent, and the limited partnership interest is held in a marital trust created by the decedent's pre-deceasing spouse, the taxpayer may be able to take the position that the interests should *not* be aggregated. *See, e.g., Estate of Bonner v. United States*, 84 F.3d 196 (5th Cir. 1996); *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981).

Review Appraisal Closely for Facts

In opining as to fair market value, the appraiser will likely take into account numerous partnership-specific facts, such as the terms of the governing partnership agreement, the fair market value of the partnership's underlying assets, cash flow to the partnership, and the distribution policy of partnership management. As a result, when reviewing the appraiser's conclusions, it is important to confirm that the appraiser has properly reflected these facts in his report so that his valuation conclusions are not based on incorrect factual assumptions. (It is also helpful to make sure that a copy of the partnership agreement is included with the final appraisal, perhaps as an exhibit.)

Try to Live by Factual Information Provided to Appraiser

Once the appraiser has completed his appraisal, it is helpful in defending his conclusions if, after the valuation date, the partnership is operated in the manner reported to the appraiser, for example, in such areas as the distribution policy, anticipated cash flow, etc. Arguably, post-valuation date facts are irrelevant to valuation conclusions. However, the IRS may assert that deviation from the factual assumptions by the appraiser indicate that the appraiser's conclusions were faulty, especially if the partners anticipate at the time of the transfer that such a transaction might occur. Living with the factual information provided to the appraiser may help avoid such assertions.

Beware of Rounding on Appraisals and Tax Returns

If there is a reason to round value up or down, be sure that the appraiser explains his reasons in the appraisal. If the appraiser cannot explain why the value should be rounded up or down, he likely will not be able to do so on the stand either. And the courts are increasingly examining and parsing practically each and every valuation conclusion of appraisers of limited partnership interests. Unexplained rounding may cause a court to question other conclusions that the appraiser has made in the appraisal.

Understand IRS Settlement Guidelines

In early 2007, the IRS issued new settlement guidelines for matters involving limited partnerships. In those guidelines, the IRS explained that its goal was to promote consistency of approaches across different jurisdictions and that its primary modes of attack would be the indirect gift theory and I.R.C. § 2036. See Settlement Guidelines, 07 No. 020 BNA Taxcore 25.

AUDIT

Consider Bringing in Litigation Counsel

Once the audit begins, it is particularly helpful to involve litigation counsel sooner rather than later. Doing so allows the litigator to be involved from step one, assisting in determinations related to the assertion or waiver of various privileges, responsiveness of documents and information, and consideration of the eventual burden of proof under I.R.C. § 7491.

Determine Whether a Document Destruction Policy Exists; If So, Suspend

Some corporate trustees and executors have document destruction policies. It has become advisable for attorneys whose clients are involved in litigation to ensure that their clients suspend document destruction policies. The consequence of failure to do so may include sanctions against the attorney and the client for spoliation of evidence. See, e.g., *Phoenix Four, Inc., v. Strategic Resources Corp.*, 2006 WL 1409413 (S.D.N.Y.).

Consider the Burden of Proof

Until the late 1990s, the burden of proof in a tax case fell on taxpayers. In other words, if a court could not decide who should win in light of the evidence, the IRS won. For examinations beginning after July 22, 1998, however, it became possible for taxpayers in certain circumstances to shift the burden of proof to the IRS, so that if a court could not decide who should win in light of the evidence, the taxpayer would win. Under I.R.C. § 7491, if a taxpayer (who is not a partnership, corporation or trust) maintains all required records under the Code and complies with the IRS's reasonable requests for documents, information, and interviews, the burden of proof shifts to the IRS, and if a court cannot decide, the taxpayer wins. Although cases in which a court weighs the evidence and still comes down on the fence are very rare, the IRS has, in recent years, been very reluctant to agree that taxpayers meet the factual requirements of I.R.C. § 7491.

Consider the Impact of Privileges

Various privileges apply in the context of estate planning, the most familiar of which is the attorney-client privilege (often referred to simply as “the privilege”). Keep in mind that the privilege is the client’s to waive, not the attorney’s. As a general rule, the privilege covers client communications made to the attorney with the purpose of seeking legal advice.

The work-product doctrine, on the other hand, protects an attorney’s thoughts and work *in preparation for litigation*. Contrary to common misconception, the work-product doctrine only begins to apply to an attorney’s work that is done “in anticipation of litigation.” According to the Seventh Circuit, audit can be the antechamber to litigation, and thus, the work-product doctrine may apply to an attorney’s work even during the audit process. See *United States v. Frederick*, 182 F.3d 496, 502 (7 th Cir. 1999).

More recently, the U.S. Congress enacted a new federal privilege under I.R.C. § 7525 – the tax practitioner’s privilege. This privilege applies only in non-criminal tax cases, and it protects from discovery communications that, if communicated to an attorney, would have been protected from discovery under the attorney-client privilege. Note, however, that in some jurisdictions, the tax practitioner’s privilege has been interpreted not to cover advice related to tax return preparation. See *United States v. Frederick*, 182 F.3d 496 (7 th Cir. 1999).

While privileges can be waived, and often waiver is highly recommended (particularly in cases where the IRS is asserting the application of I.R.C. § 2036), beware of subject matter waiver. Once the privilege has been waived on a particular subject matter, that waiver covers all communications on that subject matter. Unfortunately, one cannot just pick and choose to waive the privilege with regard to favorable documents.

Consider Whether Production of Privileged Information May Help Your Case

Various privileges may apply in any given situation – the attorney-client privilege; the work product doctrine; and the tax practitioner’s privilege under I.R.C. § 7525. As discussed above, however, there are often times when, if appropriate, it is helpful if the taxpayer waives such privilege, such that documents and information that would otherwise be protected from discovery is produced. This is particularly true in estate tax cases, where the best person with personal knowledge is the decedent taxpayer – and is not available to testify.

Provide Responses to the IRS that Are True and Correct, to the Best of Your Knowledge

The taxpayer’s duty is to provide responses to IRS requests that are true and correct to the best of the taxpayer’s knowledge. However, the taxpayer need only produce responsive documents in his possession, custody, or control; generally, there is no need to *create* documents to respond to IRS requests. If necessary, indicate in responding to the IRS that the taxpayer has no such documents in his possession, custody, or control that are responsive to the request.

Keep in Mind that Anything Stated or Written Can Be Treated as an Admission

As mentioned several times above, it is important to keep in mind that a judge or a jury might eventually read what is written related to the taxpayer’s planning. Anything stated or written to the IRS

at this stage can be treated as an admission. Further, anything written to the appraiser or any expert may be discoverable by the IRS.

Produce Responsive Documents in Your Possession, Custody, or Control

It is the taxpayer's duty to produce responsive documents in his possession, custody, or control. While documents held by the taxpayer's attorney, accountant, or bank are likely to be construed as within his possession, custody, or control, documents held by others may not. Be sure to consider the relationship between the taxpayer and the advisor in analyzing this issue.

Be precise when responding to the IRS. For instance, if the partnership owns primarily real estate, but has a small equity portfolio, be sure to disclose the existence of both (and in detail) when asked by the IRS for the assets of the partnership.

Keep Careful Track of Documents and Electronic File Produced to the IRS

Particularly if litigation counsel becomes involved at some point, it is helpful to have a precise record of the documents and electronic files that have been provided to the IRS, from inception of the audit through the close of discovery. In that regard, consider Bates-labeling every page produced to the IRS, such that there is a number associated with every page. (Doing so also helps in the stipulations process, as each exhibit can be identified by Bates-label number, ensuring that everyone (including the judge) is literally on the same page.)

Understand the IRS's Broad Subpoena Power

The IRS has a very broad power to subpoena practically any information, books, and records that it deems necessary to carry out its mission. The IRS may examine or summons a laundry list of items and people for the purpose of "ascertaining the correctness of any return, making a return where none has been made, or determining the liability of any person for any internal revenue tax." I.R.C. § 7602(a). As might be expected, however, this broad power is subject to traditional privileges.

