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QUARTERLY TAX UPDATE

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

Filing a report on tax developments covering what has been happening *other than* the Tax Cuts and Jobs Act, does not sound so exciting. But there have been some interesting developments over the past several months outside of the monster tax legislation. Please read on to get some news regarding:

- Continuing appetite in Congress for further tax-related legislation, some of which has passed, some of which is proposed.
- The latest on complex partnership audit regulations that could affect your family partnerships.
- A Tax Court win for a family office defending its position as being in a bona fide trade or business and deducting expenses.
- A Tax Court loss for a taxpayer who, like a Sixth Circuit case a year ago, sought to funnel large amounts of business revenue into a Roth IRA.
- We now know what the 2018 estate and gift tax exemption.
- Review of Treasury's plan for what guidance it intends to work on this year.

LEGISLATION AND TREASURY REGULATIONS

H.R. 1892, **Bipartisan Budget Act of 2018**, was passed by Congress on February 9, and signed into law. Along with serving as a resolution to fund government and keep the doors open, it served as a vehicle to clean up some tax law loose ends like expiring tax credits. For estate planners the item of note is that it includes the proposed exception from excise taxes for private foundation-owned businesses. Previously, private foundations were limited in how much ownership they can retain in operating business entities, and when exceeding those limits the ownership interests must be divested within a five year period (if received by gift or from the estate or trust of a decedent). The House had included in the tax reform bill a new wholly owned business exception to the excess business holdings excise tax, but the provision was left out of the conference committee final version.

The law passed in February includes the measure in its passage. The new law creates an exception to the excess business holdings limitation for 100%-owned business enterprises of a private foundation that are not acquired by purchase, where all profits are distributed to the foundation, and disqualified persons do not serve as officers, directors or managers of the enterprise.

S. 3471, **Retirement Enhancement and Savings Act of 2018**. Recently passed out of the Senate Finance Committee and still under consideration in the Senate is this bill which contains various alterations to taxation and administration of qualified plans and IRAs. Of significant note and related to estate planning:

- The bill would repeal the current maximum age (70½) of contributing to an IRA.
- An IRA could be an S corporation shareholder.
- The popular technique of planning with "stretch IRAs" would be curtailed. Upon the death of an IRA holder, or a participant in a defined contribution plan, with aggregate balances exceeding $450,000, the accounts would be required to be distributed within five years. Exceptions to the five year payout would be maintained for surviving spouses, disabled or chronically ill individuals, beneficiaries not more than ten years younger than the deceased, and minor children.

Centralized Partnership Audit Regime. In updated guidance issued under TD 9829 (1/2/2018), the IRS affirmed, without substantial change, the regulations issued in June 2017 implementing the new Centralized Partnership Audit Regime for all entities taxed as partnerships. Under the regulations which further interpret and implement legislation from 2015, all partnerships will be subject to paying any income tax deficiencies at the partnership level in the year the change occurs, rather than the old method of the IRS opening up each individual partner's tax return for direct assessment of tax at the partner level.

Small partnerships of under 100 partners may elect out of the new rules. Most every family partnership and LLC that estate planners work with will be of the small partnership variety. How much does this matter to advisors of family partnerships? If the partnership has very little change in ownership interests and transfers to new partners, there is not much practical difference in the change. IRS audits of partnership income tax returns will lead to assessment and payment at the partnership level, and each partner will have capital accounts reduced by a pro rata share, a result effectively the same as paying the share of the tax at the partner level.

If there is a desire to elect out of the new consolidated audit rules, the recent update is of importance, because the IRS confirmed the result that small partnerships cannot elect out of the rules if there are disregarded entities as partners or members of the entity. This includes grantor trusts and single member LLCs. For estate planning reasons it is common to have partnership interests owned by a revocable or irrevocable grantor trust. But doing so eliminates the ability to elect out of the audit regulations.

