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QUARTERLY TAX UPDATE

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

Any tax update at this time must mention the elephant in the room (symbolically-speaking), that being the Republican Party's looming control of the White House (will President-elect Trump actually act like a Republican?), the House of Representatives, and the Senate (subject to that minor filibuster issue). Not since the early 2000s has there been such an apparent desire for substantial changes to our federal tax laws, certainly including estate and gift taxation but extending as well into important business and individual income tax areas. Some are comparing the potential for changes to Reagan era of the 1986 Tax Reform Act.

There are as well other interesting developments over the past several months. Various cases and rulings are summarized below. Highlights include:

A charged atmosphere surrounding proposed regulations under Section 2704(b).

A technical KO for the IRS in a Section 2036 FLP case.

The continued efforts of a family to fight off a massive gift tax deficiency.

Limitations to state authority to tax trust income.

Hardly a thriller, but an interesting estate tax case for a novelist.

QTIP elections in the era of portability.

An EZ Pass lane opens for failed 60 day IRS rollovers.

LEGISLATION AND TREASURY REGULATIONS

Tax Reform. Technically of course, no actual legislation will be introduced for many months, at a minimum, but a cottage industry has taken hold for forecasting what is to come in 2017. With the results of the national elections, there are a variety of ways that we could experience shifts in tax law in 2017, or perhaps not until a later year depending on the politics of the players involved.

What are the popular bets for potential tax law changes? That depends to some degree on what is agreeable to all parties, including within the Republican Party itself. Although Mr. Trump did offer somewhat greater detail on his tax ideas vs. unknown ideas on other government policy, he was not detailed enough to be sure what will be his tax policy priorities. As well, it is hard to say how much the author of the "Art of the Deal" is

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ideologically invested in any one item of tax law (we might assume that the real estate development industry will not be negatively affected).

Since Mr. Trump was swept into office on a populist job creation vote, it is likely his attention will most focus on business tax reform that creates incentives for business activity in the U.S. Otherwise, some notable positions on tax law that were published and attributable to the Trump campaign include:

- Repeal of estate taxes (gift taxes maybe, not so clear).
- Repeal of basis step-up at death, i.e. perhaps a shift to either a carryover basis system or perhaps a gain recognition event at death (with exceptions for closely held businesses and farms), and after an exemption for estates under $10 million.
- A reduced income tax rate on income from active businesses in pass through entities such as LLCs and S corporations.
- A top corporate tax rate of 15%.
- Repeal of the .9% Medicare surtax and the 3.8% net investment income tax.
- Income tax brackets on individuals of 12%, 25% and 33%.
- A cap on the use of itemized deductions.
- Taxation of "carried interest" for managers of private equity and hedge funds at ordinary income rates, not as capital gains.

It is fair to say that the Republican majority of the House, under the leadership of Paul Ryan, has in the past year spent quite more time than the Trump campaign in fleshing out details of its tax policy wishes. The House position is published in its six part guide titled "A Better Way", which was pushed by Speaker Ryan throughout the election campaign. It includes many changes to our current tax system on corporate taxation and moving away from our current approach that causes international corporations to trap earnings overseas rather than repatriate funds and invest in the U.S.

The proposals in the House package have many similarities to the Trump campaign, with additional goals such as full expensing of the purchase of otherwise depreciable assets, no itemized deductions except mortgage interest and charitable gifts, and favorable income tax rates on capital gains, dividends and interest.

How soon might an actual tax bill be voted on in Congress and sent to President Trump? Taking into account all of the issues facing Washington with a new Administration, this is guesswork. There are so many priorities that the Republican Congress and Trump Administration will want to tackle. It is reasonable to believe it would be soon; tax reform could be one of the more "shovel ready" areas for which the legislators can achieve Year 1 progress (or even the first 90 or 100 days as nominated Treasury Secretary Mnuchin asserts), perhaps depending on whether the decision is a series of targeted tax bills, or a major comprehensive tax reform package a la the Tax Reform Act of 1986.

One benchmark that might be used is to think back to 2001, George W. Bush's first year in office. Lost in the memory the catastrophic events of 9/11 was the significant tax legislation that passed out of Congress in May of that year, just four months into that first term of the Bush Administration. Similar to what we will have as a result of this election, in 2001 there was a Republican president, a Republican majority in the House, and a Republican majority in the Senate (but not a filibuster-proof majority of 60 votes). That is an important historical fact to keep in mind now, and how it led to the structure of the 2001 Tax Act. Unable to pass some

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tax provisions that were unpopular to Senate Democrats, such as repeal of the estate tax, the Senate crafted tax legislation as a "budget reconciliation". Under Senate rules and the Congressional Budget Act of 1974, budgetary laws are not subject to points of order and filibuster rules, and only require a simple majority of 51 votes. However the provisions cannot affect the federal budget beyond a ten year window.

