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QUARTERLY TAX UPDATE

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A sampling of recent tax developments, provided by an advisor, for advisors.

COURT CASES

Estate of Edward S. Redstone v. Commissioner, 145 T.C. No. 11 (10/26/2015). The case involves a gift tax assessment against Edward Redstone, son of Mickey Redstone and brother of Sumner Redstone (the CEO of CBS Corporation). The family has a business called National Amusements, Inc. (NAI), a holding company that includes a network of drive-in movie theaters. Litigation between the family members occurred when Edward had been forced out of NAI and he demanded receipt of NAI stock certificates representing 100 common shares that he said were registered in his name. The family resisted giving him the stock certificates because he had threatened to sell the shares to a third party if the corporation did not redeem the shares at what he thought was fair value.

Eventually Edward sued his father, his brother, and the company, driven by intense family disagreement over the grandchildren. Part of the dispute was whether Mickey had in fact long ago placed the disputed shares into an oral trust for the benefit of Edward's children. An out-of-court settlement was reached where Edward received 66 2/3rd shares (which would be redeemed at an agreed $5 million), and the remaining 33 1/3rd shares in dispute were granted to Edward's children. The settlement was reached in 1972. No gift tax return was filed for 1972. Edward died in 2011.

Further litigation involving the family ensued in 2006 in Massachusetts state court. Michael, one of the grandchildren at issue in the prior disputes, sued his uncle, his grandfather, and NAI, seeking additional NAI stock that should have been added to ownership in his trust. The case was eventually dismissed. Likely as a result of this publicity surrounding the case, the IRS examined the stock transactions with an audit. The IRS asserted Edward made a gift in 1972 when he caused 1/3 of the NAI shares to be transferred to his children. The IRS assessed gift taxes and added a 50% civil fraud penalty.

Before the Tax Court, the IRS argued that Edward's children were not parties to the family litigation and therefore could not provide consideration for the settlement, so there must be a gift. The court disagreed, finding that Edward agreed to the partial transfer of shares to his children in order to reach a settlement, not due to donative intent. The court found no support in the regulations to Code Section 2511 for the IRS position that the transferees of the property, in this case the NAI stock, had to provide consideration to avoid a gift.

Sumner Redstone v. Commissioner, T.C. Memo. 2015-237 (12/9/2015). Following the October decision involving the estate of Edward Redstone, the Tax Court concluded in December that Edward's brother, Sumner, would not receive the same favorable outcome. In this related gift tax examination, the IRS had assessed over $700,000 in gift taxes, plus alternative fraud or negligence penalties, against Sumner for his part of the 1972 transfers of NAI stock. Edward had reached a settlement with the family to have a portion of his claimed 100 shares of NAI transferred into trusts for Edward's children. In Sumner's case, soon after the settlement involving Edward in 1972, Sumner created irrevocable trusts for his children, and NAI shares that were registered in Sumner's name were re-issued in the names of the trusts (of which Sumner was the trustee).

The change in ownership of Sumner's stock to the trusts was not required by Edward's settlement agreement with the family. Sumner made the transfer to demonstrate to his father that the grandchildren would all be treated on equal terms with respect to the family business stock. The transfer documents recited the same language as in Edward's settlement that all the stock had been in an oral trust created by their father, Mickey, in 1959, but Sumner presented no evidence at trial in this case that such an oral trust actually existed.

One of Sumner's arguments in Tax Court was that the statute of limitations, while technically open for gift tax purposes, should be equitably considered a bar to assessment, due to his age, the death of witnesses to the 1972 events, eroding memory, and loss of documents. The court disagreed, stating that for such an argument to prevail the IRS would have to have knowledge of the 1972 gifts and delayed action on an examination over the years.

The court concluded that a taxable gift by Sumner occurred in 1972. It found that the valuation could be based on the stock redemption that ensued from the litigation settlement for Edward's shares in the family dispute, based on a willing buyer, willing seller approach. However, the court found the IRS failed to carry its burden of proof that a fraud penalty should be imposed for Sumner attempting to evade gift taxes. The court also struck the negligence penalty assessment due to the family reliance on advice they had received at the time from outside tax advisors.

Estate of Purdue v. Commissioner, T.C. Memo. 2015-249 (12/28/2015). The Tax Court issued a family limited partnership opinion involving an estate inclusion issue, ruling in favor of the taxpayer that the entity interests were not includable in the taxable estate. Also addressed in the case were whether transfers of the interests qualified for the gift tax annual exclusion, and if interest expense on family loans during estate administration to pay estate tax, was deductible.

