FEDERAL TAX UPDATE

The Most Important Developments in
Federal Income, Estate & Gift Taxation Affecting Individuals

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This update explains several developments in the substantive federal income, estate and gift tax laws affecting individual taxpayers and small businesses. It contains summaries of the ten most significant cases, regulations, legislation and other matters from August, 2011, through January, 2013. This update generally does not discuss developments in the areas of qualified plans or the taxation of business entities (except to a very limited extent).

1. CONGRESS ACTS!

On January 1, 2013, the Senate passed the American Taxpayer Relief Act of 2012 ("ATRA 2012") by a vote of 89-8. That same day, the House passed the bill by a vote of 257-167. President Obama signed the bill into law on January 2, 2013. ATRA 2012 is notable for averting the tax side of the so-called "fiscal cliff" by extending or making permanent tax legislation passed in 2001, 2003, 2009, and 2010. How Congress intends to pay for the estimated revenue losses from ATRA 2012 ($3.63 trillion over ten years, according to Congressional Budget Office estimates) remains to be seen, as the legislative and executive branches agreed to postpone the spending side of the cliff by March of this year. This handout summarizes some of the key provisions of ATRA 2012.

A VISUAL GUIDE TO ATRA 2012

	2012	2013 – without ATRA	2013 – ATRA
Income Tax			
Rates - ordinary income	10%, 15%, 25%, 28%, 33%, 35%	15%, 28%, 31%, 36%, 39.6%	10%, 15%, 25%, 28%, 33%, 35% **(except for estates and trusts)**, 39.6%
Rates - net capital gain	• 15% for taxpayers in the 25% bracket and above • 0% for taxpayers in the 10% and 15% brackets	• 20% for taxpayers in the 28% bracket and above (18% if held > 5 years) • 10% for taxpayers in the 15% bracket	• 20% for taxpayers in the 39.6% bracket • 15% for taxpayers in the 25%, 28%, 33%, and 35% brackets • 0% for taxpayers in the 10% and 15% brackets
Treatment of dividends	"Qualified dividends" treated as net capital gain	All dividends treated as ordinary income	"Qualified dividends" treated as net capital gain

	2012	2013 – without ATRA	2013 – ATRA
Surcharge on net investment income	None	3.8% of either net investment income, or, if less, taxable income minus a threshold amount ($250,000 for MFJ, $125,000 MFS, $200,000 all others)	3.8% of either net investment income, or, if less, taxable income minus a threshold amount ($250,000 for MFJ, $125,000 MFS, $200,000 all others)
Marriage penalty	None in the 10% and 15% brackets	All brackets	None in the 10% and 15% brackets
Overall cap on itemized deductions (§68)	Did Not Apply	Reinstated	Reinstated, but limited $300,000 threshold for MFJ ($150,000 for MFS); $275,000 head of household; $250,000 unmarried
Maximum §179 election	$139,000	$25,000	$500,000 for 2012 and 2013
Bonus depreciation	§168(k) - 50% bonus	None	§168(k) – 50% bonus (through 2013)
Estate Tax			
Exemption amount	$5.12 million	$1.0 million	$5.25 million
Tax rate	Flat (35%)	Progressive (up to 55%)	Flat (40%)
Portability election	Available	Unavailable	Available
Gift Tax			
Exemption amount	$5.12 million + if elected, the DSUE Amount	$1.0 million	$5.25 million + if elected, the DSUE Amount
Tax rate	Flat (35%)	Progressive (up to 55%)	Flat (40%)
Generation-Skipping Transfer Tax			
Exemption amount	$5.12 million	$1.0 million (indexed from 1997)	$5.25 million
Tax rate	Flat (35%)	Progressive (up to 55%)	Flat (40%)

Individual Marginal Tax Rates for 2013 After ATRA (expected)

Rate	Unmarried	Married – Joint	Married – Separate	Head of Household	Trusts/Estates
10%	$0 - 8,925	$0 - 17,850	$0 - 8,925	$0 - 12,750	
15%	$8,926 - 36,250	$17,851 - 72,500	$8,926 - 36,250	$12,751 - 48,600	$0 - 2,450
25%	$36,251 - 87,850	$72,501 - 146,400	$36,251 - 73,200	$48,601 - 125,450	$2,451 - 5,700
28%	$87,851 - 183,250	$146,401 - 223,050	$73,201 - 111,525	$125,451 - 203,150	$5,701 - 8,750
33%	$183, 251 - 398,350	$223,051 - 398,350	$111,526 - 199,175	$203,151 - 398,350	$8,751 - 11,950
35%	$398,351 - 400,000	$398,351 - 450,000	$199,175 - 225,000	$398,351 - 425,000	
39.6%	$400,001 +	$450,001 +	$225,000 +	$425,001 +	$11,951 +

Though much of ATRA 2012 is permanent (well, as permanent as any tax legislation can be, that is), the Act includes a number of one-, two-, and five-year extenders. Here are some of the more significant extensions:

• Above-the-line deduction for certain expenses of elementary and secondary school teachers (revived for 2012 and 2013)

• Above-the line deduction for qualified tuition and related expenses (revived for 2012 and 2013)

• American Opportunity Tax Credit (up to $2,500 credit for tuition, fees, and course materials for first four years of undergraduate education) (through 2017)

• Exclusion for discharge of qualified principal residence indebtedness (through 2013)

• Mortgage insurance premiums treated as qualified residence interest (revived for 2012 and 2013)

• Deduction for state and local sales taxes (revived for 2012 and 2013)

• Increased contribution limits for conservation contributions (revived for 2012 and 2013)

• Tax-free distributions from IRAs to charities (so-called "charitable roll-overs") (revived for 2012 and 2013) (distributions made from January 1 – January 31 deemed to have been made in 2012) (distributions made to taxpayers in December, 2012 qualify for tax-free treatment if paid to charity in January, 2013)

• 100% exclusion for gain on the sale of qualified small business stock held more than five years (revived for 2012 and 2013)

• S corporation stock basis reductions for corporate charitable contributions limited to basis (not value) of contributed property (revived for 2012 and 2013)

• Five-year recognition period for S corporation built-in gains tax (revived for 2012 and 2013) (with bonus provision that all payments received under installment sales of built-in gain property are treated as received in the year of sale for purposes of determining which recognition period applies)

2. PRIVATE FORMULA CLAUSES COME OUT CLEAN IN THE *WANDRY*

The taxpayers, a married couple, formed an LLC in 2001 that was funded in 2002. On January 1, 2004, they gave interests in the LLC to their children and grandchildren according to a formula that read as follows:

> I hereby assign and transfer as gifts, effective as of January 1, 2004, a sufficient number of my Units [in the LLC] so that the fair market value of such Units for federal gift tax purposes shall be as follows:

Name	Gift Amount
Kenneth D. Wandry	$261,000
Cynthia A. Wandry	261,000
Jason K. Wandry	261,000
Jared S. Wandry	261,000
Grandchild A	11,000
Grandchild B	11,000
Grandchild C	11,000
Grandchild D	11,000
Grandchild E	11,000
	1,099,000

> Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service ("IRS"). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless, if, after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law.