File Protective Claims If Necessary

Keep in mind that sometimes resolutions of estate tax issues may impact income tax issues related to the partnership or the estate. Be sure to analyze whether the resolution of the estate tax issue might come too late to file a claim for refund on the income tax side. If so, you may find it necessary to file protective claims for refund to protect rights to income tax refunds that may eventually be due.

Consider Whether it is Feasible to Keep Partnership in Place

At least until the examination of the transfer tax return has been closed and the taxpayer's tax liability finally determined, it is better if the partnership remains in place. As discussed earlier, although facts that occur after the valuation date are arguably irrelevant, the IRS does not hesitate to use those facts when doing so might result in the increase in value of the transferred interest (and resulting transfer tax); and terminating the partnership could play into the IRS's hands in this regard.

Treat Informal Interviews as Depositions

Although interviews by the IRS can be quite informal, neither the taxpayer nor his advisors should be caught off guard. These interviews are, in essence, depositions. In order to ensure that any additional requests for documents and information are provided in writing, such interviews likely ought to be held at an advisor's office (that of the attorney or accountant), rather than at the taxpayer's office or home. Consider also having a court reporter present to ensure that the taxpayer's responses are not misconstrued.

Although this article refers to limited partnerships, many of the suggestions contained herein also apply to other closely held entities, such as limited liability companies.

Keep in mind, however, that relief of the contributing partner's debt in this regard may require consideration of income tax issues for that partner.

Qualified Severances for GST Tax Purposes

Final & Proposed Regulations issued August 2, 2007

By Julie K. Kwon

Under the law prior to the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the only severances recognized for GST purposes were those dividing single trusts already treated as separate trusts under Section 2654(b), based on the different beneficiaries' separate and independent shares or its multiple transferors. Thus, if a single trust was severed into separate trusts recognized under applicable state law to resolve disputes among interested parties, the severance was not recognized for GST tax purposes and parties would remain yoked together for GST tax purposes. In addition, even if the severance of a single trust with an inclusion ratio between zero and one was recognized, it resulted in separate trusts with the same inclusion ratio as the original single trust.

EGTRRA introduced Section 2642(a)(3), which describes "qualified severances" that will result in trusts that will be treated as separate trusts thereafter for GST purposes. In addition, certain severances of trusts with inclusion ratios between zero and one will result in separate trusts with inclusion ratios of zero and one. Section 2642(a)(3) applies to severances occurring after December 31, 2000. Section 2642(a)(3) also states that the trusts resulting from a qualified severance will be treated as separate trusts "thereafter" for GST tax purposes, indicating that the qualified severance becomes effective at the time when it occurs.

On August 2, 2007, the Treasury Department issued both Final Regulations (T.D. 9348) and Proposed Regulations (Notice of Proposed Rulemaking REG-128843-05, 72 Fed. Reg. 48249 (August 2, 2007)) relating to qualified severances, to be effective from August 2, 2007.

Definition of Qualified Severance.

Regulation §26.2642-6(b) itemizes the requirements for a qualified severance:

The severance of a single trust (other than a division described in Regulation §26.2654-1(b) which addresses divisions of trusts included in the transferor's gross estate) pursuant to the governing instrument or applicable local law.

The severance is effective under local law. Section 2642(a)(3) states that "any means available under" local law or the trust instrument will be effective. Accordingly, even in the absence of the specific power to sever in the trust instrument or state statute, a severance by judicial order or other means available under local law should suffice for purposes of Section 2642(a)(3).

The date of severance is either the date selected by the trustee as of which the trust assets are to be valued to fund the resulting trusts, or the court-imposed date of funding where the local court with jurisdiction over the trust has ordered the trustee to fund the resulting trusts on or as of a specific date. However, a date will only qualify under the regulation if funding must commence immediately, and funding must occur within a reasonable time (but in no event more than 90 days) after, that selected valuation date. This provision acknowledges the practical impossibility of valuing

all of the trust assets, making allocation decisions and completing the actions necessary to transfer assets to fund a non-pro rata division on the same day. However, the regulation does not require notice to the Internal Revenue Service or otherwise detail how the trustee will evidence the selection of the valuation date. Example 11 under the Final Regulations illustrates the operation of this funding provision.

The single trust (original trust) is severed on a fractional basis, such that each new trust (resulting trust) is funded with a fraction or percentage of the original trust, and the sum of those fractions or percentages is one or 100 percent, respectively. The regulation expressly authorizes the use of a formula to determine this fraction or percentage and the non-pro rata division of assets among the resulting trusts based on the fair market value of the assets on the date of severance. However, if funding on a non-pro rata basis, "each resulting trust must be funded by applying the appropriate fraction or percentage to the total fair market value of the trust assets as of the date of severance." Example 5 under the Final Regulations illustrates the method of funding the resulting trusts that conforms to these Final Regulations as required for a qualified severance. The severance of a trust based on a pecuniary amount will not constitute a qualified severance.

The terms of the resulting trusts must provide, in the aggregate, for the "same succession of interests" of beneficiaries as are provided in the original trust. This requirement is satisfied if the beneficiaries of, and their respective beneficial interests in, the original trust remain the same after the severance in the resulting separate trusts when those resulting trusts are viewed collectively.

Thus, the terms of the trusts resulting from a qualified severance are not required to be identical, as long as the trusts collectively preserve the beneficial interests under the original single trust. However, state statutes, to the extent they address trust severances at all, typically require that resulting trusts remain governed by terms "identical" to those terms governing the original, single trust. Thus, a judicial reformation may be required to sever a trust on terms that differ from the original trust if the applicable local law and trust instrument lack express authorization for divisions resulting in trusts with different terms.

Most rulings to date applying Section 2642(a)(3), prior to the issuance of the recent Final Regulations, involve qualified severances resulting in separate trusts with terms identical to the original trust, in most cases because the taxpayers severed pursuant to a state statute or governing instrument authorizing severances on identical terms. Thus, most rulings involving qualified severances have not addressed how trusts may differ from the original trust without changing the succession of beneficial interests under the original single trust for purposes of Section 2642(a)(3). However, the Examples under new Regulation §26.2642-6(j) provide additional guidance in this respect.

Example 1 under the new qualified severance regulation parallels Example 1 under Regulation §26.2654-1(b)(1), as the latter similarly requires preservation of the same succession of beneficial interests after severance of a trust included in the transferor's estate or created under the transferor's will. Thus, the preamble to the regulations under Section 2654 may provide helpful guidance that similarly applies to interpretation of this requirement for qualified severances:

The Final Regulations provide that the trusts resulting from the severance of a single testamentary trust need not be identical. Thus, if the trust provides income to spouse, remainder to child and

grandchild, the trust may be severed to create 2 trusts, 1 with income to spouse, remainder to child and a second with income to spouse remainder to grandchild. This result could be achieved through proper estate planning in any event. However, the regulations make it clear that the resulting trust must provide for the same succession of interests as provided for under the original trusts. Thus, a trust providing for an income interest to a child, with remainder to a grandchild, could not be divided into 1 trust for the child (equal in value to the child's income interest) and another for the grandchild.

As indicated in the preamble to Regulation §26.2654-1, Example 3 under Regulation §26.2642-6(j) precludes the "horizontal" division of trusts based on the actuarial value of the respective beneficiaries' temporal interests. The Final Regulations regarding qualified severances also provide several additional examples to illustrate the extent to which trusts may differ from the original trust without changing the succession of beneficial interests under the original single trust for purposes of Section 2642(a)(3).

The Final Regulations describe in particular certain severances of wholly discretionary trusts from which distributions may be made to any one or more beneficiaries on a non-pro rata basis that will satisfy this "same succession of beneficial interest" requirement if:

- (i) The terms of each resulting trust are the same as the terms of the original trust, though each permissible beneficiary of the original trust is not a beneficiary of all of the resulting trusts;
- (ii) Each beneficiary's interest in the resulting trusts (collectively) equals the beneficiary's interest in the original trust, determined by the terms of the trust instrument or, if none, "on a per-capita basis;"
- (iii) The severance does not shift a beneficial interest in the trust to any beneficiary in a lower generation (as determined under Section 2651) than the person or persons who held the beneficial interest in the original trust; and
- (iv) The severance does not extend the time for the vesting of any beneficial interest in the trust beyond the period provided for in (or applicable to) the original trust.