Barbara Purdue and her deceased husband, Robert, created a family LLC in 2000, the documents stating the usual business purposes for doing so including asset protection, consolidated asset management, avoiding fractionalization of ownership, and restriction on equity transfers. Barbara and Robert created an irrevocable trust for the benefit of their five children, with the children as trustees. Annually thereafter, gifts to the trust were made, equal to the gift tax annual exclusion amount, and the gifts were treated as present interests with *Crummey* withdrawal powers.

Robert died in 2001 and marital trusts for Barbara's benefit were created at that time. Eventually the marital trusts were includable in Barbara's taxable estate but there were not sufficient funds in the estate to pay the resulting estate tax. One of the children would not consent to the family LLC loaning funds to Barbara's estate to pay the tax, so the remaining children personally loaned the estate the funds. The estate paid interest and deducted the interest as a Section 2053 administration expense on the Form 706.

The IRS challenged on three different issues, the inclusion of the family LLC in Barbara's taxable estate, the annual exclusion gifts of the LLC interests, and the deduction of the interest on the family loans. On the estate inclusion, the Tax Court agreed with the estate that the creation and funding of the LLC was "a bona fide sale of for adequate and full consideration under Code Section 2036(a), and for a legitimate nontax purpose, following tests established in various prior cases on point. The motives stated by the taxpayer and in the governing documents were legitimate and actual, and not a mere substitute for a testamentary disposition. The court agreed with the estate that after the gifts, there was a demonstration of coordinated investment planning and involvement of the children, rather than mere continued control and management of the LLC assets by the donors.

The court also agreed with the estate that the annual transfers of the LLC interests qualified for the annual gift tax exclusion as present interests. The trust as the donee had the right to a steady and ascertainable income stream from the LLC, due in part to the LLC holding ownership of a commercial building under lease as well as marketable securities with a dividend yield. Finally, the interest on the loans by the children to the estate was deductible. The loan was bona fide, and was necessary to the estate administration.

Practitioners with family partnerships and LLCs as clients should fully review this case as a demonstration of how to structure and conduct closely held partnership plans. There has been very little court activity in this area for several years, and it should serve as a useful guide for planning.

Estate of Bernice Newberger v. Commissioner, T.C. Memo. 2015-246 (12/22/2015). In an art valuation case the Tax Court largely agreed with the IRS position in contesting the decedent's estate tax return. The estate included an original Picasso as well as other valuable works of art. The decedent died on July 28, 2009 and the Form 706 was filed on October 28, 2010. During that 15 month time period the estate engaged Christie's to auction the art. Christie's listed the Picasso in its catalog to have an estimated value of between $4.7 million and $6.4 million, and issued an appraisal to the estate concluding a value of $5 million. In February 2010 the painting sold at auction for $12, 927,874, which included the auction fee. The Form 706 was filed with the Picasso listed on the estate return at $5 million.

The IRS assessed estate tax on the basis of the Picasso being valued at $10 million as of date of death, accounting for changes in the art market in the period before the auction sale. The estate argued that the auction result was a fluke and the price could not have been reasonably anticipated as of the date of death. The court disagreed, citing various cases to the proposition that the actual sale can be used as evidence of value as of date of death, and since the estate's expert did not even consider the sale as evidence, the estate appraisal was wholly unreliable.

David and Barbara Green 1993 Dynasty Trust v. U.S., 5:13-cv-01237-D (W.D. OK 11/4/2015). The District Court in the western district of Oklahoma ruled that a trust was entitled to an income tax charitable deduction equal to the fair market value, not adjusted basis, of property transferred to charity, where the property had been received as part of the gross income of the trust in a prior year. The Green Dynasty Trust was a 99% limited partner in Hob-Lob Limited Partnership. The trust instrument stated that the trustee had the power to "distribute to charity such amounts from the gross income of the Trust as the trustee determines appropriate." The Trust had received K-1s from the partnership in prior years allocating income in the tens of millions of dollars. This prior income was used in part by the Trust to purchase various parcels of real estate. The real estate appreciated in value and was later donated to charities. On a Form 1041 the Trust recognized a charitable deduction, but later filed an amended return with the deduction increased by over $9 million, equal to fair market value of the real estate, and requesting a refund of over $3 million.

The IRS denied the refund request and the partnership filed a refund suit in District Court. The legal issue centered on Code Section 642(c)(1), which provides that a deduction is allowed to a trust "in computing taxable income (in lieu of the deduction allowed under Section 170(a), related to deduction for charitable, etc., contributions and gifts) *any amount of gross income, without limitation*" that is paid to charity during the taxable year. The government argued that the deduction should be limited to adjusted basis of the property, as the unrealized appreciation was not in "gross income" of the trust. It also argued that the statute must be strictly construed to mean the gross income of the year of the charitable contribution, and not gross income from prior years, since prior year income became part of trust principal. The District Court held for the taxpayer and allowed the refund.