This led to a law that (i) phased out the estate tax from 2001 through 2009 by increasing the exemption, (ii) called for outright repeal of the estate tax in 2010 (with carryover basis), then (iii) required the whole law to have a "sunset provision" at the end of 2010 reverting the tax rules back to what was in effect at the start of 2001.

Perhaps this is where we are headed again, a 10 year package of tax cuts and shifts to get by a unified Democrat minority in the Senate. The Republican leadership will have to decide if they will seek common ground for tax legislation that the Senate Democrats will support, or if they will bypass bipartisan support by pushing through a Republican package that is subject to the ten year expiration.

Section 2704(b) Proposed Regulations. The IRS generated long-anticipated estate planning buzz, with the issuance of proposed regulations that would heavily impact the recognition of now-common valuation discounts. The authority for the issuance of regulations (not necessarily the extent and reach of the IRS proposal) goes back to 1990 when Chapter 14 of the Code was enacted. Code Section 2704(b) states that the IRS may issue regulations to provide that:

> restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle [*ed. the estate and gift tax laws*] but does not ultimately reduce the value of such interest to the transferee.

Until now, Code Section 2704 has had limited application to restrictions that prevented the full liquidation of an entity, while not addressing the liquidation restriction on any particular owner's interest. The above provision had laid dormant for 25 years, giving the IRS the potential authority to write rules that, for any family entity where there were restrictions against the ability to sell, redeem or liquidate an ownership interest, regulations could ignore the restrictions when valuing the interest for estate tax, gift tax, or GST purposes. So here we finally are.

The proposed regulations are not yet effective, and the rules state they will not be effective until issued in final form. We are in a public commentary period which is scheduled to culminate in an IRS hearing that will have taken place on December 1. After taking into account thousands of submissions of public commentary, the IRS could issue final regulations in early 2017, or later. Is the clock is ticking on current case-driven law that allows for reductions in value such as discounts for lack of marketability, and for lack of control? The election results, combined with backlash critical of the regulations as proposed, now cast doubt over finalization. Undoubtedly the Treasury Secretary appointed by Mr. Trump will have different priorities than the implementation of these rules.

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Focusing for now on what has been proposed, for the IRS to disregard a restriction on the ability to sell or liquidate an interest in a family entity, the essential elements of the proposed regulations are as follows:

- There must be **a transfer of an interest** in a corporation or partnership (including LLCs and, apparently, disregarded entities). The transfer can be inter vivos or at death.
- The **entity must be controlled by the family immediately before the transfer**. Control is defined as holding at least 50% of the voting power or equity value of a corporation, or 50% of the capital or profits interest of a non-corporation, or any general partner of a limited partnership.
- Ownership interests held by nonfamily members and unrelated parties such as charities, etc., are not counted toward determining the above control tests, unless (i) the unrelated party held the interest at least three years prior to the transfer, (ii) the nonfamily interest is at least 10% of the equity of the entity, (iii) all nonfamily interests are at least 20% of the equity of the entity, and (iv) the nonfamily member has a put right on the interest.
- The **transfer must be to or for the benefit of a member of the transferor's family**. This is defined to include the transferor's descendants and ancestors, the transferor's spouse and descendants and ancestors, the transferor's siblings, and any spouses of these listed individuals.
- Attribution rules apply to take into account estates, trusts, and entities owned or benefitting the members of the family.

If all of the above elements apply, the valuation of the transferred interest in the entity must disregard any restrictions on the ability to liquidate the interest. How is the disregard implemented? A minimum value is assigned to the deemed redeemable interest held by the transferee. This minimum value is equal to the holder's percentage interest of the entities net assets, determined as the fair market value of the assets less debts and liabilities. It appears that this rule in effect treats each family member as deemed to own a proportionate share of the underlying assets of the entity, not an interest in the entity.

Despite recent public comments by Treasury officials insisting that valuation discounts will still be available, it would seem that the effect of the minimum value rule, combined with a disregard of a delayed payout beyond six months, is to bypass the existence of the ownership interest and stated restrictions on transferability, with value assigned based on the actual assets in the entity. Perhaps a discount will remain available for fractional ownership of each asset in the entity. There are minor exceptions that will not disregard commercially reasonable restrictions, and terms of governing documents that require up to six months to pay out the redemption price of the interest.