The regulation provides an example of a severance of a wholly discretionary trust that maintains the "same succession of beneficial interests." A discretionary trust for the benefit of A, B, and C and their descendants with the remainder to be divided equally among those three families is severed into three separate trusts of equal value: one for the benefit A and A's descendants, one for the benefit of B and B's descendants, and one trust for the benefit of C and C's descendants. This example for severances of discretionary trusts parallels Example 5 under Regulation §26.2601-1(b)(4)(E) addressing permissible modifications of trusts grandfathered from application of the GST tax that will not subject the trusts to such tax.

This provision authorizing certain severances of discretionary trusts facilitates divisions of trusts along family lines, which are often important means of resolving family disputes. However, several aspects of this rule require additional clarification. Under the example, the meaning of "per capita" for purposes of this rule is unclear. If A, B and C described in the example are the transferor's children, then a per capita division treats each family line equally and likely reflects the intention of

most transferors or interested parties. However, if A is the transferor's child while B and C represent the transferor's grandchildren born to a deceased child who was A's sibling, then the example results in the allocation to A's trust of only one-half the amount of property allocated to the trusts held for members in A's sibling's family. The division of property "per capita" may significantly differ among separate family lines based on the chance order of deaths of family members and the number of children each individual chooses to have. In contrast, experience suggests that transferors and parties negotiating resolutions to disputes regarding the division of trust property typically prefer a "per stirpes" division of property that preserves the shares of property allocated to each family line, beginning with a per capita division at the children's generation. If such per stirpes division was actually contemplated in this provision, then a technical correction might revise the reference to clarify that a per stirpes measure of the beneficiaries' interests after the severance is appropriate.

The Final Regulations also do not express whether a severance along family lines must preserve current or remainder interests in all resulting trusts so that the members of each family line may resort to the other trusts upon exhaustion of the trust originally held for that family's benefit. This example within Regulation §2642-6(d)(5)(ii) does not appear to require that each of A, B and C and their respective descendants maintain interests in all of the trusts resulting from the severance to the extent that any single trust is exhausted. However, Examples 2 and 7 of the Final Regulations illustrating qualified severances recite facts showing that the beneficiaries retain their interests in the remainders of both trusts resulting from the severance in the event a single trust is exhausted. However, without specific discussion, the Final Regulations remain unclear as to whether the preservation of the original beneficiaries' interests in all of the post-severance trusts is required for a qualified severance.

In addition, the Final Regulations do not provide extensive guidance regarding the standards for the exercise of discretion that would meet the definition of a discretionary trust for purposes of this exception. Example 2 addressing this exception merely states that the trustee may distribute "as the trustee deems advisable." Hopefully, this absolute discretion without qualification is not the only type that satisfies this exception and other discretionary standards considered similarly non-ascertainable for transfer tax purposes (i.e., "best interests and welfare," "comfort" or "happiness") will suffice.

In the case of a qualified severance of a trust with an inclusion ratio as defined in section 26.2642-1 of either one or 0, each trust resulting from the severance will have an inclusion ratio equal to the inclusion ratio of the original trust.

A trust with an inclusion ratio between zero and one must be severed initially into two trusts. One resulting trust must receive that fractional share of the total value of the original trust as of the date of severance equal to the applicable fraction and will have an inclusion ratio of zero. The other resulting trust must receive the remaining fractional share of the original trust and will have an inclusion ratio of one. However, if the applicable fraction of the original trust is .50, the trustee may designate which of the resulting equal trusts will have an inclusion ratio of zero and of one. The regulation confirms that each resulting trust may be further divided in additional qualified severances to create further separate trusts.

Qualified Severances of "Grandfathered" Exempt Trusts.

Section 2642(a)(3) addresses the recognition of the creation of separate trusts resulting from a qualified severance for GST tax purposes. However, the GST tax rules, including those authorizing qualified severances, do not apply at all to an "exempt trust" that is grandfathered from the imposition of GST tax. Instead, Regulation §26.2601-1(b)(4) (discussed further below in Section V.B of this outline) describes rules for determining whether a modification, judicial construction, settlement agreement, or trustee action with respect to an exempt trust will cause it to lose its exempt status. Thus, a severance of an exempt trust must satisfy those rules to avoid becoming subject to GST tax.

However, where contributions are added to a grandfathered trust after September 25, 1985, Regulation §26.2601-1(b)(1)(iv)(A) deems the trust to consist of one separate share attributable to contributions before such date that is not subject to GST tax (the "non-chapter 13 portion") and another separate share attributable to contributions after such date that is subject to GST tax (the "chapter 13 portion"). Regulation §26.2642-6(g) confirms that any such trust may be severed into two trusts in accordance with Regulation §26.2654-1(a)(3) to segregate the non-chapter 13 portion from the chapter 13 portion, and that the trust holding the chapter 13 portion may be further divided by qualified severance.

Reporting requirements.

Regulation §26.2642-6(e) details the information necessary to report a qualified severance to the IRS. The regulation does not require that a qualified severance be reported to be effective for GST purposes, though reporting is advisable to avoid future confusion when reporting subsequent GST events.

A qualified severance is reported by filing Form 706-GS(T), "Generation-Skipping Transfer Tax Return for Terminations" (or such other form as the IRS may provide for the purpose of reporting qualified severances) by the due date of the gift tax return (including extensions) for gifts made during the year in which the severance occurred, or if no gift tax return is filed, by April 15th of the year immediately following the year during which the severance occurred. Treas. Reg. §2642-6(e), (k)(2). The IRS requests that filers write the words "Qualified Severance" at the top of the return and attach a Notice of Qualified Severance including the basic information regarding the original and resulting trusts and their respective inclusion ratios itemized in the regulation. Treas. Reg. §2642-6(e).

- **Recognition of Capital Gain or Loss.**

Section 1001 governs the determination of the amount and recognition of capital gain or loss for income tax purposes upon the sale or other disposition of property. Effective as of August 2, 2007, Treasury Regulation Section 1.1001-1 is amended to add a helpful new subparagraph (h) describing a safe harbor for income tax purposes for certain severances of trusts, including without limitation qualified severances under Treasury Regulation Section 26.2642-6 or severances described in Treasury Regulation Section 26.2654-1(b). This new provision addresses the concern that the severance of a trust may be deemed to create a taxable exchange resulting in the recognition of capital gain by one or more of the trust beneficiaries.

The IRS addressed taxable gains resulting from the severance of a trust in PLR 9731041. PLR 9731041 describes the proposed partition of a single trust grandfathered from application of the GST tax into two separate trusts to be governed by the terms of the original trust. One resulting trust would own all of the closely held company stock and the other owning all of the remaining trust assets. Certain beneficiaries entitled to annual fixed payments from the single trust also proposed to renounce their interests in the trust holding company stock as the other resulting trust was determined to be actuarially sufficient to provide for their annual payments entirely. Due to the trustee's power to make non-pro rata distributions under the trust instrument and local law, the IRS concluded that the partition was not a taxable event for income tax purposes. However, the IRS relied primarily upon *Cottage Savings Ass'n. v. Comm'r.*, in its analysis of whether the partition resulted in recognition of gain or loss under Section 1001.

In *Cottage Savings*, the Court held that a realization event under Section 1001(a) occurs upon an exchange of properties that are "materially different." The Court further stated that properties are "materially different" for purposes of Section 1001(a) to the extent their respective possessors enjoy legal entitlements that are different in kind or extent. Under this standard, the Court concluded that a taxpayer's exchange of interests in groups of mortgage loans considered "substantially identical" by the regulating agency nevertheless resulted in a taxable exchange because the mortgage loans made to different obligors and secured by different homes embodied distinct legal entitlements. In PLR 9731041, the IRS applied the *Cottage Savings* analysis and concluded that the partition of the single trust would not change the beneficiaries' interests. Thus, the IRS concluded that "[I]t is inconsistent with the Supreme Court's opinion in *Cottage Savings* to find that the interests of the beneficiaries of the two successor trusts will not differ materially from their interests in the existing trust."