An appraisal in July, 2005, found that the value of a one-percent interest in the LLC was about $109,000. Accordingly, the gift tax return reported that each child received a 2.39-percent interest in the entity and that each grandchild got a 0.101-percent interest. The capital accounts of the LLC were adjusted to reflect these gifts.

When the Service determined that the value of a one-percent interest was in fact $150,000, it determined that each child received a gift of $366,000 (based on a 2.39-percent interest) and each grandchild got a gift of $15,400 (based on a 0.101-percent interest). That led to a deficiency. Before the Tax Court, the parties stipulated that the value of a one-percent interest in the LLC was $130,000 at the time of the gift. The Service contended that each child received a 2.39-percent interest that was therefore worth $315,800 and that each grandchild got a 0.101-percent interest that was worth $13,346. But the taxpayers argued that the gift documents only conveyed $261,000 worth of LLC units to each child and $11,000 worth to each grandchild. If a one-percent interest was worth $130,000, they said, then each child in fact got only a two-percent interest, each grandchild only received a 0.0846-percent interest, and the capital accounts would be adjusted accordingly.

The Service argued that because the gift tax returns expressed the gifts as percentage interests in the LLC, the taxpayers in fact made a gift of percentage interests and not that number of units equal to a predetermined amount. But the Tax Court rejected this argument, concluding it was clear from the gift documents that the taxpayers' intent was to give a specific dollar amount's worth of units and not a specific percentage interest. It was helpful that the gift tax returns were consistent with this intent in reporting the dollar values of the gifts as $261,000 per child and $11,000 per grandchild. The percentage interests reflected on the schedules, said the court, were just derivative of the appraisal and not an expression of what was actually gifted.

The Service also argued that the taxpayer in fact gave percentage interests instead of fixed dollar amounts because the LLC's capital accounts were adjusted to give each child a 2.39-percent interest and each grandchild a 0.101-percent interest. In effect, reasoned the Service, if the LLC's books show each child having a 2.39-interest, then that's what each child in fact has. But the court rejected this argument too, noting that "The facts and circumstances determine … [the] capital accounts, not the other way around. Book entries standing along will not suffice to prove the existence of the facts recorded when other more persuasive evidence points to the contrary." Besides, observed the court, even if the Service was right in claiming that the interests reflected in the capital accounts were binding, the evidence of the capital accounts was from an undated, handwritten register. The court was not persuaded that the Forms K-1 were probative of what was given, for those forms only show year-end balances and not the actual percentage interests.

Finally, the Service argued that the language used to make the gifts here was an invalid savings clause under *Commissioner v. Procter*, 142 F.2d 824 (4^{th} Cir. 1944), and not a valid formula clause like the ones upheld in three recent decisions from the federal circuit courts of appeal. A savings clause, you see, takes the form of "if I give too much, I get it back," while a formula clause is in the form of "if I give too much, the excess goes somewhere else but not back to me." The Service contended that to the extent the final determination of value for gift tax purposes causes a smaller percentage interest to pass to the beneficiaries, it effectively means that the donors are getting some of the previously gifted units back, making this a *Procter*-like savings clause. But the Tax Court held the language used by the taxpayers was a valid formula clause. An ascertainable amount of interests was transferred, and the transfer was complete even though the value of a one-percent interest in the entity was unknown at the time of the gift. "It is inconsequential that the adjustment clause reallocates membership units among petitioners and the donees rather than a charitable organization because the reallocations do not alter the transfers. On January 1, 2004, each donee was entitled to a predefined … percentage interest expressed through a formula. The gift documents do not allow for petitioners to "take property back". Rather, the gift documents correct the allocation of … membership units among petitioners and the donees because the [appraisal] understated [the LLC's] value. The clauses at issue are valid formula clauses." *Wandry v. Commissioner*, T.C. Memo. 2012-88 (March 26, 2012).

Wandry is a game-changer, and perhaps the most significant court decision for estate planners in several years. Virtually all gifts involving hard-to-value assets should involve the use of a formula clause like that in *Wandry* (or, for the philanthropically inclined, like those in *McCord, Christiansen,* and *Petter*) so as to minimize the risk of owing more gift tax (and associated penalties and interest) due to good faith reliance on an appraisal that ultimately proves flawed.

In the end, *Wandry* is correctly decided. The taxpayers did not give a set *percentage* interest in the LLC while crossing their fingers that the value of that percentage interest would be within the applicable limitations (annual exclusion plus applicable exclusion amount). They instead gave each beneficiary a predefined *value* of interests in the LLC. When the initial determination of the associated percentage interest matching that value proved erroneous, the percentage interests were changed. The case really was that simple.

It's the aftermath of the case that proves more troubling for some professionals. The Service rightly worries that an aggressive client will now give an interest of predefined value in a closely-held entity (or some other hard-to-value asset), but then turn around and transfer all or substantially all of his or her interest to the beneficiary. "Hey," thinks the aggressive client, "if the Service ever catches me, then I'll adjust the gift backward to reflect the correct percentage interest. But since the Service won't collect any revenue from catching me, thanks to *Wandry*, it won't even bother to seek me out." If this attitude prevails, the Service is right that *Wandry* could undermine the integrity of the federal wealth transfer tax system. Why should the rest of us play by the rules if the aggressive pigs can play this abusive game and assure themselves they never lose? That's a hard argument to rebut. But it doesn't mean that *Wandry* was wrong or that there is no place for the "private defined value formula clause" in the estate planner's quiver.

