

## SELECTED ISSUES FROM THE 1996 TAX LEGISLATION

© 1996 Robert L. Sommers

I. INTRODUCTION .....	1
A. THE END OF PURE TAX LEGISLATION?.....	1
1. What Happened to Tax Reform Acts? .....	1
2. Some Substance, But Mostly Politics .....	1
B. SUPPORT FOR SMALL BUSINESS .....	1
1. The Small Business Job Protection Act.....	1
2. Taxpayer's Bill of Rights .....	2
C. REVENUE RAISERS .....	2
1. Expatriates - The "Old Villain".....	2
2. Rich Immigrating Foreigners - The "New Villain" .....	2
II. TAXPAYERS BILL OF RIGHTS II.....	2
A. ANTI-IRS FERVOR OF REPUBLICAN CONGRESS .....	2
1. Ending the IRS as We Know It .....	2
2. Taxpayer's Bill of Rights II - More Like a Kick in the IRS's Shins .....	2
3. Shifting the Burden of Proof.....	3
B. NEW LIMITS FOR ATTORNEY'S FEES AND DAMAGE AWARDS.....	3
1. Rule .....	3
2. Shifting the Burden .....	3
3. Increase in Attorney's Fees .....	3
C. FRAUDULENT INFORMATION RETURNS.....	4
1. Rule .....	4
2. Comment .....	4
D. IRS MUST CONDUCT A REASONABLE INVESTIGATION OF INFORMATION RETURNS .....	4
1. Rule .....	4

E. INTEREST ABATEMENT.....	4
1. Rule .....	4
2. Comment .....	5
F. RETROACTIVE REGULATIONS .....	5
1. Rule: .....	5
G. PRIVATE DELIVERY SERVICES.....	5
1. Rule .....	5
2. Comment: .....	6
H. A TAXPAYER’S ADVOCATE.....	6
1. Rule: .....	6
2. Comment .....	6
I. INSTALLMENT AGREEMENTS AND OFFERS IN COMPROMISES.....	6
1. Rule .....	6
2. Comment .....	7
J. THE “100 %” PENALTY FOR RESPONSIBLE PERSONS.....	7
1. Rule .....	7
III. S CORPORATIONS.....	7
A. INCREASE IN NUMBER OF ELIGIBLE SHAREHOLDERS .....	7
1. New Maximum - 75 shareholders .....	7
B. CORPORATE SUBSIDIARIES .....	8
1. C Corporation Subsidiaries.....	8
2. Qualified subchapter S subsidiary .....	8
3. Comment .....	8
C. ELECTING SMALL BUSINESS TRUSTS (“ESBT”) .....	9
1. Qualifications .....	9
2. Beneficiaries .....	9
3. Trust’s Taxation .....	9
4. Comparing the ESBT with Other Trust Alternatives.....	10
D. TAX EXEMPT ORGANIZATIONS.....	11
1. Retirement Plans and Charitable Organizations .....	11
E. POST-DEATH HOLDING PERIOD FOR GRANTOR TRUST.....	11
1. Expansion to two years.....	11

F. FINANCIAL INSTITUTIONS PERMITTED TO HOLD SAFE HARBOR DEBT .....	11
1. Expanding the “straight debt” definition .....	11
G. INHERITED S CORPORATION STOCK .....	12
1. Basis Adjustments .....	12
2. Parity with Partnership Interests .....	12
H. BASIS ADJUSTMENTS FOR DISTRIBUTIONS DURING A LOSS YEAR .....	12
1. Adjustments to Occur Before the Loss Limitation .....	12
IV. EXPATRIATION TAXATION .....	13
A. NOT JUST FOR RICH TAX DODGERS! .....	13
1. A Wide Net is Cast .....	13
2. The 10-year Rule was Retained .....	13
B. THE EXPATRIATION TAX.....	14
1. The 10-Year Rule .....	14
2. Individuals Subject to the Expatriation Tax.....	14
3. Tax Avoidance as One of the Principal Purposes for Terminating Residency .....	16
4. New Sources Rules Pertaining to the Expatriation Tax.....	16
5. Credit for Foreign Taxes.....	18
6. Effective Date .....	19
C. ESTATE AND GIFT TAX CONSEQUENCES.....	19
1. Estate Taxes.....	19
2. Gift Taxes .....	19
3. Foreign Tax Credit.....	19
4. Effective Date .....	19
D. INFORMATION REPORTING .....	19
1. Required Statements .....	19
2. Effective Date .....	19
V. FOREIGN TRUSTS.....	21
A. FOREIGN NON-GRANTOR TRUSTS.....	21
1. Interest on Accumulation Distributions.....	21
2. Loans from Foreign Trusts.....	21
B. INBOUND FOREIGN GRANTOR TRUST RULES.....	21
1. Non-Applicability of the U.S. Grantor Trust Rules .....	21
2. Transfers by U.S. Beneficiaries .....	22

3. Foreign Tax Credits .....	23
4. Effective Date .....	23
C. OUTBOUND FOREIGN GRANTOR TRUSTS .....	23
1. Prior Law.....	23
2. Changes to the Law .....	23
3. Outbound Trust Migrations .....	25
4. Distributions by Foreign Trusts Through Nominees .....	25
5. Effective Date .....	25
D. RESIDENCE OF FOREIGN TRUSTS.....	25
1. Prior Law.....	25
2. Changes in the Law .....	25
3. Outbound Migration of Domestic Trusts .....	26
4. Effective Date .....	26
E. REPORTING REQUIREMENTS .....	26
1. Reportable Events .....	26
2. Grantor Trust Reporting.....	27
VI. FOREIGN GIFT REPORTING.....	28
A. PRIOR LAW.....	28
1. Gifts were Not Taxable or Reportable .....	28
B. CHANGE IN LAW.....	28
1. Gifts in Excess of \$10,000 per Year. ....	28
2. Definition of a Gift.....	29
3. Failure to Provide Information .....	29
4. Effective Date .....	29
VII. CHANGES IN INDEPENDENT CONTRACTOR RULES.....	29
A. INTRODUCTION.....	29
B. SECTION 530 .....	30
1. Prior Law.....	30
C. CHANGES IN SECTION 530.....	30
1. Reliance on a prior audit.....	30
2. Long-Standing Recognized Practice .....	30
3. Significant Segment of the Industry .....	31
4. Burden of Proof Shifts to IRS.....	32

5. Later Reclassification Allowed.....	33
6. Relief Not Dependent on Employee Classification for Other Purposes.....	33
7. IRS Required to Give Notice.....	33
D. EFFECTIVE DATES.....	33
1. Changes to Section 530 in General.....	33
2. Burden of Proof Rules .....	33
E. DEALING WITH CALIFORNIA ON INDEPENDENT CONTRACTOR ISSUES .....	33
1. Absence of Section 530.....	33
2. Applying California “Form over Substance” Analysis .....	34
3. Presumption of Independence for Professionals .....	34
4. New Regulations Involving Language Interpreters.....	35
VIII. PRESIDENT CLINTON’S TAX AGENDA .....	35
A. INTRODUCTION.....	35
1. The Climate for Tax Changes.....	35
2. Clinton vs. Congress.....	35
B. PRESIDENT CLINTON’S PLAN.....	35
1. Introduction.....	35
2. Clinton’s Educational Benefits .....	36
3. Child Tax Credits: .....	37
4. Expanded IRAs .....	37
5. Elimination of Capital Gains on the Sales of Residences.....	37
C. REPUBLICAN RESPONSE.....	39
1. Senator Dole’s Plan .....	39
2. Education Investment Accounts and Deductions for Student Loans. ....	39
3. Estate Tax Relief for Family Businesses and Farms .....	39
4. Ending the IRS as We Know It. ....	39
D. CONCLUSION - WHAT TO WATCH FOR IN 1997 .....	40
1. Tax policy took center-stage in the 1996 campaign for presidency.....	40
2. Changes in the IRS and Tax Administration.....	42

# SELECTED ISSUES FROM THE RECENT TAX LEGISLATION

## I. INTRODUCTION

### A. The End of Pure Tax Legislation?

#### 1. WHAT HAPPENED TO TAX REFORM ACTS?

a) The newly-enacted tax laws have been buried in parts of the following legislation:

(1) Small Business Job Protection Act (PL 104-188) enacted August 20, 1996;

(2) Health Insurance Portability and Accountability Act (PL 104-191) enacted August 21, 1996; and

(3) Personal Responsibility and Work Opportunity Act (PL 104-193) enacted August 22, 1996.

b) Only the Taxpayer's Bill of Rights II (PL 104-168) stood as a discreet piece of legislation.

c) Taken together, these changes comprise the largest number of changes in the tax code since the Tax Reform Act of 1986.

#### 2. SOME SUBSTANCE, BUT MOSTLY POLITICS

a) While the legislation contains some substance within is massive complexity, it is mostly a political document.

b) The Taxpayer's Bill of Rights II is a mild improvement that nibbles around the edges of the problem concerning the treatment of taxpayers under the Code.

c) The S corporation legislation is also helpful, but hardly impressive.

d) The attack on expatriates is political: Less than a handful of rich citizens have expatriated during the last 10 years.

e) Likewise, the change in taxation for foreign taxpayers and foreign trusts appears to address only the most straight-forward abuses.

### B. Support for Small Business

#### 1. THE SMALL BUSINESS JOB PROTECTION ACT

a) This legislation is generally supportive of small businesses. It liberalizes the rules for S corporations and tilts the independent contractor rules in favor of finding independent contractor status.

b) The benefits, however, are teeming with restrictions.