The IRS subsequently has ruled favorably for taxpayers that severances of trusts will not result in a taxable exchange under Section 1001 after applying the *Cottage Savings* test. However, the IRS also has declined to rule on at least one request for a ruling on this issue, based on "the factual nature of the problem or in the interest of sound tax administration" without offering further explanation. Given the IRS's reliance on *Cottage Savings*, taxpayers must analyze whether beneficiaries may obtain interests in the trust after a severance that are "materially different" from their original interests to avoid unexpected recognition of taxable gain under Section 1001. In particular, a severance that results in separate trusts governed by terms that are not identical to the original trust may warrant close scrutiny to ensure that resulting beneficial interests are not "materially different" under the *Cottage Savings* test -- even though the severance may retain the "same succession of interests" for GST tax purposes.

Treasury Regulation Section 1.1001-1(h) incorporates the language of the *Cottage Savings* test and provides that any severance of a trust will not constitute an exchange of property for other property differing materially either in kind or in extent if--

An applicable state statute or the governing instrument authorizes or directs the trustee to sever the trust; and

If the separate trusts created by the severance are funded on a non-pro rata basis (as provided in Treasury Regulation Section 26.2642-6(b)(3)), the non-pro rata funding is authorized by an applicable state statute or the governing instrument.

Treasury Regulation Section 1.1001-1(h)(1) is narrower in scope than the definition of a “qualified severance” under Code Section 2642(a)(3), which includes a severance that occurs pursuant to “any means available under” local law (not only by state statute). Accordingly, even in the absence of the specific power to sever in the trust instrument or state statute, a severance by judicial order or other means available under local law should suffice for purposes of the qualified severance statute. However, Treasury Regulation Section 1.1001-1(h)(1) requires authorization by “state statute” if the trust instrument does not expressly direct or authorize the severance. This express limitation to statutory authority potentially excludes severances that do not fit squarely within any statute but are effective under broader “state law.” For example, a court with proper equitable jurisdiction generally has the power to divide a trust by reformation. The basis for distinguishing among alternative means that are equally effective under state law for severance of a trust in the regulation is unclear, especially given the statutory direction to recognize any severance effective under local law.

The Preamble notes that “[n]o inference is to be drawn with respect to the income tax consequences under section 1001 of any severance that is not described in §1.1001-1(h)(1).” Where a severance is not described in the new safe harbor, the severance must be reviewed for the two elements of a taxable event for income tax purposes under Treasury Regulation Section 1.1001-1: whether an exchange of property has occurred, and if so, whether the exchange was “for other property differing materially either in kind or in extent.” No exchange should result from a severance pursuant to the trustee’s authority, because the trustee’s ongoing power generally prevented the beneficiaries from acquiring a fixed and identifiable interest in the trust that would be altered by the severance. The trustee’s exercise of a severance power should be treated the same as any other exercise of a trustee’s discretion, such as the discretion to make distributions. For example, a severance of a trust providing for wholly discretionary spray distributions of income and principal to beneficiaries does not create interests differing from the beneficiaries’ interests in the original trust because those were always subject to change through the exercise of the trustee’s discretion. Thus, the beneficiaries do not receive any new interest different from the original interest to which they were entitled and the severance should not incur gain or loss for income tax purposes. However, a severance that results from any means other than pursuant to the trustee’s authority must be reviewed for an exchange of property differing materially in kind or in extent.

Proposed Regulations.

Simultaneous with the issuance of the Final Regulations regarding qualified severances, the Treasury Department issued Proposed Regulations addressing issues that it considered as requiring further consideration. Notice of Proposed Rulemaking REG-128843-05.

The most significant change under the Proposed Regulations is the recognition of all severances effective under state law for GST tax purposes. Proposed Regulation § 26.2642-6(h) clarifies that separate trusts created in a non-qualified severance (other than a severance described in Regulation §26.2654-1) that are treated as separate under applicable state law will be respected as separate after the date of the severance for all GST tax purposes. However, the inclusion ratio of the resulting trusts will be the same as the inclusion ratio of the original trust immediately before the severance. Thus, the non-qualified severance of a trust with an inclusion ratio between zero and one will not produce separate trusts with the most efficient inclusion ratios of zero and one. However, the proposed regulation confirms that the post-severance recognition of the separate

resulting trusts means that the allocation of GST exemption, making of various GST tax elections and occurrence of generation-skipping transfers from one of such trusts will not impact any other such trust for GST tax purposes. Such recognition of non-qualified severances would increase the alternatives for taxpayers to remedy or improve the configuration of trusts creating adverse GST tax consequences. If Treasury ultimately adopts the position recognizing the separate trusts resulting from non-qualified severances, compliance with the requirements for a "qualified severance" will be unnecessary in cases where a change in the inclusion ratio from the original trust is unnecessary.

Proposed Regulation §26.2642-6(d)(4) introduces a new rule providing that if a severance is funded on a non-pro rata basis, each asset is valued solely for funding purposes by multiplying the fair market value of the asset held in the original trust as of the date of severance by the fractional or percentage interest in that asset being distributed to that resulting trust. "Thus, the assets must be valued without taking into account any discount or premium arising from the severance, for example, any valuation discounts that might arise because the resulting trust receives less than the entire interest held by the original trust." *Id.* However, it is unclear that any basis for this addition exists in the language of Section 2642(a)(3) or its legislative history. Moreover, this regulation will be internally inconsistent to the extent it requires funding at fair market value but denies legitimate discounts or premiums in the valuation of trust assets pursuant to applicable state law. The trustee also may breach its fiduciary duty by complying with this proposed regulation, to the extent compliance results in an allocation different from the allocation that would result from funding based on the fair market values determined under state law.

Proposed Regulation §26.2642-6(d)(7)(ii) also clarifies that a qualified severance of a trust with an inclusion ratio between zero and one may create multiple trusts. Section 2642(a)(3) states that a trust with an inclusion ratio between zero and one must be severed into two trusts, indicating that the statute did not contemplate a severance resulting in multiple trusts and requiring a series of severances to create multiple trusts. However, Section 2642(a)(3)(B)(iii) gives the Treasury the ability to broaden the definition of a qualified severance by providing that "[t]he term 'qualified severance' includes any other severance permitted under regulations prescribed by the Secretary." Under this delegation of authority, the Proposed Regulation provides that a qualified severance of a trust with an inclusion ratio between zero and one may create more than two resulting trusts if one or more resulting trusts in the aggregate receive that fractional share of the value of the original trust as of the date of severance equal to the applicable fraction of the original trust. The trust or trusts receiving such share will have an inclusion ratio of 0, and each of the other resulting trust or trusts will have an inclusion ratio of one. If two or more of the resulting trusts receives a fractional share of the value of the original trust equal to the applicable fraction, the trustee may designate which of those resulting trusts will have an inclusion ratio of 0 or of one.

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P.L. 107-16, 107 th Cong., 1 st Sess. (June 7, 2001).

See Treas. reg. §26.2654-1(a)(3), including Example 8.

Transfers from a trust with an inclusion ratio of 0 are not subject to GST tax, whereas transfers from a trust with an inclusion ratio of one are fully subject to GST tax.

Section 2642(a)(3) permits the issuance of regulations describing severances in addition to those described in the statute that will be treated as "qualified severances."

In contrast, Regulation §26.2654-1(b)(1) recognize some severances of trusts included in a transferor's taxable gross estate as "retroactive" to the date of death, even if the severance is not complete at the time of death or the due date of the federal estate tax return.

See PLRs 200713002, 200713001, 200502036, 200451021, 200441022, 200429004, 200408014, 200403072, 200519008, 200508001, 200502036, 200451029, 200451021, 200441022, 200352011, 200351010, 200340015, 200223016, 200213014. In numerous instances, a trust for which the qualified terminable interest property ("QTIP") election under Section 2056(b)(7) was made is severed on identical terms because the severance is required solely to facilitate an effective reverse QTIP election under Section 2652(a)(3). See 200540007, 200519008, 200508001, 200451029, 200443025, 200441022.

