FINANCIAL PLANNING ASSOCIATION OF NORTHEAST OHIO

2017 TAX UPDATE

JANUARY 19, 2017

Scott E. Swartz, J.D., LL.M.

Wellspring Financial Advisors, LLC

2017 TAX REFORM

In light of the November election results, 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.

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 some detail on his tax ideas during the campaign, compared to unknowns in other areas of government policy, it is hard to say how much the author of the "Art of the Deal" is ideologically invested in any one item of tax law (we might assume that the real estate development industry will not be negatively affected).

Rather than the guesswork and betting on particular provisions that will make it into legislation, time is best spent at this point looking at the factors and concepts that will influence how the new tax laws are developed. Here is what to watch as events unfold in Washington:

- The attention that will be consumed by the Affordable Care Act and other critical issues.
- How harmonious are the Republicans? How Republican really is Mr. Trump?
- How genuine is the stated intent to "reach across the aisle"?
- Is fiscal conservatism an issue anymore?
- The Congressional Budget Act of 1974, what does that have to do with this?
- How worried are red state Senate Democrats about 2018?

As to the major players involved, here is a summary of what they have advocated so far:

Trump Published Positions

- 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 at $100,000 for individuals and $200,000 for married persons.
- Taxation of "carried interest" for managers of private equity and hedge funds at ordinary income rates, not as capital gains.

House of Representatives

The House position was 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, 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 some 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.

In Sum

There are so many priorities that the Republican Congress and Trump Administration will want to tackle. It is reasonable to believe legislation could 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 tax provisions that were unpopular to Senate Democrats, such as repeal of the estate tax, the Senate crafted tax legislation as a "budget reconciliation" to avoid filibuster rules, and only require a simple majority of 51 votes.

However laws by budget reconciliation cannot affect the federal budget beyond a ten year window. This led to the 2001 Act 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.

2016 YEAR IN REVIEW

TREASURY REGULATIONS

A Charged Atmosphere Surrounding 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 family partnership valuation discounts. The authority for the issuance of regulations (not necessarily the extent and reach of the IRS proposal) goes back to legislation in 1990. The Internal Revenue Code 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.

The proposed regulations are not yet effective, and the rules state they will not be effective until issued in final form. An IRS hearing was held on December 1 and most of the testimony was critical of the proposed rules. The IRS could issue final regulations in early 2017, or maybe 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 of Mr. Trump and a Republican Congress, combined with backlash critical of the regulations as proposed, cast doubt over finalization. It would seem an IRS governed by a Treasury Secretary appointed by Mr. Trump will have different priorities than the implementation of these rules.

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.

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, in other words the appraiser must pretend the restriction on the ownership interest does not exist. Also, 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.

COURT CASES

A TKO for the IRS in a Family Partnership Case. *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). 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.

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. He established the Edward G. Beyer Limited Partnership (EGBLP). A revocable "Management Trust" was the 1% general partner of EGBLP, and a revocable "Living Trust" was a 99% limited partner. The FLP was funded with 800,000 shares of Abbott Labs and some other miscellaneous securities. The taxpayer held back about $4 million in wealth outside of the partnership.

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 IRS audited the Form 706 estate tax return 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. 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. The taxpayer testimony and statements in evidence before the court argued three reasons for the transfer of the partnership interest to the Grantor Trust to be legitimate: (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.

For various reasons the Tax Court agreed with the IRS position, those reasons including:

- There was correspondence with attorneys referencing that a primary reason for doing so was to realize valuation discounts for transfer tax purposes.
- Transfers to EGBLP were made by the 1999 revocable trust (not the two trusts that actually were the partners).

- 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, none of which matched the three reasons for the partnership advanced at the trial.
- After the taxpayer's 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 that were the result of taxable gifts unrelated to the partnership transactions.
- In 2008, a check was issued from the EGBLP bank account to the IRS for "IRS 706", referring to estate taxes due. 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.
- 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.
- 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.
- The reasons given for the partnership could be satisfied through other means, e.g. the block of Abbott Labs stock could have been preserved through revocable trust amendments, the nephew could have been installed in management duties through the trust agreements and power of attorney, and continuity of management could also be achieved from revocable trust amendments.
- The court even noted that due to erroneous capital accounts in the books and records of the partnership, the taxpayer could not demonstrate that adequate and full consideration was received for the capital contributions.