Subject to what transpired at the hearing on December 1, we may be a long way from an effective date for these regulations, in whatever form they are ultimately issued.

Partnership Audit Regulations, T.D. 9780, 81 Fed. Reg. 51,795 (8/5/2015), REG-105005-16 (8/5/2016). In the Bipartisan Budget Agreement of 2015, P.L. 114-74, H.R. 1314, Congress passed a budget bill that included revenue raising offsets to offset increase spending. One of those items was a change to the methods the IRS can use to examine returns and assess tax on entities taxed as partnerships. The problem for the IRS with so-called "TEFRA audits" has been that the audit is conducted at the partnership level, but any IRS tax assessments had to be imposed by opening up audits of each partner's tax return for adjustments to income for the year under audit. This normally necessitates individual amended returns.

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Under the legislation, the TEFRA audit rules are eliminated effective for years beginning after 2017, with an election to opt into the rules prior to that time. All partnerships will be 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.

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 has now issued regulations allowing partnerships to opt into the new rules prior to 2018, but cannot then use the small partnership exception to opt back out.

Practitioners advising clients with family partnerships and LLCs will need to give attention to these rules. For entities where there is periodically a transfer of interests, a mismatch could occur where a tax audit relates to a former owner's Form K-1, but the tax deficiency is charged against a new holder in a later year. Updates in drafting of the partnership and operating agreements will need to be considered. An important decision will be the designation of the tax matters representative in the agreement and whether that TMR will have the authority to make these decisions on whether to opt in or out of the new tax examination approach.

COURT CASES

Estate of Edward G. Beyer v. Commissioner, T.C. Memo 2016-183 (9/29/2016). The *Beyer* case is the latest in court opinions addressing the IRS including family partnership and LLC interests in a decedent's taxable estate under Code Section 2036(a). Other issues were involved in this case but this summary focuses on the Section 2036 issue. The Tax Court sided with the IRS in this case, finding a variety of factors caused a partnership interest transferred prior to death by the taxpayer to be included in his taxable estate under the statute.

The decedent was an executive at Abbott Labs, and accumulated a vast sum of stock shares in the public company. He transferred 800,000 shares of the stock to a revocable trust in 1999. He proceeded further along with estate planning advisors to consider transfers of his wealth, and there was correspondence with attorneys referencing that a primary reason for doing so was to realize valuation discounts for transfer tax purposes.

He created two more revocable trusts in 2003. Also established was the Edward G. Beyer Limited Partnership (EGBLP). The 2003 trusts included a "Management Trust" that became the 1% general partner of EGBLP, and a "Living Trust" that was the 99% limited partner. The Living Trust included standard common provisions regarding making trust assets available to pay the grantor's estate taxes. As part of the updated estate plan, the taxpayer named his nephew as executor of the estate, as his power of attorney, and as health care power of attorney

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The FLP was funded with 800,000 shares of Abbott Labs and some other miscellaneous securities, from transfers by the 1999 revocable trust (not the two trusts that were partners). The taxpayer held back about $4 million in wealth outside of the partnership. EGBLP never sold any of the Abbott Labs stock prior to the taxpayer's death. A written partnership agreement was created, listing 28 purposes for which the partnership was formed.

In 2004, the Living Trust sold its 99% limited partner interest to an irrevocable trust (the Grantor Trust) that the taxpayer had created. The sale was in exchange for a note in the amount of $21 million, secured by the accounts and the accounts receivable of the Grantor Trust. There is no indication in the case that the Grantor Trust had any other assets before entering into the purchase of the 99% partnership interest. The $21 million sale price was a substantial reduction of what would be a proportionate value of 99% of the partnership assets, as the facts indicate the Living Trust had contributed capital of $41 million to EGBLP.

The taxpayer died in 2007. After his death, EGBLP made various distributions, some directly to the Living Trust even though the Living Trust had sold its partnership interest. The Living Trust used a $650,000 distribution to pay 2005 gift taxes due the IRS (due to taxable gifts unrelated to the partnership transactions). From 2006 into 2008, quarterly interest payments due from the Grantor Trust to the Living Trust on the installment note were made by way of direct payments from the partnership to the Living Trust. Then in 2008, a check was issued from the EGBLP bank account to the IRS for "IRS 706", referring to estate taxes due.

Partnership income tax returns were filed with the IRS, in a manner inconsistent with the Grantor Trust being the owner of the 99% limited partner interest. For 2005, the Living Trust received the K-1, for 2006 both the Living Trust and the Grantor Trust received K-1s for a portion of the 99% interest, and for 2007 there were inconsistencies in the tax return as to the Grantor Trust being the owner of the partnership interest. After the taxpayer's death, the 2005 and 2006 partnership tax returns were amended to reflect the Grantor Trust as the 99% partner.

