Tax Update

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May 19, 2014

A. Introduction

B. Tax Court Rules on Value of LLC and Deduction of Interest by Estate

Estate of Koons T.C. Memo. 2013-94 (Apr. 8, 2013), involved two issues in which the Tax Court's decision was heavily influenced by the percentage interest in a limited liability company ("LLC") that the decedent's estate would own after certain redemptions took place that were agreed upon prior to the decedent's death but not implemented until after his death. Prior to his death, the decedent and his family members, directly and indirectly, owned a corporation that was a bottler and distributor of Pepsi products and operated a large vending machine business. The corporation and Pepsi were involved in litigation and as part of the settlement process, the corporation agreed to sell its soft drink and vending businesses to a Pepsi affiliate. In anticipation of the sale, the corporation created an LLC to which the entire corporation's assets other than the soft drink and vending businesses were transferred. The decedent owned a 46.94 percent voting interest and a 51.59 percent nonvoting interest in the corporation and the LLC. Around the time of the negotiations for the sale, the decedent apparently decided to liquidate his children's interests in the business and changed the terms of his revocable trust to eliminate them as beneficiaries, leaving only his grandchildren as beneficiaries. As a result, the children were presented with an agreement to sell their shares conditioned on the LLC's agreement to offer to redeem their LLC interests. Each child agreed to the sale and redemption agreement prior to the decedent's death even though the actual redemptions of the LLC interests did not take place until shortly after his death. After the redemptions, the estate owned 70.42% voting control of the LLC.

The Tax Court addressed the value of the LLC interests owned by the revocable trust at the decedent's death. Because of the sale of the soft drink and vending businesses prior to the decedent's death, the assets in the LLC consisted mainly of cash. The estate valued the LLC interest using a 31.7 percent discount for lack of marketability. The IRS's expert argued that the lack of marketability discount should be only 7.5 percent. One difference between the two approaches was that the IRS's expert assumed that the redemption would occur while the estate's expert assumed that the redemption would not occur. The court agreed with the assumption that the redemptions would occur because the redemption offers were binding contracts by the time the decedent died. The LLC had made written offers to each child to redeem their interest and each had signed the offer. Once signed, the offer letters required the children to sell their interests in the LLC to the LLC. The court accepted the IRS's expert's 7.5 percent lack of marketability discount. The resulting increase in the value of the LLC interests not only affected the estate tax due but also the generation-skipping transfer ("GST") tax due at the decedent's death. Because the decedent had eliminated the children as beneficiaries of his revocable trust, the trust became a skip person and the GST tax became due at the decedent's death.

The other issue addressed by the Tax Court was the deductibility of interest incurred on a loan, the proceeds of which were needed to pay the estate's transfer tax liabilities.

When a decedent's estate consists of mostly illiquid assets, the source of funds to pay federal and state estate taxes and GST taxes becomes an issue. The decedent's revocable trust borrowed $10.75 million from the LLC to raise money to pay the decedent's estate and GST taxes. Under the terms of the loan, interest and principal payments were to be made by the revocable trust in 14 equal, semi-annual installments beginning 18 years after the loan was executed. The terms of the loan prohibited prepayment. The estate claimed a deduction under section 2053(a)(2) for the total amount of interest due on the loan ($71,419,497). These types of loans are generally referred to as a Graegin loan since the loan was similar to the loan transaction approved by the court in *Estate of Graegin*, T.C. Memo. 1988-477 (Sept. 28, 1988).

Under Treas. Reg. section 20-2053-3(a), to be deductible under section 2035(a), an administrative expense must be actually and necessarily incurred in the administration of the decedent's estate. If the loan incurred by the estate to pay the estate tax liability avoids the forced sale of estate assets, the loan generally will be considered to be reasonable and necessary in administering the estate. See Rev. Rul. 84-75, 1984-1 C.B. 193. In *Estate of Graegin*, the Tax Court allowed a deduction for the full amount of interest on a loan to pay estate taxes from a wholly owned subsidiary of the decedent's closely held corporation. Payment of all principal and interest was due in a balloon payment at the end of the 15-year term of the loan (the term was set to coincide with the life expectancy of the surviving spouse, upon whose death assets would become available to repay the loan). The loan agreement prohibited prepayment of the principal and interest.