Another IRS Victory on a Family Partnership. *Estate of Sarah Holliday v. Commissioner*, TC Memo. 2016-51 (3/17/2016). The IRS prevailed in this Tax Court case on the issue of including all the assets of a family limited partnership in the taxable estate of the decedent. Sarah Holliday died in 2009 at the age of 84. Three years prior to that her family had assisted her with some estate planning, including the creation of a family partnership. She gave her two sons, Joseph and Douglas, power of attorney over her financial affairs, and although she signed all legal documents related to the plan, her sons took care of planning and implementing the structure of the partnership, Oak Capital Partners, LP.

On November 30, 2006, Sarah executed the certificate of limited partnership, the limited partnership agreement, the articles of organization for OVL Capital Management, LLC (a single member LLC formed to be general partner of Oak Capital), and the operating agreement for OVL. A week later Sarah contributed about $6 million in marketable securities and cash to the partnership, a portion of which was on behalf of and attributed to OVL's capital contribution as general partner. She retained a substantial amount of assets in personal name outside of the partnership. On the same day as the funding, Sarah assigned her ownership of the OVL interest to her two sons in exchange for $3,000 from each of them, equal to the pro rata value of the general partner interest. Also on that day she assigned by gift a 10% limited partnership interest to an irrevocable trust, retaining the other 89.9% limited partner interest.

After her death, the estate tax return included in her taxable estate only the 89.9% limited partner interest, with valuation discounts. The IRS assessed $785,000 in estate taxes on the basis that under Code Section 2036(a), the entire partnership should be included in her taxable estate. The estate denied the existence of an implied or oral agreement that allowed Sarah to retain control of the partnership assets, argued that as of her death she did not retain possession or enjoyment of or a right to income from those assets, and argued she had no right to designate who would enjoy the partnership assets. The IRS argued that she retained possession of the property, retained a right to the income as evidenced by the partnership agreement, and that there was an implied agreement that Sarah could access the partnership income.

The court evaluated whether the decedent had a legitimate nontax business purpose for creating and funding the partnership. The court reviewed the estate's arguments for the presence of legitimate nontax reasons and the actual facts of the case, and concluded that (i) asset protection was not an actual motivation but was theoretical, the decedent not being in any danger from creditors and not having been sued before, (ii) protection of her assets from caregivers exhibiting undue influence was not legitimate when Sarah had two sons managing her financial affairs, despite testimony that such influence had occurred in the case of an extended family member, (iii) the partnership was not necessary for preservation since assets of her deceased husband had been adequately managed in trust form, (iv) the decedent did not actually believe the partnership was necessary because she was completely uninvolved in the creation other than signing papers as directed, (v) she was on both sides of the transaction with no negotiations or bargaining, (vi) the partnership failed to maintain books and records, hold meetings, or keep minutes, and otherwise operated without regard to the terms of the partnership agreement, and (vii) the assets of the partnership were not actively managed after contribution of the marketable securities.

Silver Lining for a Madoff Victim. *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.

Limitations on State Powers to Tax Trust Income. *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 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.

Hardly a Fiction Thriller, But an Interesting Estate Tax Case. *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 determine 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 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 from 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.

Income Tax Liability on Life Insurance Loans. *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.

Major Taxpayer Victory on Split Dollar Insurance. *Morrissette v. Commissioner*, 146 T.C. No. 11 (4/13/2016). The Tax Court agreed with the taxpayer in case involving a split-dollar life insurance plan. For decades the family of Clara Morrissette, age 93, and her deceased husband had operated a successful moving company that eventually grew into a multi-state business holding company, Interstate Group Holdings, Inc. (IGH), an S corporation with several qualified subchapter S subsidiaries. Clara transferred all of her IGH stock to her revocable trust.

Clara was declared incompetent, and an employee of the company was named her guardian with broad authority to handle her financial affairs. Through her legal guardian, Clara established dynasty trusts for her sons. Clara's revocable trust was amended to permit the trustee to pay premiums on life insurance policies acquired to fund the buy-sell provisions of IGH's business succession plan, make loans, and enter into split-dollar life insurance arrangements or make other arrangements. The amendment also authorized the trustee to transfer each receivable it was due from the split dollar arrangement back to the irrevocable trust owing the receivable or directly back to each son.