Throughout these years, no partner distributions were being made to the Management Trust as the 1% general partner. In fact throughout those years the Management Trust did not have a bank account. This non-pro rata treatment was remedied in 2009 when equalizing distributions were made to the Management Trust.

On the decedent's estate tax return, the installment note was included on Schedule G. The Management Trust's 1% general partner interest was also included on Schedule G. The IRS audited the Form 706 and assessed an estate tax deficiency of $19 million.

The court case turned on whether all the partnership interests should be included in the taxable estate under Code Section 2036(a). The court examined whether the sale had been for adequate and full consideration, and whether the taxpayer had retained possession or enjoyment of the partnership interests or income that were transferred. Under the *Estate of Bongard* approach, this is tested by determining if the transfer was motivated by a legitimate and significant nontax purpose. Testimony and statements in evidence before the court indicated three reasons for the transfer of the partnership interest to the Grantor Trust, being (i) a desire to keep the 800,000 shares of Abbott Labs intact as a block of stock, (ii) the desire to transfer management of the assets to the taxpayer's nephew, and (iii) continuity of asset management. The opinion notes that these three reasons do not appear in the list of 28 purposes of the partnership in the written partnership agreement.

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The court concluded that the stated reasons did not satisfy the legitimate and significant nontax purpose test. The court opined that the block of stock goal could have been satisfied through revocable trust amendments, that the nephew could be installed in management duties through the trust agreements and power of attorney, and continuity of management could also be achieved from revocable trust amendments.

Other bad facts that led the Tax Court to siding with the IRS included the direct transfers of cash to or for the benefit of the taxpayer, for payment of estate and gift tax obligations, showed an implied understanding of continued enjoyment of the partnership assets and income. Also cited was a failure to maintain sufficient personal assets outside of the partnership to pay anticipated tax obligations. The court waded further into the weeds by observing that due to erroneous capital account books and records of the partnership, the taxpayer could not meet the Section 2036 requirement that adequate and full consideration was received for the capital contributions. Interestingly, the court concluded that the direct payments by the partnership of quarterly interest due on the note, was not an indicator of such an implied understanding.

Cavallaro v. Commissioner, Dkt. No. 15-1368, First Circuit *affirming in part and remanding* T.C. Memo. 2014-189 (9/17/2014). The First Circuit Court of Appeals reviewed a Tax Court gift tax case involving a successful family business. The Tax Court had held in favor of the IRS that there gift tax deficiencies related to prior transfers by the taxpayers of intellectual property to an entity owned and controlled by the taxpayers' children. It is an interesting case illustrating drastic consequences that can occur when taxpayers engage in business planning without prior advice and counsel, and the details of the Tax Court case are worth revisiting.

William Cavallaro never finished high school, could barely read, but attended a trade school to learn how to make tooling. William and Patricia had three sons. After holding down various jobs William convinced Patricia to open a business of their own, a machine shop that made custom order tooling for large and small manufacturing customers. They formed Knight Tool Co. in 1979, and later elected S corporation status in 1993, with William owning 49% of the stock and Patricia owning 51%. Patricia had no formal training but learned to keep the books and run the office. The boys worked at the company during their teenage years. All three boys, Ken, Paul and James, came into the business full-time after completing their schooling.

To grow the business beyond single custom tool orders, William and Ken began planning to create a product that could be sold in greater numbers and for increased profits. They came up with an idea to make a computerized machine that would inject liquid glue on to computer circuit boards, as many companies made circuit boards with manual application of glue. The planning began in 1982 and a prototype was developed. They chose to market the liquid-dispensing machine as "CAM/ALOT". The expenses of developing the product were paid by Knight Tool. The early designs proved not to work as well as hoped, and sales did not exceed the expenses of producing the CAM/ALOT machine. William lost interest in continuing with the product and was concerned with rising debt levels. Ken wanted to pursue the venture and he and his brothers decided to form a separate company, Camelot Systems, Inc. Along with their parents, in 1987 they met the attorney who had incorporated Knight Tool, who prepared the stock certificates and corporate record book. The brothers were each 1/3 owners of Camelot Systems. Their total capital contributions were $3,000.