In *Koons*, the Tax Court found that in this case it was not necessary for the revocable trust to borrow from the LLC because at the time of the loan the revocable trust had 70.42 percent voting control over the LLC and the LLC had over $200 million in highly liquid assets. The revocable trust had the power to force the LLC to make a pro rata distribution to its members. Because of the revocable trust's ability to force a distribution of assets to it, the loan was unnecessary.

C. Supreme Court holds definition of marriage in DOMA unconstitutional

In *United States v. Windsor*, Docket Number 12-307 (S.Ct. June 26, 2013), the taxpayer challenged the constitutionality of section 3 of the Defense of Marriage Act ("DOMA") because it would require her to pay federal estate tax on the estate of her same-sex spouse's estate that would not be due if the couple were heterosexual. Section 3 of DOMA provides that for purposes of determining the meaning of any act of Congress or pronouncement of any United States government agency, the word "marriage" means only a legal union between one man and one woman as husband and wife and the word "spouse" refers only to a person of the opposite sex who is a husband or a wife.

In a 5-4 decision, the Supreme Court affirmed the Second Circuit's opinion that Section 3 of DOMA is unconstitutional as a deprivation of the equal liberty of persons that is protected under the Fifth Amendment. In so holding, the Court determined that the

concept and regulation of marriage is virtually the exclusive province of states and the federal government cannot enact laws which frustrate the states' rights to regulate marriage.

The Supreme Court's ruling that Section 3 of DOMA is unconstitutional extends marriage status to legally married same-sex couples for all sections of the Internal Revenue Code. It is important to recognize what this ruling did not do. Because section 2 of DOMA was not at issue in *Windsor*, it remains good law. Section 2 allows states to refuse to recognize same-sex marriages performed under the laws of other states. As a result, the ruling only applies for federal tax law purposes and the laws of the individual states regarding the definition of marriage still control for state tax law purposes.

Marital status affects dozens of separate sections of the Internal Revenue Code. This single change in the interpretation of the federal definition of marriage will require a reconsideration of all federal tax planning opportunities for same sex couples. In addition to the fundamental issues of filing status and gift and estate tax marital exemptions, other planning considerations in light of *Windsor* include:

- Naming the spouse as a designated beneficiary of a qualified retirement account and allowing a surviving spouse to "roll over" the decedent's retirement account into his or her retirement account;
- Electing portability to allow a surviving spouse to use the deceased spouse's unused exclusion amount;
- Simplifying the basis and contribution determinations for jointly owned property;
- Splitting of gifts;
- Application of section 1041 to transfers of property between spouses and transfers of property subject to a qualified marriage settlement agreement which allows the tax-free transfer of appreciated property between spouses;
- Right to certain Social Security, Medicare and Medicaid benefits;
- Treatment of related party loss transactions under section 267 which prevents related parties, such as spouses, from recognizing losses on transfers of built-in loss property;
- Applying the retained interest rules on transfers between related persons under sections 2701 through 2704;
- Applying the adoption tax credit;
- Applying the thresholds for the tax penalties and health insurance subsidies available under the Patient Protection and Affordable Care Act;
- Federal income and transfer tax consequences to same-sex couples who are married or reside in states with a community property regime.

In light of *Windsor*, the IRS issued Rev. Rul. 2013-17, 2013-38 I.R.B. 201 which amplifies and clarifies Revenue Ruling 58-66, 1958-1 C.B. 60. In Rev. Rul. 58-66, the IRS determined that if applicable state law recognizes common-law marriages such that state law would treat individuals in such relationships as husband and wife they would be treated as husband and wife for federal income tax purposes. Rev. Rul. 20013-17 determines the status of individuals of the same-sex who are lawfully married under the

laws of a state that recognizes such marriages for federal tax purposes. The revenue ruling holds:

1. The terms "spouse," "husband and wife," "husband," and "wife" include an individual married to a person of the same sex if the individuals are lawfully married under state law, and the term "marriage" includes such a marriage between individuals of the same sex.

2. The IRS adopts a general rule recognizing a marriage of same-sex individuals that was validly entered into in a state whose laws authorize the marriage of two individuals of the same sex even if the married couple is domiciled in a state that does not recognize the validity of same-sex marriages.