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COURT CASES

Lender Management LLC v. Commissioner, T.C. Memo 2017-246 (12/13/2017). The Tax Court heard an interesting case involving a management company for a high net worth family office (Lender family – think bagels) and the ability to deduct the expenses of that family office as a trade or business. On partnership tax returns filed by Lender Management LLC for the years at issue, net losses occurred in 2010 and 2011, and net income in 2012. The losses and income were allocated and passed on to the members on the IRS Forms K-1 as trade or business activity.

On audit the IRS assessed income taxes to the members, disallowing the expenses of the family office as business deductions, but allowing the expenses of the activity as miscellaneous itemized deductions. The sole issue of the case was whether the management company was engaged in a trade or business, the expenses of which were deductible as business expenses.

Lender Management had been in existence for 25 years, and operated as a fund manager. Harry Lender was the founder of Lender's Bagels, and two of his five children, Marvin and Murray, participated in the bagel company, and then in the ownership of various family investment LLCs. Lender Management was created to manage the investments of the investment LLCs, however Lender Management was owned by trusts only in the Marvin branch of the family. In 2010, a third generation family member, Keith (son of Marvin), succeeded into being an owner of Lender Management and became the managing member.

Lender Management provided investment management services to three family LLCs: M&M, Lenco and Lotis, all formed in 2005. The three LLCs were formed to focus on different investment approaches such as hedge funds, private equity, and public equities. The members of the investment LLCs were various trusts, family partnership, and multiple generations of individuals in the Marvin and Murray branches of the Lender family. Lender Management also had small ownership interests in each investment LLC.

No unrelated parties had ownership in any of the three investment LLCs managed by Lender Management. However, Lender Management also managed some "downstream" entities in which M&M was a controlling owner. Some investors in these downstream entities were parties unrelated to the Lender family. Fees for services were paid to Lender Management directly by these entities.

Keith was the CIO and president of Lender Management and devoted full time to its activities. He consulted with outside investment specialists and hedge fund managers to identify best investments for the Lender entities. He received salary for his work until becoming a member of Lender Management, thereafter receiving a guaranteed payment as partner. There were four other employees of Lender Management including a CFO, all unrelated to the family. Other expenses included office rent and costs of researching and monitoring investment activity. Lender Management outsourced some of its services to an independent multi-family office. The fees paid to the independent firm for accounting, tax compliance, and investment reporting and advisory services were paid by Lender Management, not the investment LLCs.

Individual family members were updated with advisory meetings and also received other financial planning services. The family members, trusts and entities were not required to use Lender Management, and could exit from ownership in the investment LLCs Lenco and Lotis if desired in exchange for their capital account balances on certain dates of the year. For M&M, the manager had to approve the withdrawal from ownership.

Rather than being paid a fixed fee, hourly or solely as a percentage of assets under management, Lender Management earned its income from the investment LLCs on a profits interest, with a management fee based on percentage of asset value plus also a percentage of the increase in value for the year. These fees were separate from its underlying share of the capital membership interest in each investment LLC.

The IRS essentially argued that the whole matter involved a family managing its own investments, and the expenses of doing so were not trade or business expenses. Rather, the expenses were incurred in connection with activity for producing or collecting income (i.e. Code Section 212 expenses amounting to miscellaneous itemized deductions). The taxpayer contended that activities of Lender Management did constitute the conduct of a trade or business with expenses deductible in full under Code Section 162. The taxpayer argued that even though the parties were related, the services were conducted between the parties under arm's length agreements.

The court agreed with the IRS that the arrangement was subject to heightened scrutiny given the related parties involved, citing *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005) among others. However, the court concluded that the taxpayer met that heightened scrutiny, and agreed that Lender Management was engaged in a bona fide trade or business. There was no requirement (and the court concluded there was an understanding even in M&M that any member could exit from ownership and have its investments managed elsewhere) that the extended family members continue to use Lender Management's services. The ownership of Lender Management did not match the ownership of the investment LLCs. The individual participants in the extended family did not act in concert with each other and received separate advisory services from Lender Management. The court found no attribution rules that required the ownership of Lender Management to be combined with the investment LLC ownership for tax purposes. Accordingly, the expenses of Lender Management were deductible as trade or business expenses.