Ken led an effort to improve on the design and use of the CAM/ALOT machine, but much of the expenses, including Ken's compensation, and those of his brothers, were still covered by Knight Tool. Ken's role was mainly to sell and develop markets for the machine. Knight Tool personnel were involved in implementing the improvements to the function of the CAM/ALOT machine. Through 1995, the tax reporting and contracts with outside customers continued to reflect Knight Tool as being the company that was producing the

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CAM/A LOT machine, not Camelot Systems. With minor exceptions there was no documentation that reflected a transfer of intellectual property and technology from Knight Tool to Camelot Systems, or that reflected the terms of usage of the technology between the companies.

To increase sales for the machine, Ken determined during the early 1990s they needed access to European customers. Due to manufacturing regulations in European Union, this required a CE certification. This would require both Knight Tool and Camelot Systems to become certified. William was unwilling to go through this certification process with his company. Ultimately in 1994 the family decided to merge the corporations in order to make use of Camelot's certification. The taxpayers sought help from a national accounting firm to structure a tax-deferred merger of their S corporations. At the same time they engaged an estate planning attorney to advise William and Patricia on their estate plans. A debate ensued between the CPAs and the attorney as to the relative value of the two companies and how best to reduce exposure of William and Patricia to wealth transfer taxes. There was some question as to whom or what entity owned the technology that had been developed as part of CAM/ALOT machine. The attorney prevailed upon the parties that the technology and IP in question was owned by Camelot as part of the incorporation of Camelot in 1987. Appraisals of the corporations were obtained with that assumed fact, and the allocation of post-merger stock between the parents and the sons was calculated on that basis. The parents received back 19% of the stock of the merged entity, their sons receiving the other 81%.

The IRS audited the tax returns for the year of the merger, and contested the stock allocations to the family members. The IRS issued an assessment for gift tax based on taxable gifts by William and Patricia of $46 million, assigning no value to Camelot Systems pre-merger. After retaining an expert appraiser for trial preparation, the IRS reduced its position of the taxable gifts to $29.6 million. The court agreed with the IRS that the parents did not receive full and adequate consideration for their Knight Tool stock in the merger, and made a net gift as a result of the transfer of stock value to their children.

The Tax Court agreed with the IRS that a large unreported taxable gift of around $30 million occurred when the taxpayers received stock in a merger of their closely held corporation with a corporation owned by their sons. The taxpayers failed to receive stock in the merged entity that equated in value to the stock of their separate company. Combined, William and Patricia were adjudged to owe over $15 million in gift taxes.

The taxpayers appealed the decision to the First Circuit largely on technical legal grounds, including that the Tax Court erred in forcing the evidentiary burden of proof on the taxpayers rather than shifting the burden of proof to the IRS under Code Section 7491. The First Circuit agreed with the Tax Court. The taxpayers also argue that the Tax Court erred in concluding that all of the technology was owned by the parents' separate corporation prior to the merger. The appellate court found no basis for overturning the Tax Court's conclusions on this factual matter. Finally, the taxpayers argued that the Tax Court improperly accepted the appraisal report of the value of the separate companies' stock, prepared by the IRS expert. The taxpayers argue the Tax Court should have considered challenges to the government appraisal. The First Circuit agreed with the taxpayers on this issue and have remanded the case to the Tax Court to further consider the valuation issue.

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Estate of James Heller, 147 T.C. No. 11 (9/26/2016). The Tax Court upheld an estate's theft loss deduction for losses incurred after the taxpayer had been ensnared in the Ponzi scheme of Bernie Madoff. The taxpayer died in January 2008 while owning a 99% interest in a family LLC. The sole asset of the LLC was an account at Bernard L. Madoff Investment Securities, LLC. Date of death value on the estate tax return was later determined as $16.6 million. Over the course of the next several months after the taxpayer's death, the LLC distributed $11.5 million to members and the estate used its share to pay taxes and expenses. In December 2008, Bernie Madoff was arrested.

The estate claimed a $5.2 million theft loss estate tax deduction under Code Section 2054 equal to the date of death value of the Madoff account less distributions taken from the account during 2008. The IRS issued a deficiency notice disallowing the theft loss deduction because the theft loss was incurred by the LLC, not during the settlement of the estate.

The court concluded that even though the theft victim was the LLC, there was sufficient nexus between the loss in the LLC and the reduced value of the estate. The theft by Madoff reduced the value of the LLC which reduced the value of the assets passing from Heller to his family, a "direct and indisputable" connection and therefore, the theft loss deduction was appropriate.