Congress could easily solve for the abusive cases by imposing a penalty in cases where the value of the initial transfer pursuant to a defined value formula clause exceeds 120% of the value of the transfer as finally determined for estate and gift tax purposes. For example, suppose a donor purports to transfer $1 million in LLC units to a beneficiary through a private defined value formula clause. The beneficiary then receives a 30% interest in the entity. If the Service could prove that the value of this 30% interest is in fact worth $3 million, two things would happen: (1) the beneficiary's interest would be adjusted so that he or she receives only a 10% interest (with retroactive changes to capital accounts, of course); and (2) the donor would pay a penalty, perhaps equal to the gift tax that would have been paid on a $3 million transfer in the year of the gift. The Service would have incentive to make sure that the actual interests transferred match the formula clause, and donors would have the incentive not to abuse the formula. Most importantly, the integrity of the federal wealth transfer tax regime is restored (at least on this point).

One expects, however, that the Service will not wait for Congress to solve the problem through a solution like that proposed in the last paragraph. Planners were surprised that the Service ultimately stipulated to the dismissal of the *Wandry* appeal to the Tenth Circuit. Yes, the Service issued its nonacquiescence to the *Wandry* result, the equivalent of taking its ball and going home. But some speculate that the Service will raise its arguments again in another case, perhaps ideally one in which an appeal would lie in the Fourth Circuit (where *Procter* is controlling precedent and not merely persuasive authority). Frankly, the better strategy for the Service would be to codify its litigation position in *Wandry* through regulations. We know now that even interpretive tax regulations are entitled to deference on judicial review, so if the Service were to outlaw gifts through private defined value formula clauses (the form any such regulations would take is a matter of considerable speculation) one would expect such regulations to be upheld if challenged. In the normal course, regulations are made retroactive to the date they are first published as proposed regulations. This suggests clients should act quickly if they intend to rely on *Wandry*, for once regulations come out, the opportunity to use a private defined value formula clause may be lost.

3. PORTABILITY REGULATIONS

Treasury has issued temporary regulations providing guidance on the portability election and a surviving spouse's ability to use the deceased spousal unused exclusion amount of his or her last deceased spouse. Although the statute speaks of a "deceased spousal unused exclusion amount" that suggests the acronym DSUEA, the temporary regulations employ the acronym "DSUE amount." Beyond semantics, the temporary regulations contain a number of important clarifications.

First, the temporary regulations provide that the last return filed by the return due date, including extensions actually granted, will supersede any previously-filed return. This means a personal representative can supersede a previously-filed portability election on a subsequent timely-filed estate tax return. But the temporary regulations also make clear that once the due date for the estate tax return has passed, a portability election set forth on the last filed return is irrevocable.

Second, the temporary regulations require an estate claiming the portability election to file an estate tax return within nine months of the decedent's death (unless an extension of time for filing has been granted), regardless of the size of the gross estate and regardless of whether an estate tax return would otherwise be required to file a return. But in the case of smaller estates, the temporary regulations provide that estates not otherwise required to file a Form 706 do not have to report the value of certain property that qualifies for the marital or charitable deduction. Instead, the personal representative must estimate the total value of the gross estate (including the values of the property that do not have to be reported on the estate tax return under this provision), based on a determination made in good faith and with due diligence regarding the value of all of the assets includible in the gross estate. It is anticipated that the instructions accompanying the revised Form 706 will provide ranges of dollar values from which the personal representative would select the range that includes his or her best estimate of the total gross estate.

Third, and perhaps most important, the temporary regulations create an ordering rule under which a surviving spouse uses up the "DSUE amount" of his or her last surviving spouse before making use of his or her own basic exclusion amount. To illustrate, suppose for example that H1 died in 2011 with a taxable estate of $3 million, survived by H1's spouse, W. Assuming the executor of H1's estate files a timely estate tax return, W has $7.12 million of exclusion to play with for estate and gift tax purposes (W's own $5.12 exclusion plus $2 million of "DSUE amount" from H1's estate). If W makes a gift of $3.12 million in 2012, the gift is deemed to first reduce the DSUE amount to zero, with the remaining $1.12 million coming from W's basic exclusion amount. The ordering is important, because if W marries H2 and predeceases H2 in a year in which the portability election is available, the DSUE amount that passes to H2 can be as high as $4 million, the balance of W's basic exclusion amount.

Finally, the temporary regulations provide that the DSUE amount available to a surviving spouse includes both the DSUE amount of the last deceased spouse *and* any DSUE amount from a prior deceased spouse that has already been used up. To illustrate, assume the same facts as above except that H2 dies (sometime after W's $3.12 million gift) with a taxable estate that is $1 million less than H2's basic exclusion amount. Under the temporary regulations, W gets another $1 DSUE amount to play with (assuming a timely filed estate tax return for H2's estate) even though W already used $2 million of DSUE from H1. Though the statute speaks of a surviving spouse using only the DSUE amount of his or her "last deceased spouse," this giveaway in the regulations effectively encourages the wealthy surviving spouse to engage in the following planning: (1) gift the deceased spouse's DSUE amount, (2) remarry (preferably one who is "asset-challenged" and sickly), (3) outlive that new spouse, and (4) repeat as needed. Not a bad stunt if you can avoid prosecution. *Treas. Reg. §§ 20.2010-2T; 20.2010-3T; 25.2505-2T* (June 18, 2012).

4. THREE FAMILY LIMITED PARTNERSHIP/LLC CASES OF NOTE

Every year we see battles between the Service and taxpayers over so-called "family limited partnerships" and family LLCs. The past year brought three cases of significance, and two of them were taxpayer victories.

The first case was a taxpayer victory. The decedent, together with her husband, owned nine "woodland parcels" near a man-made lake in Tennessee. In 1997, they formed a family limited partnership to which they contributed these parcels in exchange for all of the partnership interests. The decedent and her husband formed the partnership both to simplify the gifting of interests in the parcels (they wanted the tracts to be a "family asset") and to protect the parcels against partition suits, as limited partners cannot force the partition of land held by the partnership.

