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Chairman's Message

*David F. Golden, Section Chair
Troutman Sanders, LLP*

I am delighted to present the first issue of the Taxation Section's newsletter. I want to thank Bill Ewing and Woody Stewart and their Editorial Board for their outstanding job in editing the newsletter. I also thank the authors for their contributions. I believe you will find the newsletter to be informative and timely. This newsletter represents the Taxation Section's continuing efforts to enhance the value of your membership.

I would also like to remind all members that the State Bar of Georgia annual meeting will be held at Amelia Island beginning Thursday evening, June 12th through Sunday, June 15th. The Taxation Section will be having a breakfast meeting on Friday morning, June 13th. Amelia Island is a beautiful family friendly resort and I encourage all members who are able to join us for our breakfast meeting the morning of the 13th.

Editors' Message

*Bill Ewing, Kilpatrick Stockton, LLP and
Woody Stewart, Stewart, Melvin & Frost, LLP
Co-Editors*

We are very grateful to the authors of this quarter's articles for providing new, diverse and exciting articles relevant to our daily practice. We believe you will find one or more of these articles relevant to your practice, irrespective of your specialty area. We encourage our readers to think about writing an article on techniques of your tax practice that you find to be beneficial to your clients, particularly those that have not received much publicity.

We also want to thank our editors, Jennifer Cobb, Kevin Cowart, Lawrence Freiman, Aaron Kowan, Alice Nolen, and Jeff Scroggin. They have been very responsive and helpful, and I know the authors with whom they have worked would also join us in giving them kudos for their assistance.

We are committed to presenting fresh articles in each quarterly edition of this year's Newsletter to help you in your practice. Let us know of any topics you would particularly like to see included in our Newsletter. We look forward to our next edition of the Tax Newsletter.

An About-Face: Application of the Final Regulations of the Sarbanes-Oxley Act to Tax Services

By Tim Carlson, Ernst & Young, LLP

Certainly passage of the Sarbanes-Oxley Act of 2002¹ (the "Act") has changed the rules of the game regarding the provision of certain non-audit services by accounting firms to audit clients. While tax services seem to have escaped the wave of specific prohibition, they did not escape the wake of ten expressly prohibited services and remain ultimately subject to independence review and pre-approval by the audit committee.

Once regarded as a highly controversial aspect of the Act, the recently published regulations (or lack thereof) regarding tax services have been released with little fanfare. Under the regulations implementing the Act, the Securities and Exchange Commission (the "SEC") has taken a position that seems counterintuitive to both the proposed regulations as well as the three guiding principles of the Act.² In short, tax related services are seemingly entirely permitted by an accountant³ to its audit client, subject to approval by the audit committee.

The final regulations, released January 30, 2003, can be divided into two segments: specifically prohibited services, and services subject to approval by the audit committee. In examining the impact of a certain tax service *vis-à-vis* the independence of the accountant, the analysis begins first with a review of the specifically prohibited services. If the tax service passes muster and is not disqualified under the specifically prohibited services, the service is nonetheless subject to review and pre-approval by the audit committee.⁴ On the other hand, any time a particular tax service contravenes one of the specifically prohibited services, it will automatically impair the independence of the auditor, leaving no discretion with the audit committee to pass on its propriety.⁵

Although the analysis seems straightforward, application of the final regulations to tax services is clouded by the language of the preamble to the regulations. Many of the ten specifically prohibited services would seemingly encompass tax services; however, the preamble provides exceptions - and in some cases affirmations - that allow an accountant to provide otherwise prohibited tax services to its audit client.

Specifically Prohibited Services

The following ten non-audit services are specifically

prohibited under the regulations (including a general provision that contemplates future promulgation under the Act):

- ♦ Bookkeeping or other services related to the accounting records or financial statements of the audit client
- ♦ Financial information systems design and implementation
- ♦ Appraisal or valuation services, fairness opinions, or contribution-in-kind reports.
- ♦ Actuarial services
- ♦ Internal audit outsourcing services
- ♦ Management functions
- ♦ Human resources
- ♦ Broker-dealer, investment adviser, or investment banking services
- ♦ Legal services
- ♦ Expert services unrelated to the audit⁶
- ♦ Any other services that the Public Company Accounting Oversight Board determines, by regulation, to be impermissible

Under a flush reading of the regulations alone, an accountant's independence would seemingly be compromised if that accountant provides any of the above listed services to an audit client. Undoubtedly, this "black list" certainly would appear to encompass traditional tax services as well as specialized tax support, including tax department outsourcing, transfer pricing studies, and tax controversy resolution. Certain sections of the regulations, however, contain what could be construed as an "out-clause," and the language of the preamble appears to permit tax services, subject to certain limitations. The tone the SEC preamble and final regulations suggests that the SEC intended to permit auditors to provide many tax services, whether traditional or specialized, to their audit client.

Appraisal and Valuation Services

The final SEC regulations provide that the following services will render an auditor not independent:

- (iii) Appraisal or valuation services, fairness opinions, or contribution-in-kind reports. Any appraisal service, valuation service, or any service involving a fairness opinion or contribution-in-kind report for an audit client, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements.⁷

Furthermore, the preamble to the final regulations explains:

Appraisal and valuation services include any process of valuing assets, both tangible and intangible, or liabilities. They include valuing, among other things, in-process

research and development, financial instruments, assets and liabilities acquired in a merger, and real estate.⁸

The breadth of the proscription of appraisal and valuation services would seem to prevent accountants from providing many tax services. Property tax services invariably center on the valuation of the subject real and personal property. Transfer pricing reports often center on the value of intangible assets and management services, leading to a market rate at which inter-company transactions should be respected under the Internal Revenue Code. At this juncture, it would seem wholly consistent with the three guiding principles of the Act and the flush language of the regulation that the tax services listed above would not be permitted under the Act. However, the preamble goes on to explain:

Our rules do not prohibit an accounting firm from providing such services for non-financial reporting (e.g., transfer pricing studies, cost segregation studies, and other tax-only valuations) purposes.⁹

Accordingly, such tax services appear to qualify as specifically permitted services, subject only to the audit committee pre-approval guidelines set forth in the regulations, so long as they have no direct financial statement impact.

Moreover, an "out clause" can be found in the flush language of the regulation. Such services are proscribed ". . . unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements".¹⁰ The preamble addresses this "out clause" as well:

Accordingly, the rules we are adopting prohibit the accountant from providing any appraisal service, valuation service or any service involving a fairness opinion or contribution-in-kind report for an audit client, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements.¹¹

In practice, for financial statement presentation purposes, these tax-related services are generally deemed immaterial to the audit as a whole, and thus are not subject to the direct testing procedures of the auditors. The flush language of the final regulations, considered in conjunction with the language of the preamble, arguably directs application of this section away from absolute proscription of tax-related appraisal and valuation services.

Management Functions

The final regulations also limit the ability of the accountant to serve in certain roles for its audit client.