The dynasty trusts, the children, and Clara's revocable trust all entered into a shareholders' agreement for IGH with buy-sell provisions. The buy-sell obligations were to be funded with life insurance under a split-dollar arrangement. The agreement provided that upon the death of any of the three sons of Clara, the surviving siblings and their dynasty trusts would purchase the shares of the deceased son or in the deceased son's trust. To provide the dynasty trusts with liquidity to meet the stock purchase obligations, each dynasty trust purchased two universal life insurance policies, one on the life of each other brother (6 policies total).

To fund the purchase of the policies, each dynasty trust and Clara's revocable trust entered into two split-dollar life insurance arrangements. Clara's revocable trust transferred $29,300,000 in equal shares to each dynasty trust The dynasty trusts then used that money to pay a lump-sum premium on each universal life policy to maintain that policy for the insured's (each respective son) projected life expectancy. Under the split-dollar life insurance arrangements, upon the death of the insured, Clara's trust would receive a portion of the death benefit from the respective policies insuring the life of the deceased son, equal to the greater of (i) the cash surrender value of that policy, or (ii) the aggregate premium payments toward that policy. Each dynasty trust would receive the remaining balance of the death benefit under the policy it owned on the life of the deceased, which would be available to fund the purchase of the IGH stock owned by or for the benefit of the deceased. The split-dollar agreements specifically stated that the arrangements were to be treated under the economic regime split dollar final regulations and that the only economic benefit to the dynasty trusts was death benefit insurance protection. Additionally, the dynasty trusts executed collateral assignments of the policies to Clara's revocable trust to secure payment of the amounts owed to her trust. Neither the dynasty trusts nor Clara's trust retained the right to borrow against the policies.

From 2006 to 2009, gift tax returns were filed by Clara for the transfers to the dynasty trusts. The amount of the taxable gifts were determined using the economic benefit regime set forth under the regulations under Regulations Section 1.61-22. The amount of each gift reported was (i) the cost of the current life insurance protection for the year as determined using IRS Table 2001, less (ii) the amount of each premium paid by the respective dynasty trust. So after the total transfer of $29.3 million from Clara to the dynasty trusts, Clara reported taxable gifts for the four years in question in a total amount of about $630,000.

Clara died in 2009. Included on her estate tax return was the value of the receivables due from the dynasty trusts to Clara's revocable trust under the terms of the split-dollar agreements. An independent appraiser valued the receivables at a total of $7.48 million. The IRS issued notices of deficiency to the estate for unpaid gift taxes of $13.8 million, plus penalties, arguing primarily that Clara had made gifts of $29.3 million in 2006. The issue for the Tax Court was whether the split-dollar agreements conformed to the economic benefit regime regulations under Code Section 61, the question being whether the dynasty trusts received any additional economic benefit other than the cost of the current life insurance protection. The court concluded that the arrangements conformed to the regulations put in place in 2003. It observed that the instant case was identical to an example included in the preamble to those regulations. The dynasty trusts did not have access to the cash value of the policies or any other economic benefit. Clara's trust had retained a right to receipt of the split-dollar receivables, including all of the policy cash value, either at her death or in the event of a termination of the arrangement prior to her death.

Amorous Payments – Gifts or Income? *Blagaich v. Commissioner*, T.C. Memo. 2016-2 (1/4/2016). The Tax Court ruled against a taxpayer on a question of whether the IRS should be prevented from assessing unpaid income taxes. Diane Blagaich argued that the matter of whether she received a gift or income was already litigated in state court, and the IRS should be bound by that ruling. The court declined to grant judgment to dismiss the IRS' case in her favor.

Blagaich, age 54, was on romantic terms with Lewis Burns, age 72. During 2010, Lewis made several large gifts to Diane, including $200,000 wired from his account, a Corvette, and various other checks. In November 2010, they each signed a document that memorialized their understandings of the relationship and formalized their "respect, appreciation and affection for each other." Intending not to be married, they agreed in the document "to respect each and continue to spend time with each other consistent with their past practice", that both would "be faithful to each other and refrain from engaging in intimate or other romantic relations with any other individual." The agreement provided for an immediate payment of $400,000 from Lewis to Diane.