From 1997 to 2000, the decedent and her husband made gifts of limited partner interests to their children, their children's spouses(!), and to their grandchildren. Interestingly, they did not claim valuation discounts on any of the gifted interests. They simply multiplied the percentage interest gifted by an appraised value of the collective real estate. By the end of their gifting spree, the decedent and her husband each owned a one-percent general partner interest, while their beneficiaries shared the 98-percent limited partner interests.

The partnership had a checking account at one point, but the account was closed since the partnership never generated any income. The only expense of the partnership was about $700 in annual real property taxes. The decedent and her husband paid these taxes from their own funds.

Following the decedent's death, the Service sought to unwind the partnership and include fifty percent of the undiscounted value of the nine parcels in her gross estate. But the Tax Court agreed with the taxpayers that § 2036(a)(1) did not apply on these facts because the arrangement qualified for the bona fide sale exception. The court determined that the desire to protect the parcels as a family asset immune from partition actions to be a legitimate and significant nontax purpose. Yes, facilitating gifts was also a motivation for the entity, but that alone does not flunk the bona fide sale exception.

The Service argued that a number of facts suggested the decedent and her husband failed to follow the formalities that would one would adhere to with respect to a legitimate entity. In addition to the decedent's direct payment of property taxes, the Service focused on the fact that the gifting documents, in the form of a "bill of sale," were inadequate proof and that divorce documents by which the decedent's former in-laws reconveyed their interests to their children pursuant to their divorce settlements failed to reference the partnership entity at all. While those facts were not helpful, the court felt that, on balance, the facts reflected the decedent's respect for the partnership as a legitimate entity. It certainly helped that the decedent was not dependent on distributions from the partnership (indeed, this partnership never made a distribution) and that there was no commingling of partnership and personal funds except for the personal payment of partnership property taxes. The court liked that the parcels were in fact conveyed to the partnership and the decedent and her husband were in good health at the time the partnership was funded. Although the court made favorable mention of the fact that the decedent and her husband never claimed valuation discounts when reporting their gifts of partnership interests, it is uncertain whether the absence of this fact would have led to a different result. *Estate of Stone v. Commissioner*, T.C. Memo. 2012-48 (February 22, 2012).

The second case was likewise a victory. The decedent suffered from Alzheimer's disease, so her children were appointed as her guardians. In that capacity, the children had the chance to sneak a peek at the decedent's will, only to discover that the will did not evenly divide her estate (mostly due to even appreciation in the assets to be gifted to each child). The children also became concerned about the decedent's personal exposure from ownership of two rock quarries on which active blasting frequently occurred. Acting on the advice of counsel, the children set about forming four family limited partnerships on behalf of the decedent. They transferred an equal amount of assets to three of the partnerships (one for the benefit of each child) and then transferred the rock quarries to a fourth partnership. Each of the partnerships had a corporate general partner owned entirely by the decedent. A local court approved the children's petition to implement this plan. Following formation and some gift transfers over three taxable years, the children caused the corporate general partner to be paid a management fee.

The Service took the position that the partnerships should be ignored for federal estate tax purposes and that the assets of the partnerships should be included in the decedent's gross estate. The Tax Court held that the partnerships should not be ignored. First, the court concluded that the partnerships were formed for substantial non-tax business reasons, thus triggering the bona fide sale exception to § 2036(a)(1). Formation of the partnerships helped ensure an equal distribution of assets to the children because they could pool assets of different values. The entities served to reduce liability exposure with respect to the assets, and this was a legitimate concern of the decedent and her children. Finally, all contributions were reflected on capital accounts that were properly maintained. "Decedent respected the partnerships and [the corporate general partner] as separate and distinct legal entities, observed partnership formalities, and retained sufficient assets for personal needs."

The court was not concerned with the management fee paid to the corporate general partner that the decedent controlled. The decedent already had sufficient assets outside of the partnership, so it's not like the decedent needed this fee in order to meet basic living needs. Further, reasoned the court, there is no authority that a management fee represents a retained right to income. Where, as here, the corporate general partner performs legitimate services, a management fee is appropriate and is not a retained right to income. *Estate of Kelly v. Commissioner*, T.C. Memo. 2012-73 (March 19, 2012).

But this last case was a victory for the Service. Here the decedent and his wife formed a family limited liability partnership in 2002. They contributed almost $8.7 million in cash, certificates of deposit, and stock (mostly in banks) to the partnership in exchange for all of the interests in the entity, though they still retained enough income-producing assets to meet their annual cash flow needs. Over time, they managed to give away the bulk of the partnership interests such that, at the decedent's death, the decedent owned a 27.8% limited partner interest and a 0.5% general partner interest. But the Service argued that the decedent's initial share of all the contributed property should be included in his gross estate, rather than the 27.8% limited partner and 0.5% general partner interests, because the entity should be disregarded.

The Tax Court held that the assets contributed to the partnership by the decedent had to be included in his gross estate. The estate argued that it qualified for the bona fide sale exception to § 2036(a), but the court disagreed. The estate argued that the decedent and his wife had three nontax reasons for forming and funding the partnership: (1) to consolidate assets for management purposes and allow someone other than themselves or their children to maintain and manage the family's assets; (2) to facilitate resolution of family disputes through equal sharing of information; and (3) to protect the family assets and the decedent's spouse from a beneficiary with addiction issues. But the court felt the evidence proved none of these reasons was legitimate. As for the first purpose, there wasn't anything to manage, really, since all of the contributed properties were passive assets over which neither the decedent nor the partnership had any real managerial control. Moreover, said the court, the decedent did not have a distinctive investment philosophy that the partnership would perpetuate. As for the second purpose, the court determined that the real source of family tension was a domineering child and not anything having to do with the partnership's assets. Thus, the need for equal sharing of information to reduce family tensions rang hollow. The final reason was also not supported by the facts, said the court, because there was no evidence that the decedent's spouse was vulnerable to the beneficiary with addiction issues. Since the bona fide sale exception did not apply, the Service was right to ignore the entity.