Specifically, the following services are identified:

(vi) Management functions. Acting, temporarily or permanently, as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client.¹²

In typical tax outsourcing arrangements whereby an audit client may retain the accountant to provide a full service tax department, the accountant's tax practitioners serve in many roles for the audit client, including the role of tax director. Often, the outsourcing team is afforded full discretion and authority in managing the operations of the audit client's outsourced tax department, and it is not uncommon for the client to provide the tax practitioner an on-site office, access and reign over client staff, email access, and telephonic and network access.

Under this section of the regulations, it would seem that these tax outsourcing services would compromise the independence relationship between an accountant and its audit client. Nothing in the preamble qualifies or otherwise alters this initial conclusion, and in fact, the preamble is consistent with at least two of the three guiding principles of the Act:

Consistent with our proposal, the final rules prohibit the accountant from acting, temporarily or permanently, as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client.¹³

Application of this section of the regulations proves clear and is in perfect harmony with the Act. Auditors cannot provide traditional tax outsourcing arrangements to audit clients.

Tax Services

Conspicuously absent from the final regulations is any substantive discussion regarding tax services. However, the preamble speaks clearly to the issue of proscribed tax services:

Tax services are unique among non-audit services for a variety of reasons. Detailed tax laws must be consistently applied, and the Internal Revenue Service has discretion to audit any tax return. Additionally, accounting firms have historically provided a broad range of tax services to their audit clients.

In the proposing release, we suggested that in determining whether a given tax service should be allowed, the audit committee should be mindful of the three basic principles.

* * *

The Commission reiterates its long-standing position that an accounting firm can provide tax services to its audit clients without impairing the firm's independence. Accordingly, accountants may continue to provide tax services such as tax compliance, tax planning, and tax advice to audit clients, subject to the normal audit committee pre-approval requirements under 2-01(c)(7). Additionally, the rules we are adopting require registrants to disclose the amount of fees paid to the accounting firm for tax services. The rules are consistent with the Act which states that:

A registered public accounting firm may engage in any non-audit service, including tax services, that is not described in any of paragraphs (1) through (9) of subsection (g) for an audit client, only if the activity is approved in advance by the audit committee of the issuer.¹⁴

Nonetheless, merely labeling a service as a "tax service" will not necessarily eliminate its potential to impair independence under Rule 2-01(b). Audit committees and accountants should understand that providing certain tax services to an audit client would, as described below, or could, in certain circumstances, impair the independence of the accountant. Specifically, accountants would impair their independence by representing an audit client before a tax court, district court, or federal court of claims. In addition, audit committees also should scrutinize carefully the retention of an accountant in a transaction initially recommended by the accountant, the sole business purpose of which may be tax avoidance and the tax treatment of which may be not supported in the Internal Revenue Code and related regulations.¹⁵

The preamble states with no uncertainty that representation of an audit client in tax court, district court, or federal court of claims would impair the independence of the accountant, which seems consistent with the ban on legal services. In light of the spirited discussion regarding the provision of tax services, the SEC's omission of "tax services" as an expressly proscribed non-audit service gives rise to an inference that such services are indeed permissible, subject to the conclusions of the audit client's audit committee regarding overall independence of the accountant. Based on the language of the preamble, such permissible tax services could arguably include administrative appeals and hearings, letter rulings, and/or negotiated settlements, subject only to pre-approval by the audit committee.

Nonetheless, the SEC caution contained in the preamble should be considered with all due deliberation.

Under its guidance, when an accountant identifies a tax-advantaged strategy to its audit client, the audit committee should increase its level of scrutiny regarding retention of the accountant in implementing that structure. Undoubtedly, at minimum, an audit committee would be well advised to consider accounting materiality regarding the impact of any tax structure, yet exactly how this relates to the SEC's acquiescence that traditional tax services are permissible remains to be seen.

Conclusion

Much remains to be seen regarding ultimate application of the regulations and preamble to tax services. Based on the shift between the proposed regulations and those issued in final form, it is apparent that the SEC has significantly backed off from its original position regarding application of the three guiding principles of the Act to tax services. Although the regulations on their face appear to prohibit many non-audit services, many of such traditional tax services can find solace in the language of the preamble. As implemented by the regulations, the Act makes prohibition of tax services the exception rather than the norm, often ~~leaving ultimate discretion with the audit committee.~~¹⁶

¹ Pub. L. 107-204, 116 Stat. 745 (2002).

² The Act is founded upon three basic principles: an auditor cannot function in the role of management; an auditor cannot audit his or her own work; and an auditor cannot serve in an advocacy role for his or her client.

³ The terms "accountant" and "auditor" are used interchangeably throughout this commentary.

⁴ 17 CFR §210.2-01(c)(7).

⁵ Preamble - Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence.

⁶ 17 CFR §210.2-01(c)(4)(i)-(x).

⁷ 17 CFR §210.2-01(c)(4)(iii).

⁸ Preamble - Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence.

⁹ *Id.*

¹⁰ 17 CFR §210.2-01(c)(4)(iii).

¹¹ Preamble - Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence.

¹² 17 CFR §210.2-01(c)(4)(vi).

¹³ Preamble - Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence.

¹⁴ Emphasis in original.

¹⁵ *Id.*

¹⁶ The final regulations governing audit committees are

due in April 2003, and may be the subject of a future commentary.

Georgia's New Consolidated Reporting Regulations

By Peter G. Stathopoulos
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In November of 2002, the Georgia Department of Revenue formally promulgated new consolidated income tax reporting regulations. These regulations introduced sweeping changes to Georgia's consolidated reporting scheme. This article contains a brief discussion of the reasons why new regulations were deemed necessary by the Department, a comparison of the most important features of the old and new consolidated reporting rules, and some administrative history shedding light on why certain provisions were structured as they are in the new regulations.

Georgia's Former Consolidated Reporting Scheme

The Georgia Revenue Code provides that Georgia will not follow the federal consolidated return election.¹ Consolidated Georgia income tax returns shall be required if two or more corporations file federal consolidated income tax returns and "all of the corporations derive their all their income from sources within this state."² Affiliated corporations that file federal consolidated returns but "which derive income from sources outside this state must file separate income tax returns unless they have prior approval or have been requested to file consolidated returns by the Department." Further, "[t]he income of two or more corporations shall not be included in a single return except with the express consent of the Commissioner."³

The Georgia Code does not give any further guidance as to the scope of the Revenue Commissioner's discretion to approve or deny the filing of Georgia consolidated returns. The Department formerly provided administrative guidance under Ga. Comp. R. & Regs. r. 560-7-3-.06(4). Under the former regulations, permission to file consolidated returns would only be granted where two or more corporations:

- (1) Filed as part of a federal consolidated income tax return,
- (2) Transacted a substantial portion of their business in Georgia,
- (3) Submitted an affidavit thirty (30) days prior to the date of filing of their Georgia income tax return attesting that they filed a federal consolidated income tax return,
- (4) Showed in the affidavit that filing a

- Georgia consolidated return is necessary to clearly and equitably reflect their Georgia income tax liability, and
- (5) The Commissioner finds that the filing of a consolidated tax return will clearly and equitably reflect their Georgia income tax liability.⁴

The regulations provided no further guidance as to the form of the consolidated return (pre or post apportionment), whether any SRLY limitations applied, what "clearly and equitably reflect Georgia income" means, or what "transacting a substantial portion of their business in Georgia" means. Further, there were no administrative provisions governing the protest of the denial by the Commissioner of a taxpayer's request for permission to file consolidated returns. Not surprisingly, due to the vagueness of the regulations, the Department developed a significant body of unwritten (some taxpayers would say "secret") administrative policy with regard to these matters. This unwritten administrative policy created a number of problems for the Department and for taxpayers.