3. The terms "spouse," "husband and wife," "husband," and "wife" do not include individuals (whether of the opposite sex or the same sex) who have entered into a registered domestic partnership, civil union, or other similar formal relationship recognized under state law that is not denominated as a marriage under the laws of that state, and the term "marriage" does not include such formal relationships.

D. IRS issues guidance consolidating late S corporation election procedures

In Rev. Proc. 2013-30, 2013-36 I.R.B. 173, the IRS consolidates and modifies, supersedes and/or obsoletes these previously released revenue procedures. The revenue procedure provides procedures for certain situations that are in lieu of a letter ruling ordinarily required to obtain relief for a late election with regard to S corporations. Thus, a user fee does not apply to the corrective actions set forth in the revenue procedure.

In order to obtain relief for any situation covered by the revenue procedure, the following requirements must be met;

1. the taxpayer requesting the relief intended to be classified as an S corporation, intended the trust to be an ESBT, intended the trust to be a QSST, or intended to treat a subsidiary corporation as a QSub as of the “effective date” (relating to the taxpayer’s intent for the election to be effective);

2. the taxpayer requesting the relief requests relief under the revenue procedure within 3 years and 75 days after the date on which the election is intended to be effective (the “effective date”);

3. the failure to qualify as an S corporation, ESBT, QSST, or QSub as of the effective date was solely because the election was not timely filed; and

4. in the case of a request for relief for a late S corporation or QSub election, the taxpayer requesting the relief has reasonable cause for its failure to make the timely election and has acted diligently to correct the mistake upon its discovery; or (2) in

the case of a request for relief for an inadvertently invalid S corporation election or an inadvertent termination of an S corporation election due to the failure to make the timely ESBT or QSST election, the failure to file the timely election was inadvertent and the S corporation and the person or entity seeking relief acted diligently to correct the mistake upon its discovery.

The revenue procedure then describes additional specific requirements for each of the following types of relief: (1) relief for late S corporation elections; (2) relief for late ESBT and QSST elections; and (3) relief for late Qsub elections.

E. Tax Court finds appraisal was qualified

In *Friedberg v. Commissioner*, T.C. Memo 2013-224 (Sept. 23, 2013), the Tax Court originally denied a $3,775,000 charitable deduction for the donation of a facade easement because the appraisal did not meet the definition of a qualified appraisal under section 170(f)(11)(E) and Treas. Reg. section 1.170A-13(c)(3). On reconsideration, the court held that the appraisal of the property was a qualified appraisal for purposes of section 170.

Pursuant to section 170(f)(11)(D), no charitable deduction is allowed for contributions of property by an individual for which a deduction of more than $500,000 is claimed unless the individual obtains and attaches to its return for the tax year in which the contribution was made a qualified appraisal of the property performed by a qualified appraiser. A qualified appraisal of real property should include the following information:

1. A description of the property in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was (or will be) contributed;

2. The date (or expected date) of contribution to the donee;

3. The terms of any agreement or understanding entered into (or expected to be entered into) by or on behalf of the donor or donee that relates to the use, sale, or other disposition of the property contributed;

4. The name, address, and the identifying number of the qualified appraiser;

5. The qualifications of the qualified appraiser who signs the appraisal, including the appraiser's background, experience, education, and membership, if any, in professional appraisal associations;

6. A statement that the appraisal was prepared for income tax purposes;

7. The date (or dates) on which the property was appraised;

8. The appraised fair market value of the property on the date (or expected date) of contribution;

9. The method of valuation used to determine the fair market value, such as the income approach, the market-data approach, and the replacement-cost-less-depreciation approach; and

10. The specific basis for the valuation, such as specific comparable sales transactions or statistical sampling, including a justification for using sampling and an explanation of the sampling procedure employed.

Meeting the requirements of a qualified appraisal is critical. If the appraisal does not meet the requirements, the taxpayer is prohibited from claiming even $1 of charitable deduction. If the appraisal meets the requirements, the taxpayer is entitled to a charitable deduction. The issue of how much of a charitable deduction the taxpayer is entitled to may still be an issue for trial but the taxpayer is not foreclosed from taking a charitable deduction (as he or she would be if the substantiation requirements were not met)

F. IRS issues final and proposed regulations on the net investment income tax

On November 26, 2013, Treasury and the IRS issued final and proposed regulations under section 1411, which was enacted as part of the Affordable Care Act of 2010.