The case came back to the Tax Court when the estate posed a different argument. If the court would not change its mind as to the bona fide sale exception (which it didn't), then, claimed the estate, there is still no deficiency because it is now entitled to a larger marital deduction equal to the increased value of the gross estate. The problem with this claim, though, is that while all of the partnership assets are included in the decedent's gross estate, the partnership interests gifted to children and other beneficiaries during life means that at least some portion of those assets does not pass to the surviving spouse, a key element to the marital deduction. What the estate sought, specifically, was a marital deduction for the 21.7% interest that the decedent had gifted to his children during his life. Here was the basis for its claim: the will's pecuniary marital deduction formula clause allocated the minimum amount necessary to produce an estate tax of zero to a credit shelter trust with the balance passing to a QTIP trust. An increase in the value of the estate, therefore, means a dollar-for-dollar increase in the share allocable to the QTIP trust.

Nice try, but the court concluded that "[t]he regulations read as a whole suggest that irrespective of whether property is included in the decedent's gross estate, property that passed to a person other than a surviving spouse cannot also be considered as passing to the surviving spouse." Besides, said the court, it makes no sense to give a marital deduction for the share that actually went to the kids via their partnership interests since those interests will not be included in the spouse's gross estate when she dies, and that's a threshold requirement for securing a marital deduction. *Estate of Turner v. Commissioner*, 138 T.C. No. 14 (March 29, 2012).

5. AN ANNUAL EXCLUSION CASE OF NOTE

The decedent formed a family limited partnership with his wife in 1996. Formally, the partnership interests were held by their revocable living trusts. The decedent and his wife then made gift transfers of limited partner interests to various related parties in each of 1996 through 2000. The issue in this case is whether those gifts qualified for the annual exclusion. Since there were restrictions on a limited partner's right to transfer partnership interests outside of the family unless certain conditions are met, "the donees did not receive unrestricted and noncontingent rights to immediate use, possession, or enjoyment of the limited partnership interests themselves."

But that does not end the inquiry. As the court observed, the annual exclusion can still apply to the gifted interests if the estate could prove under the facts and circumstances that: "(1) the partnership would generate income, (2) some portion of that income would flow steadily to the donees, and (3) that portion of income could be readily ascertained." The court found that the estate did prove all three of these points, so the annual exclusions were upheld. Regarding the first requirement, the partnership held publicly-traded and dividend-paying stock. The partnership has received dividends throughout its existence. So it's easy to conclude that the partnership would generate income as of the date of each gift. With respect to the second requirement, "the fiduciary relationship between the general partners and the trustee of the Grandchildren Trust (one of the donees) shows that on the date of each gift some portion of partnership income was expected to flow steadily to the limited partners." Because the only assets of the Grandchildren Trust was the partnership interest, "distributions of partnership income to the trustee were necessary to satisfy the Grandchildren Trust's annual Federal income tax liabilities. The Court holds that the necessity of a partnership distribution in these circumstances comes within the purview of the fiduciary duties imposed on the general partners." Finally, regarding whether the income flowing to the donees could be readily ascertained, the court observed that the partnership "held publicly traded, dividend-paying stock and was thus expected to earn dividend income each year at issue. Because the stock was publicly traded, the limited partners could estimate their allocation of quarterly dividends on the basis of the stock's dividend history and their percentage ownership in the partnership."

Since all three requirements were met here, the gifts of limited partnership interests were present interest gifts on the date of each gift and thus qualified for the annual exclusion. In distinguishing this case from two others in which gifts of partnership interests did not constitute gifts of present interests, the court observed in a footnote that "unlike the taxpayers in *Hackl* and *Price*, decedent, in his fiduciary capacity as general partner of the partnership, made distributions each year at issue and was required to do so." *Estate of Wimmer v. Commissioner*, T.C. Memo. 2012-157 (June 4, 2012).

6. INCOME TAX CHARITABLE DEDUCTION CASES

Two cases concerning the §170 deduction for charitable contributions merit mention. The first involves a married couple that, in May, 2006, purchased property in Vienna, Virginia, with the intent to demolish the existing house on the property and construct a new one. Their realtor told them about the local fire department's "acquired structures program," under which a property owner allows the fire department to conduct live fire training exercises on his or her property. As part of the exercises, the fire department burns a designated building on the owner's property. Shortly after purchasing the Vienna property, the taxpayers contacted the local fire department and learned about the requirements for participating in the program. They then obtained a demolition permit. After completing all the other requirements, they executed documents granting the fire department the right to conduct training exercises on the Vienna property and to burn the house during the exercises. That October, the local fire department and six other fire departments used the Vienna property to conduct live fire training exercises, and during the course of these exercises the house was intentionally destroyed by fire.

On their 2006 return, the taxpayer claimed a charitable contribution deduction of $339,504 for the donation of the house to the fire department. The Service disallowed the deduction, concluding that the donation was a contribution of a partial interest in property and § 170(f)(3) denies a deduction for contributions of partial interests in property. The taxpayers claimed that they conveyed all of their right, title and interest in the house and not the underlying land, thus it was not a gift of a partial interest.

The Tax Court held that under applicable state law, the house is considered part of the land, so by conveying their entire interest in the house, the taxpayers were really conveying a portion of the property. "Where a taxpayer contributes to a charity an interest in a building that is part of the land under State law but retains all title to and interest in the remaining land, the taxpayer has donated less than his entire interest in the land." Further, this partial interest in the land did not fall within any of the exceptions to § 170(f)(3). It was not an undivided interest in the whole land, it was not a remainder interest in the residence, and it was not a qualified conservation contribution. In effect, said the court, the taxpayers conveyed a "mere license" that permits the fire department to do an act which without such a grant would be illegal. That license, in turn, is not an interest in the underlying property, meaning no deduction is allowed regardless of the value of the license. *Patel v. Commissioner*, 138 T.C. No. 23 (June 27, 2012).

In the second case, the taxpayers (again a married couple) granted a façade easement restricting the use of a single-family rowhouse located in a historic preservation district in Boston to the National Architectural Trust (NAT). NAT required that the taxpayers also donate a certain amount of cash (calculated as a percentage of the estimated value of the easement) for monitoring and administration of the easement, so the taxpayers contributed $16,840 late in 2003. The taxpayers claimed a deduction of $220,800 for the contribution of the easement, but they could only use $103,377 of that amount in 2003, so the balance ($117,423) carried over to 2004. They also deducted $16,870 as a cash contribution on the 2003 return (don't ask me where the extra $30 came from). When the Service denied all of these deductions, the taxpayers filed suit in Tax Court. The Service moved for summary judgment on the whole matter.