- (1) With the adoption of Limited Liability Company legislation by all the states, the relevancy of complicated S corporation legislation is questionable.
  - c) The independent contractor rules are not part of the Internal Revenue Code which means they are not incorporated into California law. Therefore, the schism between California and Federal tax law will continue.
2. TAXPAYER'S BILL OF RIGHTS
    - a) Incensed with what it perceived as IRS arrogance, incompetence and heavy-hand tactics with taxpayers, Congress enacted a second Taxpayer's Bill of Right on July 30, 1996.
    - b) This legislation will benefit small businesses, although the intended target appears to have been individual taxpayers.

### **C. Revenue Raisers**

1. EXPATRIATES - THE "OLD VILLAIN"
  - a) Congress decided to sock it to those ungrateful Americans who made a fortune in the U.S. and then decide to expatriate (give up U.S. citizenship) to avoid paying taxes.
  - b) Unfortunately, the sweep of this legislation may ensnare foreign immigrants who choose to repatriate because of a change in the political situation of their country of origin.
2. RICH IMMIGRATING FOREIGNERS - THE "NEW VILLAIN"
  - a) For decades, foreign citizens who were planning to become permanent U.S. residents, engaged in sophisticated tax planning to keep their wealth outside the grasp of the U.S. tax authorities.
    - (1) In a search for revenue, these plans were suddenly deemed "abusive loopholes."
    - (2) The legislation may work in some straight-forward instances, but the well-advised taxpayer will be able to circumvent most of these changes.

## **II. TAXPAYERS BILL OF RIGHTS II**

### **A. Anti-IRS Fervor of Republican Congress**

1. ENDING THE IRS AS WE KNOW IT
  - a) When the Republicans came to power in Congress, they vowed to end the IRS as we know it. One radical tax proposal, the national sales tax, would have completely eliminated the IRS.
2. TAXPAYER'S BILL OF RIGHTS II - MORE LIKE A KICK IN THE IRS'S SHINS

- a) Rather than end the IRS, Congress chose to kick it in the shins. Some of the disparities between the IRS and taxpayers have been addressed.

### 3. SHIFTING THE BURDEN OF PROOF

- a) The most intriguing provision in Rights II is the concept of shifting the burden of proof to the IRS under certain circumstances. For years, the IRS argued that since the taxpayer possessed the information used to file a tax return, he had the burden of proof that an IRS adjustment was incorrect.

- (1) Congress has decided that in some circumstances, when the taxpayer fully cooperates and provides information to the IRS, the burden of proof should shift to the IRS to prove that an adjustment was warranted.

## **B. New Limits for Attorney's Fees and Damage Awards**

### 1. RULE

- a) Once a taxpayer substantially prevails against the IRS in a tax matter, the burden of proof shifts to the IRS to prove its position was substantially justified; otherwise, the taxpayer will now be entitled to attorney's fees. IRC Sec. 7430(c)(4)(B).

- b) The maximum rate of recovery has been raised from \$75 an hour to \$110 an hour.

- c) Also, a taxpayer may now recover \$1 million in actual and direct economic damages caused by IRS wrongful collection activities. Previously, the limit was \$100,000. IRC Sec. 7433(b).

- (1) The award may be reduced if the taxpayer does not exhaust administrative remedies. IRC Sec. 7433(d).

### 2. SHIFTING THE BURDEN

- (1) There is a rebuttable presumption against the IRS under IRC Sec. 7430(c)(4)(B)(ii) if it fails to follow —

- (a) Published regulations;

- (b) Revenue rulings, revenue procedures, notices or announcements;

- (c) The most current private letter ruling, determination letter or technical advice memorandum affecting the taxpayer's case.

### 3. INCREASE IN ATTORNEY'S FEES

- a) The increase for attorney's fees is helpful, but in reality the hourly rates charged by experienced tax attorneys usually range between two to three times the \$110 per hour allowance.

- b) Failure of the taxpayer to extend the statute of limitations for assessment is not relevant to the determination of attorney's fees.

- c) These rules apply to successful actions for declaratory relief.
- d) Effective Date: Proceedings commenced after the date of enactment.

### **C. Fraudulent information returns**

#### 1. RULE

- a) Rights II addresses false information returns (often Form 1099) filed by third parties which adversely affect the taxpayer. IRC Sec. 7434.

- (1) A taxpayer may bring a civil case for damages against a person who files a fraudulent information return and may collect the greater of \$5,000 or the amount of actual damages suffered, plus court costs, and, in the trial court's discretion, reasonable attorney's fees.
- (2) The statute of limitations for bringing suit is six years from the date the fraudulent information return was filed or one year after the date the document would have been discovered through the exercise of reasonable care, whichever comes later.

#### 2. COMMENT

- (1) This change is long overdue. Taxpayers have been burdened with false Form 1099s by unscrupulous employers and others, with little legal recourse.
- (2) Now, those who submit fraudulent information returns can be sued for a minimum of \$5,000. This rule should serve as a deterrent.

### **D. IRS Must Conduct a Reasonable Investigation of Information Returns**

#### 1. RULE

- a) If there is a dispute between the IRS and a taxpayer regarding the information provided by a third party on an information return (often a Form 1099), and if the taxpayer has reasonably cooperated with the IRS to provide the information and witnesses supporting the taxpayer's contention, the burden of proof shifts to the IRS regarding the accuracy of the information return. IRC Sec. 6201(d).

- b) Once this occurs, the information return will be considered inaccurate, unless the IRS can prove otherwise.

- c) This shift in the presumption of the accuracy of information returns will favor taxpayers.

- (1) Currently, the taxpayer must prove the inaccuracy of an information return.

- (2) Even when the information is false, there might be little evidence (outside the taxpayer's word) to prove it.

### **E. Interest Abatement**

#### 1. RULE

- a) Interest may be abated if the tax payment is delayed by unreasonable mistakes or delays by IRS employees. IRC Sec. 6404(c).
- b) Interest abatement includes both "ministerial" (non-discretionary, bookkeeping types of mistakes) and now "managerial" acts by the IRS.
  - (1) These managerial acts can include delays resulting from a loss of tax records, personnel actions such as transfers, training, illness or leave.
  - (2) There is no interest abatement for general administrative decisions that cause delay, such as the systematic review of certain deductions.
- c) The failure to abate interest is reviewable by the Tax Court. The action must be filed no later than 180 days from the date the IRS mails an adverse final determination. IRC Sec. 6404(g).
  - (1) Eligibility for Tax Court relief is limited to individuals with a net worth not exceeding \$2 million and businesses with a net worth not exceeding \$7 million.
  - (2) Effective Date: This change applies to interest accruing beginning after the date of enactment.

## 2. COMMENT

- a) These interest abatement provisions are potentially significant. Generally, the IRS has not been permitted to abate interest on taxes, even though interest accrued because of its negligence.
  - (1) Unfortunately, the IRS could thwart Congress's intent by making an unduly restrictive interpretation of what constitutes an "unreasonable" mistake.
    - (a) If the reference to reasonableness is made with respect to private industry, the IRS would be held to a much higher standard.

## F. Retroactive Regulations

### 1. RULE:

- a) Rights II prohibits any temporary, proposed or final regulations from being implemented earlier than the date that the regulation is first printed in the Federal Register. IRC Sec. 7805(b).
- b) Regulations issued within 18 months of a statute's enactment, to remedy a procedural defect or to prevent an abuse are exempt from the retroactive prohibition.

## G. Private Delivery Services

### 1. RULE

- a) This provision allows taxpayers to rely on the postmark of a private delivery service to prove the timeliness of mailing tax documents.

- b) Prior to Rights II, taxpayers could rely on postmarks only from the U.S. Postal Service as evidence that tax documents had been mailed.

- (1) There is a "timely-mailed, timely-filed" rule which states a document is filed when it is deposited in the mail.

2. COMMENT:

- a) This was a trap for the unwary that has been fixed. The IRS claimed that the delivery of a document (such as a Tax Court petition) by Federal Express (or other private courier) did not meet the requirement of mailing.

- (1) For example, a document delivered to Federal Express before a deadline, but received by the IRS or a court after the deadline was untimely. If, however, the taxpayer used the U.S. mail and could prove the document was mailed prior to the deadline, the document would have been timely filed.

- (2) Filing documents by certified mail, return receipt requested, remains the most effective for filing, but Federal Express and the other private delivery services are now officially accepted.

## **H. A Taxpayer's Advocate**

1. RULE

- a) The ineffective taxpayer "ombudsman" has been replaced by a "Taxpayer's Advocate" with expanded powers.

- b) The Taxpayer's Advocate will assist taxpayers in their dealings with the IRS, identify problems within the tax system and work with the Congressional tax writers to solve problems identified by the taxpayer's advocate. IRC Sec. 7802(d).

- (1) Reports by the Taxpayer's Advocate are not subject to prior IRS review, but are not considered official legislative recommendations, since that function remains with the Treasury.

- c) The Taxpayer's Advocate reports directly to the IRS Commissioner and his authority has been broadened to cover any action taken by the IRS.

- (1) For instance, the Taxpayer's Advocate can order the immediate reissuance of a lost refund check.

2. COMMENT

- a) The ombudsman was an IRS official, who was often uncomfortable challenging the system.