Section 1411 imposes a tax on net investment income of individuals, estates and trusts. Section 1411 does not apply to a trust in which all of the unexpired interests are devoted to one or more charitable purposes under section 170(c)(2)(B). For individuals, section 1411(a) imposes a tax equal to 3.8% of the lesser of: (1) the individual's net investment income for the tax year; or (2) the excess (if any) of the individual's modified adjusted gross income for the tax year over the threshold amount. Under section 1411(b), the threshold amount is $250,000 for a taxpayer filing a joint return or a surviving spouse, $125,000 for a married taxpayer filing separately and $200,000 for all other individuals. For estates and trusts, the threshold amount is $11,950.

Section 1411(c)(1) defines net investment income as the excess of: (1) the sum of gross income from (a) interest, dividends, annuities, royalties and rents other than income derived in the ordinary course of a trade or business that is not a passive activity, (b) other gross income derived from a trade or business that is a passive activity or trading in financial instruments or commodities, and (c) net gain attributable to the disposition of property that produces income in (a) or (b); over (2) the deductions allowed for income tax purposes that are properly allocable to such gross income or net gain.

The final regulations permit trustees to use the existing section 664 category and class system for charitable remainder trusts (CRTs) and exempt income accumulated prior to January 1, 2013.

The final regulations clarify that for purposes of section 1411, the term trade or business follows the meaning of section 162 and incorporates all case law and administrative guidance applicable to section 162. Furthermore, the IRS declined to offer a bright-line definition because the large number of factual combinations would make such a definition impractical and would be imprecise. The IRS also declined to create a new definition of working capital and rather defined it by reference to section 469(e)(1)(B).

The final regulations clarify that amounts received under annuity contracts that are includible in income under section 72(a), (b), and (e) are subject to section 1411.

G. Tax Court determines gift tax deficiency against estate

The Tax Court, in an unpublished opinion, entered a judgment against an estate and finalized gift tax deficiencies on the amount of deferred annuity contracts that were traceable to a decedent's qualified terminable interest property ("QTIP") trusts.

In *Estate of Kite v. Commissioner*, T.C. Memo. 2013-43 (Feb. 7, 2013), the Tax Court addressed the gift tax consequences of an elaborate estate plan involving the creation of family limited partnerships ("FLPs"), the termination of QTIP trusts and the sale of FLP interests for a private annuity. For the most part, the court's decision was taxpayer favorable although the court struggled with the gift tax consequences of the termination of QTIP trusts when the property was distributed to the surviving spouse (via her revocable trust) who subsequently transferred the property for a private annuity equal to the value of the property the spouse received from the terminated QTIP trusts.

In *Kite*, the Tax Court determined that the transfer of the QTIP trusts' property to the surviving spouse and her later sale in exchange of the property for the private annuity were "part of a prearranged and simultaneous transfer of the QTIP assets [and] would circumvent the QTIP regime." Thus, the court treated the termination of the QTIP trusts and the sale of the property for the private annuity as one integrated transaction under the substance over form doctrine and the surviving spouse was deemed to have made a gift of the reminder interest in the QTIP trusts under section 2519.

The Tax Court agreed with the estate in that the surviving spouse received full and adequate consideration in the annuity transaction. However, the court pointed out this did not equate to the surviving spouse receiving full and adequate consideration for the termination of the QTIP trusts (i.e., when the property in the QTIP trusts was transferred to the surviving spouse). The court determined the QTIP trusts' terminations days before the annuity transaction must be considered in the application of section 2519. The IRS argued, and the Tax Court agreed, the annuity transaction was done to avoid the application of section 2519 before the selling of the QTIP trusts' assets to the children. The QTIP trusts' terminations and the subsequent sale of their assets should be viewed as one integrated transaction under the substance over form

doctrine. The decedent was deemed to have made a gift of the full value of the remainder interests in the QTIP trusts despite the surviving spouse receiving full and adequate consideration on the transfer.