David and Barbara Green 1993 Dynasty Trust v. U.S., #16-6371, 2018 Westlaw 386656, 121 A.F.T.R.2d 2018-427 (10th Cir. 2018), *rev'g* 144 F. Supp. 3d 1254 (W.D. Ok 11/4/2015). The Tenth Circuit Court of Appeals has reversed a District Court decision in the western district of Oklahoma. The lower court had ruled that a trust was entitled to an income tax charitable deduction equal to the fair market value (not adjusted basis) of real property transferred to charity. The property in question had been acquired by 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 with allocations of 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 the Form 1041 income tax return, the Trust recognized a charitable deduction, but later filed an amended return with the charitable deduction being increased by over $9 million to the fair market value of the donated real estate at the time of the donation, and requesting a tax 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) for *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 had sided with the taxpayer and allowed the refund.

The Tenth Circuit disagreed with the lower court reasoning. The court focused on the fourth element of Code Section 642(c)(1) to qualify for a charitable deduction, that being the contribution by the trust is unlimited in amount but must be from "any amount of gross income". The court sided with the government argument that the amount of the deduction was limited to the adjusted basis of the donated property, since the unrealized appreciation had never been included in trust's gross income. But the court did not agree with the IRS view that the gross income must have occurred in the same year as the property transfer.

Celia Mazzei v. Commissioner, 150 T.C. No. 7 (3/5/2018). The case involves another in a line of court opinions evaluating the use of self-directed Roth IRAs created to hold ownership of active trades or businesses. The fact pattern has some similarities to *Summa Holdings, Inc. v. Commissioner*, No. 16-1712 (6th Cir. 2/16/2017), *rev'g* T.C. Memo. 2015-119 (6/29/2015), a pro-taxpayer result, but the outcome here was not so taxpayer-friendly. The case will surely generate much analysis in light of its detailed opinion, concurring opinions, and a dissenting opinion, all against the backdrop of the *Summa Holdings* case.

This case was a consolidation of IRS examinations of members of the same family who each created Roth IRAs that purchased stock in a new foreign sale corporation (FSC). Under law prior to 2003, FSCs were used as export sales entities and offered favorable tax attributes. This case involved a FSC that was created prior to the elimination of the FSC provisions in the Internal Revenue Code.

The family had a successful operating company that sold injectors that been developed and patented, and much of the sales were to overseas customers. Through a FSC program operated by the Western Growers Association, a farmer trade group, the three family members created the FSC, first by making $2,000 contributions to three separate Roth IRAs. The Roth IRAs then each paid $500 for stock in the FSC that was administered by an unrelated entity managed by the trade association. The packaged program, offered to the members of the association, provided legal documents and administration services for a FSC/IRA program. The documentation led the members through the process of how to form a FSC that was owned by self-directed IRAs.

Commissions on the foreign sales, as determined by the family's injector corporation that it controlled, were deposited into the FSC. That corporate entity then distributed a dividend to the Roth IRA shareholders. In total for 1998 through 2002, over $500,000 was transferred into the three Roth IRAs. Due to changes in the tax law, no further commissions were paid into the FSC after 2002, but the Roth IRAs continued to hold the funds that had been distributed by FSC dividends.

The IRS audited the taxpayers' personal returns for tax years 2002 through 2007, and assessed excise taxes under Code Section 4973 for excess contributions to a Roth IRA. The Section 4973 excise tax applies to the actual contributions, and to the tax years the IRAs continue to hold the excess contributions without distribution to the IRA holder.

The IRS position at court was a substance over form argument, i.e. that the scheme was in essence a dividend from the FSC to the controlling family members, who then contributed the funds to the IRAs in excess of contribution limits. The taxpayers contended in court that the *Summa Holdings* case stood for the proposition that a statutory sales corporation such as a FSC should be treated like the domestic international sales corporation (DISC) in that case where the Sixth Circuit deemed no business purpose was necessary, that no substance over form analysis should be applied, and the transactions were valid on their face as formed.