- b) An independent Taxpayer's Advocate should more zealously represent taxpayers who encounter egregious situations or conduct when dealing with the IRS.

## **I. Installment Agreements and Offers in Compromises**

1. RULE

- a) The IRS must give 30 days written notice of its reasons for terminating, modifying or altering an existing installment arrangement. IRC Sec. 6159(b).
- b) The IRS must establish an independent administrative review process for terminations of installment agreements. This review process should assist taxpayers who are given notice of a termination. IRC Sec. 6159(c).
- c) For offers in compromises, a written opinion from Chief Counsel's office must be received for tax compromises to \$50,000 (up from \$500). IRC Sec. 7122(b).

## 2. COMMENT

- a) The change in installment agreement modifications and terminations is helpful since the IRS must state the reasons for its actions.
- b) Unfortunately, the independent administrative review process is limited to installment agreement terminations, not modifications.

## **J. The "100 %" Penalty for Responsible Persons**

### 1. RULE

- a) The IRS must provide 60 days written notice to a responsible person before it can issue a notice and demand for payment. This applies to the failure of a corporation to collect and pay over to the IRS payroll taxes withheld from its employees. IRC Sec. 6672(b).
- b) If a responsible person makes a request in writing, the IRS must now disclose in writing any other person it considers to be a responsible person and whether it has attempted to collect or has received, any penalty sums from other responsible persons.
  - (1) A responsible person will have a separate federal cause of action for contribution against the other responsible parties to recover any payments in excess of his ratable share. IRC Sec. 6672(d).
- c) Board members of tax-exempt organizations who operate in an honorary capacity and who are not involved in the operation or financial activities of the organization, are not subject to the responsible person penalty. IRC Sec. 6672(e).

## **III. S CORPORATIONS**

### **A. Increase in Number of Eligible Shareholders**

#### 1. NEW MAXIMUM - 75 SHAREHOLDERS

- a) The number of eligible shareholders has been increased from 35 to 75, effective for tax years after December 31, 1996. IRC Sec. 1361(b)(1)(A).
- b) Each income beneficiary of a "electing small business trust" (discussed below) is considered a separate shareholder for purposes of the 75 shareholder total.

## B. Corporate Subsidiaries

### 1. C CORPORATION SUBSIDIARIES

- a) S corporations are now allowed to own 80 percent or more of the stock in a C corporation.
  - (1) The S corporation is not permitted to file a consolidated return with an affiliated C corporation.
  - (2) If the C corporation subsidiary has earnings and profits derived from an active trade or business, then the dividends received by the S corporation are not treated as passive investment income.

### 2. QUALIFIED SUBCHAPTER S SUBSIDIARY

- a) There is now a new entity under subchapter S called a “qualified subchapter S subsidiary (“QSSS”). IRC Sec. 1361(b)(3).
  - (1) A QSSS is a domestic corporation which qualifies as an S corporation and is 100% owned by the S corporation parent.
  - (2) The S corporation parent must elect QSSS treatment.
- b) For tax purposes, the QSSS is merely part of the S corporation.
  - (1) All income, deductions, credits, assets and liabilities are considered to belong to the S corporation parent.

### 3. COMMENT

- a) Permitting S corporations to have subsidiaries will enhance their flexibility.
- b) A QSSS could have advantages for non-tax purposes, such as isolating tort liability of each activity into a separate corporation, but at a cost of forming a separate corporation for each activity.
  - (1) A QSSS should net out its income and expenses and pass-through any gain or loss to the S corporation parent, but unfortunately, the law does not appear to permit this netting treatment.
  - (2) Will California allow a QSSS to shift its \$800 minimum tax to the S corporation parent?
    - (a) For example: An S corporation has 5 QSSS corporations. One makes a \$500,000 profit and the others lose a combined \$50,000.
    - (b) Will the \$800 corporate minimum franchise tax be “upstreamed” to the S corporation parent to off-set the income from the one profitable QSSS or will California insist that the minimum tax apply to each corporation separately?
    - (c) Unless the QSSS is treated as a separate entity for tax purposes, how can it limit its liability for tort or contract purposes?

## C. Electing Small Business Trusts (“ESBT”)

### 1. QUALIFICATIONS

- a) An ESBT is a non-grantor trust which is permitted to hold S corporation stock. IRC Sec. 1361(e).
  - (1) Its beneficiaries must be individuals or estates (otherwise eligible to be S corporation shareholders).
    - (a) Charitable organizations are permitted to hold contingent remainder interests.
  - (2) Beneficial interests in the trust must be acquired by gift or bequest, or some other non-taxable method.
    - (a) Generally, a tax gift will be payable on an inter vivos transfer of stock to a ESBT.
  - (3) Beneficial interests cannot be purchased or otherwise acquired with a cost basis.

### 2. BENEFICIARIES

- a) Each income beneficiary is counted towards the 75 shareholder maximum.
  - (1) An income beneficiary is a person who is a member of the class of beneficiaries that is entitled to or eligible to receive either income or principal from the trust.
  - (2) An income beneficiary may include a non-resident alien.
    - (a) This presents a tax planning opportunity since non-resident aliens are not permitted to be S corporation shareholders.

### 3. TRUST’S TAXATION

- a) Income derived from the earnings of S corporation stock is taxed at the highest individual rate (currently 39.6%). Capital gains are taxed at 28%.
  - (1) Moreover, there is no deduction for distributions to the beneficiaries.
    - (a) The income is not included in the distributable net income of the trust; therefore, it is not considered gross income to the beneficiaries.
    - (b) Since the trust is taxed on this income, later distributions to non-resident alien beneficiaries are tax-free.
  - (2) No item of the S corporation stock is apportioned to any beneficiary.
- b) For tax purposes, if a trust holds stock in one or more S corporations, it is treated as a separate trust for each corporation for purposes of computing the income tax.

- (1) The taxable income attributable to this separate trust include —
  - (a) The items of income, loss or deduction that would be allocated to a shareholder;
  - (b) Gain or loss from the sale of S corporation stock; and
  - (c) Any state or local income taxes and administrative expenses of the trust property properly allocable to the S corporation stock.
- (2) Capital losses are allowed to the extent of capital gains.
- (3) There is no alternative minimum tax exemption available.
- c) Trust assets not associated with S corporation stock include those items not taken into account by the S corporation portion of the trust. Also, the DNI rules apply to those non-S corporation stock assets.
- d) If the trust terminates prior to the end of the S corporation's tax year, then it takes into income its pro-rata share of S corporation items in its final year.
  - (1) This rule will apply to all trusts and estates that terminate prior to the end of the S corporation's tax year.

#### 4. COMPARING THE ESBT WITH OTHER TRUST ALTERNATIVES

##### a) The Grantor Trust

- (1) Grantor trusts are permitted S corporation trusts in which the grantor (taxpayer) takes into income the S corporation income, gains and losses. Upon death, the trustee will have two years to distribute the S corporation stock to an individual beneficiary.
  - (a) This two-year distribution provision applies also to a testamentary trust. Also, the testamentary trust will be taxed at the progressive trust tax rates (income over \$7,500 per year is taxed at 39.6%).
  - (b) Under prior law, an S corporation would have a disqualified shareholder, unless the grantor or testamentary trust distributed the stock of an individual beneficiary within 60 days of the grantor's or decedent's death.
- (2) The ESBT has the advantage of multiple beneficiaries and the ability to accumulate income. The disadvantage is that all income is taxed at 39.6%.
- (3) In cases where the grantor is already in the 39.6% bracket, an ESBT will provide greater trust planning flexibility without adverse tax cost; otherwise, the grantor trust will probably remain the trust of choice to hold S corporation stock because of its lower tax cost.

##### b) The Qualified Subchapter S Trust ("QSST")

- (1) A QSST is similar to a grantor trust, except the beneficiary, rather than the grantor, reports the S corporation income, gain or loss on his individual tax return, whether or not the income is accumulated or distributed.
  - (a) A QSST is restricted to one current income beneficiary (husband and wife count as one beneficiary).
- (2) The tax comparison between a grantor trust and the ESBT apply here as well. Generally, the QSST beneficiary will be in a lower tax bracket than the ESBT.
- c) Conclusions: Unless there is a need for a ESBT, such as an non-resident alien beneficiary, or the grantor is in the 39.6% tax bracket, the tax cost of a ESBT seems too high.
  - (1) With the lengthening from 60 days to 2 years for distributions of S corporation stock held in a grantor trust or by a decedent, the downside of using a grantor or testamentary trust has been diminished.

#### **D. Tax Exempt Organizations**

##### 1. RETIREMENT PLANS AND CHARITABLE ORGANIZATIONS

- a) Tax-exempt entities under IRC Sec. 401(a) and 501 (c)(3) are eligible to become S corporation shareholders. IRC Sec. 1361(c)(7).
- b) Each entity counts as one shareholder for the 75-shareholder limit.
  - (1) All S corporation items, and any gains or losses on sales of stock by the S corporation, are taken into account in computing the unrelated business taxable income and loss (“UBIT”).
  - (2) All items of income and loss flow through to the tax-exempt entity shareholder, regardless of the source and nature of the items.
- c) Effective date: December 31, 1997.