H. Seventh Circuit holds inherited IRA not exempt from bankruptcy estate

In *In re: Heffron-Clark*, 714 F.3d 559 (7th Cir. Apr. 23, 2013), a decedent owned an IRA that she personally established in 2000. She named her daughter as the designated beneficiary. After the daughter inherited her mother's IRA, the daughter and her husband filed for bankruptcy. The Bankruptcy Court ruled that an inherited IRA does not represent "retirement funds" in the hands of the current owner and, as a result, is included in the bankruptcy estate. The court concluded that money counts as "retirement funds" (a term that the Bankruptcy Code does not define) only when held for the owner's retirement, while an inherited IRA must be distributed earlier. The District Court reversed the Bankruptcy Court stating that any money representing "retirement funds" in the decedent's hands must be treated the same way in successors' hands, *i.e.,* not subject to the bankruptcy estate. The Fifth Circuit and Eighth Circuit have agreed with this approach. *See In re Chilton*, 674 F.3d 486 (5th Cir. Mar. 12, 2012); *In re Nessa*, 426 B.R. 312 (8th Cir. Apr. 9, 2010).

On appeal, the Seventh Circuit determined that "[i]nherited IRAs represented an opportunity for current consumption, not a fund of retirement savings" and, therefore the Bankruptcy Court in this case had properly classified the inherited IRA as non-retirement funds subject to inclusion in the bankruptcy estate.

On November 26, 2013, the Supreme Court granted *certiorari* to resolve the split in the federal circuits as to whether an inherited IRA constitutes a retirement fund.

I. IRS rules on GSTT consequences of distributions from a trust created in 2010

In Priv. Ltr. Rul. 2013-52-003 (Sept. 11, 2013) the IRS sets forth the treatment of a trust created in 2010 for generation-skipping transfer ("GST") tax purposes. The decedent died in 2010 leaving part of an annuity she owned to a trust for the benefit of her grandchild. The executor of the decedent's estate timely made the election under section 1022 to not be subject to estate tax and to allocate basis as provided by section 1022. The executor attached Schedule R, *Generation-Skipping Transfer Tax*, to Form 8939 and allocated the decedent's remaining GST exemption to other trusts established under her will. None of the decedent's GST exemption was allocated to the trust.

Pursuant to the terms of the trust, the trustee will receive the required minimum distributions for a term based on the decedent's life expectancy. During this term, the trustee is required to distribute annually the amounts paid to the trust to the grandchild. If the grandchild dies before the end of the annuity's distribution period, the grandchild's issue are entitled to the remaining distributions as beneficiaries of the trust. At the end of the distribution period, the trust will terminate and the trustee will distribute any remaining assets outright to the current beneficiaries of the trust.

The IRS issued the following rulings:

1. The trust is a skip person under section 2613(a)(2).

2. The annuity passing to the trust is a direct skip.

3. The decedent is the transferor of the annuity to the trust for GST tax purposes.

4. The GST tax resulting from the direct skip of the annuity to the trust is the value of the interest on the date of transfer multiplied by zero (because death occurred in 2010).

5. Under section 2653(a), the trust will be treated as if the transferor were assigned to the first generation above the highest generation of any person who has an interest in trust immediately after the generation-skipping transfer.

6. Periodic payments made after the date of transfer from the annuity to the trust and then from the trust to the grandchild while the grandchild is alive are not subject to GST tax because the transferor "moved down" to the generation one generation above the grandchild. Thus the grandchild is no longer a skip person.

This ruling confirms the result that occurred when individuals made transfers to a trust that was a direct skip in 2010. What this ruling did not state is what would happen if the grandchild dies before all periodic payments were made to the trust. In this case, the inclusion ratio is still 1 which means that the trust is not exempt from GST tax. Under the trust instrument, if the grandchild dies before the trust terminates, distributions are to be made to the grandchild's descendants. A distribution by the trust to a great-grandchild of the decedent would be a taxable distribution under section 2612(b) because the transferor (the decedent) is two or more generations above the transferee (the great-grandchild). Unless GST exemption was allocated to a transfer in trust in 2010, the trust may have a GST tax event if it has beneficiaries in the trust that are two or more generations younger than the transferor.

J. IRS provides for a simplified method for certain taxpayers to receive an extension of time to elect portability

In Rev. Proc. 2014-18, 2014-7 I.R.B. 513, the IRS has provided relief to elect portability for the estate of certain individuals who died between 2011 and 2013 if the estate was not required to file a return. Under the limited circumstances described in Rev. Proc. 2014-18, the IRS will allow an executor to file a return to elect portability of the decedent's unused exclusion amount for the benefit of the decedent's surviving spouse until the end of 2014.