◆ Form of the Return/Pre- Apportionment Consolidation

The Department's administrative policy was that consolidated returns should be filed on a pre-apportionment basis using a combined apportionment factor. That is, every corporation included in the consolidated return would combine their income or losses. This combined income/loss would then be apportioned to Georgia using a combined apportionment factor whereby every corporation's apportionment factor numerators were added together and divided by every corporation's combined denominators.

Pre-apportionment consolidated reporting of this type can lead to significant swings in revenue for a state because there is no correlation between the relative amount of income or loss that a particular corporation will bring into the group and relative contribution of that corporation to the overall group apportionment factor. For example, a corporation with immense losses relative to other members of the Georgia consolidated group might have a relatively small Georgia apportionment factor and further, its overall apportionment factors might not contribute much to the overall consolidated group apportionment denominator. The net result would be a significant infusion of loss into the consolidated group even though the loss corporation's connection with the state is trivial.

Alabama experienced this problem first hand when they introduced elective pre-apportionment consolidation in 1997. Revenue losses for the state as a result of the consolidation election far exceeded estimates, even

though the election was binding for a period of years. As a result, Alabama moved in 2001 to a post-apportionment consolidated reporting system. It is likely that the "clearly and equitably reflect income in Georgia" and "transact a substantial portion of their business in Georgia" requirements in the former regulations were designed to limit exposure to this issue. *See infra*.

◆ SRLY

The Department had no clear policy regarding whether any Georgia SRLY limitations applied to net operating losses or other tax attributes. For example, it was arguably possible for corporations to include in their consolidated income or loss all net operating losses incurred and carried forward or back before the corporations began filing consolidated returns in Georgia. This issue also exacerbated potential revenue losses for Georgia as a result of allowing consolidation.

◆ Clearly and Equitably Reflect Georgia Income

As discussed *supra*, the Department attempted to limit "distortion" in the consolidated return (i.e., a disproportionate amount of a corporation's income or loss being reflected in Georgia consolidated income) through the "clearly and equitably" requirement. The problem was that the requirement as written was so vague as written as to arguably be unconstitutional under the Due Process Clause.

The Department had developed a number of unwritten administrative policies with regard to this requirement. For example, the Department would not allow the inclusion in a consolidated group of a holding/parent company commercially domiciled in Georgia if that holding/parent company had expenses attributable to subsidiaries not participating in the Georgia consolidated return (usually because they had little or no Georgia apportionment factors). A common example was a 100% Georgia holding company with significant NOLs as a result of interest expense from debt used to purchase out of state subsidiaries. In such cases, the Commissioner would either require the exclusion of the holding company from the consolidated return, or, if the taxpayer knew enough about Georgia's unwritten administrative policies to request it, require that the holding company allocated its losses amongst in-state and out of state subsidiaries. Of course, the allocation rules were also unwritten.

◆ Binding Election

Although the former consolidated return regulations specified that, once permission to file a consolidated return was granted, such permission was binding upon the taxpayer for future years, it was the Department's

administrative policy to issue permission letter for one year only, thereby requiring taxpayers to go through the permission process every year.

◆ Transact a Substantial Portion of Their Business in Georgia

Problems with this requirement probably most contributed to the drafting of new regulations. The Department had developed a hazy body of administrative policies concerning this requirement. For example, at one time or another, the Department required every taxpayer in the consolidated group to have a separate Georgia apportionment factor of at least 70% (but without using a double-weighted sales factor in the calculation). Sometimes the magic number was 80%.

The point is that the number was arguably arbitrary and unevenly applied amongst taxpayers, as well as being unwritten. This created issues under the Uniformity Clause of the Georgia Constitution and the Equal Protection Clause of the United States Constitution, and probably violated the rule-making provisions of Georgia's Administrative Procedure Act. Further, the requirement of a significant Georgia apportionment factor in effect favored in-state companies versus out of state companies. Therefore, this policy was likely unconstitutional for violating the Commerce Clause of the United States Constitution, which prohibits states from discriminating against interstate commerce in their tax laws. After the Missouri Supreme Court held that Missouri's requirement of a 50% apportionment factor for consolidation violated the Commerce Clause, the Department of Revenue began to seriously consider new consolidated return regulations.⁶

New Consolidated Reporting Rules

The Department convened a joint Department of Revenue-State Bar of Georgia Liaison Committee in 2000 to begin work on new consolidated regulations.⁷ The purpose of the Committee was to jointly develop regulations that would cure potential constitutional infirmities in the old regulations, move to a more elective form of consolidated reporting for taxpayers, limit revenue losses for Georgia as a result of moving to a more elective system, set down in writing all of the Department's unwritten policies, and give taxpayers significantly more guidance as to the scope of the Commissioner's discretion in granting permission.

New regulations were formally adopted by the Department under Ga. Comp. R. & Regs. r. 560-7-3.13 in November of 2002. The major changes in the new regulations are:

◆ Procedures for Requesting and Granting Permission

Permission to file a consolidated return is now accomplished by means of completing a form (Georgia Form IT-CONSOL) rather than through a letter and affidavit. Permission must be requested at least 75 days prior to the filing of a return.⁸ The Department may, if it has not had sufficient time to review the application prior to 15 days before the time of filing, issue only tentative permission, in which case the Department shall have 75 days to issue a final decision.⁹ If tentative permission is revoked, the taxpayers must file separate income tax returns within 60 days of the denial.¹⁰ Once permission is granted, the election to file consolidated is binding until such time as the group members cease to file a federal consolidated income tax return or business conditions change so that the Georgia income or the group is no longer clearly and equitably reflected by a consolidated return.¹¹

◆ **Composition of the Group**

The Department replaced the old standard for being in the consolidated group (i.e., companies that (a) requested to be included and (b) transacted substantial business in Georgia) with nexus consolidation. That is, each and every member in the federal consolidated group that has nexus with Georgia for income tax purposes must be included in the elective Georgia consolidated group.¹² Companies that have nexus with Georgia but are not required to file because they have immunity under federal law (P.L. 86-272) may not be included in the group.

◆ **Method of Consolidation**

The new regulations adopt a post-apportionment consolidation methodology.¹³ That is, each member of the consolidated group first calculates its own income or loss on a separate company basis. This income or loss is then apportioned to Georgia using that company's separate Georgia apportionment factor. After every company has calculated its separate Georgia apportioned income, this apportioned income or loss is added together to create the group's consolidated income. This method of calculation eliminates much of the potential for "distortion" inherent in the old pre-apportionment consolidation method and will likely minimize revenue losses for Georgia from elective consolidation.