Estate of Russell Badgett, Jr. v. Commissioner, T.C. Memo. 2015-226 (11/24/2015). The taxpayer died on March 8, 2012. His 2011 personal tax return was extended and filed in May 2012. The personal tax return included an overpayment of $429,315, of which a small amount was applied to the 2012 tax year and the remainder was refunded. The deceased's final income tax return for 2012 was filed in April 2013, with an overpayment of $14,126 that was then refunded by the IRS. In December 2012, the federal estate tax return was filed. The estate tax return did not include any income tax refunds as assets of the estate. The IRS issued a deficiency for estate taxes as a result of not claiming the refunds as part of the taxable estate. The estate raised various arguments for not being required to do so, including that the refunds were not property of the estate under state law, but merely an expectancy, and that is was possible that the refunds would not be received if they were later offset against other federal government claims after the date of death. The Tax Court agreed with the IRS that the refunds must be part of the taxable estate.

Dunn v. Commissioner, T.C. Memo. 2015-208 (10/26/2015). A tax attorney made contributions to his IRA during 2008 through 2010. The 2008 contributions totaled $6,000, and he took a deduction on his income tax return in that year for that amount. However, he was an active participant in his law firm retirement plan for that year and the IRS disallowed the deduction. The taxpayer did not dispute that disallowance, but filed a 2010 tax return (a year in which he was not an active participant in the plan) claiming the $6,000 deduction on the theory that the 2008 IRA contribution was an excess contribution that can be carried forward to a later year. An amused Tax Court found no basis in the law for the argument, and agreed with the IRS that accuracy related penalties should be upheld.

LEGISLATION AND TREASURY REGULATIONS

Protecting Americans from Tax Hikes Act of 2015, H.R. 2029 (12/18/2015). The President and Congress capped a year of uncertain action on tax-related bills by signing into law the PATH Act, a significant element of which is the extension of over 50 "extenders", various deductions and credits that expire out of law annually unless legislative action is taken. An item of particular interest to the estate planning community is the IRA to charity rollover, where taxpayers over the age of 70 ½ can direct up to $100,000 be transferred from an IRA to a public charity. The recipient cannot be a private foundation or a donor advised fund. The rollover amount will count toward the taxpayer's required minimum distribution but not be includable in gross income. Going even beyond the hoped for annual extension, the measure has now been placed into law "permanently", without a sunset date.

Also related to charitable giving, the legislation includes the extension of increased contribution limits and carryforward periods for conservation easement deductions. As well, there is a clarification on the early termination of charitable remainder trusts with net income features (NICRUTs and NIMCRUTs), such that the valuation of the remainder interest on early termination will disregard the net income feature, consistent with the valuation of the remainder interest at the initial funding of the trust. Prior to this change, the Code contained no rule on this valuation issue.

For taxpayers who support nonprofit organizations engaged in public issues advocacy, the Act bars the IRS from treating contributions to 501(c)(4), 501(c)(5) and 501(c)(6) organizations as taxable gifts. For business owner clients, the extension of the reduced built in gains period for S corporation elections, now five years, can be important for long term tax and estate planning.

Bipartisan Budget Agreement of 2015, P.L. 114-74, H.R. 1314 (11/2/2015). With the breach of the federal debt ceiling looming, Congress and the President came together to pass a budget deal that increases the national debt limit and raised some spending limits for both domestic and military expenditures. The budget bill pushes any further controversy on budgeted spending and debt limits beyond the 2016 fall elections.

In order to find offsets for the cost of the budget bill, some tax items were included. One of those items is a change to the methods the IRS can use to examine returns and assess tax on entities taxed as partnerships. Since the early 1980s the IRS has had to follow the partnership audit rules of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), in what came to be known as TEFRA audits. The problem for the IRS with TEFRA audits has been that the audit is conducted at the partnership level but any tax assessments had to be imposed by opening up for adjustments to income each individual partner's tax return for the year under audit. This normally necessitates individual amended returns. Many more large operating businesses are now conducted in partnership or LLC form, and the TEFRA rules have hampered IRS ability to conduct pass-through entity audits on a more widespread basis.

Under the Budget Agreement, the TEFRA audit rules are eliminated. Now, all partnerships are subject to paying any tax deficiencies at the partnership level for the year the change occurs, rather than the individual partners paying the tax deficiency at the partner level for the year under audit. Tax will be calculated at the "imputed underpayment" rate, which is the highest individual or corporate marginal rate. However, the partnership can show that a lower rate is appropriate by providing partner level information. The IRS will have to develop rules for taking into account that a partner is a tax exempt entity.