Section 2010(c) allows the estate of a decedent who is survived by a spouse to elect portability (i.e., the surviving spouse is allowed to add the decedent's unused estate tax

applicable exclusion amount to the surviving spouse's applicable exclusion amount). To get the benefit of portability, section 2010 (c)(5)(A) establishes that the executor of the estate must elect portability on a Form 706 and file the return within the time prescribed by law (including extensions).

In Rev. Proc. 2014-18, the IRS has set forth a simplified method to apply for relief if the following requirements are met:

1. The taxpayer is the executor of a estate of a decedent who:
   a. Has a surviving spouse;
   b. Died between 2011 and 2013; and
   c. Was a US citizen or resident on the date of death;

2. The executor is not required to file an estate tax return under section 6018 (a);

3. The executor did not file an estate tax return within the time prescribed by Treas. Reg. section 20.2010-2T (a)(1); and

4. The executor
   a. Files a complete and properly-prepared Form 706 on or before December 31, 2014; and
   b. States at the top of Form 706 that the return is "filed pursuant to Rev. Proc. 2014-18 to elect portability under Section 2010 (c)(5)(A)."

Estates that do not meet these requirements may still request an extension of time to make the portability election via a request for a letter ruling.

K. Tax Court Rules Again on Valuation for Built-in Gains Tax

In *Estate of Richmond v. Commissioner*, T.C. Memo. 2014-26 (Feb. 11, 2014), the Tax Court has returned to its present value concept to determine the discount for built-in capital gains ("BICG") tax when valuing an interest in an entity for estate tax purposes. The discount for BICG tax is founded upon the premise that a hypothetical buyer, in determining the price he or she would pay for an interest in an entity, would take into consideration the tax on the capital gain inherent in an entity whose assets' fair market value meaningfully exceeds its tax basis compared to an entity whose assets' fair market value approximates its tax basis. The discount is applicable when the best estimate of an entity's value is based upon the net asset value ("NAV") method for valuation. While the case law is clear that such a discount is applicable when an entity's value is based upon the net asset value method, the cases are much less clear on the method for determining the amount of the discount.

The Tax Court continues to reject the very simple method to determine the discount associated with the BICG tax by simply determining the BICG tax on the date of death and subtracting it from the value of the interest. Instead, it follows its previous decisions in *Estate of Jensen v. Commissioner*, T.C. Memo. 2010-182 (Aug. 20, 2010)

and *Estate of Jelke v. Commissioner*, T.C. Memo. 2005-131 (May 31, 2005), *rev'd* (507 F.3d 1317 (11th Cir. Nov. 15, 2007)) and estimates how long it will take the "average investor" to turn over a similar portfolio and taking the present value of the tax liability using such turnover period. The court also imposed penalties. This case is appealable to the Third Circuit.

L. Tax Court rules on material participation of a trust for passive activity loss exception

In *Frank Aragona Trust v. Commissioner*, 142 T.C. No. 9 (Mar. 27, 2014), the Tax Court held that a trust qualified as a "real estate professional" under section 469(c)(7) and materially participated in the real estate activity for purposes of the passive loss rules under section 469. This decision is important for non-grantor trusts who own interests in pass-through entities that conduct a trade a business for purposes of both the passive activity rules and the determination of net investment income under section 1411.

In *Frank Aragona Trust*, a trust owned rental real estate properties and also engaged in other real estate activities such as holding and developing real estate. After the grantor died, his five children and an independent trustee succeeded the grantor as the new trustees. The trustees managed and made all major trust decisions, and each trustee received trustee fees from the trust. Three of the trustees worked full time and received wages from a limited liability company ("LLC") that was disregarded as to the trust. The LLC managed most of the trust's real estate properties and employed several other people. Two of the trustees held minority interests in some of the real estate entities also owned by the trust. The trust conducted its rental real estate activities directly, through wholly owned entities, and through entities in which the two trustee/sons also owned minority interests. In the 2005 and 2006 tax years, the trust incurred losses from its rental real estate properties which it treated as non-passive activities for the 2005 and 2006 tax years. The IRS issued a notice of deficiency determining that the trust's rental real estate activities were passive activities.
Section 469(a) disallows passive activity losses in excess of passive activity income in any given year. Section 469(c)(1)(A) provides that the term "passive activity" means any activity that involves the conduct of any trade or business in which the taxpayer does not materially participate. Sections 469(c)(2) and (c)(4) together provide that, with the exception of real estate professionals described in Section 469(c)(7), any rental activity is considered a passive activity, even if the taxpayer materially participates in the activity.