◆ **SRLY Rules**

A detailed description of the new SRLY rules is outside the scope of this Article. However, the new rules do contain Georgia SRLY limitations intended to limit the introduction of pre-consolidation NOLs in consolidated income. Basically, companies in the Georgia consolidated group may only use pre-consolidation NOLs against their own separately calculated income or loss. Such losses may not be applied uniformly against con-

solidated group income. After individual each group member applies SRLY NOLs against individual income, any remaining income may be offset by consolidated group NOLs.¹⁴ The SRLY rules also address how consolidated losses follow individual members when they leave the consolidated group.¹⁵

◆ **Transitional Rules**

The strict Georgia SRLY rules will not apply for affiliated groups of taxpayers that were allowed to file Georgia consolidated income tax returns for years prior to the effective date of the regulations. Members of such consolidated groups may essentially import existing consolidated Georgia NOLs into the Georgia consolidated group and may use such losses against separate company income.¹⁶

◆ **Clearly and Equitably Reflect Income Requirement**

The new rules formally incorporate some of the Department's old unwritten policies concerning when inclusion of a company in the consolidated group will cause "distortion." For example, taxpayers are formally put on notice that expenses borne by companies within the Georgia consolidated group on behalf of companies not included in the group may be cause for adjustment by the Commissioner. Adjustment may include excluding such losses from the Georgia consolidated return, excluding the loss companies from the group, or denial of permission altogether.¹⁷

◆ **Effective Date**

The new regulations are effective for all tax years beginning on or after January 1, 2002.

Score Card

The new regulations address many of the concerns and problems caused by the old regulations. *Prima facie* unconstitutional provisions were excised and many unwritten policies were formalized pursuant to Georgia's Administrative Procedures Act requirements.¹⁸ Taxpayers have been given significantly more guidance concerning the scope of the Commissioner's discretion to grant permission for consolidated filing.

Some problems with the old regulations were never addressed. For example, a purely elective method of consolidation backed up by the Department's standard audit procedures would make the application process much more simple. Further, no procedures have been ~~implemented for protesting a denial~~ of permission by the Commissioner to file a consolidated return. However, given that the regulations have only been in

place for a short period, it remains to be seen whether the new regulations solve more issues than they raise.

- 1 Ga. Code Ann. § 48-7-21(a)(7).
- 2 Ga. Code Ann. § 48-7-21(a)(7)(A)(i).
- 3 Ga. Code Ann. § 48-7-51.
- 4 Ga. Comp. R. & Regs. r. 560-7-3-.06(4).
- 5 See, e.g., *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).
- 6 *General Motors v. Director of Revenue*, 981 S.W.2d 561 (Mo. 1998).
- 7 The Author was one of the State Bar representatives on the Committee.
- 8 Ga. Comp. R. & Regs. r. 560-7-3.13(2)(a).
- 9 Ga. Comp. R. & Regs. r. 560-7-3.13(3)(f).
- 10 *Id.*
- 11 Ga. Comp. R. & Regs. r. 560-7-3.13(4).
- 12 Ga. Comp. R. & Regs. r. 560-7-3.13(2)(b).
- 13 Ga. Comp. R. & Regs. r. 560-7-3.13(5).
- 14 Ga. Comp. R. & Regs. r. 560-7-3.13(8).
- 15 Ga. Comp. R. & Regs. r. 560-7-3.13(8)(h).
- 16 Ga. Comp. R. & Regs. r. 560-7-3.13(9).
- 17 Ga. Comp. R. & Regs. r. 560-7-3.13(3)(a)-(e).
- 18 Ga. Stat. Ann. § 50-13-1 et seq.

Exchanging Tenancy-In-Common Interests Under I.R.C. §1031: A Golden Opportunity or a Risky Proposition?

By Jesse O. Kaba
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Like-kind exchanges under I.R.C. §1031.

Section 1031 of the Internal Revenue Code ("§1031") has long been a useful and powerful tool to defer the recognition of capital gain and to provide a means to diversify and increase the flexibility of investments. In a nutshell, §1031 allows taxpayers to transfer their basis from an asset to a "like-kind" asset, without paying any tax on the realized gain in the transaction. Only certain property currently held for investment or productive use in a trade or business may be eligible for a §1031 exchange and the property in question must be exchanged for "like-kind" property.¹ In a traditional "forward" or "deferred" exchange, a third-party facilitator (a "qualified intermediary") is, for exchange purposes, assigned the contract for the sale of the taxpayer's currently held property (the "relinquished property"). The

property is transferred directly by the taxpayer to the relinquished property purchaser, the funds are held in escrow and then used by the qualified intermediary to purchase new qualified property (the "replacement property") within the statutory time constraints. The replacement property is deeded to the taxpayer directly by the replacement property seller.

§1031 is often used by individual taxpayers as part of a larger strategy in what can be tantamount to a permanent capital gain deferral. For example, assume a taxpayer converts a non-income producing property to an income producing office building in a §1031 tax-deferred exchange and holds the replacement property for the rest of his or her life. Under the current law, at the death of the taxpayer, the heirs can take advantage of IRC §1014 and receive a stepped-up basis equal to the fair market value ("FMV") of the inherited property.² Effectively, the gain on the originally transferred property is never recognized for income tax purposes.

TIC programs.

While many variations of tax-deferred exchanges exist, one variety has recently received significant attention. Rather than obtaining a 100% interest in qualified like-kind replacement property, taxpayers are increasingly using §1031 to obtain undivided fractional interests as tenants-in-common with other investors.

Tenant-in-common real estate investment structures, or "TIC programs", have gained popularity in the last few decades. "Promoters" sell undivided interests in the property at a premium and typically relinquish control as they sell off their entire interest, much like condominium or subdivision developers. In many TIC programs, the co-tenants enter into a contract with a property management company, which assumes daily responsibility for activities such as maintenance, security, and collecting rent from lessees. The rents are then distributed pro rata to the co-tenants, minus a management fee and expenses.

The TIC approach has recently become very popular. Real estate investment in general has historically grown stronger when Wall Street becomes sluggish because people tend to shy away from the perceived risk of the securities market. Unlike many other forms of real estate investment, TIC ownership is largely passive and requires little day-to-day management. Additionally, joint ownership as tenants-in-common may enable taxpayers to have a substantially more valuable investment with lower overall risk. For example, assume \$1.0 million will buy a 100% interest in a medium-sized gas station or fast food restaurant located in a marginal area. The same \$1.0 million could be invested in a 5% TIC interest in a highly desirable office building already net-leased to a tenant having a high credit rating. Furthermore, TIC programs allow taxpayers to rapidly identify and precisely tailor the desired

value of their replacement property, making such programs particularly well suited for §1031 exchanges. For example, suppose a taxpayer receives \$500,000 from the disposition of relinquished property in a §1031 exchange and can only find suitable replacement property to identify in the \$400,000 price range. The taxpayer will now have "boot" and will have to pay tax on any cash which cannot be reinvested in replacement property. However, if the taxpayer chooses to use a TIC interest as replacement property, the TIC sponsor³ can "carve out" an interest having a value of exactly \$500,000.

