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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

Kimberly Rice Kaestner 1992 Family Trust v. North Carolina Department of Revenue, Superior Ct. NC, 12 CVS 8740 (4/23/2015). A county court in North Carolina held that the state did not have sufficient nexus to impose state income tax on a trust where a trust beneficiary lived in North Carolina. The trust had no connections to North Carolina other than the residency of the beneficiary, who did not receive distributions of income from the trust in the year in question. The trustee, the trust administration, the investment advisory services, and the grantor of the trust, all were located outside of North Carolina. Distributions to the beneficiary were in the discretion of the trustee. The court concluded that North Carolina's imposition of tax was a violation of the nexus standards to impose tax under the U.S. Constitution's Due Process Clause and Commerce Clause.

Heers v. Parsons, 2015 BL 107621, B.A.P. 9th Cir. (4/15/2015). A Bankruptcy panel of the Ninth Circuit Court of Appeals held that an attorney, acting as administrator of an estate, could not have IRS interest and penalties discharged in her bankruptcy, where acting as the estate administrator the attorney had failed to timely file the estate tax return and pay estate tax. Darrell Parsons was the sole heir of his father's estate, which included real estate in California and North Carolina, a closely held business, and bank accounts, all worth approximately $5 million. According to the opinion, Darrell had to choose an administrator for the estate for California probate proceedings. His father's attorney volunteered to be administrator and retain a probate attorney, but he was deemed unacceptable by Darrell because that attorney had not even told Darrell of the father's death until after the burial service. Darrell was acquainted with another attorney (who was ultimately the debtor in this bankruptcy case), and he decided that lawyer should be appointed to administer the estate.

The attorney/adminstrator failed to timely file an extension on the estate tax return, and did not pay all the estate tax with the extension. The IRS charged interest and penalties of $440,000. The lawyer used estate funds to pay the penalty and interest charges to the IRS and filed a probate accounting. The lawyer argued blame was on an accounting firm she had tried to hire for tax matters, but there was no signed engagement letter retaining that firm., The probate court surcharged the administrator for those costs. She filed for bankruptcy. The bankruptcy panel concluded that the IRS interest and penalties could not be discharged, by reason that the amounts were a "defalcation" under bankruptcy law while acting in a fiduciary capacity, and that under the facts the attorney had consciously and recklessly disregarded the need to timely file the estate tax return and pay tax.

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Davis v. Commissioner, T.C. Memo. 2015-88 (5/6/2015). In U.S. Tax Court, a taxpayer was allowed a charitable deduction arising from a bargain sale of real estate to a charity, but disallowed some of the deduction on valuation issues. The IRS had disallowed the entire deduction on audit, charging there was not substantiation of the charitable gift and that the taxpayer lacked charitable intent.

Bob Davis entered into a transaction to sell some land near Waco, Texas for $2 million to the Sears Methodist Foundation, a charity affiliated with a company developing senior living facilities. He claimed a charitable deduction for $2.1 million based on the difference between the land value and the sales price. The IRS disallowed the charitable deduction on audit.

The IRS argued that (i) Davis lacked charitable intent because it was not until the charity informed him of the option of a bargain sale that Davis agreed to the deal structure, (ii) Davis was only motivated by tax benefits rather than charitable intent, and (iii) Davis had expectations of receiving benefits beyond the cash price as he retained an interest in adjacent land that could appreciate from the charity's land development. The court rejected all these arguments. The IRS also argued there was no contemporaneous written acknowledgement of the gift. A letter was issued to Davis that described the property transferred to the Foundation and the court found the letter fulfilled this requirement. The court did disallow a portion of the deduction based on review of the appraised value of the property.

El v. Commissioner, 144 T.C. No. 9 (3/12/2015). In a case of first impression, the Tax Court held that the addition to tax under Code Section 72(t) for a premature distribution from a qualified plan, is really a tax, not a penalty. As such, the taxpayer has the burden of proof in court to show that the funds taken from the plan should not be treated as a distribution occurring before age 59½ (the opinion does not actually disclose what was the taxpayer's age).

Ralim El received funds from a retirement plan administered by his employer. The distribution was more than half of his account balance, and more than $10,000, thus violating the requirements of Code Section 72(p) for qualifying loans. At trial Ralim argued the IRS should have the burden to present evidence that the receipt of funds was a premature distribution, because the 10% charge under Code Section 72(t) was really a penalty, and the IRS has the burden of proof for penalties. The court disagreed, finding the 10% charge is a tax, thus the taxpayer was required to produce evidence that the tax amount should not apply.