Kimberley Rice Kaestner 1992 Family Trust v. North Carolina Department of Revenue, NC Ct. Ap. No. COA15-896 (7/5/2016). In an appellate review of a lower state court decision against the state's ability to tax trust income, a Court of Appeals in North Carolina affirmed that the application of a state statute was unconstitutional under the Due Process and Commerce Clauses. The settlor, a resident of New York, had established a trust in New York in 1992 when none of the beneficiaries lived in North Carolina. The original trust was divided into three separate trusts in 2002, one for the benefit of Ms. Kaestner, a resident of North Carolina. In 2005 a successor trustee was appointed, who was located in Connecticut. The trust paid North Carolina income tax on undistributed income for 2005 through 2008 tax years, then later filed for a refund of over $1 million in tax.

The issue in the refund litigation was whether it was constitutional for North Carolina to tax the undistributed income of a trust solely based on the residency of a beneficiary. The court reviewed case law on the limits of states' rights to tax interstate commerce, cases based sales tax and business income tax issues. The court applied those prior cases around the country to the present matter and concluded that North Carolina was exceeding its authority to tax the income of a trust, which had no property or administration activity in the state, solely based on the residency of a beneficiary of that trust. The next step would likely be the state appealing to the North Carolina Supreme Court.

Bandy v. Clancy, MD Ct. Ap. No. 93 (8/24/2016). In case involving the estate of novelist Tom Clancy (also a part owner of the Baltimore Orioles), Maryland's highest state court affirmed a lower court ruling that a savings clause contained in a codicil to the Will prevented a family trust from being apportioned any of the federal estate taxes due. He died in October 2013 with a second wife, Alexandra Bandy, surviving, a minor child from that second marriage, and four children from a first marriage.

Tom Clancy executed a Will in 2007 and later, two codicils. He also had in place a trust which provided for various charitable and noncharitable distributions, with the residue of the trust to be split between three trusts; a marital trust for Alexandra, a family trust benefitting his surviving spouse and daughter, and another trust benefitting only his four children from the prior marriage. The allocations to the various trusts

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apparently were not tied to a formula to eliminate estate tax, but rather based on percentage of the trust property. The second codicil in July 2013 included a provision to qualify the family trust as a QTIP trust. It provided that the personal representative of the estate was prevented from exercising any "authority, power, or discretion" to disqualify any portion of the family trust form the marital deduction, and it clarified the testator's intent that the family trust not be charged with any estate taxes. The beneficiaries of the family trust were Alexandra Bandy and their minor daughter.

The personal representative of the estate, Clancy's lawyer who had drafted the instruments, sought to apportion the estate taxes among the residual trusts other than the marital trust. Alexandra filed an action to have the lawyer removed as personal representative. In the end, the appellate court concluded that the language of the second codicil was clear on its face that the family trust would not be charged with any estate taxes, therefore the entire estate tax due would have to be paid from the trust for the benefit of the four adult children.

Mallory v. Commissioner, T.C. Memo. 2016-110 (6/6/2016). The Tax Court agreed with the IRS that the discharge of loans taken against an insurance policy created cancellation of indebtedness income to the taxpayer when the policy was terminated. The taxpayer had purchased a single premium variable life insurance policy with a single payment of $87,500. The taxpayer retained the ability to borrow from the carrier with loans secured by the policy.

Several loans were taken and eventually the total debt exceeded the cash value of the policy. Interest was not being paid on a current basis and was capitalized to the loan. The insurance company eventually issued a notice to the taxpayer that to keep the policy in force, a payment of $26,000 was necessary on the loans. The notice also stated that failure to keep the policy current would result in termination and any taxable income would be reported to the IRS. The payment was not made, the policy was terminated, and a Form 1099R was issued to the taxpayer for a $237,897 gross distribution. The court dismissed taxpayer arguments that there was no taxable income.

IRS RULINGS AND ANNOUNCEMENTS

QTIP Elections and Portability. Rev. Proc. 2016-49 (9/27/2016). The Revenue Procedure brings current its position on the validity of an estate tax return QTIP election when the election is not needed to reduce federal estate tax. The IRS has had a position on the books for some time, detailed in Rev. Proc. 2001-38, 2001-24 I.R.B. 1335, where the IRS would disregard and treat as a nullity for federal estate, gift and GST purposes a QTIP election that did not serve to reduce the estate tax liability on the Form 706. This was seen as a safety mechanism for taxpayers who made an unnecessary election that would cause the assets of the QTIP marital trust to be included in the taxable estate of the surviving spouse when it was not necessary to do so for tax purposes. In pre-portability days, of course, the exemption of the first spouse to die was wasted when not used.