Example 1 of Regulation §26.2642-6(j) addressing qualified severances parallels the following Example 1 of Regulation §26.2654-1(b)(1), in each case illustrating a trust severance that preserves the succession of beneficial interests in the original trust:

Example 1. Severance of single trust. T's will establishes a testamentary trust providing that income is to be paid to T's spouse for life. At the spouse's death, one-half of the corpus is to be paid to T's child, C, or C's estate (if C fails to survive the spouse) and one-half of the corpus is to be paid to T's grandchild, GC, or GC's estate (if GC fails to survive the spouse). If the requirements of paragraph [Regulation §26.2654-1](b) of this Section are otherwise satisfied, T's executor may divide the testamentary trust equally into two separate trusts, one trust providing an income interest to spouse for life with remainder to C, and the other trust with an income interest to spouse for life with remainder to GC. Furthermore, if the requirements of paragraph [Regulation §26.2654-1](b) of this Section are satisfied, the executor or trustee may further divide the trust for the benefit of GC. GST exemption may be allocated to any of the divided trusts.

Regulation §26.2601-1(b)(4) defines "exempt trust" as a trust that is not subject to GST tax due to the application of Regulation §26.2601-1(b)(1) to (3).

The notice should identify: the severed trust, the name of the transferor, date of creation, tax identification number, the inclusion ratio of the trust before severance, each of the trusts resulting from the severance, the date of the severance, the fraction of the total assets of the original trust funding each resulting trust and other details explaining the basis for funding the resulting trusts, the inclusion ratio of each resulting trust.

499 U.S. 554 (1991).

Id. at 560-61.

Id. at 564-65.

PLR 200010037 (trustee had discretionary power to divide trust and IRS concluded trustee's division of trust was not an exchange and no gain realization). Similarly, in PLRs 200116016 and 200210056 trustee's power in trust instrument to divide trusts and the subsequent division of trust was not an exchange and no gain realization. In PLR 200128035, the IRS determined the beneficiaries interests in proposed trusts resulting from a division of a trust were not materially different from their interests in the original trust, and, therefore, no gain realization.

PLR 9831023.

For a detailed discussion of *Cottage Savings* and its application to planning with trusts for GST tax purposes, see Lloyd Leva Plaine, "How Cottage Savings and Recognition of Gain Relate to Trusts," 38th Annual Heckerling Institute on Estate Planning, Chapter 4 (2004).

§2642(a)(3).

The Proposed Regulations continue to deny the recognition of separate *shares* of a single trust that are not actually severed into separate trusts. See Proposed Regulation 26.2654-1(a)(1)(i). However, the rationale for treating separate shares differently from separate trusts for GST tax purposes is unclear and consistent treatment for both separate types of interests would seem appropriate.

Executives and Others Face Tough Tax Liability Unless Deferred Compensation Deals Timely Updated For New Internal Revenue Code Section 409A Compliance

By Cynthia Marcotte Stamer

American businesses and their employees and other service providers frequently participate in employment or settlement agreements, incentive compensation, deferred compensation plans or other deferred compensation arrangements that defer payment of compensation for services performed in one taxable year until a later year. Parties sponsoring or entitled to receive compensation under these deferred compensation plan need to act promptly to evaluate the implications of new Internal Revenue Code (“Code”) § 409A upon such arrangements to avoid unintentionally triggering harsh tax consequences for employee or service provider entitled to receive the compensation.

On October 22, 2007, the Internal Revenue Service (“IRS”) granted employers additional time to finish updating “deferred compensation plans” covered by Code § 409A to comply with the broad reaching provisions of § 409A. While providing welcome breathing room, most businesses and employees involved in deferred compensation arrangements covered by Code § 409A still will need to act expeditiously to ensure that necessary arrangements to update their particular deferred compensation arrangements are timely completed.

Enacted to curb perceived abuses related deferred pay and other compensation arrangements for high-ranking executives, Section 409A essentially regulates any arrangement that defers compensation other than those specifically exempt from its provisions. Code § 409A defines “deferred compensation plan” broadly

to reach to a wide range of practices and arrangements. Because of the broad definition of “deferred compensation plan” employed by Code 409A, it impacts virtually all types of pay and compensation practices that operate to defer the payment of compensation beyond the tax year of the taxable year of the performance of services giving rise to the compensation right. As defined by Code § 409A an arrangement generally provides for the deferral of compensation if, under the terms of the plan or other arrangement and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income, and that, pursuant to the terms of the plan, is payable to (or on behalf of) the service provider in a later year. Accordingly, Section 409A impacts deferred compensation and pay arrangements established pursuant to formal deferred compensation plans, as well as those created by employment agreements, severance agreements, settlement agreements, certain bonus agreements, change of control and other corporate transactions, and a host of other contexts.

Until October 22, 2007, businesses and employees faced a December 31, 2007 deadline to update deferred compensation plans to comply with Code § 409A. In Notice 2007-86, however, the IRS granted additional time for employers to finish updating deferred compensation plans subject to Code § 409A to comply with from December 31, 2007 to December 31, 2008, provided that the arrangements are operated in good faith operational compliance with final regulations published earlier this year for the period from January 1 to December 31, 2008.

Added to the Code by Section 885 of the American Jobs Creation Act of 2004 (the "Act") and applicable to virtually all nonqualified deferred compensation practices, plans and arrangements, Code § 409A will impose punitive tax consequences upon employees and other service providers entitled to receive deferred compensation under a deferred compensation plan or other covered deferral arrangement unless the arrangement either meets the requirements of § 409A or otherwise qualifies as exempt from its provisions. If a deferred compensation arrangement does not comply with Code § 409A or otherwise qualify as exempt from its provisions, the employee or other service provider earning the compensation immediately incur the following liability to the IRS:

- Income tax on all amounts deferred under the arrangements regardless of whether the taxpayer is entitled to payment of that compensation at that time;
- A 20% penalty tax; and
- Interest is assessed at a "nonpayer rate" (which is higher than that imposed for other violations) plus 1% from the date or dates of deferral.

This liability will arise in the year that the employee obtains a right to receive the compensation that is not subject to a substantial risk of forfeiture regardless of whether the employee in fact then has a right to receive the compensation or whether the arrangement otherwise meets applicable requirements to qualify for deferred taxation under other relevant provisions of the Code.

Furthermore, if the employer seeks to protect an affected employee from the taxes and penalty by making tax protection payments to cover the tax liability triggered by Code § 409A, Code § 409A will bar the employer from deducting the

tax protection payments and impose additional excise tax liability equal to 20% of the amount of any such tax-protection payment on the recipient employee or other service provider.

Final regulations construing Code § 409A exempt various compensation arrangements from its provisions. Employers planning to treat one or more compensation arrangements as exempt from the Section 409A mandates beware, however. While the IRS granted additional time for employers to bring covered deferred compensation arrangements into compliance with § 409A, the guidance does not grant additional time to redesign existing programs to qualify as exempt from § 409A. Therefore, employers desiring to treat any deferred compensation arrangements as exempt from Section 409A should act quickly to ensure that those compensation arrangements intended to qualify as exempt meet all of the conditions for exemption by December 31, 2007.