After the agreement the relationship deteriorated such that by March 2011, Diane moved out of Lewis' residence. Lewis sent Diane a written notice of termination of the agreement. Somehow Lewis came to believe that Diane had violated the monogamous aspects of the agreement and filed a lawsuit in a local Illinois court, seeking return of the Corvette, a diamond ring, and the prior cash transfers, all totaling over $700,000. He also filed a Form 1099-MISC with the IRS for 2010, reporting a sum paid to Diane of $743,819. The state court issued a ruling in 2013 that the various transfers to Diane were gifts, with the exception that Diane owed Lewis' estate (he died after the trial) the $400,000 amount, which she paid in 2014.

The executor of Lewis' estate filed an amended Form 1099 with the IRS, reducing the amount reported to $400,000. The IRS had issued a tax assessment against Diane on unreported income of $743,819. In Tax Court, Diane argued (i) the IRS should be estopped from arguing any amount above the $400,000 returned is income, and (ii) the $400,000 is not income under the doctrine of rescission, because ultimately she was bound to repay it in a later year. The IRS argued it was not a party to the state court action, and can maintain its position on what was income to Diane at the Tax Court level. The court agreed with the IRS that it was not prevented from maintaining its action on the "gift portion" of the Form 1099, and found the doctrine of rescission not applicable since the amount was not repaid in the same year.

Taxpayer Shenanigans with IRAs. *Thiessen v. Commissioner*, 146 T.C. No. 7 (3/29/2016). This is a case of a taxpayer trying to increase the usefulness of the tax deferral with IRAs by taking ownership of a controlled business venture in the IRA. James Thiessen retired out of 30 years of work at Kroger Co. Through a business broker he found a seller of Ancona Job Shop, a metal fabrication business. The business broker advised Thiessen that he could use his retirement account to acquire Ancona by forming a new C corporation that would be owned by his rollover IRA that would purchase Ancona.

Thiessen proceed to form Elsara Enterprises, Inc., and sold the stock to his IRA for over $431,000, approximately the balance of the IRA. Elsara then purchased the asset of Ancona for $600,000, funded by a $60,000 escrow deposit from Thiessen's personal bank account, $342,000 from the IRA, and a promissory note executed by Elsara for the balance. The note was guaranteed by Thieseen personally.

The IRS assessed income taxes on a deemed distribution of $431,000 from the IRA, arguing that the guarantee of the note was an indirect lending of money or extension of credit to the IRA, a prohibited transaction under Code Section 4975. The prohibited transaction caused the deemed IRA distribution. The Tax Court agreed with the IRS position.

More Shenanigans. *Polowniak v. Commissioner*, T.C. Memo 2016-31 (2/25/2016). The taxpayer, through his wholly-owned S corporation named "Strategies", entered into a $680,000 consulting agreement with Dephi Automotive Systems. Soon thereafter, he formed Bevco, a C corporation, and directed his Roth IRA to purchase 98% of the stock of Bevco. Strategies entered into a subcontracting agreement with Bevco to provide consulting services, which would be provided by Polowniak. The agreement called for Strategies to pay Bevco 75% of its revenue that Strategies received from Delphi. Delphi was not aware of the subcontract agreement. Bevco had no other source of revenue, no address, or phone number.

Payments by Delphi to Strategies were later deposited into a Bevco checking account. Strategies filed an S corporation tax return that did not report the income from Delphi. The IRS assessed tax against Polowniak as the shareholder of the S corporation for underreporting of the Delphi income and also assessed a Section 4973 excise tax for excess contributions to the Roth IRA, on the basis that the income assigned to Bevco (98% owned by the Roth IRA) was really a contribution to the IRA by Polowniak. The

Tax Court agreed with the IRS that the transactions as a whole were a mechanism to direct funds into the Roth IRA in excess of allowed limits. There was no independent substance to the Bevco contract with Strategies, no normal business dealings, no invoices, and no records of services performed.

IRS RULINGS AND ANNOUNCEMENTS

QTIP Elections and Portability. Rev. Proc. 2016-49 (9/27/2016). This IRS Revenue Procedure brings current the position of the Service 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 a Revenue Procedure from 2001, which stated that the IRS would disregard and treat as a nullity for estate and gift purposes a QTIP election that did not serve to reduce the estate tax liability on the Form 706 estate tax return. 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. In pre-portability days, of course, the exemption of the first spouse to die was wasted when not used.