The problem with partnership interests.

§1031 specifically lists certain types of interests that may not be exchanged under the section's auspices.⁴ Interests in a partnership, securities, bonds, inventory, and choses in action are all examples of property excluded from non-recognition treatment under §1031. The exclusion of partnership interests from §1031 is especially relevant to the discussion of TIC interests. If a taxpayer, in an attempted §1031 exchange, trades into a TIC interest that is later characterized by the IRS to be a partnership interest under federal tax law, the §1031 exchange will fail, the gain on the relinquished property must be recognized, and income tax on such gain will be due.⁵ Clearly, exchangers must avoid buying into a partnership (or any other form of business entity) if they wish to receive tax-deferred treatment on the disposition of their relinquished property.

The question of whether a given ownership form constitutes a partnership for tax purposes is an area of potential conflict with the IRS. The term "partnership" is broad and is a question of fact and federal law. Characterizations under state law may be substantially immaterial.⁶ There need not be any official decision or writing between parties. A *de facto* partnership can exist by operation of law or by IRS interpretation. Practitioners looking to the federal tax code, case law, regulations, revenue procedures and other sources of federal tax law for a working definition of a partnership may be frustrated. There are no clear safe harbors by which two or more taxpayers may conform their actions to clearly defined parameters and be assured that the IRS will not find that a "partnership" has been formed.

Partners or tenants-in-common?

Suppose that several individuals all own undivided interests in a particular piece of real property. Are they co-tenants in a tenancy-in-common or are they partners in a partnership? With these limited facts, the individuals might be either, and we must examine a number of issues. Many tax professionals consider *Luna*⁷, a 1964 Tax Court case, to be a benchmark for the characterization of a business venture as being either a partnership or merely co-ownership. The court in *Luna* identified key factors in determining whether or not a given venture was a partnership, including

whether there was an agreement between the parties, whether the parties had control over income and capital, and whether business was conducted in the joint names of the parties, to name a few.⁸ In the earlier *Culbertson*⁹ case, the United States Supreme Court succinctly distilled this "partnership question" down to an inquiry as to whether "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."

While these two cases may cause trepidation for investors hoping to use TIC interests as §1031 replacement property, the IRS has provided significant guidance as to what joint owners may do to avoid being viewed by the IRS as a partnership for tax purposes. Treasury Regulation §301.7701-1(a)(2) states that "mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes." Similarly, Revenue Ruling 75-374 states: "The furnishing of customary services in connection with the maintenance and repair of [an] apartment project will not render a co-ownership a partnership." It appears that these "customary services" referenced in Revenue Ruling 75-374 incorporate standards similar to those in the regulations under I.R.C. §§856 and 512; these regulations provide a laundry list of services considered "customary" and should be referred to for guidance in drafting TIC agreements or structuring a §1031 exchange involving TIC interests.

There also exists the possibility of using I.R.C. §761(a) to elect out of the partnership provisions of subchapter K.¹⁰ This election, however, involves certain requirements that could prove more difficult for most TIC regimes to meet, when compared to the guidelines contained within the most recent IRS guidance on this subject, Revenue Procedure 2002-22.¹¹

The latest from the IRS: Revenue Procedure 2002-22.

In response to both growing utilization of TIC interests as §1031 exchange property and heavy lobbying from the TIC industry, Treasury issued Revenue Procedure 2002-22, outlining 15 prerequisites for obtaining a private letter ruling as to whether an undivided fractional interest in real property will be characterized by the IRS as a partnership. A large number of practitioners view these as 15 solid guidelines to follow so as to stay out of the "partnership zone", even though Revenue Procedure 2002-22 is not a true safe harbor. They are summarized as follows:

There can be a maximum of 35 co-owners, each holding title as a tenant-in-common under local law.

- The co-ownership may not file partnership or corporate tax returns, conduct business under a common name, represent itself to third parties as an entity. The co-owners may enter into a limited co-ownership agreement; rights of first sale and majority voting

requirements are specifically as allowed.

- All co-owners must retain the right to vote on major decisions, such as the hiring of a manager, the sale of the property, creation of "blanket" financing. Such decisions must be unanimous. Other actions may be by majority vote. Co-owners may give the manager a specific, but not global, power of attorney to act on their behalf.

- Each co-owner must have the right to sell and encumber their pro rata portion of the property without another co-owner's approval. Restrictions on co-owners' actions that are "consistent with customary commercial lending practices," however, are not prohibited. The co-owners may provide for a right of first offer as to alienation of portions of the property by other co-owners.

- If property is sold, any blanket lien must first be satisfied and the remaining proceeds then be distributed among the co-owners *pro rata*.

- Each co-owner must share in profits, debt and costs in proportion with their pro rata interest in the property, and co-owners may only advance funds to one another under strict guidelines.

- A co-owner may issue to another co-owner an option to purchase their interest (a call option), if the exercise price for the option reflects the FMV of the interest. An option to sell one's interest to a party related to the TIC transaction (a put option) is not allowed.¹²

- The activities of co-owners and their agents must be limited to those "customarily performed in connection with the maintenance and repair of rental real property." This would appear to include the furnishing of services such as HVAC maintenance, trash removal and the cleaning of public areas, to name a few.¹³

- Co-owners may enter into management or brokerage agreements with an agent who may be the sponsor or co-owner (but not a lessee), provided that such agreements are renewed no less frequently than annually. Net revenues must be distributed by the manager no later than three months after being received.

- All leases must be *bona fide* and arm's-length, reflecting FMV, but not predicated upon net income, cash flow or increases in equity.

- Any lender with respect to the property may not be a related party to any co-owner, the sponsor, or the manager.

- Payments to the sponsor for the acquisition of a co-ownership interest may only reflect the fair market value of the interest acquired and of the sponsor's services.

Making It Happen.

Revenue Procedure 2002-22 has served to vastly increase the confidence of attorneys, tax practitioners and those in the exchange industry in using §1031 to exchange TIC interests. Nonetheless, it is important to remember that it is not a safe harbor, only a set of requirements for obtaining a private letter ruling. The

utility of this procedure may also be lessened due to the time it often takes to obtain a favorable ruling from the IRS, which may not be practical for many exchanges. There is no absolute guaranty that the IRS will favorably regard a transaction conforming to Revenue Procedure 2002-22's guidelines. However, it appears that the IRS has warmed up to TIC structures, and has provided more and more detailed guidance for those seeking to utilize §1031 in the TIC context. Consequently, the TIC industry has expanded and investors (both sophisticated and fairly cautious) are using TIC interests as §1031 exchange property. Revenue Procedure 2002-22 should definitely be considered a guiding light, but it is important to also contemplate the sum of the case law and IRS guidance in structuring §1031 exchanges of TIC property, and to fully disclose to clients the potential risk if the IRS denies the tax-free exchange.

Additional Information on this Topic can be Found at:
- Lipton, "New Rules Likely to Increase Use of Tenancy in Common Ownership in Like Kind Exchanges," *Journal of Taxation*, May 2002.