Some of the more notable highlights of Notice 2007-86 include the following:

- Employers have until December 31, 2008 to amend plans and arrangements to comply with § 409A and the final regulations, including the specification of the time and form of payment;
- Nonqualified deferred compensation arrangements subject to § 409A must operationally comply with § 409A on a reasonable, good faith basis based on the statute and any generally applicable guidance issued through December 31, 2008;
- Until January 1, 2008, the IRS will not require compliance with either the QACA Rule issued in October 2005 or the final regulations but will treat

compliance with either guidance as reasonable, good faith compliance; After January 1, 2008, however, reliance on the QACA Rule will no longer be permitted;

- The reasonable, good faith standard will be treated as violated if the employer exercises discretion under a plan in a manner that causes the plan to fail to meet the requirements of § 409A;
- Plans may permit changes to existing elections as to the form and time of payments through December 31, 2008 provided that such changes made in 2008 can't apply to amounts that would otherwise be payable in 2008 or cause an amount to be paid in 2008 that would otherwise not be payable in 2008;
- Payment elections under a nonqualified deferred compensation plan may still be linked to elections under a qualified retirement plans, a § 403(b) annuities, § 457(b) eligible plans or certain foreign broad-based retirement plans through December 31, 2008;
- The Notice extends the relief set forth in Notice 2005-1 and the preamble of the QACA Rule that permitted the substitution of nondiscounted stock options or SARs for discounted stock options or SARs to allow before December 31, 2008 the replacement of a stock option or SAR that otherwise provides for a deferral of compensation under § 409A with a stock option or SAR that satisfies the criteria for exemption from the application of § 409A subject to fulfillment of certain specific conditions; and
- The Notice affirms the IRS plans to establish a program for correcting certain § 409A errors in the near future.

Accordingly, to avoid triggering unintentionally the punitive tax penalties of § 409A, employers should continue to move expeditiously to identify all arrangements potentially impacted by Code § 409A and to act to redesign and redeploy those arrangements either to comply with Code § 409A, to qualify for exemption from its provision, or to otherwise to assess and report tax as required to comply with Code § 409A. To this end, employers and employees or other service providers involved in these arrangements that have not already done so should take prompt action to:

- Inventory all compensation and pay arrangements to identify those that may provide “deferred compensation;”
- Identify those arrangement subject to the Section 409A rules and those that may qualify as exempt under the final regulations;
- Assess the extent to which each applicable deferred compensation arrangement in form and operation complies with the requirements of § 409 or, where applicable, the conditions for exemption;
- Act promptly to implement any corrections necessary to preserve any desired ability to treat a deferred compensation arrangement as exempt from Code § 409A before December 31, 2007, pending further guidance;
- Administer all covered deferred compensation arrangements to comply with Code § 409A after December 31, 2007;
- Timely amend all covered deferred compensation arrangements to comply with Code § 409A by December 31, 2008; and

- Operate all programs potentially covered by Code § 409A in operational compliance with the final regulations published earlier this year.

IRS and Department Of Labor Issue Automatic Enrollment and Investment Guidance

By Cynthia Marcotte Stamer

Recent guidance from the U.S. Department of Labor (“Labor Department”) and Internal Revenue Service (“IRS”) is helping to chart a pathway for plan sponsors and fiduciaries of 401(k), 403(b) and 457 defined contribution plans to add and use automatic enrollment and investment features automatically to enroll and invest contributions of participants that fail to return plan enrollment and investment elections. Using automatic or default enrollment and investment features can help employers increase participation in their 401(k) or other defined contribution plans. Until recently, however, concern about tax disqualification and fiduciary liability risks deterred most employers and plan fiduciaries from using these processes to promote plan participation.

As part of the Pension Protection Act (PPA,ⁱ however, Congress sought to facilitate the adoption by employers of automatic enrollment features in 401(k), 403(b), and 457 plans by enacting a series of amendments to the Employee Retirement Income Security Act (“ERISA”) and the Internal Revenue Code (the “Code”). Under the PPA, Congress amended the Code to make it easier for employers to sponsor 401(k), 403(b) and 457(b) defined-contribution plans containing default enrollment and contribution features without disqualifying the plan. The PPA amendments to the Code establish rules under which these plans can provide that an employee will be automatically enrolled in the plan unless he affirmatively elects not to participate, and permit these plans to avoid some of the

Code's nondiscrimination testing requirements by qualifying for a "safe harbor" by adopting specific plan design features. In addition, the PPA also amended ERISA to provide a safe harbor within which accounts of participants in ERISA-covered 401(k) and other individual account retirement plans who fail to make investment elections can be default invested under the plan and still qualify as "self-directed" investments for purposes of ERISA § 404(c).

On November 8, 2007, the IRS published proposed rules (the "QACA Rule") construing the PPA auto-enrollment amendments to the Code for post December 31, 2007 plan years. The preamble to the proposed QACA Rule provides that employers and plans may rely upon the QACA Rule for purposes of designing and administering default enrollment processes until the IRS adopts final rules. Additionally, on October 24, 2007, the Labor Department published final regulations (the "QDIA Rule") interpreting the statutory relief for plan fiduciaries of 401(k) and other individual account plans covered by ERISA who invest the assets of participants who do not provide investment direction (such as automatically enrolled workers) in "qualified default investment alternatives" or "QDIAs."

Code Requirements For Automatic Enrollment Features

The PPA amends the Code to facilitate employer adoption of automatic enrollment in 401(k) plans, and similar features in 403(b) tax-sheltered annuities and 457(b) governmental deferred compensation plans. If the requirements of the QACA Rule are met for plan years beginning on or after January 1, 2008, a plan qualifying as a QACA will be deemed to satisfy the actual deferral

percentage (“ADP”) and actual contribution percentage (“ACP”) nondiscrimination tests, as well as the top-heavy rules that generally prohibit owners and other key employees from disproportionately benefiting under the plan. In addition, the PPA allows “eligible automatic contribution arrangements” (“EACAs”) to adopt a permissible withdrawal provision to allow plans to return default elective deferrals to participants under certain circumstances without the distributions being subject to the 10% early withdrawal tax that normally would apply.

To qualify as an EACA, the PPA generally requires that the default enrollment arrangement must:

- Allow the participant to elect to have the employer make contributions to the plan on his behalf when a participant fails to return an election;
- Make certain automatic contributions to the plan by the employer on behalf of the participant equal to a uniform percentage of compensation;
- Satisfy the requirements of ERISA §404(c)(5) with respect to default investments; and
- Provide specific information in a notice to participants.

To fall within the new safe harbor for EACAs established by the QACA Rule, a 401(k), 403(b) or 457(b) plan must satisfy several conditions including requirements that:

- The Plan uniformly must apply a minimum and escalating percentage of automatic elective deferrals for each eligible employee who fails to elect otherwise;

- The Plan must give each participant the opportunity to elect out of the plan or to make elective deferrals at a different level;
- The Plan must provide minimum employer matching or nonelective contributions on behalf of each eligible nonhighly compensated employee;
- The Plan must comply with applicable vesting requirements for employer matching or nonelective contributions;
- The Plan must comply with applicable Code requirements that it restrict distributions; and
- The Plan must comply with the Code's requirements for providing notification to participants about its default enrollment provisions.

The QACA Rule, as proposed, provides clarification about the application of these rules in several respects. The following paragraphs highlight some of the key components of this guidance.

Regarding the application of the uniformity requirement, the QACA Rule clarifies that to qualify as a QACA, a plan must uniformly apply the qualified percentage (i.e., an initial minimum automatic elective deferral of 3% of compensation through the end of the plan year following the year of initial participation, increasing by 1% for each of the next three plan years, not ever to exceed 10% of compensation) to all eligible employees. The QACA rule clarifies that the qualified percentages are minimums and that a QACA can provide for higher percentages not in excess of 10%. Additionally, the QACA Rules states that a QACA will not fail the "uniformity" requirement if the plan:

- Varies the elective deferral percentage based on the number of years an employee has participated in the plan;
- Does not reduce the rate of elective deferral under a participant's prior election that is in effect when the QACA becomes effective;
- Limits the amount of elective deferrals so as not to exceed the limits on compensation, elective deferrals, or benefits and compensation (under Code §§401(a)(17), 402(g), and 415, respectively); or
- Suspends employees from making elective deferrals for six months after they take a hardship distribution.

The QACA Rule also specifies that the a plan can allow current employees who were eligible to participate in the CODA immediately before the QACA's effective date and who have an election in effect on the QACA's effective date to be excluded from the plan-specified deferral percentages.