Israel Mikel v. Commissioner, T.C. Memo. 2015-64 (4/6/2015). The Tax Court found in favor of taxpayers who claimed annual exclusions on gifts made to an intervivos irrevocable trust. In 2007 Israel and Erna Mikel each transferred assets worth $1.6 million to the trust. The beneficiaries of the trust were the couple's children, lineal descendants, and their spouses. There were 60 such persons, and with the annual exclusion then in effect of $12,000, a total of $720,000 was deducted from the total gifts for the year.

The trust instrument provided that upon a transfer of property to the trust, each beneficiary had the power to withdraw the lesser of a formula amount or the annual exclusion. In the case, the lesser figure was the annual exclusion. The demand right was required to be exercised in writing by the beneficiary or the beneficiary's guardian within a 30 day period. All other distributions from the trust beyond the withdrawal rights were at the sole and absolute discretion of the trustees.

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The trust provided that in the event a dispute arose regarding the proper interpretation of the trust, the dispute "shall be submitted to arbitration before a panel consisting of three persons of the Orthodox Jewish faith." In Hebrew this is a *beth din*. The panel is to give any party to the dispute the rights such party would have under New York state law. The trust also contained an *in terrorem* clause, where if a beneficiary would "directly or indirectly institute, conduct or in any manner whatever take part in or aid in any proceeding to oppose the distribution of the Trust Estate, *or files any action in a court of law*, or challenges any distribution set forth in this Trust in any court, arbitration panel or any other manner, then in such event the provision herein made for such beneficiary shall thereupon be revoked and such beneficiary shall be excluded from any participation in the Trust Estate (emphasis added)."

The gifts to the trust in 2007 consisted of transferring title to the taxpayers' residence Brooklyn, two other Brooklyn properties, and a condominium in Florida. After making the gifts in 2007, the taxpayers did not file Forms 709. Upon examining the gifts, the IRS assessed gift tax based on not allowing any annual exclusion gifts to the 60 beneficiaries. The basis for the IRS disallowance of the annual exclusions was that there was not a present interest in the gifts to the trust as required under Code Section 2503(b). While conceding that on its face the notices of withdrawal rights were proper, the IRS still argued that there was no present interest because the beneficiaries could not go to state court to enforce the withdrawal right, instead being bound to a religious *beth din* process. Further, the IRS argued that the wording of the *in terrorem* clause would cause any beneficiary to be unlikely to go to court to enforce a withdrawal right as the beneficiary could end up forfeiting all rights under the trust. The IRS argued therefore the withdrawal rights were "illusory" and not a present interest.

The court dismissed the IRS arguments and held for the taxpayers. Reviewing Estate of Cristofani v. Commissioner, 97 T.C. 74 (1991), the court found that the test is not the likelihood of a beneficiary exercising the withdrawal power, but rather whether the right is legally enforceable. The court concluded that under the terms of the trust agreement, the beneficiaries had a legal right to exercise a withdrawal power, and the IRS was interpreting the *in terrorem* clause too broadly in suggesting the trustees could refrain from allowing the withdrawal. The court was also not aware of any law that provides a beneficiary must be able to go to state court as a first step in lieu of the provided *beth din* process.

Estate of Belmont v. Commissioner, 144 T.C. No. 6 (2/19/2015). An estate lost a case in U.S. Tax Court regarding an income tax charitable deduction taken for amounts designated for charity. Eileen Belmont died in April, 2007 in Ohio. Her Will provided for $50,000 to be distributed to her brother, David, and the residue of her estate to pass to the Columbus Jewish Foundation. A Form 1041 was for filed the estate for a fiscal year ended March 31, 2008.

The estate included a condominium in Santa Monica, California. David lived in the condo during his Eileen's life. During the estate administration period some controversy ensued between David and the Foundation. He wanted a life estate in order to continue living in the condo in lieu of the cash bequest. The Foundation declined, not wanting to manage a California real estate interest for a long period, and instead offered him $10,000 to vacate the property without further action. David declined the offer, would not vacate the property, and filed a lawsuit in probate court, alleging there was a verbal agreement with Eileen that he would be given the right to live in the condo for life in exchange for taking care of her. These ongoing actions extended well past the fiscal year end of the estate income tax return.