- Lipton, "Like-Kind Exchanges of Undivided Interests in Real Estate: Wrestling with the Issues," 43 *Tax. Mgt. Memo* 35 (2/11/02).

- Merrill & Belanger, "Revenue Procedures and Rulings," *Tax Advisor*, June, 2002.

¹ While either personal or real property may be the subject of a §1031 exchange, our discussion here is limited to real property only.

² This is true under current law, but The Economic Growth and Tax Relief Reconciliation Act of 2001 reduces the step-up in basis in 2010 and then reinstates the pre-2001 law in 2011.

³ In the TIC industry, a "sponsor" refers to a person or entity that purchases commercial real estate and sells off portions to co-owners in exchange for compensation.

⁴ Internal Revenue Code §1031(a)(2)

⁵ Interest and penalties may also be imposed.

⁶ Internal Revenue Code §7701(a)(2) provides: "The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization." This is the official definition but perhaps not very useful in practice. See also Treasury Regulation 301.7701-1(a)(2) and IRC section 761(a).

⁷ *Luna v. Commissioner*, 42 T.C. 1067 (1964). See also Revenue Ruling 75-374, 1975-2 CB 261 and Revenue Ruling 79-77, 1979-1 CB 448.

⁸ *id.*

⁹ *Culbertson v. Commissioner*, 337 U.S. 733 (1949) at 742.

Charitable Remainder Trust- An Investment Tool

By Bob Willis, Willis Investment Counsel

This article will not discuss the usual tax and planned giving features of charitable remainder trusts (CRTs). Instead, this article will discuss a new approach to explaining CRTs to clients. CRTs are under-utilized, which suggests that the standard approach to explaining and "selling" CRTs is deficient. Practitioners often focus on tax and planned giving factors, but ignore investment factors. Some common reasons practitioners (and clients) offer in rejecting CRTs as a means to diversify a low basis concentrated stock position are: (1) the client does not need additional income, (2) the client has little charitable interest, or (3) the family will accumulate more wealth by just holding the stock.

THE PROBLEM: RISK IS MISUNDERSTOOD

Often, CRTs are incompletely presented because the psychological issues associated with investment and risks are misunderstood. Investment considerations, when understood, can offset most common objections to CRTs.

Some CRT models compare selling a low basis stock inside a CRT to not selling the stock at all. While these models consider some investment factors, usually they usually fail to address "decay" risk and behavioral finance influences on investor decision-making. By expressing the difference in the projected wealth accumulation in present value terms, the risk management trade-off of selling part of the low basis stock (to diversify and improve risk management) is better evaluated. If risk was better understood, especially its psychological elements, CRTs could be more effectively explained to clients.

SELLING LOW BASIS STOCK OUTSIDE VS. INSIDE A CRT

Table 1 compares an outright sale of low-basis Coke stock (Portfolio A) to selling that same stock inside a CRT (Portfolio B+C). This comparison illustrates that the client does not necessarily end up with less wealth accumulation when a CRT is used.

Table 1

End of Year	Portfolio A		Portfolio B + C		Portfolio C
	NO CRT	WITH CRT	Char. Deduction	Annual CRT	
	Portfolio Value	Portfolio Value	Tax Savings A/C	Distribs A/C	Portfolio
18	2,860,908	2,549,283	237,414	2,311,869	1,196,147
20	3,305,829	3,117,609	274,336	2,843,273	1,220,190
22	3,819,944	3,777,774	317,001	3,460,774	1,244,716
23	4,106,249	4,146,698	340,760	3,805,939	1,257,163
25	4,744,842	4,972,217	393,754	4,578,463	1,282,432
30	6,810,250	7,659,506	565,153	7,094,353	1,347,849

INVESTMENT REASONS TO SELL A CONCENTRATED POSITION

Although using a CRT does not necessarily mean the family will end up with less wealth, a CRT probably should not be used unless the client has charitable interests. With that said, the CRT can be a compelling investment tool regardless of the level of the client's philanthropic interest. Of course, outcomes 20-30 years from now are unknown. Therefore, whether the replacement/diversified portfolio (when the CRT is used) will accumulate more wealth than the concentrated Coke stock portfolio (the remainder of this article will assume that the client has an inappropriate concentration in low basis Coke stock) is unknown. The uncertainty of an outcome is what risk is all about.

BEHAVIORAL FINANCE - PAST TRENDS GIVEN TOO MUCH WEIGHT

Behavioral finance describes the influence of psychology on the behavior and decision-making patterns of investors. Simply put, people habitually over-weight their own experiences when they make decisions. For example, a person might assume that because Coke stock has performed well over the past thirty years, it will always perform well.

This naïve method of decision making is not about ignorance or lack of sophistication. Rather, this decision making process describes the psychological phenomenon of basing decisions on recent trends. People habitually project recent trends into the future. Over-reliance on data or experience that is most available and most familiar is well-documented. Such reliance is not an objective or complete analysis. But, it is often all the "analysis" that is done.

Another way to view this behavioral issue is in how one frames any analysis. People cannot help but frame an issue in the context of their own experiences. That is how the human brain works. While experience may lead a hypothetical client to rely on the possibility of Coke stock continuing to generate solid long-term returns, the range of potential outcomes must give appropriate weight to Coke stock experiencing decay over the next ten years.

DECAY RISK - COMPETITION AND MEAN REVERSION

Most clients assume that the stock being considered for a CRT will continue to grow at a rate similar to that stock's impressive past trend. These clients usually assume that the stock will continue to grow at a rate at least equal to the overall market rate of return. This assumption is problematic and fails to reflect a clear

tendency of stock prices to experience "decay." There is a pronounced tendency for stocks that have enjoyed a price appreciation rate that far exceeds the market rate of return to eventually enter a long period of growth that is below the market's growth rate. In short, decay is a pronounced slowing of the stock's growth rate. Many times an above average twenty-year stock growth rate decays into a thirty-year market growth rate as the next ten years (from year 20 to year 30) experience a much slower growth rate.

This decay risk should be considered by clients when they assign a high probability to the stock continuing to grow at the rate they have become accustomed to (but few clients do little more than rely on recent stock price trends). Clients should not under-weight the possibility that the next ten-year growth rate of their Coke stock could be much less than the last ten years, even less than the market's return. Consider the following table of stock prices stocks:

Table 2

COMPANY	12/31/82	12/31/92	12/31/02	28-92%	92-02%
	Price	Price	Price	Change	Change
S&P 500 Median	5	15	29	200%	93%
McDonalds	2	12	18	500%	50%
Bristol Myers Sq	4	17	25	325%	47%
Disney	1	14	17	1300%	21%
General Mills	6	34	41	467%	21%
Kellogg	3	34	32	1003%	-6%
Apple Computer	7	30	16	328%	-47%

How much annual decay would it take for the CRT portfolio to eventually exceed the concentrated portfolio? That is, how much less (as compared to the CRT portfolio) would the average annual growth rate of the client's low basis stock over the next 15-25 years have to be for the CRT portfolio to have a reasonable opportunity of accumulating more wealth for the client? The following table is over-simplistic, but it illustrates that a drastic decay rate is not required. The crossover year column is the projected year when the CRT portfolio value could exceed the concentrated stock portfolio.