The QACA Rule construes the PPA's requirement that the plan provide notices "within a reasonable period before each plan year" as met where the plan furnishes a notice to participants at least 30 days and no more than 90 days before the beginning of each plan year that explains the QACA and informs participants of the opportunity to elect out of the program or to change their deferral percentages from the QACA's qualified percentages. In keeping with its announced intention under the QACA Rule, the IRS posted on its website a sample notice for use in providing this notice on November 14, 2007.ⁱⁱ

With respect to the permissible withdrawals of automatic contributions, the QACA Rule sets forth guidance on returning default elective deferrals to participants. It

clarifies that this PPA provision gives all 401(k), 403(b), and governmental 457(b) plans with EACAs to return under the conditions specified in the QACA Rule amounts requested by a participant within 90 days of the first elective deferrals to the EACA. Returned amounts must be distributed with earnings, if any. These distributions are treated as taxable income in the year distributed but are not subject to the early withdrawal tax. If elective deferrals are withdrawn, employees also forfeit any applicable employer matching contributions associated with the withdrawn amounts.

The QACA Rule also reflects the PPA amendments to §4979, which permit an EACA to distribute excess contributions and excess aggregate contributions to participants within six months (rather than two-and-one-half months) after the close of the plan year in which the contributions were made. This provision, which will affect corrective distributions made in 2009, gives plans a longer period to make corrective distributions to avoid the imposition of the 10% excise tax on the employer. The amounts so distributed need not include income allocable to the period after the end of the plan year (i.e., the “gap period income”) but are included in the employee’s gross income for the taxable year in which they are distributed.

The QACA Rule also clarifies that:

- A plan sponsor need not offer the permissible withdrawal feature to all employees eligible under the EACA, but also may not condition employees’ right to receive a distribution on whether or not they elect future elective deferrals;

- The 90-day window for making the withdrawal election begins on the date the amounts would have been includible in the participant's gross income if the amounts were not contributed, and the effective date of the election cannot be later than the last day of the payroll period that begins after the date of the election;
- The distribution generally is the employee's account balance attributable to the default elective deferrals, adjusted for gains and losses, and may be reduced only for generally applicable fees (i.e., the plan may not charge a different fee for this distribution than it would for other distributions);
- Any employer matching contributions forfeited on account of the distributed amounts must remain in the plan and be treated under the plan terms as any other plan forfeitures (i.e., the amounts may not be returned to the employer); and
- Withdrawn amounts other than designated Roth contributions are includible in the employee's gross income and must be reported on Form 1099-R in the year of distribution but are not subject to the 10% additional early withdrawal tax under §72(t).

Fiduciary Relief For Default Investments Under ERISA

The QDIA Rule defines the conditions under which fiduciaries of defined contributions plans providing for participant self-direction of investments can continue to enjoy the protection of the self-directed investment relief provided by ERISA 404(c) when accounts of participants failing to provide direction to the plan are invested automatically in default investment alternatives established

under the plan. The QDIA Rule protection requires that the default investment meet all of the technical requirements of the QDIA Rule and applicable IRS regulations, and those fiduciaries otherwise comply with applicable ERISA fiduciary standards when selecting and overseeing the QDIA options.

To meet the requirements of the QDIA Rule, the QDIA Rule specifically requires that default investments meet the following conditions in order for the default investment to be treated as a self-directed investment for purposes of ERISA § 404(c):

- The Plan must offer a “broad range of investment alternatives” as defined in the ERISA § 404(c) regulations;
- The Plan can only make default investments in “qualified default investment alternatives” or “QDIA as defined in the QDIA Rule;
- Default investments are allowed only for participants and beneficiaries given an opportunity to provide investment direction who failed to make an investment choice;
- The Plan must furnish a notice to participants and beneficiaries in advance of the first investment in the QDIA and annually thereafter that provides the information dictated by the QDIA Rule;
- The Plan must furnish material, such as investment prospectuses, for the QDIA to participants and beneficiaries;
- The Plan must give participants and beneficiaries the opportunity to direct investments out of a QDIA as frequently as from other plan investments, and not less frequently than quarterly;

- The Plan must limit fees for participants opting out of participation in the plan or electing to self-direct their investments;
- Fiduciaries remain responsible for appropriate selection and monitoring of the QDIA investments in accordance with ERISA's fiduciary responsibility standards; and
- Each QDIA must be managed either by an investment manager, plan trustee, or plan sponsor who is a named fiduciary, or by an investment company registered under the Investment Company Act of 1940.

The QDIA Rule describes four types of mechanisms that can qualify for treatment as a QDIA:

- A product with a mix of investments that takes into account the individual's age or retirement date such as a life-cycle or targeted-retirement-date fund;
- An investment service that allocates contributions among existing plan options to provide an asset mix that takes into account the individual's age or retirement date such as a professionally-managed account;
- A product with a mix of investments that takes into account the characteristics of the group of employees as a whole, rather than each individual such as a balanced fund; and
- A capital preservation product for only the first 120 days of participation offered as an option for plan sponsors wishing to simplify administration if workers opt-out of participation before incurring an additional tax.

The QDIA Rule does not provide any relief for any default investment of participant contributions in employer securities. Furthermore, in recognition that

certain plan sponsors adopted stable value products as their default investment prior to passage of the PPA, the QDIA Rule provides a transition rule that “grandfathers” these arrangements by providing relief for contributions invested in stable value products prior to the effective date of the final QDIA Rule. Otherwise, however, the transition rule does not provide safe harbor relief for future contributions to stable value products. The QDIA Rule also clarifies that a QDIA may be offered through variable annuity contracts or other pooled investment funds.

Other DOL Enforcement & Regulatory Activity

In addition to its publication of the QDIA Rule, the EBSA also published other notable guidance and engaged in aggressive enforcement of ERISA during the first quarter of 2007. During the first three quarters of 2007, for instance, the EBSA:

- Amended Interpretive Bulletin 95-1 to limit its application to the selection of annuity providers for defined benefit plans;
- Revised its rules for imposing civil penalties under ERISA § 502(c)(7);
- Published new rules on the timing and order of issuance of domestic relations orders;
- Released new Mental Health Parity Regulations applicable to health plans;
- Amended safe harbor rules for distributions from terminated individual account plans and termination of abandoned individual account plans to require inherited individual retirement plans for missing nonspouse beneficiaries; and

- Issued a statutory prohibited transaction exemption for cross-trading of securities.

It also has proposed, but not yet adopted in final form, rules concerning when multi-employer pension plan information must be made available on request; guidance concerning the selection of annuity providers for individual account plans; additional amendments affecting the assessment and collection of civil penalties under ERISA § 502(c)(7); and guidance about fee and expense disclosures to participants in individual account plans. Meanwhile, EBSA also has maintained an active enforcement agenda.

The Labor Department enforcement activities this year also reflect its longstanding and ongoing policy of aggressive investigation and enforcement of alleged misconduct by companies, company officials, and service providers in connection with the maintenance, administration and funding of ERISA-regulated employee benefit plans.

The EBSA continues to investigate embezzlement, kickbacks, and false statements, or other criminal violations involving ERISA-covered employee benefit plans and to refer its findings for prosecution by the Justice Department.

The EBSA and Justice Department have announced a number of criminal prosecutions and settlements as a result of these efforts this year.

With business failures on the rise, the EBSA also continues to devote substantial resources to the enforcement of ERISA's fiduciary responsibility rules against bankrupt and financially distressed plan sponsors and the employees, officers and service providers. Labor Department officials report that these aggressive

enforcement activities resulted in the recovery by the Labor Department of more than \$1.4 billion related to pension, 401(k), health and other benefits from companies, company executives and others for alleged violations of ERISA in fiscal year 2006 alone. In addition to prosecutions brought by the Labor Department, companies and individuals that exercise discretion and control of the administration or funding of employee benefit plans regulated by ERISA also may be sued personally by participants and beneficiaries for breach of fiduciary under ERISA. A review of the Labor Department's enforcement record makes clear that where the Labor Department perceives that a plan sponsor or its management fails to take appropriate steps to protect plan participants, the Labor Department continues to aggressively pursue ERISA enforcement regardless of the size of the plan sponsor or its plan, or the business hardships that the plan sponsor may be facing.ⁱⁱⁱ For this reason, businesses providing employee benefits to employees or dependents, as well as members of management participating in, or having responsibility to oversee or influence decisions concerning the establishment, maintenance, funding, and administration of their organization's employee benefit programs need a clear understanding of their responsibilities with respect to such programs, the steps that they should take to demonstrate their fulfillment of these responsibilities, and their other options for preventing or mitigating their otherwise applicable fiduciary risks.