The Tax Court majority here declined to follow either side's reasoning in whole, rather going to a narrow factual holding, being that the facts of record presented to the court demonstrated that the individual taxpayers were the substantive owners of the FSC, not the Roth IRAs. The court engaged in a long analysis of prior FSC tax law and the method by which the family's FSC came to existence and contracted with the injector corporation already in existence. The family controlled how much and when any commissions from foreign sales would be paid to the FSC that was owned by the Roth IRAs, so in substance the families controlled the FSC dividends as if they were personal earnings contributed to the IRAs.

The court further found it was not bound by the reasoning of the Sixth Circuit in *Summa Holdings* since this case is appealable to the Ninth Circuit. The court determined there are distinguishing factors between DISCs and FSCs that made the two cases not entirely on point with each other. The majority focused its reasoning on the Roth IRA purchase of the FSC stock, finding the stock to be worth something quite different than the $500 per shareholder that was paid, and the terms of the contracts between the corporations.

IRS RULINGS, ANNOUNCEMENTS AND DETERMINATIONS

New Estate and Gift Tax Exemptions, IRS Revenue Procedure 2018-18, IRB 2018-10 (3/2/2018). As a result of the tax reform legislation, the measure of inflation for tax code adjustments, including the estate, gift and GST exemptions, had been changed to "chained CPI". So as the new year dawned, that revised inflation adjustment had not yet been determined and we have not really been sure what the exact exemption would be in 2018. In the Revenue Procedure, the IRS issued the various inflation adjusted rates, brackets and limitations for 2018, and the final determination of the estate, gift and GST exemption is $11,180,000. The annual exclusion from taxable gifts increases to $15,000.

Treasury Regulation Guidance Plan (2017-2018 second quarter update as of December 31, 2017 and released February 7, 2018). The Treasury released its updated Priority Guidance Plan, the official statement setting forth its plan for regulatory guidance on various tax projects. The new format of the Priority Guidance Plan includes three new sections, in part a reaction to President Trump's Executive Orders for reduction of regulatory burden. The three new sections included the regulatory burden reduction, the eight regulation projects identified in October 2017 for reduction or withdrawal (which included the withdrawal of the proposed Section 2704(b) valuation discount rules), and projects related to the new partnership audit rules (discussed above). Certainly a major portion of the Treasury Plan is to issue regulations and guidance on the Tax Cuts and Jobs Act.

In the estate planning area, an interesting change from prior releases is the movement of two regulation projects from active status to the area of the Plan listing regulations identified for possible reduction in taxpayer burden. Those include the temporary and proposed regulations released in March 2016 on basis consistency under Sections 1014(f) and 664, and the Section 2642(g) regulations released way back in 2008

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relating to extensions of time to allocate GST exemption. Look for changes to those previously released regulations in the coming months.

Donor Advised Funds, IRS Notice 2017-73, 2017-51 IRB 1. The IRS has signaled it is considering issuing regulations on the operation of donor advised funds. In Notice 2017-73, the IRS requested comments on proposed positions taken by the IRS in the Notice. Those positions, subject to further development in later regulations, include:

- Situations involving a question of whether more than an incidental benefit has been received by a donor or related person when (1) the DAF sponsor fulfills a request to distribute funds from the advised fund to a charity, and (2) the donor then receives reduced prices for tickets or a table at that charity's event. The IRS proposes that there will be considered to be a direct benefit that is more than incidental if reduced ticket prices are available to the donor. This can cause a prohibited benefit excise tax.

- The IRS anticipates the same analysis will apply to reduced membership fees of a charitable organization offered as a result of a donation from a donor advised fund.