The new guidance 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 the Revenue Procedure 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.

A Self Checkout Lane Opens 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 avoid 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 day 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 option will help to avoid seeking relief through an expensive private letter ruling.

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.

Mortgage Interest Deduction 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 indebtedness limit. This becomes important, as in this case, in situations with unmarried taxpayers who share a residence and payments on the mortgage debt.

Automatic Extensions of Portability Returns. Through information posted to the IRS website, the Service has confirmed that IRS Form 4768 may be used to obtain an automatic six month extension period to file an estate tax return riled solely for the purposes preserving portability of the deceased spouse's unused exclusion amount (DSUEA). The DSUEA of the first spouse to die can only be preserved by the surviving spouse via a complete and properly prepared estate tax return that is timely filed. The Q&A in the website posting states that if the deadline, or extended deadline, is not met for filing an estate tax return that has not met the filing threshold level based on the gross estate and adjusted taxable gifts, a request for late approval may be filed in the form of a private letter ruling request under the Section 301.9100-3 relief regulations. However this relief is not available for electing portability for late returns where the gross estate/adjusted taxable gifts filing threshold is exceeded.

Basis Consistency Reporting – Continued Delay and Questions. In the summer of 2015, new legislation created new Internal Revenue Code Section 1014(f) and Section 6035. The combined effect of these new laws is a required basis consistency standard, where tax basis of an asset acquired from a decedent may not exceed the value of the asset as determined for federal estate tax purposes. The law imposes a reporting requirement on administrators of estates regarding basis in assets received by heirs. Effective for estate tax returns filed after July 31, 2015, the administrator was to file with the IRS, and provide to the recipients of estate assets, the value used for estate tax purposes. This effective date was continuously delayed through 2016 as the IRS tried to figure out how to apply the rules.

The law is now effective under proposed regulations issued by the IRS In March 2016. Public commentary followed with many questions as to how to comply with the law. The regulations state that estate tax returns filed solely for the purpose of portability of unused estate tax exemption do not trigger the need to file Form 8971 "Information Regarding Beneficiaries Acquiring Property From a Decedent". It is a two page form, the second page of which is the Schedule A that is given to the beneficiary. Certain assets do not need to be included on the form, such as cash, IRD items, tangible personal property with a value of less than $3,000 (the same as the threshold for a required appraisal), and property that is not ultimately distributed to an estate or trust beneficiary (such as if it is sold or disposed of by the estate/trust). Basis consistency does not apply to property that qualifies for the marital or charitable deduction, i.e. the rules only apply to assets that would increase estate tax liability.

A source of current debate is completing the new IRS Form 8971. In some estate administrations an issue can arise on this filing where by the time of the of the due date for the Form 8971, it is not yet determined which beneficiary is receiving which assets identified on the estate tax return. In that case, the regulations provide that the Schedule A submitted to the beneficiary list all possible assets the beneficiary might receive, resulting in potential duplicative reporting. If a beneficiary cannot be located by the due date, Schedule A is still filed with the IRS, with explanation of the efforts to locate the beneficiary.

Scott E. Swartz is Counsel to Wellspring Financial Advisors, Cleveland, Ohio. . His responsibilities with Wellspring include internal legal matters of the Firm, as well as advisory work for client families. His advisory services include areas of concern to business owners, such as business venture structure and formation, federal and state income taxation, business tax planning, purchase and sale transactions, and ownership succession with key employees and family members. He also advises firm clients on issues with estate plans, corporate and partnership taxation, long-term trust arrangements, and tax minimization in the management and transfer of wealth.

Prior to joining Wellspring, Scott was in the private law practice of law for over twenty years, and was a certified public accountant after obtaining his business administration degree and majors in accounting and finance from Bowling Green State University. He completed law studies at Cleveland-Marshall College of Law and New York University, where he received his Masters of Law in Taxation.

Scott has served as an Adjunct Professor of Law in the Graduate Tax Program at Case Western University's School of Law. He also has been an Adjunct Professor in the Masters of Accounting program at Cleveland State University. He authors the Tax and Estate Planning Update to the National Association of Estate Planning Councils' quarterly newsletter, and provides frequent updates and planning ideas on matters of federal and state taxation in various forums. He is a past director of the Estate Planning Council of Cleveland and currently serves on the board of the Tax Club of Cleveland.