Earlier this year, the EBSA also initiated a nationwide investigation project that examines and seeks to uncover ERISA violations arising from the use by the adviser/consultant of its position with a benefit plan to generate additional fees

for itself or its affiliates, failures to adhere to investment guidelines, improper selection or monitoring of the consultant or adviser, potential criminal violations, such as kickbacks or fraud and other potential improprieties under ERISA. The scrutiny of the consultant and advisor activities follows Congressional hearings examining these relationships earlier this year.^{iv}

In addition, EBSA also has ongoing national projects targeting health care fraud involving multiple employer welfare arrangements or “MEWAs,” violations of ERISA’s rules for the timely investment, administration and use of employee contributions; enforcement of ERISA’s requirements with respect to various ESOP rules and transactions; investigation of participant and beneficiary complaints; and Form 5500 audit and return enforcement.

Along side these special areas of enforcement, the EBSA also continues aggressively to pursue collection of ERISA civil against plan administrators and others for other violations of ERISA, including:

- Failing to operate the plan prudently and for the exclusive benefit of participants;
- Using plan assets to benefit certain related parties to the plan, including the plan administrator, the plan sponsor, and parties related to these individuals;
- Failing to properly value plan assets at their current fair market value, or to hold plan assets in trust;
- Failing to follow the terms of the plan (unless inconsistent with ERISA);
- Failing to properly select and monitor service providers; and

- Taking any adverse action against an individual for exercising his or her rights under the plan (e.g., being fired, fined, or otherwise being discriminated against).

These evolving and ongoing EBSA regulatory and enforcement activities emphasize the continuing and growing need for employee benefit plan fiduciaries, the employers sponsoring these plans, and the internal staff and external consultants involved in the design and administration to act diligently to ensure that their programs are properly designed and administered to comply with ERISA and existing enforcement policy.

ⁱPublic Law 109-280.

ⁱⁱSee *Sample Automatic Enrollment and Default Investment Notice* posted at http://www.irs.gov/pub/irs-tege/sample_notice.pdf.

ⁱⁱⁱSee, "Enron Litigation Has Implications For Plan Sponsors And Management," *401K Advisor* (December 1, 2006).

^{iv}See, "Congress Scrutinizing Relationships Between Companies & Executive Compensation Consultants & Other Executive Compensation Practices," *H.R. Employee Benefits & Internal Controls E-Update* (May 25, 2007).

Agencies Release 2007 Form 5500 Annual Report

By Cynthia Marcotte Stamer

The U.S. Department of Labor Employee Benefits Security Administration (“EBSA”), the Internal Revenue Service (“IRS”) and the Pension Benefit Guaranty Corporation (“PBGC”) recently released advance informational copies of the 2007 Form 5500 Annual Return/Report of Employee Benefit Plan and related instructions (“Form 5500”).

The Form 5500 package released October 10, 2007 includes several changes compared to the 2006 Form 5500 Forms. Significant changes to the 2007 Form 5500 package include:

- A new simplified reporting option for eligible plans with fewer than 25 participants required by the Pension Protection Act (“PPA”); and
- Revised Schedule B instructions to reflect the updated mortality tables and the list of codes used for valuation purposes, as well as for calculating current liability for plan years beginning on or after January 1, 2007.

Instructions included in the package also caution 2008 Form 5500 filers to expect additional changes to the 2008 Form 5500 package in response to changes required to comply with the PPA. Given these expected changes, the EBSA is warning plan administrators expecting to file 2008 short plan year Form 5500s to anticipate that it may be necessary for them to delay preparation of the 2008 short plan year return until the 2008 forms become available for use.

Subject to limited exceptions, all ERISA plan administrators generally are required by ERISA to file an annual Form 5500 for their employee benefit plans.

Separate Form 5500 filing obligations also may apply under the Internal Revenue Code (the “Code”).

All plan administrators and plan sponsors need to keep in mind that timely filing of Form 5500 is important. Plan administrators caught by the EBSA failing to file required Form 5500s can face stiff penalties. For instance, under existing EBSA enforcement policy, plan administrators filing annual reports after the date the report was required to be filed (a “late report”) may be assessed \$50 per day, with no limit, for the period they failed to file, determined without regard to any extensions for filing. Plan administrators caught by the EBSA failing to file an annual report may be assessed a penalty of \$300 per day, up to \$30,000 per year, until a complete annual report is filed. Plan administrators who presently are exposed to these penalties due to an unresolved failure or untimely filing required by ERISA can qualify for reduced penalties by filing these forms in accordance with the EBSA’s existing Delinquent Filer Voluntary Compliance Program (“DFVC Program”). The EBSA recently has released a tool to help plan administrators calculate their penalties under the DFVC Program.

For plans subject to Form 5500 filing obligations under the Code, the Code imposes separate penalties, which are administered and assessed by the IRS. Accordingly, the DFVC program does not resolve any penalties assessable under the Code. Rather, tax penalties for non-filing or late filing in violation of the Code must be resolved separately with the IRS.

If you have questions about the Form 5500 or other ERISA matters relating to the design or administration of your employee benefit plans or human resources

practices, contact Cynthia Marcotte Stamer at 972.419.7188 or cMarcotte
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About Cynthia Marcotte Marcotte Stamer

Vice Chair of Section of Real Property, Probate and Trust Law Employee Benefit Plans And Other Compensation Arrangements Group and Board Certified In Labor and Employment Law by the Texas Board of Legal Specialization, attorney Cynthia Marcotte Stamer has more than 20 years experience helping employers and business leaders, plan fiduciaries and administrators, insurers and other plan vendors and others design, implement, administer and defend health and other employee benefit and compensation, insurance and other human resources practices, policies and strategies.

Proposal to Prohibit Tax Planning Patents - S. 2369

By Rana H. Salti

McDermott Will & Emery LLP

On November 15, 2007, legislation was introduced in the Senate that would prohibit the issuance of any patents for tax planning inventions. The bill, S. 2369, was sponsored by Senate Finance Committee Chairman Max Baucus (D-MT) and Ranking Member Charles Grassley (R-IA), along with Senator Carl Levin (D-MI), Senator Ron Wyden (D-OR), Senator Barack Obama (D-IL), and Senator Jeff Bingaman (D-NM).

S. 2369 would amend Section 101 of Title 35 of the U.S. Code to prevent the grant of patents for any tax planning inventions. "Tax planning inventions" are defined in S. 2369 as "a plan, strategy, technique, scheme, process, or system that is designed to reduce, minimize, avoid, or defer, or has, when implemented, the effect of reducing, minimizing, avoiding, or deferring, a taxpayer's tax liability or is designed to facilitate compliance with tax laws." A tax planning invention does not include "tax preparation software and other tools or systems used solely to prepare tax or information returns."

If successful, the amendments of S. 2369 would apply to any applications for patents or reissue patents that are filed after the date of the enactment of S. 2369. In addition, the amendments would apply to any pending applications for patents or reissue patents.

Senator Baucus noted that "taxpayers should not have to pay a toll charge or worry that they're violating patent law when they try to file their tax returns. Tax practitioners should be able to provide advice and services to their clients without paying a fee to the patent holder."

S. 2369 follows the House of Representatives' efforts to prevent the issuance of tax planning patents. On September 7, 2007, the House passed the Patent Reform Act of 2007 (H.R. 1908) that included a provision making tax planning methods unpatentable. The provision includes a slightly different definition of tax planning method, providing that a tax planning method "does not include the use of tax preparation software or other tools used solely to perform or model mathematical calculations or prepare tax or information returns."

S. 2369 has been referred to the Senate Judiciary Committee for further review.