- Another situation addressed is the donation of funds from a donor advised fund that satisfies an outstanding pledge of the donor to the recipient charity. The IRS indicates in the Notice that it is considering a rule that a distribution from an advised fund to a charity in satisfaction of a pledge will not result in more than an incidental benefit to the donor, if (1) the sponsor of the DAF does not make reference to the existence of a charitable pledge when distributing the funds to the charity, (2) there is no other benefit received by the donor or related party as a result of the distribution that is more than incidental, and (3) the donor does not attempt to claim a charitable deduction as a result of the distribution from the DAF.

- An issue can arise with a charity's test of public support, a part of qualifying as a public charity. Under those tests the donations from a particular person and related persons and entities cannot exceed 2% of the charity's total support. The IRS believes the limitation is being circumvented in certain situations where a donor advises distributions from a DAF to be contributed to a charity, in lieu of making direct donations that would exceed the 2% limit. The IRS is considering a rule that, for purposes of the public support test, it would treat distributions from a DAF as an indirect donation from the donor, rather than a contribution from the sponsor organization.

Life Expectancy Distributions with Trust as IRA Beneficiary, PLR 201750004 (12/15/2017). In a private letter ruling the IRS considered a fact pattern of a trust being named as the beneficiary of IRAs, and whether the life expectancy of the trust beneficiary could be used in determining post-death required minimum distributions. The trust agreement provided that upon death of the grantor, a subtrust titled a "Designated Beneficiary Trust" would be created. Further language was inserted in the agreement that the subtrust was intended to qualify as a "see-through" or "conduit" trust under Reg. Sec. 1.401(a)(9)-4, A-5.

A daughter of the decedent is the sole beneficiary of the subtrust created in the revocable trust agreement. The Trustee is directed to withdraw all required minimum distributions from retirement accounts of which the trust is the beneficiary, and distribute the sums to the daughter or her successors. The daughter is granted a testamentary general power of appointment over the trust balance if she dies prior to age 30. The IRS concludes in the ruling that despite the general power of appointment held by the daughter, the cited regulation is satisfied in that the daughter is identifiable as the beneficiary, and the subtrust is a see-through trust, and the daughter's life expectancy can be used for the annual distributions. The IRS reasoned that when reading together the provision on the general power, and the provisions for requiring all retirement account distributions be passed on to the daughter, there will be no accumulation over which the daughter could exercise the power to other beneficiaries.

Purchase of GRAT Interest a Taxable Gift. ILM 201745012 (11/9/2017). The IRS determined in a legal memorandum that a decedent's deathbed purchase of the remainder interests in two grantor retained annuity trusts, of which he was the grantor, was a taxable gift, and the obligations under the notes were not a reduction of the taxable estate. The ruling is not binding but it does reflect the position the IRS would take on litigation under the facts. The decedent died prior to the expiration of the terms of the GRATs he had created and funded, so the trust assets would be includable in his gross estate for estate tax purposes.

The IRS determined that the decedent did not purchase the remainder interests for full and adequate consideration in the context of the application of estate and gift tax laws. The deathbed purchase of the remainder interest was the acquisition of property that was already includable in the gross estate under Code Section 2036, and the Service thus concluded the purchase cannot be for adequate consideration. It concluded the promissory notes were merely a cloak for gifts. Accordingly the IRS also determined that the liabilities associated with the obligation under the unsecured promissory notes were not deductible for estate tax purposes.

No Charitable Deduction Upon Trust Modification. CCA 201747005 (11/24/2017) Reviewing a case under field audit, IRS National Office determined there should be no income tax charitable deduction where distributions from a trust to a charity were made pursuant to a local court modification order that did not qualify as a governing instrument. The court issued an order approving a modification adding a limited power of appointment for a beneficiary. The power was exercised to cause distributions to a private foundation and the trust deducted the charitable payments under Code Section 642(c). This determination was an affirmation of prior CCA 201651013, where the IRS concluded that payments to the foundation were not pursuant to a governing instrument. Thus, the distributions did not satisfy the test for amounts paid or permanently set aside for charitable purposes.