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The tax issue before the court was the validity of the charitable deduction taken by the estate on the Form 1041, about $220,000. Code Section 642(c)(2) allows for a deduction for amounts in the gross estate permanently set aside during the tax year for a charitable purposes. But the regulations to Section 642 prohibit the deduction "unless under the terms of the governing instrument and the circumstances of the particular case, the possibility that the amount set aside…will not be devoted to such purpose or use is so remote as to be negligible." In fact, the estate did subsequently expend some portion of the $220,000 that was designated for the Foundation on legal costs related to the action filed by David.

The Tax Court concluded that by the time the estate filed the Form 1041 in July 2008, there was sufficient certainty that the estate would incur legal fees and other costs as a result of David's challenge to a life estate, that the "so remote as to be negligible" test was failed. The charitable deduction was disallowed for that fiscal year.

TREASURY REGULATIONS

Modified Carryover Basis for 2010 Deaths. The IRS has issued proposed regulations under Code Section 1022 (Reg -107595-11, 5/8/2015) addressing rules for modified carryover basis in assets of taxpayers who died in 2010. That was the one year where under EGTRRA (tax legislation passed in 2001 under the Bush Administration), there was no federal estate tax applicable to deaths during that year. The 2001 law added Section 1022 to the Code so that in exchange for no federal estate tax on 2010 deaths, property would not have basis step up normally occurring at death under Code Section 1014.

The Job Creation Act of 2010 reinstated the federal estate tax for that year, but allowed the executor of an estate to make an election to avoid the estate tax and apply the modified carryover basis rules of Section 1022. While the applicability of Section 1022 is narrow, its effects could be felt for many years as the carryover basis rules will apply to the assets until sold or are part of another taxable estate. Under Section 1022 when it is applied, there can be a step down in basis for a decedent's assets, but no step up in basis, i.e. the same as transfer by gift. The proposed regulations add provisions to coordinate the carryover basis rules with several other sections under the Code where property basis can effect ongoing tax deductions. The regulations are not effective until issued in final form.

Portability. The IRS has recently issued final regulations under Code Sections 2010 and 2505 (T.D. 9725, 6/12/2015) detailing the rules for preserving portability of the unused estate and gift tax applicable exclusion of the first spouse to die. The final regulations replace temporary regulations that had been issued in 2012.

An item not addressed in the final regulations is relief for late elections of portability due to a timely estate tax return not being filed by the due date. The IRS had issued some relief for late filings by small estates (those with gross valuations under the required filing threshold), by allowing automatic extensions of time to file the requisite Form 706. Revenue Procedure. 2014-18, 2014-7 IRB 513. But that relief only applies to deaths prior to 2014. In the preamble to the final regulations, Treasury states that extending such relief will be considered in the future.

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The preamble to the final regulations also mentions the issue of coordinating portability with Revenue Procedure 2001-38, 2001-24 IRB 1335, where the IRS had stated that a QTIP election on the estate tax return of the first spouse to die could be treated as a nullity if a marital deduction was not necessary to reduce estate tax liability to zero. Now that unused applicable exclusion of the first spouse to die can port to the survivor, there are situations where a QTIP election may be desired in conjunction with a portability election, even if the marital deduction is not needed to reduce estate tax. The preamble states that the issue of an unneeded QTIP election will be addressed in future guidance from the IRS.

IRS RULINGS AND ANNOUNCEMENTS

Estate Tax Return Closing Letters. A posting on the IRS website states that as of June 2015, the IRS will no longer issue estate tax closing letters, unless requested by the taxpayer. Closing letteres had been issued for all federal estate tax returns prior to this announcement. No reason for the change is given in the posting. It states that the taxpayer should wait at least four months after the filing of the Form 706 to make the closing letter request.

No Ruling Stance on Basis Step Up. In Revenue Procedure 2015-37, scheduled to be published in the Internal Revenue Bulletin in late June, the IRS has added to its no-ruling list in Revenue Procedure 2015-3, the issue of whether assets in a grantor trust can receive a Section 1014 basis adjustment upon the death of the grantor, where the assets of the trust are not includable in the decedent's gross estate. An example would be an irrevocable grantor trust that by gift or sale has assets that are not included in the grantor's gross estate, but over which the grantor is treated as the owner for income tax purposes under the grantor trust rules in Code Sections 671-679.