#### **E. Post-Death Holding Period for Grantor Trust**

##### 1. EXPANSION TO TWO YEARS

- a) The holding period for a grantor trust has been extended from 60 days to two years from the date the grantor dies. IRC Sec. 1361(c)(2)(A).
- b) A testamentary trust which receives S corporation stock has a two-year holding period, commencing on the date it receives the stock.
- c) Effective date: December 31, 1996

#### **F. Financial Institutions Permitted to Hold Safe Harbor Debt**

##### 1. EXPANDING THE “STRAIGHT DEBT” DEFINITION

- a) Straight debt now includes debt held by non-individual creditors that are actively and regularly engaged in the business of lending money, provided that debt would not be otherwise treated as a disqualifying second class of stock. IRC Sec. 1361(c)(5).
- b) Straight debt is not considered a second class of stock, provided —
  - (1) There is an unconditional promise to pay a sum certain on demand on a specified date;
  - (2) The interest rate is not contingent on profits or at the discretion of the lender;
  - (3) The debt is not convertible to stock; and
  - (4) The debt is owed to a creditor who is a permissible shareholder of an S corporation. It is this fourth prong that has been expanded to include non-individual creditors.

## **G. Inherited S Corporation Stock**

### **1. BASIS ADJUSTMENTS**

- a) Items received from S corporation stock received as an inheritance is treated as income in respect to a decedent (“IRD”) as though the original owner had received it. IRC Sec. 1367(b).
  - (1) The deduction under IRC Sec. 691 (c) is allowed.
- b) The basis of the acquired stock is reduced by the amount of the stock’s value that is attributable to IRD.

### **2. PARITY WITH PARTNERSHIP INTERESTS**

- a) These rules are designed to treat the beneficiary of S corporation stock the same as someone inheriting a partnership interest.
- b) These rules apply to decedents dying after August 20, 1996.

## **H. Basis Adjustments for Distributions During a Loss Year**

### **1. ADJUSTMENTS TO OCCUR BEFORE THE LOSS LIMITATION**

- a) Basis adjustments for distributions made by an S corporation are taken into account before applying the loss limitation for the year. IRC Sec. 1366(d).
  - (1) Distributions reduce the adjusted basis for purposes of the allowable loss for the year.
  - (2) The resulting loss, however, does not reduce the adjusted basis for determining the tax status of the distributions.
  - (3) Net negative adjustments are disregarded when determining the tax status of distributions made by an S corporation which has accumulated earnings and profits.

- (a) This provision is supposed to create parity with the treatment of partnership losses.
- b) Since adjustments for distributions are made before the adjustments to basis, shareholders are no longer limited to tax-free treatment of a distribution only to the extent of adjusted stock basis.
  - (1) Example: If X owns all the stock in an S Corporation and has a basis of \$1,000. The S corporation distributes \$600 to X, recognizes a \$200 capital gain and sustains a \$900 net operating loss —
    - (i) X's basis is first increased to \$1,200 (original basis + capital gain)
    - (ii) X's basis is then reduced to \$600 by the distribution of \$600
    - (iii) X is allowed to take into account \$600 of the \$900 NOL which reduces his basis to zero. The remaining \$300 loss is carried forward.
- c) Effective date: December 31, 1996.

#### **IV. EXPATRIATION TAXATION**

##### **A. Not Just for Rich Tax Dodgers!**

###### 1. A WIDE NET IS CAST

- a) U.S. citizens have a Constitutional right to renounce their citizenship or intentionally abandon it.
- b) Over the past decade, there was less than a handful of these Americans, yet, the few highly publicized cases caused Congress to react.
- c) Congress expanded the reach of IRC Sec. 877 which could affect the tax planning of many foreign taxpayers who decide to give up U.S. residency for legitimate personal reasons.
- d) IRC Sec. 877 is subservient to U.S. tax treaties entered into before 1966 and those treaties which do not contain special provision reserving the right of the U.S. to tax former citizens.

###### 2. THE 10-YEAR RULE WAS RETAINED

- a) Despite proposals to immediately tax those who expatriate as if all their assets were sold at fair market value (subject to the unified estate and gift tax credit), congress decided to leave the present 10-year rule under IRC Sec. 877 in place. IRC Sec. 877(a).
  - (1) Congress broadened the present statute to ensnare many more transactions and sales.
  - (2) The definition of taxpayers who now come within the purview of IRC Sec. 877 has been expanded to include long-term residents.

- (3) The tax will apply without inquiry as to the motive for losing citizenship, but certain expatriates will have an opportunity to show an absence of tax motivation if they request a ruling from the Secretary of the Treasury as to whether the expatriation had as one of its principal purposes tax avoidance.
- (4) There are some relief provisions against double taxation of items subject to the expatriation tax.

## **B. The Expatriation Tax**

### **1. THE 10-YEAR RULE**

- a) The expatriating individual is subject to tax on his or her U.S.-source income and gains for tax years ending within 10 years from the date of termination. IRC Sec. 877.
- b) Individuals subject to the expatriation tax will pay tax at graduated rates.
  - (1) Compensation, including deferred compensation, will be taxed at graduated rates.
  - (2) Stock options earned while employed in the U.S., even though the exercise of the option is delayed until after the person loses U.S. citizenship or residency, will be considered U.S. source income, even if the stock received is in a foreign corporation.
    - (a) This rule could impact "Silicon Valley" engineers who have significant stock options and who have become permanent residents.
- c) Long-term residents may use a fair market value basis in their property as of the date the person became a U.S. resident, although they may file an election not to have their basis determined in this manner.
- d) Replacement property acquired during the 10-year period will create U.S. source income and gains, even if the property was acquired after the person expatriated.
  - (1) For example: If property is inherited before a person expatriates, but is sold thereafter, although there will be no gain on the sale of the property under the basis rules of Sec. 1014, the income from the property will be considered U.S. source during the 10-year period.

### **2. INDIVIDUALS SUBJECT TO THE EXPATRIATION TAX**

- a) Those subject to these new provisions, include —
  - (1) U.S. citizens who give up their citizenship;
  - (2) Long-term U.S. residents who terminate their residency; and
  - (3) Long-term U.S. residents who commence residency in another country pursuant to an existing treaty (usually under the tie-breaking provisions of the treaty) and fail to waive the treaty benefits as a resident of that country.

- (a) A long-term resident is an individual who is a lawful permanent resident of the U.S. for eight of the fifteen years preceding termination of residency.
- (b) Applicable treaty provisions regarding residency are taken into account.

### 3. TAX AVOIDANCE AS ONE OF THE PRINCIPAL PURPOSES FOR TERMINATING RESIDENCY

- a) Under IRC Sec. 877(a)(2), there will be a presumption of tax avoidance for the purpose of terminating residency under either of the following objective tests —
  - (1) During the five years preceding termination, the individual's average annual net income exceeds \$100,000; or
  - (2) The individual's net worth equals at least \$500,000.
  - (3) These amounts will be indexed for inflation for terminations occurring after December 31, 1996.
- b) Exceptions to the net worth and net income presumptions. IRC Sec. 877(c).
  - (1) If a U.S. citizen terminates citizenship and files a ruling request with the Secretary of Treasury within one year of the termination, as long as he can demonstrate that one of the principal purposes of expatriation was not tax avoidance, the following exceptions are available —
    - (a) In the case of a dual citizen, retention of citizenship in the other country;
    - (b) Becoming a citizen of the country of the individual's birth, the country of a spouse, or the birth country of either parent;
    - (c) Terminating citizenship before age 18 ½;
    - (d) Failing to be present in the U.S. for more than 30 days each year of the preceding 10-year period; or
    - (e) Exemptions contained in regulations.
  - (2) The Secretary will take into account the following factors —
    - (a) The substantiality of the former citizen's ties to the U.S.;
    - (b) The extent of ownership of U.S. assets;
    - (c) Whether a spouse retains U.S. citizenship; and
    - (d) Whether the new country of citizenship imposes little or no income tax.
  - (3) Note: These exemptions do not apply to long-term residents. Regulations will be issued regarding the exceptions available to them.

### 4. NEW SOURCES RULES PERTAINING TO THE EXPATRIATION TAX.

- a) Traditionally, those who terminate citizenship were taxed as non-resident aliens, except that U.S.- source income included gains from the sale of U.S. corporate stock or of a debt obligation of a U.S. person or federal, state or local government entity.

- b) Under IRC Sec. 877(d), the following income is considered U.S. source —
- (1) Stock held in a foreign corporation in which the U.S. individual owned more than 50% in vote or value, measured within two years prior to the date the individual terminated U.S. citizenship or residency.
    - (a) The rules of IRC Sec. 958 will apply to determine whether a taxpayer owns stock directly, indirectly or constructively.
    - (b) This source rule is limited to earnings and profits accumulated prior to the termination date and during the time the individual met the ownership tests.
    - (c) Example: Taxpayer loses U.S. citizenship on January 1, 1996 and is subject to the expatriation tax rules of IRC Sec. 877. On June 30, 1997, taxpayer transfers the stock he owns in a U.S. corporation (basis \$10,000; fair market value \$100,000) to a wholly-owned foreign corporation under IRC Sec. 351.
      - (i) Under the old law, an expatriating taxpayer could avoid IRC Sec. 877 by transferring appreciated U.S. assets to a foreign corporation IRC Sec. 351 (tax free incorporation).
        - (aa) The foreign corporation would then sell the assets without a capital gain (foreign taxpayers are generally not subject to taxes on long-term capital gains).
        - (bb) IRC Sec. 367 (which denies tax-free treatment to transfers by a U.S. person to a foreign corporation) would not apply to this transfer since the expatriating taxpayer was not a U.S. person at the time of transfer. IRC Sec. 367(a)(1).
      - (ii) Under the new law, unless the taxpayer entered into a gain recognition agreement, there would be an immediate tax of \$90,000 on the transfer of stock to the foreign corporation.
        - (aa) If a gain recognition agreement is entered into, then all dividend income and gains from the foreign stock during the 10-year period will be U.S. source income.
        - (bb) If the foreign corporation disposes of the stock before the 10 years period expires, then taxpayer will recognize the deferred \$90,000 gain. Changes in the value of the stock after the transfer will not affect the gain recognized.
  - (2) Gain attributable to property contributed by an expatriating individual to a Controlled Foreign Corporation (“CFC”) during the 10-year tax period will be considered earned directly by the taxpayer and not the CFC.
    - (a) The person transferring the property to the CFC is treated as a U.S. citizen.