Under new Code Section 6221(b), small partnerships of under 100 partners may elect out of the new rules. If such election is made the individual partners will receive adjustments under normal IRS examination rules, i.e. tax changes applied to the year under audit on a partner by partner basis. However, the small partnership election out is not available unless all partners are individuals, C corporations, S corporations, and estates of deceased individuals. The IRS is given authority to write regulations to apply the small partnership exception to other types of partners (e.g. nongrantor trusts).

While this issue is mostly of importance to business and tax lawyers, estate planners with large family partnerships and LLCs as clients should be familiar with the pending change in the landscape of audits of flow-through entities.

Type III Supporting Organization Regulations, T.D. 9746 (12/23/2015). The IRS issued final regulations under Code Section 4942 regarding non-functionally integrated (NFI) Type III supporting organizations (SO), and determining the required annual distribution from the organization. The final regulations replace various prior issuances of proposed and temporary regulations and adjust for some public commentary. The final regulations require an NFI Type III SO to annually distribute an amount equaling or exceeding its distributable amount for the year. The distributable amount of the SO is defined as the greater of 85% of its adjusted gross income, or its minimum asset amount. The minimum asset amount is defined as 3.5% of the excess of the fair market value of the SO's non-exempt-use assets, over acquisition debt. Non-exempt use assets do not include asset used or held for use to carry out exempt purposes of the SO.

Excise Taxes on Private Foundation Jeopardy Investments. The IRS has issued Notice 2015-62 2015-39 IRB (9/16/2015), with guidance on the application of the Section 4944 excise tax on private foundation investments that do not qualify as program-related investments (PRI). The excise tax is applied when a foundation makes an investment in a manner that jeopardizes carrying out its charitable purpose, such as high-risk investments. PRIs are exempted from the excise tax, and must be an investment of which the primary purpose is to accomplish a charitable purpose. The Notice explains that an investment will not trigger the excise tax if the foundation managers, while exercising ordinary business care and prudence, consider the relation of the investment to the foundation's charitable purpose. It is not necessary that highest rates of return, lowest risk or greatest liquidity be selected.

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IRS RULINGS AND ANNOUNCEMENTS

New DING Rulings, PLR 20155005 (12/11/2015). Every so often the IRS issues a series of private letter rulings the subject of which is the establishment of incomplete gift, nongrantor trusts. The planning is mostly driven by state income tax reduction on trusts, as opposed to federal income tax effects. A recent series of rulings again asked the IRS to agree with the taxpayers' requested status that transfers to irrevocable trusts of which the grantors remaining potential beneficiaries, were nongrantor trusts under Subchapter J of the Code, but the transfers were not completed gifts. A difference from prior letter rulings over the last few years is that the grantors are contributing community property to the trust, and the IRS granted the ruling that all the trust property would receive a 100% basis step up on the death of the first spouse.

Disclaimer not a Taxable Gift. PLR 201540006 (10/2/2015). In a private letter ruling the IRS concludes that the spouse of a trust beneficiary validly disclaimed her interest in the trust within nine months of marriage, and the disclaimer was not taxable gift. The Taxpayer had married a person who was a beneficiary of an existing irrevocable trust (Trust 1) established by his father. The terms of Trust 1 were that the son would receive the trust income for life, but during any period the son was married, the spouse of the son would receive one-half of that trust income. Further, Trust 1 provided that if that spouse was not a life in being on the date the trust was created, the income interest would terminate on the death of the family lives in being (the son, his children, and his two siblings) plus 21 years. At the time of their marriage the son had adult children from a prior marriage.

Prior to the marriage, the son created an irrevocable trust (Trust 2) for the benefit of his new spouse (the Taxpayer under the letter ruling). The terms of the new trust were that as long as the son and the Taxpayer were cohabitating, the Taxpayer would receive a specified sum from that trust each month for her lifetime. In addition, after the son's death, the Taxpayer would receive distributions for medical and education expenses, as well as other discretionary principal distributions. Further, upon marriage of the son and the Taxpayer, the distribution rights of the Taxpayer under Trust 2 would terminate unless she disclaimed her interest in Trust 1.

By affidavit submitted with the letter ruling request the son stated that the Taxpayer did not participate in the establishment of Trust 2, had no control over its provisions, and had no knowledge of the terms of Trust 2 until after it had been established. The ruling request states that the Taxpayer will irrevocably disclaim her interest in Trust 1, had not accepted any benefits of the trust principal or income, and had not received any consideration in exchange for executing the disclaimer. The disclaimer will be executed within nine months of marriage.