Statute of Limitations on Unreported Foreign Assets. IRS PMTA 2014-18 (3/17/2015). In an internal memorandum issued by the IRS Office of Chief Counsel, the Service addressed a question regarding the correct statute of limitations to apply to an estate tax return and related income tax returns, where the estate did not report interests in "specified foreign financial assets". In the tax audit in question, an individual U.S. person owned interests in foreign accounts. The executor for the estate filed a federal estate tax return, a final personal income tax return for the deceased, and an income tax return for the estate.

Section 6038D of the Code requires specified foreign financial assets to be disclosed on attachments to income tax returns. The final 1040 and the Form 1041 did not include disclosure of foreign accounts owned by the deceased. The assets were also omitted from the gross estate on the estate tax return.

The normal three year statute of limitations for assessment of tax had expired. However, the Code provides that the running of the statute of limitations for assessment on a tax return will be suspended for such tax return, event, or time period to which the undisclosed information relates. The Service concludes in the memo that the Forms 706, 1040 and 1041 all are related to the missing foreign account information, thus the statute of limitations would not run until the disclosure is made. If there is reasonable cause for the omission of the disclosure, then the statute of limitations would run on items and taxes shown on the tax returns not related to the foreign accounts.

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Charitable Contribution of Partnership Interest. CCA 201507018 (2/26/2015). In a Chief Counsel Advice, the Service reviewed a charitable deduction taken by a taxpayer who transferred an interest in a limited liability company to a charity. However, the CCA refers to the entity throughout as a partnership and to the parties as partners. The partnership agreement included a mandatory call right by the partnership over any units, at fair market value of the units, unless the partner attempted to transfer units in an unapproved transaction. There, the call right would be based on the capital contributions of the transferring partner. A partner could not transfer any units to a third party without the "manager's" approval. The taxpayer served as manager under the agreement.

The taxpayer assigned his partnership units to a charity. The charity was controlled by another partner in the partnership. The assignment document stated that the partnership and other partners consented to the transfer. Under a purchase agreement dated one day later, a corporation controlled by the partner who made the charitable contribution, purchased the partnership units from the charity, in exchange for a 20 years promissory note. The note provided for interest payments only with principal due on maturity. The corporation had no other assets or equity.

The IRS on audit challenged the taxpayer's claim of a charitable deduction. The CCA discusses the law relevant to the fact pattern. The advisory opinion cites IRS Revenue Ruling 68-174, where the IRS takes the position that a gift of a promissory note to a charity is not a gift, but the promise of a gift, and does not generate a charitable deduction until the payments on the note are made. The IRS concludes here that the transfer to the charity and the purchase of the partnership units by a controlled corporation one day later should be collapsed into a deemed transfer of a note to the charity. The CCA states that the charity was compelled to sell the partnership units to the corporation because it had no unfettered rights to dispose of the interest without the partners' approval.

Continued DING Rulings. PLR 201510001 (3/6/2015). Another string of identical private letter rulings has been issued by the IRS involving irrevocable nongrantor trusts funded with incomplete gifts. The rulings are approved by the IRS but really involve state income tax planning with trusts, known as "DINGs". The new rulings involved basically the same fact pattern and requested rulings as prior DING rulings issued in 2013 and 2014. In this ruling, persons who were not descendants of the grantor are included as beneficiaries of the trust and serve on the distribution committee, but otherwise the structure of the trust terms is the same and the IRS rulings are consistent with those issued in the last couple of years.

Rollover of IRA Designated to Trust. PLR 201507040 (12/24/2014). In a fact pattern where a decedent designated an IRA to the decedent's trust, the IRS ruled that after death, the surviving spouse as sole trustee could allocate the IRA to a marital trust, and transfer the IRA from the marital trust to an IRA established by the spouse. The marital trust in question allowed for the surviving spouse a right to withdraw and revoke all or any part of the trust. The surviving spouse as trustee allocated the IRA to the marital trust under the terms of the decedent's trust agreement, and then took possession individually of the IRA as the trust beneficiary. The IRS approved the transfer as a rollover to a surviving spouse, and not as an inherited IRA under Code Section 408(d).

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