- (b) This rule applies only if the income received by the individual would have been treated as U.S. - source income.
  - (c) A look-through rule applies to treat CFC stock sold by the individual as the sale of a pro-rata portion of the contributed property at its fair market value.
  - (d) If property is sold by a CFC, the basis of which is determined in whole or in part by the basis of the transferred property, these rules will apply to tax the expatriating individual.
- (3) Gain recognition on certain exchanges. Currently, an otherwise tax-free exchange transaction involving an expatriating individual will be taxed as a sale when the property acquired is non-U.S. source property.
- (a) Under current law, the gain may be deferred if the expatriating individual enters into an agreement with the U.S. Secretary of the Treasury to treat any gain for the acquired property as U.S. source income during the 10-year period ("gain recognition agreement").
    - (i) The gain recognition agreement is terminated if the acquirer disposes of the property during the 10-year period.
    - (ii) Under the new law, this 10-year period may be extended to 15 years under the regulations. The period for gain recognition would include the 5-year period prior to the date of expatriation.
      - (aa) Note: the termination of the gain recognition agreement is not restricted to dispositions by related parties.
      - (bb) The 10-year period may be extended when the expatriating individual diminishes the risk of ownership by holding a "put" on the property, giving another person an option to purchase the property, a short sale or other similar transaction.
- (4) Other transactions identified by regulation. Transaction in which appreciated tangible personal property is removed from the United States or in the case where U.S.- source property is converted to non-U.S.- source property.
- (a) Example: A former citizen who removes appreciated artwork that he or she owns from the U.S. could be subject to an immediate tax on the appreciation under this provision, unless the individual enters into a gain recognition agreement.

## 5. CREDIT FOR FOREIGN TAXES

- a) As a relief provision, Congress provided a credit for foreign taxes paid on income that is subject to U.S. taxation solely because of the expatriation tax provisions.

- b) Treasury believes that the presumption of tax avoidance contained in the expatriation tax rules creates a conflict with existing treaties.

#### 6. EFFECTIVE DATE

- a) The expatriate tax provisions apply to those who terminated citizen or residency on or after February 6, 1995.
- b) These provisions also apply to those who performed an act of expatriation between February 5, 1994 and February 6, 1995 and who failed to provide the Secretary of State a signed declaration relinquishing citizenship by February 6, 1995.

### **C. Estate and Gift Tax Consequences**

#### 1. ESTATE TAXES

- a) If an expatriating person dies within 10 years of termination, the estate tax is computed under IRC Sec. 2106 as modified by IRC Sec. 2107.
  - (1) Stock in foreign corporations is included in the gross estate if the decedent owned more than 50% of the stock, by vote or value, at the time of death.

#### 2. GIFT TAXES

- a) Lifetime transfers of intangible property by an expatriating individual within the 10-year period are subject to gift tax. IRC Sec. 2501(a)(3)(C).

#### 3. FOREIGN TAX CREDIT

- a) A limited credit is available for actual taxes paid for foreign estate or death taxes with respect to the expatriation tax. The same rules apply to foreign taxes paid for gift taxes. IRC Sec. 2501(a)(3)(D).

#### 4. EFFECTIVE DATE

- a) The same effective dates apply to the estate or gift tax provisions.

### **D. Information Reporting**

#### 1. REQUIRED STATEMENTS

- a) An expatriating individual must file a statement regarding his identity, foreign residence, assets and liabilities. IRC Sec. 6039G
- b) The penalty for failing to file the statement is the greater of 5% of the expatriation tax or \$1,000 for each year the failure continues.
- c) Citizens will file the statement with the Secretary of State; long-term residents will include the statement with their tax return in the year of termination.

#### 2. EFFECTIVE DATE

- a) This provision is effective for expatriating individuals on or after February 6, 1995. These statements are not due until November 21, 1996.

## V. FOREIGN TRUSTS

### A. Foreign Non-Grantor Trusts

#### 1. INTEREST ON ACCUMULATION DISTRIBUTIONS.

- a) The interest rate applicable to the accumulations of income within these trusts was 6% simple. This interest rate applied to accumulations through tax year 1995.
- b) The interest rate has now been changed to the compounding interest rate charged for underpayments of tax under IRC Sec. 6621(a)(2).
- c) Effective date: Distributions made after August 20, 1996
  - (1) Planning Note: If possible, use a foreign corporation to accumulate income tax-free, then pay dividends to a foreign trust in the year in which distributions to beneficiaries will occur.
- d) The Treasury is directed to issue regulations to prevent abusive transactions in this area.

#### 2. LOANS FROM FOREIGN TRUSTS

- a) To prevent indirect distributions to a beneficiary, a loan of cash (including foreign currency and cash equivalents) or marketable securities from a foreign non-grantor trust to a U.S. grantor or beneficiary will be treated as a distribution that person.
  - (1) This rule applies to loans made to persons related to a U.S. grantor or beneficiary, but will not apply to loans to a tax-exempt entity.
  - (2) This rule will not apply to arm's-length loan transactions.
  - (3) Note: Congress had considered treating any use of property, such as rent-free use of a trust's condominium by a beneficiary, as a taxable distribution. The final legislation did not contain this provision.
- b) Effective Date: Loans made after September 19, 1996.

### B. Inbound Foreign Grantor Trust Rules

#### 1. NON-APPLICABILITY OF THE U.S. GRANTOR TRUST RULES

- a) To prevent foreign grantors from setting up foreign grantor trusts (taxed to the foreign person) with U.S. beneficiaries receiving the income tax-free, the grantor trust rules have been modified. IRC Sec. 6651(d)(2).
  - (1) Under the new law, the grantor trust rules will not apply if the grantor is a foreign person.
  - (2) The grantor trust rules will only apply when computing the income of a U.S. person or entity.
  - (3) If this new law applies, then the foreign trust will be considered a non-grantor trust and the U.S. beneficiaries will be taxed on their

distributions and the new interest rules on accumulated distributions will apply.

- b) Under IRC Sec. 672(f), the old grantor trust rules will continue to apply when —
  - (1) The grantor retains the power to revoke the trust and that power is not conditioned upon the approval or consent of anyone else;
    - (a) Note: approval or consent by a non-adverse related party who is subservient to the grantor under IRC Sec. 672(c) is permitted.
      - (i) If the consent of the grantor's child is necessary for the grantor's actions and the child does not have beneficial interest in the trust, IRC Sec. 677 will usually treat the grantor as the owner of the trust.
  - (2) Income or corpus during the grantor's lifetime is solely distributable to the grantor or the grantor's spouse;
  - (3) A trust is established to pay compensation for services rendered; and
  - (4) Trusts owned by the grantor or another person under Code Sec. 676 or 677 [other than Code Sec. 677(a)(3)] that are in existence on September 19, 1995.
- c) Planning note: A foreign grantor trust naming a U.S. beneficiary which is revocable by the grantor, or in which the income is distributable only to the grantor or the grantor's spouse, will continue to be treated as a grantor trust.
  - (a) Under such an arrangement, the trust's income will continue to be taxable to the grantor (or spouse) and distributions of that income to the U.S. beneficiary will be tax-free.
  - (b) The U.S. beneficiary will become taxable on the distributions of income only when the grantor (or the grantor's spouse) dies.
- d) The grantor trust rules will apply to CFC's (controlled foreign corporations) which are treated as grantors.
  - (1) Under prior law, use of a foreign corporation as the grantor of a revocable trust could have resulted in a perpetual grantor trust.

## 2. TRANSFERS BY U.S. BENEFICIARIES

- a) Under IRC Sec. 672(f)(5), when a U.S. beneficiary makes a gift to a foreign grantor and the beneficiary retains an interest in the property, the trust is recast as a grantor trust in which the U.S. person is the grantor as to the transferred property.
  - (1) IRC Sec. 672(f)(5)(A) provides that the U.S. person will be considered the grantor of the trust even if the foreign grantor would otherwise be considered the grantor of the trust.

- (2) Transfers by family members of property to a foreign grantor will not cause the U.S. beneficiary to become the grantor of a U.S. grantor trust.

### 3. FOREIGN TAX CREDITS

- a) The Secretary of Treasury may devise regulations to account for any taxes paid by the foreign grantor on the income from the trust and allow a credit under the foreign tax credit limitations.

### 4. EFFECTIVE DATE

- a) These rules will take effect on August 20, 1996.
- b) If a domestic trust becomes a foreign trust or assets are transferred to a foreign trust before January 1, 1997, then no tax will be imposed under IRC Sec. 1491.