Table 3

Column A	Column B	Column C
Don't Sell Coke Portfolio CAGR	Sell Coke via CRT Portfolio CAGR	Crossover Year
6.00%	6.50%	23
6.50%	7.50%	21
7.00%	8.25%	20
7.50%	9.00%	19

Column C indicates how many years it takes for the CRT strategy (Col. B) to accumulate a greater amount for the family than the concentrated strategy (Col. A).

A "CAN'T SELL" MINDSET LEADS TO COMPLACENCY

Complacency is another investment behavior problem that interferes with effective risk management. Investors tend to pay less attention to stocks that are performing well. There is a tendency not to worry about a stock that is following a pleasing upward trend line. That tendency is especially strong if the decision to never sell the stock has been made. By deciding to never sell the stock (because of the low basis), any serious analysis of the stock will cease.

RESTORATION OF RATIONAL VS. EMOTIONAL DECISION-MAKING

If the Coke stock concentration / lack of diversification issue did not exist, the client could dismiss behavioral finance as irrelevant to the family's wealth management. Even with a concentrated position, the client could decide that the concentration risk was reasonable and prudent.

The following question is often an effective way to prove emotional influences must be present:

Today, if you owned no Coke stock, would you write a check to buy exactly the same amount of Coke stock that you now own?

Most clients respond "no" because they know it would not be prudent to establish that amount of concentration in any stock. When asked why they responded "no" they will give the right answer (it is not prudent or sound investment practice). This dialogue helps illustrate that emotions are playing a large role in the client's decision, because maintaining the undesirable concentration is the same as establishing the concentration. Most clients will acknowledge the incongruence between their prudent answer and their imprudent status quo stance, but will circle back to their original position--there is no resolution to the low tax basis dilemma. If the CRT is established, and the Coke stock is transferred to it, then the tax dilemma is eliminated and the client can more rationally, and less emotionally, revisit the investment logic of remaining concentrated in Coke stock.

CONCLUSION

Clients must be educated on the power of their emotions. They must also be educated that investment and

risk management are about trade-offs, not about which portfolio accumulates the most money. Table 2, above, shows the danger of naïve (or emotional) behavior. Hundreds of years ago Horace knew this when he said in *Ars Poetica*: Many shall be restored that now are fallen and many shall fall that now are in honor.

This article is a condensed version that will appear in the Estate Planning Journal in the Spring. For sources, explanation of tables, and calculations go to Research section of www.wicinvest.com.

Testamentary Trust as the Beneficiary of an Individual's Retirement Plan in Georgia

By Sarah Moore, Kilpatrick Stockton, LLP

Today's clients often have significant amounts of wealth invested in individual retirement accounts and other tax-qualified retirement plans. As this article will describe, the most appropriate estate planning strategy for a client with significant tax-qualified retirement assets may be to name a testamentary trust (a trust to be created in the client's will) as the beneficiary of these assets. This strategy can fulfill the client's asset management objectives while preserving income tax deferral opportunities for the assets. Under current Georgia law, however, it is unclear whether this strategy would be effective.

Estate Planning Rationales Behind Naming Trusts as Plan Beneficiaries

There are four fairly common situations in which naming a trust as the beneficiary of retirement plan assets makes sense from an estate planning standpoint. Those situations may exist where:

- ♦ A married individual's primary asset is a retirement plan and that individual has an insufficient amount of assets outside of the plan to fund a credit shelter trust. This client may want to name a credit shelter trust as the beneficiary of a portion of the retirement plan to maximize the use of his or her estate tax credit. As the applicable credit amount increases, this option becomes more important.
- ♦ A person in a second marriage has children from a first marriage. Here, the parent may want to name a marital trust as the beneficiary of his or her retirement plan to provide for the surviving spouse during the sur-

living spouse's lifetime but to insure that the children of the first marriage will inherit the remaining plan asset upon the surviving spouse's death.

- ♦ A parent has a young child (or an adult child with poor judgment) and does not want the child to have unrestricted access to the retirement funds when the child reaches age 18. By placing the retirement assets in a trust, the parent can control the distribution of the funds - either by releasing the funds in smaller increments every few years, or by waiting until the child reaches a more mature age to distribute the funds.
- ♦ A member of the family is disabled or otherwise impaired. A parent of a disabled child may want to name a "special needs" trust as the beneficiary of his or her retirement plan assets in order to provide for the child's needs that are not otherwise covered by a state or federal agency. If these funds were distributed outright to the special needs child, the child may cease to qualify for certain federal or state benefits.

Preserving Income Tax Deferral Benefits When Naming Testamentary Trusts as Plan Beneficiaries

In general, all assets in a tax-qualified retirement plan, including an IRA, which names a non-individual as a beneficiary (e.g., the estate of the account holder or a non-qualifying trust) are required to be paid out to the named beneficiary no later than the end of the fifth year following the account holder's death. Under applicable tax regulations, however, a trust meeting certain requirements may be named as the account beneficiary and the life expectancy of the oldest trust beneficiary may be used to calculate the minimum distribution requirements from the plan after the account holder's death. This longer distribution period allows the assets in the plan to grow on a tax-deferred basis and spreads the income tax burden on distributions from the plan over a much longer period. The benefits of this long term tax-deferred compounding of the plan assets can be substantial and particularly attractive when coupled with other non-tax estate planning objectives of the client.

Georgia Law Does Not Address Naming Testamentary Trusts as Plan Beneficiaries

Despite the positive tax and estate planning attributes, it is unclear whether Georgia courts would recognize a testamentary trust as a legitimate beneficiary of retirement plan assets. The courts may express a concern that the plan's beneficiary designation form does not satisfy the formalities required for a valid will or other testamentary devise. While section 53-12-71 of the Georgia Code permits a testator to transfer part or all of his estate to a testamentary trust by will, the Georgia Code does not address the validity of a bequest to a

testamentary trust made in a non-probate document, such as a retirement plan or life insurance policy beneficiary designation form.

If the Georgia Code were interpreted to disallow naming a testamentary trust as the beneficiary of retirement plan assets, then the only option for a Georgia resident is to create an inter vivos trust to name as the beneficiary of such assets in order to accomplish the estate planning and tax deferral goals described above. Unfortunately, this option involves unwarranted expense and administrative burdens on the client.

For the foregoing reasons, Georgia should amend its probate code to specifically permit Georgia residents to designate a trustee named in an individual's will as the beneficiary of death benefits of any kind, including retirement plan benefits. South Carolina enacted such a law at Section 62-2-510 of its probate code.

Paragraph (c) of that section allows death benefits to be paid to a trustee named in the will of the account holder. Such payments are deemed to pass directly to the trustee and are specifically not be deemed to have passed to the executor of the estate, thus avoiding the unfavorable five-year minimum distribution rules.