Section 469(c)(7)(B) provides two tests, both of which must be met, in order to be classified as a real estate professional. The first test is met if more than one-half of the "personal services" performed in trades or businesses by the taxpayer during the tax year is performed in real property trades or businesses in which the taxpayer materially participates. Regulatory guidance in Treas. Reg. section 1.469-9(b)(4) provides in part that "personal services" means any work performed by an "individual" in connection with a trade or business. The second test is met if the taxpayer performs more than 750

hours of services during the year in real property trades or businesses in which the taxpayer materially participates. The requirements of section 469(c)(7)(B) can be met only by a taxpayer who materially participates in a "real property trade or business." Section 469(c)(7)(C) defines the term "real property trade or business" as any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. Section 469(h) provides that a taxpayer materially participates in an activity only if the taxpayer is involved in the operations of the activity on a basis that is regular, continuous and substantial. Section 469(h) does not provide a method for determining how a trust may materially participate in an activity, and Treas. Reg. section 1.469-5T(g) which provides for material participation of trusts and estates has been reserved since the regulations were issued in 1988. In 2003, a District Court in *Mattie K. Carter Trust v. United States*, 256 F. Supp. 2d 536 (N.D. Tex. Apr. 11, 2003), held that the activities of a trust's trustees and non-trustee employees may be considered in determining whether the trust materially participated in a ranching activity. To date, the IRS has not followed the *Mattie K. Carter* case.

The IRS argued that no trust could qualify for the real estate professional exception because a trust cannot perform "personal services," since personal services means work performed by an "individual" in connection with a trade or business. Thus, only a natural person could be considered an "individual" in the performance of personal services. The Tax Court rejected this argument finding that the trustees were individuals and their work for the trust qualified as personal services by the trust. The court noted that if Congress had wanted to exclude trusts from the passive activity loss exception, it could have done it explicitly by limiting the exception to "any natural person," as Congress had done in a different provision of section 469. Because Congress did not clearly specify that only natural persons could perform services under section 469(c)(7), the court determined that Congress did not intend to exclude trusts from the exception.

In the alternative, the IRS argued that even if some trusts qualified for the section 469(c)(7) exception, the current trust did not because it did not materially participate in its real property business. The crux of the IRS's argument raised the issue of what trustee activities would count towards the material participation requirement. The IRS argued that only the activities of the trustees in their fiduciary capacity should be considered. Pointing to the absence of regulatory guidance, the Tax Court again disagreed with the IRS and held that the trust materially participated in its real estate trade or business in light of the trustees' regular, continuous, and substantial activities in the trust's real estate operations. The court noted that the trustees' fiduciary activities for the trust, including their activities as employees of the LLC, should be considered because "[T]rustees are not relieved of their duties of loyalty to beneficiaries by conducting activities through a corporation wholly owned by the trust." In essence, the court determined that a trustee cannot change hats or retire fiduciary duties even when working as a trust employee. Therefore, all of the trustees' activities counted towards material participation. In addition, the court declined the IRS's invitation to discard the employee activities of two of the trustees who held minority

interests in some of the trust's entities because these interests were below 50 percent (never greater than the ownership interests of the trust), were generally compatible with the trust's goals, and they were involved in managing the trust's real estate operations.

Finding that the trust materially participated in its real property trades or businesses, the Tax Court concluded there was no need to consider the two-part test of section 469(c)(7)(B) since the IRS limited its arguments to those above and did not raise issues as to whether the trust materially participated in its real estate business in: (1) more than one-half of the trust's personal services and (2) more than 750 hours of services. Therefore, the court held that the trust met the passive activity loss exception for the years at issue and its activities were non-passive.