## C. Outbound Foreign Grantor Trusts

### 1. PRIOR LAW

- a) If a U.S. person transferred property to a foreign trust, he was treated as the owner of the property in any year in which the trust had U.S. beneficiaries ("ownership rule"). Also, sales to a trust for fair market value were exempted from IRC Sec. 679(a)(1), even when the trust paid for the property with an obligation.

### 2. CHANGES TO THE LAW

- a) If the trust pays fair market value for the property transferred by a U.S. beneficiary, then the beneficiary will not be treated as the owner of the trust. IRC Sec. 679(a)(2).

- (1) Obligations issued by the trust, grantor or beneficiaries or parties related thereto, containing arm's-length terms and conditions will qualify for this exception to the ownership rule as well.

- b) Transfers to charitable trusts are exempted from the ownership rule.

- c) A foreign grantor who transfers property to a trust who then becomes a U.S. **resident** within 5 years of the transfer is now brought within the ownership rule. IRC Sec. 679(a)(4).

- (1) The ownership rule will apply retroactive to the first date the person became a U.S. resident.

- (a) Note: This ownership rule applies when residency is acquired under IRC Sec. 7701(b)(2)(A), the physical presence test (as modified by the closer connection test).

- (2) The amount transferred includes the non-distributed income arising between the time of the property transfer to the trust and the date of residency.

- d) If a foreign person becomes a U.S. resident more than 5 years after the transfer, the ownership rules will not apply.

### 3. OUTBOUND TRUST MIGRATIONS

- a) A transfer of property by a U.S. person to a domestic trust, which subsequently becomes a foreign trust while the beneficiary is still alive, will be considered a transfer to a foreign trust on the date of migration.

- (1) The transferor, under IRC Sec. 679(a)(1), is treated as the grantor to the portion previously transferred to the trust and the reporting requirements will apply.

### 4. DISTRIBUTIONS BY FOREIGN TRUSTS THROUGH NOMINEES

- a) Amounts paid or derived from a foreign trust, directly or indirectly, to a U.S. beneficiary will be considered a direct payment to a U.S. beneficiary.

- (1) Intermediaries or nominees interposed between the foreign trust and the U.S. beneficiary are disregarded.

- b) These rules do not apply to a withdrawal from a foreign trust by its grantor, with a subsequent gift or other payment to a U.S. person.

- (1) Planning point: If a foreign grantor has children living in the U.S. and other countries, the grantor should withdraw the income from the trust and make a gift to the U.S. beneficiary, rather than causing a trust distribution.

- (2) Also, consider not making the U.S. children beneficiaries of the foreign trust. Gifts can be made to the U.S. children from the grantor or children living in other countries who are the beneficiaries of the trust.

### 5. EFFECTIVE DATE

- a) The ownership rules will apply to transfers of property after February 6, 1995.

## **D. Residence of Foreign Trusts**

### 1. PRIOR LAW

- a) Under prior law, there was not an objective test to determine whether a trust was domestic or foreign.

### 2. CHANGES IN THE LAW

- a) Under IRC Sec. 7701(a)(30) and (31), there is a two-part objective test to determine the residency of a trust. A trust is considered domestic if —

- (1) A U.S. court can exercise primary supervision over the administration of the estate or trust; and

- (2) One or more U.S. fiduciaries have the authority to control all substantial decisions of the trust.

- b) A trustee may elect the application of these objective tests for the trust's tax year after the date of enactment.

### 3. OUTBOUND MIGRATION OF DOMESTIC TRUSTS

- a) If a domestic trust changes its situs and becomes a foreign trust, there will be a deemed outbound transfer of assets which occurs on the date of migration. IRC Sec. 679(a)(5).
  - (1) The 35% excise tax under IRC Sec. 1491 will apply to the deemed transfer, unless one of the exceptions to IRC Sec. 1491 apply.
  - (2) The U.S. grantor is required to report the transaction under the newly-enacted reporting requirements.
- b) If a trustee, through an election, changes a domestic trust's situs to foreign, the deemed outbound transfer will occur on the date of election.

### 4. EFFECTIVE DATE

- a) The residency provisions are applicable to tax years beginning after December 31, 1996. A trust may make an irrevocable election to apply the provision to tax years ending after August 20, 1996.
- b) The imposition of IRC Sec. 1491 to transfers to foreign trusts is effective on or after August 20, 1996.

## **E. Reporting Requirements**

### 1. REPORTABLE EVENTS

- a) A "responsible party" must file certain information reports when the following reportable events under IRC Sec. 6048(a)(3) occur —
  - (1) The creation of a foreign trust by a U.S. person;
  - (2) The transfer of money or property (either directly or indirectly) to a foreign trust by a U.S. person; and
  - (3) The death of a U.S. citizen or resident if the decedent was treated as the owner of any portion of a foreign trust under the grantor trust rules, or a portion of the foreign trust was includible in the decedent's gross estate.
- b) Reportable events do not include transfers of assets to foreign trusts for fair market value, transfers involving deferred compensation or transfers to charitable trusts.
- c) A responsible party includes the grantor of an inter vivos trust, the transferor of money or property (except at death) and the executor of the decedent's estate.
  - (1) Written notice of a reportable event must be given on or before the 90<sup>th</sup> date after the event.
  - (2) The notice will probably contain the amount of money or value of the property transferred to the trust, the identity of the trust, trustee and beneficiary, but the Secretary of the Treasury will prescribe what information is needed.

## 2. GRANTOR TRUST REPORTING

- a) A U.S. person treated as the grantor of a foreign trust under the ownership rules is responsible under IRC Sec. 6048(b) for ensuring that the trust —
  - (1) Files a return containing a full and complete accounting of trust activities, the name of the U.S. agent for the trust, and any other information the Secretary prescribes, and
  - (2) Furnishes other information that the Secretary of the Treasury may require regarding U.S. grantors or beneficiaries.
- b) A U.S. agent needs to be appointed for accepting service of process for IRS summonses or requests.
  - (1) If a U.S. agent is not appointed, then the Secretary of the Treasury, at his sole discretion, may determine the amounts of income under the grantor trust rules.
  - (2) The judicial review standard of the Secretary's discretion is "arbitrary and capricious," which gives the Secretary great latitude in exercising his discretion.
- c) U.S. beneficiaries must report any distributions received from a foreign trust and the name of the trust.
- d) Penalties for failure to file the appropriate returns.
  - (1) The penalty for failing to provide the required notice or return in cases involving the transfer of property to a foreign trust or the distribution from a foreign trust to a U.S. beneficiary is 35% of the gross reportable income.
  - (2) If this information is not filed within 90 days of notice to file from the Secretary, an additional \$10,000 penalty for each 30-day period is imposed.
    - (a) This penalty applies to the failure to report transfers subject to the 35% excise tax under IRC Sec. 1491.
    - (b) NOTE: The reporting requirements under IRC Sec. 1491 encompass all transaction under that statute, not just foreign trust transfers.
      - (i) Therefore, penalties could be imposed for the non-reporting of cash or property transfers to foreign entities, whether or not the underlying transaction is taxable.
      - (ii) Under prior law, there were no penalties for the failure to report a non-taxable transfer under IRC Sec. 1491.
  - (3) If a U.S. grantor fails to ensure proper trust reporting, the penalty is 5% of the gross reportable income.

- (4) There is a reasonable cause exception to these penalties. Reasonable efforts to comply with the reporting requirements will constitute reasonable cause.
- (5) In no event will the total penalty amount exceed the gross reportable income.
- (6) Effective date:
  - (a) The reportable events provision is effective for events occurring after August 20, 1996.
  - (b) The grantor reporting provisions applies to tax years after December 31, 1995.
  - (c) The beneficiary reporting provision applies to distributions received after August 20, 1996.

## **VI. FOREIGN GIFT REPORTING**

### **A. Prior Law**

#### 1. GIFTS WERE NOT TAXABLE OR REPORTABLE

- a) Gifts of non-U.S. property by a foreign donor to a U.S. donee were not taxable nor reportable. The same was true for bequests from foreign sources.

### **B. Change in Law**

#### 1. GIFTS IN EXCESS OF \$10,000 PER YEAR.

- a) U.S. persons (other than charities) that receive foreign gifts during the tax year totaling more than \$10,000 must now provide information to the IRS. IRC Sec. 6039F.
  - (1) Note: The draft legislation provided for the reporting of gifts in amounts over \$100,000. This reduction to \$10,000 will affect many donees.
- b) A U.S. person is a citizen or resident of the United States, a domestic partnership or corporation or any estate or trust (other than a foreign estate or trust). IRC Sec. 7701(a)(30).
- c) The definition of a gift excludes qualified tuition or medical payments under IRC Sec. 2503(e)(2).
- d) Also excluded are amounts distributed to a U.S. beneficiary of a foreign trust if such amounts are properly disclosed under the new reporting requirements.
- e) The \$10,000 annual limitation is adjusted for inflation for tax years after December 31, 1996.

## 2. DEFINITION OF A GIFT

- a) A gift is any amount received from a donor who is not a U.S. person that is treated as a gift or bequest by the recipient.

(1) Note: Focus on the **donor**, not the location or source of the gift. The term “foreign gift” is deceptive.

- b) Excluded from this definition are gifts of more than \$100,000 from a spouse who is a U.S. person to a non-resident alien spouse.
- c) Apparently included in this definition would be the creation of a joint tenancy in stock, though the creation of the tenancy must be treated as a gift by the recipient.