In an April, 2010, decision, the Tax Court granted the motion as to the donation of the easement but not as to the cash contribution. The court agreed that the taxpayers did not meet all of the requirements for a deduction of the easement. Among other things, the regulations require that "at the time of the gift, the donor must agree that the donation of the perpetual conservation restriction gives rise to a property right, immediately vested in the donee organization, with a fair market value that, at the time of the gift, is at least equal to the proportionate value that the perpetual conservation restriction bears to the value of the property as a whole." The taxpayers could not meet this requirement because the rowhouse was encumbered by a mortgage. "Petitioners concede that … the bank retained a 'prior claim' to all proceeds of condemnation and to all insurance proceeds as a result of any casualty, hazard, or accident occurring to or about the property. Moreover, petitioners do not dispute that the bank was entitled to those proceeds 'in preference' to NAT until the mortgage was satisfied and discharged. The right of NAT to its proportionate share of future proceeds was thus not guaranteed." Seeing no issue of material fact here, the court granted summary judgment on this issue to the Service.

The court would not grant summary judgment with respect to the cash contribution, however. On that point, the Service's position is that the cash contribution was a conditional gift in violation of the regulations and that it was a given as part of a quid pro quo, but the court agreed with the taxpayers that there is a genuine issue of material fact as to whether there was such an arrangement between the taxpayers and NAT. At trial, the Service argued that the cash payment was a prohibited conditional payment because the agreement between the taxpayers and NAT was that the cash would be refunded if the appraisal showed a zero value for the façade easement. The Tax Court agreed, concluding the taxpayers did not prove that by the end of 2003 that "the possibility of a zero appraisal value was not so remote as to be negligible." Thus the cash payment could not be deducted on the 2003 return because it was a contingent payment. However, the court rejected the Service's claim the cash payment represented a quid pro quo payment for services, as it saw no benefit to the taxpayers personally from the payment. The court did not view the cash donation as a payment made to enlist NAT's help in generating a deduction for the taxpayers. Ultimately, the court concluded that the taxpayers could claim a deduction for the cash payment in 2004, the year in which the conditions under which the payment would be refunded finally expired.

On appeal, the First Circuit focused its inquiry on whether the Tax Court correctly applied the regulation requiring subordination of a preexisting mortgage. The First Circuit found the Tax Court's interpretation of the regulation effectively made it so that no façade easements on encumbered properties could qualify for a deduction, and that was "surely contrary to the purpose of Congress." The taxpayers lacked any power to make the lender agree to subordinate the mortgage, yet the Tax Court's interpretation of the regulation would deny the taxpayers a deduction for a reason beyond their control. Besides, the court reasoned, tax liens could potentially trump the charity's right to funds upon extinguishment of the easement. The Tax Court's conclusion that the charity must have an "absolute right" to any proceeds as a condition to a deduction is therefore impracticable. The court sent the case back to the Tax Court to determine the proper value of the easement, with the instruction that the Tax Court consider the fact that the rowhouse was already subject to neighborhood landmark district rules. Those portions of the Tax Court's decision related to the cash contribution were affirmed. *Kaufman v. Commissioner* (1^{st} Cir., July 19, 2012).

7. IT’S NOT EVERY DAY YOU SEE REGULATIONS DECLARED INVALID

Where applicable, § 2032A allows a personal representation to elect to value qualified real property used for farming purposes (or in a trade or business) on the basis of the property’s actual use rather than its highest and best use. In this case, the decedent owned just over 61% of the stock in Finfrock Farms. On the date of the decedent’s death in 2008, the corporation owned four parcels of land totaling over 520 acres. The “adjusted value” (gross estate value less those directly attributable § 2053(a) deductions) of the gross estate was just over $2.6 million, and the adjusted value of the real estate held by the corporation was $1.775 million, about 68% of the value of the adjusted gross estate.

Because the surviving family members opted to cease farming operations on three of the four parcels of land, the estate claimed a § 2032A special use valuation only for the fourth parcel of land, the one that would continue farming operations after the decedent’s death. The estate claimed a special use valuation for the one parcel, but the adjusted value of that parcel (almost $403,000) was only about 15% of the adjusted value of the gross estate. That’s a problem under Regulation § 20.2032A-8(a)(2), for it requires not only that the adjusted value of all of the estate’s qualifying real property exceed 25% of the adjusted value of the gross estate but also that the value of the real property for which the personal representation makes the special use valuation election exceed such threshold. So the Service increased the reported value of the parcel from its special use value (about $227,000) to the agreed fair market value (the adjusted value, almost $403,000) and assessed additional tax on the difference.

An earlier decision from this court held that the regulation was invalid because there is no requirement in the statute that the value of the real property for which the personal representation makes the special use valuation election exceed 25% of the adjusted value of the gross estate. But the *Finfrock* court noted that the earlier decision pre-dated the Supreme Court’s decision in *Chevron v. National Resources Defense Council* (U.S. 1984). Now that *Chevron* requires courts to give deference to interpretive regulations, said the Service, the court should now find the regulation valid. *Chevron* is a two-step dance, however. In order for a regulation to get judicial deference, the court must first determine that “the statute is silent or ambiguous with respect to the specific issue.” If the intent is clear, both an agency and the courts must give effect to that intent. But if there’s an ambiguity, an agency’s interpretation of the statute will get deference if it is a “permissible construction of the statute” (not necessarily the best one).

The District Court here held that the statute is not at all ambiguous: “under the plain language of the statute, once the estate meets the thresholds identified in subsections (1)(A), (1)(B), and (1)(C), the only other requirement to qualify as ‘qualified real property’ is to designate the property in the required agreement. Congress did not require that the designation be of all or a certain percentage of the real property in the estate that meets the requirements of 1(A), 1(B), and 1(C).” Furthermore, reasoned the court, “[t]his additional requirement is contrary to the plain language of the statute. … The regulation neither clarifies an ambiguity in the statute, because the statute contains no ambiguity, nor fills any gap, as there is no gap to fill. Therefore, Treasury Regulation § 20.2032A-8(a)(2) is invalid.” The case presents other issues, however, so the litigation continues. *Finfrock v. United States* (D.C. Ill., March 20, 2012).