The IRS granted the rulings that the disclaimer was made within a reasonable time after knowledge of the existence of the transfer for purposes of the gift tax regulations under Code Section 2511, and that the disclaimer did not result in a taxable gift by the Taxpayer. Critical to the plan, the IRS also ruled that the establishment of Trust 2 and its terms did not constitute consideration to the Taxpayer in exchange for her disclaimer.

Estate Tax Closing Letters. Last summer, the IRS announced by way of a posting to its website that it will no longer as a matter of course issue closing letters for the filing of the federal estate tax return, Form 706. A statement by the IRS indicated that the increased number of filings due to portability of the estate tax exemption to a surviving spouse led to the change in policy. The changed indicated that the IRS will issue a closing letter to an estate representative upon request, and suggested waiting four months after the filing of the estate tax return to make that request, allowing time for it to process the tax return.

In an updated posting to its website, the IRS now announces that taxpayer account transcripts which reflect transactions including the acceptance of Form 706 and the completion of an examination, may be an acceptable substitute for the estate tax closing letter. Account transcripts are available online to registered tax professionals using the Transcript Delivery System (TDS) or to authorized representatives making requests using IRS Form 4506-T.

Gift Tax Issue on Judicial Reformation, PLR 201544005 (10/30/2015). The executor of an estate requested estate tax and gift tax rulings with respect to a trust. The trust was created by a husband and wife during life for the benefit of their children. It stated it was irrevocable, but also had a provision in that the grantors could amend the trust. The grantors were trustees of the trust. The trust agreement provided that the trustee could distribute income and principal for the "well-being" of each child, and in making the distributions the trustee should emphasize education, health, and personal development of the beneficiary. They filed gift tax returns reporting transfers of property to the trust.

The grantors learned that the provisions would cause the transfers to the trust to be an incomplete gift and the trust to be includable in their taxable estates. They sought and were granted a reformation of the trust instrument in the local court. The drafter of the trust agreement executed an affidavit attesting to the intent of the grantors and the scrivener's error. The local court granted a reformation of the trust removing the amendment power and adjusting the trust distributions provisions to match ascertainable standards of health, education, maintenance and support. The IRS granted the rulings that the transfers to the trust would be treated as completed gifts for tax purposes and the trust assets not included in their taxable estates, reasoning that the local court was following state law governing interpreting the trust with extrinsic evidence.

Failed IRA Rollover. PLR 201547010 (12/3/2015). In a private ruling the IRS declined to grant a waiver of the 60 day rollover requirement for an IRA distribution. The taxpayer directed a custodian of his IRA account to transfer funds for the purchase of a partnership interest, with the intent to have the partnership interest held in the IRA. The records of the partnership showed the interest was held by the taxpayer's IRA, however the custodian determined that is was unable to own the partnership interest. At the end of the year the custodian issued a Form 1099-R for a distribution, and the taxpayer realized that the partnership interest was not accepted by the custodian as an IRA asset. The taxpayer asserted that his financial advisor and the partnership management were in error to not inform him of the partnership interest not being accepted in the IRA, and he would have found another custodian who would do so within the 60 day rollover period. The IRS reviewed factors found in Revenue Procedure 2003-16 for relief, and found the taxpayer did not qualify for relief.

OTHER DEVELOPMENTS

The Chan Zuckerberg Initiative. A news splash was made nationally late in 2015 when Mark Zuckerberg, the founder and CEO of Facebook, and his wife, Priscilla Chan, wrote a letter to their newborn child, not a typical letter to a newborn. They disclosed in that letter, as well as in an SEC filing, that they will dedicate 99% of their Facebook stock wealth to philanthropy. At current stock prices this equates to about $45 billion of value. There is a great deal of chatter about the merits of this announcement but what should not be lost in the noise is what they have really announced. They have not formed a donor advised fund, or a stand-alone public charity, or a private foundation to which to transfer the stock. The development really amounts to a public disclosure in an SEC filing stating that Zuckerberg intends to transfer almost all of his stock to a limited liability company that he and Priscilla will control during their lives, and a commitment that the LLC will be managed in a manner for the public good.

That transfer to the LLC would not be one that qualifies as a charitable deduction. The LLC is not in itself a charitable entity. Of course, if a qualified charitable transfer is made from their LLC, such as a grant to a public charity or private foundation, that would create a tax deduction that flows through to the LLC owners. Commentators are discussing this development as signaling a new form of philanthropy that is not bound by charitable tax rules. The family will determine how to engage in a wide range of pursuits for what they believe is the common good, with freedom to retain control over the funds and set the parameters for spending.