In 2010, Code Section 2010(c) was changed to allow an executor of the estate of deceased to make an election (the portability election) allowing a decedent's unused applicable exclusion amount to benefit a surviving spouse. This changed the past dynamics of potentially losing the use of the applicable exclusion of the first spouse to die when making an unnecessary QTIP election. It also raised concern that the IRS might apply Rev. Proc. 2001-38 to nullify QTIP elections even in situations where taxpayers, for valid planning purposes, wanted the QTIP election to apply even with portability.

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Rev. Proc. 2016-49 makes clear that the IRS will honor QTIP elections even in situations where the election is not necessary to reduce federal estate tax, except in a case where (i) the estate tax liability is zero regardless of the QTIP election, (ii) the executor of the estate neither made nor is considering making a portability election under Code Section 2010(c), and (iii) the procedures of Rev. Proc. 2016-49 are followed. There is still the ability to have a QTIP election treated as void when desired, which will require an affirmative act by the taxpayer to include information with a Form 706 or 709 of a surviving spouse, noting on the return that the information is filed pursuant to the new revenue procedure, and requesting the QTIP election be treated as void.

Circumstances where Rev. Proc. 2016-49 does not treat a QTIP election as void include where a partial election is made to reduce estate tax to zero, where the election is stated in terms of a formula to reduce estate tax to zero, where a protective QTIP election is made, or where a portability election is made even when the deceased spouse's DSUE amount is zero.

CRATs and Exhaustion Test, Rev. Proc. 2016-42, 2016-34 I.R.B. 269 (8/22/2016). The IRS issued a sample provision that can be included in the trust instrument for a charitable remainder annuity trust providing for annuity payments payable for one or more measuring lives followed by the distribution of trust assets to one or more charities as remainder beneficiaries. The sample provision will be treated by the IRS as a qualified contingency within the meaning of Code Section 664(f), and the trust to not fail as a CRAT due to the "probability of exhaustion" test. This test is described in IRS Rev. Rul. 70-452, 1970-2 C.B. 199, and is used to determine whether a CRAT complies with the requirement in regulations that only a negligible chance exists that the charity will not receive anything at the CRAT termination.

Specifically, if there is more than a 5% probability that the annuity payments will exhaust the trust assets by the end of the trust term, the test is failed. Rev. Rul. 77-374, 1977-2 C.B. 329, applies this test to CRATs. The sample trust provision is stated in Section 5 of Rev. Proc. 2016-42. The approach is that a contingent termination clause would be inserted in the CRAT instrument, requiring the trust to terminate at any time where the next annuity payment would result in the value of the trust property, when multiplied by a specified discount factor (determined using the Section 7520 rate in effect when the CRAT was created), would be less than 10% of the initial value of the trust property when the CRAT was funded.

Relief for Failed 60 Day Rollovers, Rev. Proc. 2016-47, 2016-37 IRB (8/24/2016). The IRS issued a revenue procedure addressing the use of the 60 day rollover period for IRA distributions to not result in a taxable distribution. The guidance establishes that a taxpayer may engage in a self-certification procedure to achieve a deferred rollover, even where the 60 period limitation is missed. The taxpayer may certify to the plan administrator or IRA custodian that deadline was missed for one of the reasons specified in the Revenue Procedure. This procedure will help to avoid the need for an expensive private letter ruling seeking relief.

To meet the relief in the Revenue Procedure, the taxpayer must not have been previously denied a waiver for the same failed rollover, must fit within one of eleven specified reasons for missing the 60 day period, and must complete the rollover as soon as possible after the reason is removed. Those eleven reasons include among others an error by the financial institution making or receiving the distribution, a lost check that was never cashed or negotiated, a deposit into an account the taxpayer thought was an eligible retirement account, damage to the principal residence, death or serious illness in the family, incarceration, and postal error.

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Revocation of ING Ruling, PLR 201642019 (10/14/2016). The IRS has been issuing a steady drip of private letter rulings, the subject of which is the establishment of incomplete gift, nongrantor trusts (INGs, formerly known as DINGs but Delaware no longer has a stranglehold on the business). The planning is mostly driven by state income tax reduction on trusts, as opposed to pursuing federal income tax planning. A common fact pattern in the ruling will include a Distribution Committee of the trust that includes the grantor and members of the grantor's family who are also trust beneficiaries. One of the ruling requests will be that the ability of the Distribution Committee to direct distributions to a member of that committee by varying combinations of vote, will not cause the trust to be a grantor trust as to any committee member.