8. COMPANION CASES ON THE MORTGAGE INTEREST DEDUCTION

We all remember that taxpayers can deduct the "qualified residence interest" paid during any taxable year on a "qualified residence" (generally, the taxpayer's principal residence and one other residence as selected by the taxpayer). Qualified residence interest, recall, consists of the interest paid on the first $1 million of "acquisition indebtedness" (debt incurred to buy, build, or improve a "qualified residence") and the first $100,000 of "home equity indebtedness" (any other debt secured by the qualified residence, but only to the extent of the taxpayer's equity in the residence after subtracting any acquisition indebtedness). The mortgage interest deduction has been around long enough that we know virtually all of its wrinkles. But this year there were two cases in the Tax Court that proved there were still some ambiguities to resolve.

In the first case, the taxpayers, Charles and Bruce, together owned their Rancho Mirage, California, home as joint tenants with rights of survivorship. For the taxable years in question, the principal balance for the mortgage on the home (which qualified as acquisition indebtedness) was about $2.7 million. On their 2006 and 2007 returns, the taxpayers took the position that they could each deduct the interest on up to $1.1 million of the mortgage ($1 million as acquisition indebtedness, $100,000 as home equity indebtedness), meaning that between the two of them they could deduct interest on the first $2.2 million of the mortgage.

Reasoning that the $1.1 million limitation applied <u>per residence</u> and not per taxpayer, the Service determined that each taxpayer could only deduct the proportionate share of the interest paid on the first $1.1 million of the mortgage. The Service determined each taxpayer's deduction according to this formula:

$1.1 million
---------------- x total interest paid by the taxpayer = deductible interest paid by the taxpayer
Total debt

The Tax Court agreed with the Service's approach. It noted that the statute uses the phrase "any indebtedness with respect to any qualified residence" in defining both acquisition indebtedness and home equity indebtedness. That phrasing suggests that the limitations should be applied per residence. If Congress intended the limitations to apply per taxpayer and not per residence, the court reasoned, it would have added "of the taxpayer" at the end of that phrase. Moreover, said the court, married couples who co-own their residence and file joint returns must deal with a $1.1 million limitation, and married couples filing separately see that $1.1 million figure sliced in half. The taxpayers argued that Congress intended a marriage penalty in this situation, that it's one of the hazards of filing a joint return. But the court found no evidence of Congressional intent for this result, so it upheld the asserted deficiencies. *Sophy v. Commissioner*, 138 T.C. No. 8 (March 5, 2012).

In the second case, the taxpayer obtained a $1 million mortgage to help finance the purchase of her home. Although she was married, the taxpayer paid the mortgage only with her own funds during the taxable year at issue (2007). The taxpayer elected "married filing separately" filing status on her 2007 tax return and claimed a deduction for all of the interest paid on the $1 million of mortgage debt. The Service determined a deficiency on the basis that, by claiming "married filing separately" status she was limited to a deduction for interest paid on the first $500,000 of home acquisition indebtedness plus the interest paid on $50,000 of home equity indebtedness. This is consistent with the statute, as § 163(h)(3)(B)(ii) clearly limits a married taxpayer filing separately to a deduction for interest paid on the first $500,000 of acquisition indebtedness, and § 163(h)(3)(C)(ii) similarly limits the deduction to interest paid on the first $50,000 of home equity indebtedness.

The taxpayer argued that these limitations are intended to apply where both husband and wife are claiming mortgage interest deductions so that together they do not claim a deduction on more than the first $1 million in acquisition debt or more than the first $100,000 in home equity debt. Here, she claimed, the taxpayer was the only one paying the mortgage interest, so the half-sized limitations should not be imposed on her simply because she chooses to file separately. The Tax Court rejected this argument. The statutory language is clear and the taxpayer did not offer "any unequivocal evidence of legislative purpose which would allow us to override the plain language." The court thus upheld not only the limitation on the interest deduction but also an accuracy-related penalty. *Bronstein v. Commissioner*, 138 T.C. No. 21 (May 17, 2012).

9. FINALLY—GUIDANCE ON THE MEANING OF "A HOME"

Section 107 allows a member of the clergy to exclude from gross income "the rental value of a home furnished to him as part of his compensation" for carrying out his or her duties (or any rental allowance to the extent it is used to rent or provide "a home" and to the extent the allowance does not exceed the fair rental value of the home, its furnishings, and reasonable appurtenances). Many congregations have come to rely on this exclusion as an efficient means of providing compensation to their clergy members. But as at least one holy text reminds us, all good things have limits.

The taxpayer, an ordained minister for Mighty Horn Ministries, and his wife owned both a principal residence and a lake home. The taxpayer received a parsonage allowance for both homes, and the taxpayer excluded the entire allowance from gross income. The Service assessed a deficiency on the grounds that § 107 only permits exclusion of parsonage allowance on "*a* home" (i.e., one home). The taxpayer went to Tax Court, arguing that the statute merely requires property to be used as a residence ("a *home*") and that it does not impose a limit on the number of properties than can serve as a residence for this purpose.

The Tax Court (7-6) held that the taxpayer's interpretation was correct. Tracing the history of § 107 and its predecessors, the majority concluded that the phrase "a home" was used to distinguish residences from properties on which business activities were conducted. Further, § 7701(m)(1) cross-applies 1 U.S.C. § 1 (the so-called "Dictionary Act"), which provides that unless the context suggests otherwise, "words importing the singular include and apply to several persons, parties, or things." The dissenters believe the context here indeed suggests the intent to limit the exclusion to allowances paid in connection with a single residence. They argue that most people have only one home, so it is fair to say the plain meeting of "a home" is a "a single residence." They also argued that extending the exclusion to multiple residences would not accomplish any legislative purpose.