(1) Query: Would the creation of a joint tenancy by a non-resident alien who owns U.S. real property with his U.S. person daughter be a reportable transaction under this provision? In such a case, the donor made a taxable gift of U.S. real property and has the obligation to report it.

## 3. FAILURE TO PROVIDE INFORMATION

- a) If the donee fails to provide the proper information, the IRS may determine the tax consequences of the transfer, subject to judicial review under the “arbitrary and capricious” standard (which provides a high degree of deference to the determination), and may impose a penalty of 5% of the gift amount for each month the information is not furnished.

(1) The penalty cannot exceed 25% of the gift amount.

(2) There is a good cause exception to these penalties.

## 4. EFFECTIVE DATE

- a) These provisions apply to amounts received after August 20, 1996, in tax years ending after that date.

## **VII.CHANGES IN INDEPENDENT CONTRACTOR RULES**

### **A. Introduction**

- a) In 1978, Congress mandated that the IRS stop reclassifying workers as employees provided the company had “any reasonable basis” for treating the worker as an independent contractor. Section 530 of the Revenue Act of 1978.

(1) Since it was intended to be a temporary measure, Sec. 530 was never codified as part of the Internal Revenue Code , but it has continued in effect since enactment.

(2) Because it was not part of the Internal Revenue Code, Section 530 does not apply to independent contractor status disputes with California.

- b) Despite an impressive string of taxpayer victories under Sec. 530, the IRS continued to insist on a restrictive interpretation of this exception.
- c) As part of the Small Business Act, Section 1122, Congress clarified and expanded the scope of Sec. 530.

## **B. Section 530**

### 1. PRIOR LAW

- a) Section 530 was available to companies that treated workers as independent contractors, if —
  - (1) The company always treated the particular worker as an independent contractor and the general class of workers performing similar work as independent contractors;
  - (2) After 1978, the company filed all returns (including information returns) required for the worker and all such returns were consistent with independent contractor status; and
  - (3) The company had a “reasonable basis” for treating the worker as an independent contractor.
    - (a) There were 3 express safe harbors associated with the reasonable basis standard —
      - (i) A judicial precedent, published rulings or technical advice or letter ruling to the employer;
      - (ii) A prior IRS audit in which no assessment was made on account of improper treatment of the worker; or
      - (iii) A long-standing recognized practice of a significant segment of the industry in which the individual worked.

## **C. Changes in Section 530**

### 1. RELIANCE ON A PRIOR AUDIT

- a) Under the original law, any audit, whether or not it involved employment tax issues, came within the prior audit safe harbor exception. The new law limits this exception to prior employment tax audits involving the particular worker, or workers performing similar jobs.
- b) Companies may rely on audits that began prior to 1977 under the old rules.

### 2. LONG-STANDING RECOGNIZED PRACTICE

- a) The IRS had incorrectly maintained that a long-standing practice safe harbor exception required a 10-year period or that the practice was in existence prior to 1979, thus preventing new industries from using this exception.

- b) Congress clarified this exception by stating that no fixed period of time will apply. This change will benefit new industries.

### 3. SIGNIFICANT SEGMENT OF THE INDUSTRY

- a) Congress stated that there is no fixed percentage needed to show reliance on this exception.
- b) A showing of 25% or more of the companies in an industry, excluding the taxpayer's company, is now deemed a significant portion of the industry for this standard.
  - (1) The IRS had maintained that a showing of more than 50% of the industry was required to meet this exception.
  - (2) The change under this exception will assist companies. Often, a trade publication, which polls its members as to practices in the industry, may be used as evidence of the practice in a significant segment of the industry.

### 4. BURDEN OF PROOF SHIFTS TO IRS

- a) Companies who rely on one of the three safe harbor exceptions will have to make a prima facie showing only.
- b) The company must cooperate with the IRS investigation to shift the burden.
  - (1) Previously, the IRS claimed that the taxpayer had the burden of proving the applicability of a safe harbor exception.
  - (2) Congress expressly stated that the change in this shift of burden does not imply that the IRS was correct in its interpretation; therefore, taxpayers may still argue the IRS has the burden of proof in cases arising before the change in the law.
  - (3) The IRS must request information that is related to the taxpayer's position regarding reasonable basis, and compliance with the IRS must not be impracticable given the particular circumstances and relative costs involved.
- c) Once the burden of proof shifts to the IRS, it applies to all aspects under Section 530, including the consistency and filing requirements.
  - (1) With respect to the consistency requirement (workers in substantially similar positions were treated as independent contractors), consideration of the relationship between a taxpayer and a worker includes the degree of supervision and control by the taxpayer.
  - (2) Note: This will permit separate treatment for the same general class of worker if the degree of supervision and control is different.
  - (3) Note: The IRS Training Guide, issued in July 1996, evidently provides several pro-independent contractor interpretations that the IRS is supposed to use in an audit, including —
    - (a) The intent of the parties is considered important in cases of professional workers and in close cases.

- (b) The designation of a worker as an independent contractor in a contract is persuasive.
- (c) Also, exclusion of a worker from employee benefit plans is relevant.

#### 5. LATER RECLASSIFICATION ALLOWED

- a) A company may classify a former independent contractor as an employee without jeopardizing the past classification under the consistency requirement of Section 530.
- b) Current classification of a worker as an employee will not be used as evidence of an improper classification for any year prior to the reclassification.

#### 6. RELIEF NOT DEPENDENT ON EMPLOYEE CLASSIFICATION FOR OTHER PURPOSES

- a) The IRS wrongly maintained that Sec. 530 only applied to workers who would have otherwise been considered employees under the traditional common-law tests under Revenue Ruling 87-41, 1987-1 CB 296.
- b) Congress makes it clear that Sec. 530 applies to the classification of workers, whether or not workers are considered independent contractors for other purposes.

#### 7. IRS REQUIRED TO GIVE NOTICE

- a) Under prior law, reference to Section 530 was deceptively described or entirely hidden from the forms and publications most taxpayers and companies use to determine these issues.
- b) Now, the IRS is required to notify companies of their rights under Section 530 as soon as the issue of worker classification is raised in an audit.

### **D. Effective Dates**

#### 1. CHANGES TO SECTION 530 IN GENERAL

- a) These changes will apply for periods after December 31, 1996.

#### 2. BURDEN OF PROOF RULES

- a) The shift in the burden of proof rules will also take effect for disputes involving tax periods after December 31, 1996.
- b) The requirement that the IRS must give notice of Sec. 530 is effective for audits that begin after December 31, 1996.

### **E. Dealing With California on Independent Contractor Issues**

#### 1. ABSENCE OF SECTION 530

- a) California continues to apply the traditional common-law tests to determine independent contractor status.

- b) Recently, California employment tax audits (Employment Development Department - "EDD") have focused on the "trappings of independence" shown by the worker, rather than a solid analysis of the "control" issue.

## 2. APPLYING CALIFORNIA "FORM OVER SUBSTANCE" ANALYSIS

- a) Since the focus of most EDD auditors is on the independent business aspects of the worker, the following should be considered by companies concerned about this issue —

- (1) The worker should conduct business under a fictitious business name.

- (a) Auditors look for individual names on Form 1099's. Use of "John Smith and Associates" or "John Smith Consulting," rather than merely "John Smith" is evidence of independence.

- (2) The worker should have his or her own federal identification number, rather than using a social security number.

- (a) Again, an auditor reviewing Form 1099's will be less inclined to question a worker who uses a federal ID number.

- (3) The worker should have a business license and have a listing or advertisement in the telephone directory under the company name.

- (a) These steps are helpful in convincing an auditor that the worker is engaged in an independent business.

- (4) The worker should have printed stationery and business cards, preferably two color. Resumes and promotional materials should use the company's name. The home answering machine and greetings should be in the company's name.

- (5) Invoices should be on the workers stationary and for services rendered.

- (a) Avoid statements that look like time sheets.

- (b) When possible, workers should bill on a flat rate per project, rather than on an hourly rate.

- (6) The parties should have a written contract stating that the worker is responsible for completing the job, may hire sub-contractors or have employees work on the project, and is liable for contract damages for negligence in the performance of the contract.

- (7) The company should have provisions requiring the worker to cooperate with the company in any employment tax audit, including the presentation of the worker's Schedule C or other tax forms showing that the income was reported as an independent business.

## 3. PRESUMPTION OF INDEPENDENCE FOR PROFESSIONALS

- a) Under Unemployment Insurance Code Section 656, there is a rebuttable presumption in favor of independent contractor status for those engaged

- in a professional practice, such as physicians, attorneys, accountants, engineers and architects.
- b) Scientists in the physical, chemical, biological and natural sciences also fall within this presumption.
    - (1) Note: Those involved in the social sciences do not enjoy the benefit of this presumption.
  - c) If the presumption applies, then the burden of proof shifts to the state to prove that an employment relationship existed.
4. NEW REGULATIONS INVOLVING LANGUAGE INTERPRETERS
- a) There is a new set of regulations and criteria for determining whether a "language interpreter" is an independent contractor. See Regulation 4304-9 of Title 22, California Code of Regulations.
    - (1) Language interpreters include translators of text and interpreters of conversations.
  - b) This set of new regulations was enacted after extensive hearings and are generally favorable towards the classification of such workers as independent contractors.