In PLR 201642019, the IRS has revoked a prior favorable ruling that had been granted in PLR 201426014 (6/27/2014). In the 2014 ruling, one of the four issues was that the IRS concluded in a favorable manner to the taxpayer, was that the trust was not a grantor trust, even though the grantor had a reversionary interest in the trust property, due to a provision in the trust that if two of the grantor's children were no longer on the Committee, and there were not at least two people serving on the Committee, the trust would terminate and the property be distributed to the grantor.

Under Code Section 673(a), a trust is a grantor trust if a reversionary interest has a value that exceeds 5% of the trust principal or income at the inception of the trust, and under Section 673(c) that value must be calculated assuming the maximum exercise of discretion in the grantor's favor. In this case that meant assuming the children would resign from the Distribution Committee, causing the termination. The IRS went to the replay monitor and upon further review, revoked its non-grantor trust ruling on the basis of the reversionary interest.

Automatic GST Allocation Election, PLR 201628013 (7/8/2016). An annual exercise for advisors involved in gift and GST planning with trusts is the filing of the Form 709 and the allocation of GST exemption. In a letter ruling, the IRS granted relief to taxpayers who had failed to correctly opt out of the automatic GST allocation rules.

The taxpayers had created an irrevocable trust, which would split into three separate trust shares for the benefit of each of their three children and the descendants of the children. The three separate trusts could then be further divided into separate trusts with different inclusion ratios for GST purposes. The taxpayers proceeded to fund the trusts and create exempt and nonexempt trusts under each of the three children's trusts (6 trusts in total).

The accountant prepared the gift tax returns properly reporting the gifts to the trusts, but did not check Column C on Schedule A, Part 3 of the Form 709, to indicate that they were opting out of the automatic GST exemption rules of Code Section 2632 (the 2632(c) election). The accountant did attach a Notice of Allocation to the gift tax returns, but the Notice inadequately described the trusts to which the GST exemption was to be allocated. A copy of the trust instrument was attached to the gift tax returns. The IRS granted the requested ruling that the taxpayer substantially complied with Code Section 2642(g) and should be deemed to have opted out of the automatic allocation rules. Section 2642(g) provides an allocation of GST exemption will be followed if it demonstrates an intent to have the lowest possible inclusion ratio with respect to a transfer to a trust. The terms of the trust and the Notice of Allocation attached to the 709s demonstrated that intent.

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Trust Modification and Continued Status as GST Exempt, PLR 201633022 (8/12/2016). In a ruling involving the administration of a long term trust for the benefit of great-grandchildren, the IRS granted the request that a modification of the trust terms would not upset the trust status as a grandfathered trust exempt from the GST rules. The settlor had created trusts for great-grandchildren in 1985. The trust terms included that upon the GGC attaining age 25, the beneficiary had a right of withdrawal of one-half of the trust principal, and the trust would terminate at age 35. The beneficiaries had testamentary powers of appointment.

One of the great-grandchildren was born with special needs and lifetime disability, and incompetent to manage her financial affairs or exercise her power of appointment. The trustee petitioned the local court to modify the terms of the trust to remove the ages of distribution, allow for continuing discretionary distributions, and terminate at the beneficiary's death. The remainder would be distributed as follows: if death prior to age 25, the balance to issue of the beneficiary's grandparent; if death between ages 25 and 35, half the trust would be paid to the beneficiary's estate and half to issue of the beneficiary's grandparent; if death after age 35, the trust balance would be paid to the beneficiary's estate.

The IRS granted the ruling that no subsequent transfers would be deemed a taxable distribution or taxable termination for GST purposes. Since the beneficiary was not able to exercise the power of appointment, the modified terms of distribution were the same as the original trust for under age 25, and for ages 25 to 35 the original terms of the trust were followed for one-half the trust balance and the beneficiary's estate would receive the other half. The trust would fully vest in the beneficiary's estate at later deaths. Accordingly, the modification would not cause a shift in a beneficial interest to a lower generation.

Mortgage Interest Limitations on Joint Residence, AOD 2016-2, IRB 2016-31 (8/1/2016). In an Action on Decision, the IRS has addressed the results of Voss v. Commissioner, 796 F.3d 1051 (9th Cir. 2015), rev'g Sophy v. Commissioner, 138 T.C. 204 (2012). The IRS acquiesced to, and will not further contest the results of, the *Voss* and *Sophy* decisions, where the Ninth Circuit determined that the mortgage interest deduction limitations in Code Section 163 are to be applied on a per taxpayer basis, not a per residence basis as had been argued by the IRS. Those limitations include the maximum $1 million acquisition indebtedness limit and the $100,000 line of credit limit. This becomes important, as in this case, with unmarried taxpayers who share a residence and payments on the mortgage debt.

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