On appeal, the Eleventh Circuit embraced the position of the dissenters and reversed the Tax Court. The appellate court determined that the Tax Court majority made too much of the cross-reference to the Dictionary Act. Under § 7806(a), cross-references are made only for convenience and are to be given no legal effect. There is also Supreme Court precedent for the proposition that the Dictionary Act does not apply if "the context indicates otherwise." Since the context of § 107 does not support the application of the Dictionary Act's singular-to-plural provision, the Dictionary Act is not relevant. As the dissenters at the Tax Court observed, the legislative history of the parsonage allowance consistently uses the singular ("a dwelling house," "a home," and "the home"). This suggests Congressional intent that § 107 apply to only one home. *Driscoll v. Commissioner* (11^{th} Cir., February 8, 2012).

10. IT COULD HAPPEN TO YOU. AND IF IT DOES, YOU'RE MAKING A TAXABLE GIFT.

The taxpayer was a waitress working at a Waffle House in Grand Bay, Alabama. In 1999, a customer gave her an envelope containing a lottery ticket from the prior night's Florida lottery drawing. Although the customer was a Waffle House regular, the taxpayer was not the customer's waitress that day, so everyone has agreed this was a gift and not a tip. As it turned out, and unbeknownst to the customer, this was a winning ticket. At first the taxpayer thought it was a joke, but when her father confirmed the numbers, they realized they had hit the jackpot.

The case is about the "they" in that last sentence. The taxpayer's family was "in to lotteries" (sic), and there was an unwritten understanding in the family that "we would take care of each other or share in the family" if anyone ever won a substantial amount of money in the lottery. So the taxpayer and members of her family formed an S corporation (named "9 Mill," perhaps in reference to the size of the jackpot) to claim the proceeds. Under the corporation's capital structure, the taxpayer held 49% of the stock and members of her family held the rest. It was the taxpayer's father who decided that the taxpayer should hold 49% so that no one family member would control the company. After formation of the company, the taxpayer cashed in the winning ticket, claiming the prize as president of the corporation. As president, she elected to have the corporation receive 30 annual installments of $354,000.

Six days later, however, counsel for the taxpayer's co-workers at Waffle House filed a lawsuit disputing the taxpayer's ownership of the ticket. According to the suit, the Waffle House employees were part of a "pooling arrangement" because they had all agreed to split lottery winnings if any of them won. The complaint asked for 80% of the lottery ticket proceeds. The plaintiffs won a judgment some six weeks later, so the Florida lottery commission paid the awarded share of the jackpot, net of taxes, to the Mobile County Circuit Court. But the taxpayer's corporation appealed, and in February, 2000, the Alabama Supreme Court reversed, finding that while there was sufficient evidence that an oral agreement existed, the agreement was unenforceable because it was "founded on gambling consideration."

Ten months later, the customer who originally gave the ticket to the taxpayer brought a lawsuit alleging that the taxpayer breached her agreement with her co-workers to share the proceeds, but that complaint was tossed out by the county court—an action affirmed by the Alabama Supreme Court in 2002.

The taxpayer did not file a gift tax return for 1999 until she was asked to do so by an attorney in the Service's Estate Tax Division. That return, filed in October, 2007, showed no taxable gifts. But the Service determined that the taxpayer made a gift of over $2.4 million in 1999 by transferring the lottery ticket to the corporation, and that triggered a gift tax liability of $771,570. The Tax Court held that the taxpayer made a gift of a 51% share in the winning ticket. The taxpayer claimed there was no gift because of preexisting binding contract to share the winnings with her family or, in the alternative, that she and her family members were partners in a preexisting partnership that was the true owner of the ticket.

The court found no binding contract to acquire tickets and share winnings. "The 'terms' of the so-called … family agreement consist solely of offhand statements made throughout the years about sharing and taking care of one another in the event someone came into a substantial amount of money. This is not enough. There was no requirement that each family member buy lottery tickets. There was no pattern. There was no pooling of money. There were no predetermined sharing percentages. And while both petitioner and [her father] testified that the agreement covered only 'substantial' winnings, neither gave any indication as to what 'substantial' was defined as." As the court concluded, "a feeling of moral obligation to take care of one's family and a few statements that one would do so in the hypothetical situation that one won the lottery simply does not rise to the level of an enforceable contract. What the family had at best was an unenforceable contract to agree on something if in fact one of them was the recipient of a substantial lottery prize."

The court likewise held that the taxpayer and her family members had not formed a partnership prior to the receipt of the winning ticket. This "partnership" did not conduct its activity on a regular and consistent basis. There was no evidence of joint effort or collaboration among the "partners," as the evidence shows the taxpayer's father made all the operative decisions. "Petitioner and her family have nothing to rely on other than a family meal, offhand statements throughout the years, and a familial sense of duty to take care of each other." Thus there was no partnership. That meant the taxpayer had made a gift in contributing the winning ticket to the S corporation.

The other main question presented to the court related to the valuation of the 51% gifted interest. The taxpayer argued that if there was a gift in 1999, the value of the gift should be discounted to reflect the disputed claims to the corporation's ownership of the ticket. On this point, the taxpayer prevailed. Although the lawsuit from the other Waffle House employees had not been filed at the time of the ticket's contribution to the S corporation, the taxpayer had received notice from their counsel indicating that they disputed ownership of the ticket. The Tax Court reasoned that a "willing buyer" would take this "potential cloud on title" into consideration in determining the fair market value of the winning ticket. In determining the value of the gift, then, the court used this reasoning: "The parties agreed in their briefs that the present value of the ticket proceeds, if there were no claims or discounts, was $4,730,172. … [W]e believe an appropriate discount for the 80% of the lottery ticket disputed by the Waffle House claimants is 67%. Eighty percent of $4,730,172 is $3,784,137.60. Applying a discount of 67% gives a value for the 80% disputed portion of the lottery ticket as of the date of gift of $1,248,765.41. Fifty-one percent of this amount is $636,870.36. Fifty-one percent of the undisputed 20% is $482,477.54. Therefore, the total gift petitioner made is $1,119,347.90."

Why a 67% discount, you (didn't) ask? An expert claimed the applicable discount for the risk from the claim by the Waffle House employees should be between 65% and 80%. The court found the testimony credible but decided to err on the lower side of that range because the suit had not been filed at the time of the transfer. The expert also said that the cost of litigation would be from 2% to 5% of the lottery ticket proceeds. So the court added another two percent to the discount, bringing the total discount to 67%. *Dickerson v. Commissioner*, T.C. Memo. 2012-60 (March 6, 2012).