## **VIII. PRESIDENT CLINTON'S TAX AGENDA**

### **A. Introduction**

1. THE CLIMATE FOR TAX CHANGES
- a) The presidential debates were dominated by competing tax-cutting plans, which pitted the collective good of the "village" against individual self-interest. Government vs. the marketplace, collective good vs. individual profit.
    - (1) President Clinton presented a limited, narrowly-targeted set of tax proposals aimed at education for lower-middle income taxpayers.
    - (2) In contrast, Bob Dole called for much larger tax cuts in the personal income tax, 5% per year for 3 years, and for a 50% capital gains tax cut.
2. CLINTON VS. CONGRESS
- a) Since the Republicans maintained control of Congress, at a minimum, I would expect a broadening of the income tax limitations imposed on tax breaks proposed by Clinton and a capital gains tax cut. The Republicans do not like targeted tax cuts.
  - b) Also, the Republicans are apparently committed to reforming the IRS and to simplifying the tax code.

### **B. President Clinton's Plan.**

1. INTRODUCTION

- a) Narrowly-focused and modest, it aims at what he perceives is the collective social good.
- b) While his campaign trumpets tax breaks for education, his proposal was meager, paying only for a fraction of education costs, and will be unavailable to many middle class taxpayers.
- c) Ironically, several new tax breaks involving home sales and liberal use of retirement funds, will benefit middle and upper income taxpayers.

## 2. CLINTON'S EDUCATIONAL BENEFITS

- a) Taxpayers with joint incomes under \$70,000 (single filers with incomes less than \$50,000), would get an annual \$1,500 tax credit for the first two years of post-high school education (\$3,000 in total).
  - (1) Part-time students are entitled to a \$750 per year credit until they complete two years of higher education. Students must maintain a "B" average.
  - (2) Those with a felony conviction for using dangerous drugs (including marijuana) are ineligible for the program.
- b) In addition to the tax credit program, taxpayers meeting these income limitations may deduct \$10,000 for total educational expenses.
  - (1) The \$10,000 deduction is an overall limitation, regardless of how many children the family must educate.
  - (2) During the debates, Clinton stated the \$10,000 was an annual deduction, but his official position papers on the subject stated it was an overall limitation.
- c) **Comment:** The education program is well intentioned, but its eligibility requirements are too restrictive.
  - (1) Also, there is too much government meddling with school-grading policies:
    - (a) Will the "B" average requirement lead to "grade inflation?"
    - (b) What about courses taught on a "pass-fail" system?
    - (c) Will students be discouraged from taking harder academic classes because of grade concerns?
  - (2) Regarding the disqualification for a drug conviction, how would colleges enforce these restrictions?
    - (a) Also, why should a prior drug conviction stop someone from later trying to improve his life?
    - (b) Does this disproportionately impact minority groups, which have a higher felony conviction rate for drug offenses?

- d) Reviving the deduction for interest payments on educational loans would provide educational incentives for all taxpayers, with none of the value-laden pitfalls of the Clinton proposal.

### 3. CHILD TAX CREDITS:

- a) Clinton is offering a \$300 per child tax credit for 1996, 1997 and 1998 tax years, and \$500 per child in 1999 and thereafter, for families whose adjusted gross income (AGI) is under \$60,000.
- b) The credit will be phased-out between \$60,000 and \$75,000.
- c) **Comment:** Part of Clinton's original campaign promise of a middle-class tax cut, it is narrowly targeted to the lower end of the middle class.
- d) Unfortunately, these benefits, along with the President's educational benefits, will prove illusory to many middle class taxpayers.

### 4. EXPANDED IRAS

- a) Clinton wants to double the current income requirements for IRA contributions.
  - (1) For joint filers, the deduction will be phased-out for incomes between \$50,000 and \$100,000.
  - (2) For single filers the phase out begins at \$35,000 and ends at \$70,000.
  - (3) The current \$2,000 maximum contribution will be indexed for inflation.
  - (4) He has proposed penalty-free withdrawals for major life expenses, such as education, training, first-time home purchases and financially devastating medical expenses (including nursing care for one's parents).
    - (a) Permissible IRA investments would be expanded to include state pre-paid tuition programs.
- b) **Comment:** Allowing penalty-free withdrawals for education expenses could be extremely useful.
  - (1) IRAs have proven to be tremendous wealth-generating vehicles since all earnings are tax-free until withdrawn.
  - (2) If approved, the IRA could become the major investment vehicle for future educational expenses.

### 5. ELIMINATION OF CAPITAL GAINS ON THE SALES OF RESIDENCES

- a) Clinton proposes eliminating \$500,000 of taxable gain on sales of a principal residence by a joint filer (\$250,000 for single filers), once every two years.
  - (1) This new law will replace the current once-in-a lifetime exclusion of \$125,000 for taxpayers over age 55, plus the tax-free deferral provisions for replacing a home of equal or greater value.

- b) **Comment:** This is a huge tax break for those with expensive homes and will permit the downsizing of home ownership without tax.
- (1) Those selling high-priced homes and moving to an area with lower housing costs could realize tremendous savings, enough to pay for educational costs and provide for retirement.

## C. Republican Response

### 1. SENATOR DOLE'S PLAN

- a) Senator Dole's centerpiece was an unrestricted tax cut in income and capital gains taxes, which he believed would stimulate the economy and encourage investment and savings.
- b) Absent from the Dole plan were the restrictive and targeted tax cut approach espoused by Clinton.
- c) The Dole plan is much more ambitious. Criticism against his approach is that it will increase the deficit.

### 2. EDUCATION INVESTMENT ACCOUNTS AND DEDUCTIONS FOR STUDENT LOANS.

- a) Dole offered a \$500 per year, per child, tax-free investment into an Educational Investment Account for couples with AGIs of \$110,000 or less and single head of household filers with AGIs of \$75,000 or less.

(1) These accounts could have been funded with the child tax credit or after-tax dollars. Funds may have been withdrawn tax-free after 5 years to meet education costs.

- b) Also, interest on student loans would have qualified as an itemized deduction for 5 years.

(1) These benefits will be phased-out for single taxpayers with AGI's between \$45,000 and \$60,000, and joint filers with AGIs between \$65,000 and \$85,000 and will be adjusted for inflation.

- c) **Comment:** Dole's education proposals were smaller in scope and with less governmental regulation than Clinton's.

(1) More middle-class taxpayers will qualify under the Dole proposals.

(2) The deduction for student loans addressed a major problem: recent college graduates bear enormous education debts and must repay both the interest and principal from after-tax dollars. An interest deduction will lessen this burden.

### 3. ESTATE TAX RELIEF FOR FAMILY BUSINESSES AND FARMS

- a) Dole proposed an additional \$1,000,000 exclusion from estate taxes for family-owned businesses and farms.
- b) I'd expect the Republican Congress to include this type of relief, along with an increase in the annual gift tax exclusion and the unified estate and gift tax credit.

### 4. ENDING THE IRS AS WE KNOW IT.

- a) One of Senator Dole's best applause lines is to "End the IRS as we know it!"

- (1) There would be tax amnesty for one-year in which non-filers may pay their back taxes without penalty or interest charges.
- b) The burden of proof in tax cases will shift from the taxpayer to the IRS.
- c) He wanted to end controversial "life-style" audits which ask personal questions about a taxpayer's spending habits.
- d) He desired to eliminate IRS filings for taxpayers who have wages subject to withholding and less than \$250 of investment income.
- e) He hoped to reduce the "IRS bureaucrats" by 30% by 1999; those remaining will help taxpayers comply with the tax code, rather than waiting to "pounce on them with an audit."
- f) **Comment:** Senator Dole's efforts to end the IRS may not be necessary:
  - (1) According to news reports, the IRS will self-destruct on January 1, 2000, because the IRS computers will not be able to handle the change in date to the year 2000!
  - (2) The amnesty program has been consistently rejected as unfairly rewarding taxpayers who failed to comply with the tax laws, while punishing those who have paid their taxes, along with the penalties and interest.
  - (3) Life-style audits are already an unacceptable intrusion into the personal lives of taxpayers and have caught the attention of Congress.
- g) Shifting the burden of proof to the IRS might work in instances where the taxpayer has cooperated and provided all available information to the IRS and the taxpayer's claim is reasonable.
  - (1) The level of proof necessary in tax cases, however, should be relaxed.
  - (2) The use of averages and approximations when actual receipts are unavailable, should be permitted. Also, industry standards for deductions should be considered as substitutes for actual proof and documentation.
- h) Elimination of unnecessary tax filings and promoting correct filings, rather than using audits to punish taxpayers, are desirable goals to be pursued by whomever becomes president.

#### **D. Conclusion - What to Watch For in 1997**

1. TAX POLICY TOOK CENTER-STAGE IN THE 1996 CAMPAIGN FOR PRESIDENCY.
  - a) The Clinton plan reflected general satisfaction with the economy. Modest in scope, it uses tax cuts to target "socially desirable" investments.
  - b) The Dole plan was much more aggressive and incorporates the tax-cut philosophy of supply-side economics to stimulate economic growth.

- c) Look for general agreement on IRA withdrawals and education savings accounts. Look for disagreement on income tax and capital gains tax cuts.

## 2. CHANGES IN THE IRS AND TAX ADMINISTRATION

- a) The IRS is apparently in for significant, if not radical, restructuring, since it has become a hot-button target that congress appears ready to exploit.
- b) Look for expanded use of the shift in burden of proof to the IRS, especially when the taxpayer cooperates with an audit.
- c) Ironically, the recent tax legislation, with its heavy emphasis on notice requirements and penalties, appears at odds with the political trend of congress to make the IRS less threatening and more helpful in the process of tax administration.