A statute such as that enacted in South Carolina leaves no doubt as to the validity of naming a testamentary trust as the beneficiary of retirement plan assets. Until a similar statute is enacted in this state, Georgia practitioners may want to advise their clients to create an inter vivos trust as the beneficiary of retirement plan assets. In the alternative, the client could take the risk of naming a testamentary trust as the plan beneficiary and try to protect against a negative judicial decision by executing the beneficiary designation form with all the formalities required for a valid will.

2002 Southeast Region IRS/Bar Liaison Committee Meeting

By Jeffrey H. Kess, Alan C. Manheim, LL.C.

On October 10 and 11, 2002, I attended the 2002 Southeast Region IRS/BAR Liaison Committee Meeting held at the TradeWinds Island Grand Beach Resort & Conference Center in St. Pete Beach, Florida. Representatives from fifteen (15) of the southeast region state bar associations together with a host of Internal Revenue Service senior officials from all over the country were in attendance. There was a lot of information about the continuing Internal Revenue Service reorganization together with the Internal

Revenue Services goals, objectives and other newsworthy items disseminated at the meeting. This communication was invaluable. The following was excerpted from the minutes of the meeting prepared by Martin J. Horwitz, Esq., Chair of the 2002 Southeast Region IRS/BAR Liaison Committee Meeting.

Some of the goals, objectives and other newsworthy items within the Internal Revenue Service were discussed openly at this bar liaison. The following target areas were discussed as audit and collection goals, coordinated with Criminal Investigation for the upcoming fiscal year:

- o Tax abuse promoters and trusts
- o Off-shore abuse
- o Abusive corporate shelters
- o High-income underreporters
- o Employment taxes for in-service businesses

It was announced that in the future, individual collection matters are going to be handled primarily through the automatic collection system ("ACS"), while Revenue Officers will focus on in-service business delinquent employment taxes. The Internal Revenue Service hopes that any in-service business with delinquent employment taxes will be contacted within thirty (30) days of such delinquency for immediate attention and response. LMSB will focus immediately in the areas of tax-sheltered promoters, tax-sheltered investors, and tax shelters in general.

There were comments regarding the National Research Program ("NRP"). This program is suggestive of the old "TCMP Program"; but hopefully will be much less intrusive. Approximately thirtythree percent (33%) of the "examination divisions" resources will be allocated to conduct up to fifty thousand (50,000) fact-gathering exams nationwide.

The Office of Appeals has announced several new programs and enhancement of others. In the tax shelter area, Appeals is working towards early stage determination and prompt resolution. The goal is to provide a preemptive early resolution on aggressive issues rather than a delayed reaction after the issue balloons into a large national participation. The issues today for application of a settlement approach are:

- o Corporate-owned life insurance
- o Section 351 shelter approach
- o Section 302/318 basis shifting

Additionally, Appeals has introduced or expanded on three different approaches to problem solving;

- o Fast-track mediation
- o Fast-track settlement
- o Post-appeals mediation

Information on all of the above is available at www.irs.gov/appeals.

Hiring has been scant; five hundred (500) Revenue

Agents and zero (0) Revenue Officers have been hired for this fiscal year; such hiring does not even keep up with attrition. There is hope there will be more hiring in 2003. Criminal Investigation with thirty five hundred (3,500) agents in 1995, now has approximately two thousand nine hundred and fifty (2,950) agents. Such agents are being challenged in many areas including terrorism assistance, money laundering and illicit income issues. Nevertheless, Criminal investigation has initiated three thousand nine hundred and one (3,901) cases in the past fiscal year, with twenty one hundred (2,100) prosecution recommendations. Initiations are up while targeting more sophisticated taxpayers and shelter operations. Criminal Investigation reported an incarceration percentage of eighty percent (80%) following convictions. The national focus now appears to be corporate fraud and abusive trusts.

Following recent years of fluid reorganization, the IRS is barely recognizable. Who is accountable and where do you go with a problem? It is not easy to understand.

The Southeast Region IRS/Bar Liaison Committee Meeting is the ultimate means of keeping informed as to the direction of the Internal Revenue Service and to stay in contact with those making and implementing policy. Thank you for the opportunity to participate and for the unique insight and information that I gained. Please do not hesitate to contact me with any questions you may have.

Results of November Ballot Questions on Property Tax Issues

By Scott M. Dixon, Dixon Law Firm, PC

Five of the six statewide proposed Constitutional Amendments on the ballot in the 2002 General Election last November were questions relating to property taxes. All five of the Referendum questions concerned property taxes.

Following is a summary of the official ballot questions, along with the election results and percentage of answering votes, according to the Secretary of State's website:

Statewide Constitutional Amendment No. 1

YES (78.8%) Shall the Constitution be amended so as to provide that certain officeholders or candidates who are defaulters for federal, state, or local taxes shall be ineligible to hold any public office in this state?

Statewide Constitutional Amendment No. 2

NO (53.9%) Shall the Constitution be amended so as to provide that qualified low-income building projects may be classified as a separate class of property for ad valorem property tax purposes and different rates, methods, and assessment dates may be provided for such building projects?

Statewide Constitutional Amendment No. 3

YES (59.6%) Shall the Constitution be amended so as to provide that counties and municipalities may establish community redevelopment tax incentive programs under which increased taxation shall apply to properties maintained in a blighted condition and decreased taxation shall apply for a time to formerly blighted property which has been rehabilitated?

Statewide Constitutional Amendment No. 4

YES (68.6%) Shall the Constitution be amended so as to provide that the General Assembly may provide by general law for the separate classification and taxation of properties on which there have been releases of hazardous waste, constituents, or substances into the environment so as to encourage cleanup, reuse, and redevelopment of such properties?

Statewide Constitutional Amendment No. 5

NO (56.7%) Shall the Constitution be amended so as to provide that commercial dockside facilities consisting of real and personal property whose primary use is the landing and processing of seafood may be classified as a separate class of property for ad valorem property tax purposes and different rates, methods, and assessment dates may be provided for such dockside facilities?

Statewide Referendum A

YES
(79.6%)

Shall the Act be approved which changes the state-wide \$10,000.00 homestead exemption from all school district ad valorem taxation for educational purposes for persons 62 years of age or older by changing the \$10,000.00 gross household income limitation to a \$10,000.00 net income, excluding certain retirement income, of the applicant and spouse thereof?

NO
(55.2%)

Statewide Referendum C

Shall the Act be approved which grants an exemption from ad valorem taxation on certain historic property owned by a nonprofit corporation which houses a medical museum or medical society?

Statewide Referendum B

YES
(83.0%)

Shall the Act be approved which provides that an exemption from certain ad valorem taxation for the surviving spouses of military personnel killed while serving in a war or armed conflict shall extend to the surviving spouse of such persons who otherwise died as a result of such war or armed conflict?

NO
(67.1%)

Statewide Referendum D

Shall the Act be approved which grants an exemption from ad valorem taxation on commercial fishing vessels whose primary use is the catching of seafood?

YES
(72.2%)

Statewide Referendum E

Shall the Act be approved which increases the total value of the exemption from the payment of ad valorem taxes on certain tangible personal property owned by the taxpayer within the county from \$500.00 total value to

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