The primary taxpayer favorable holding in this case is that if one or more trustees of a trust work in the underlying business as employees, the activity of those trustees is taken into account in determining whether a trust materially participates for purposes of section 469. The holding is important in two respects. First, in the case of a business that generates losses, the material participation of trustees will allow the losses from the non-passive activity to offset other trust income such as interest or dividends, and may even result in a net operating loss (as in the present case). Second, in the case of a business that generates income, the non-passive nature of an activity will significantly minimize the trust's section 1411 net investment income tax on the earnings from that business. Furthermore, if non-passive income is distributed to a beneficiary, the non-net investment income character of the distributed income will also not be taken into account by the beneficiary in calculating their net investment income tax.

M. Transfer Tax Provisions in President's Budget

On March 4, 2014 the President released his 2015 budget. It included the following gift, estate and generation-skipping transfer ("GST") tax revenue raisers.

- **Estate tax reform –** Even though the American Taxpayer Relief Act of 2012 made permanent changes to the gift, estate and GST tax regimes, the budget seeks to modify some of these provisions. The budget would increase the maximum rate from 40 percent to 45 percent and reduce the exemption amount from $5,340,000 to $3,500,000 for estate and GST tax purposes and $1,000,000 for gift tax purposes. It would continue to allow portability. The budget would make this proposal effective for decedents dying, and for transfers made, after December 31, 2017.

- **Minimum GRAT term** – This proposal would put a minimum term requirement of 10 years for grantor retained annuity trusts ("GRATs"). This would make a GRAT a riskier planning technique because the transfer tax benefits of GRATs are typically achieved when the grantor outlives the GRAT term. The maximum term of the GRAT could not be longer than the life expectancy of grantor plus 10 years. The proposal would also require the remainder interest of a GRAT to have a value other than zero but does not give a required minimum amount. Finally, the

proposal would prohibit any decrease in the amount of the annuity during the annuity term to prevent front-loading a GRAT.

- **Coordination of income and transfer tax treatment for grantor trusts** – This proposal would provide that if a grantor engages in a transaction that constitutes a sale or exchange that is disregarded for income tax purposes, the portion of the trust attributable to property received in the transaction (including all retained income, appreciation and reinvestment net of the amount of consideration receive by the grantor) will be subject to gift or estate tax when the property is no longer subject to the grantor trust rules. Any gift or estate tax payable due to this proposal would be borne by the trust. The proposal is targeted at shutting down the gift and estate tax benefit of sales to intentionally defective grantor trusts.

- **Limit duration of GST exemption** – This proposal would terminate the GST exemption of a trust no later than the 90th anniversary of its creation. After the 90th anniversary, the trust would have an inclusion ratio of one. The proposal is an attempt by the administration to deal with many states that have changed or repealed their rules against the maximum term of a trust.

- **Consistency in valuations** – This proposal would limit the basis of property for income tax purposes to the value reported by a decedent's estate for estate tax purposes or by a donor for gift tax purposes. It would also provide a grant of authority to the IRS to require a donor or decedent to furnish basis information to the recipient of a gift or descent and to the IRS.

- **Extend liens on estate tax deferrals** – This proposal would extend the general estate tax lien that applies to all estate tax liabilities under section 6323 to continue past the normal 10 year period until the deferral period the decedent's estate has elected under section 6166 expires.

- **Clarify GST tax treatment of health and education exclusion trusts (HEETs).** Section 2503(e) excludes from gift tax any payments made directly to the provider of medical care and payments made directly to an educational institution for tuition. Section 2611(b)(1) excludes from GST tax any transfer made pursuant to section 2503(e). HEETs provide for medical and tuition expenses of multiple generations and distributions from them for these purposes are excluded from GST tax. Since they are exclusively for purposes described in section 2503(e), there is no need to allocate GST exemption to them as distributions from them are excluded from GST tax. This proposal would *clarify* that section 2611(b)(1) only applies to a payment by a living donor.

- **Simplify gift tax annual exclusion for gifts to trusts (new).** In general, gifts to a trust are not considered gifts of a present interest and, therefore, are not eligible for the gift tax annual exclusion which, in 2014, excludes the first $14,000 of gifts made to a donee. In *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. June 25, 1968), the Ninth Circuit ruled that a transfer to a trust that would otherwise be a gift of a future interest is the gift of a present interest if the beneficiary has the

unrestricted right to withdraw the contribution to the trust even if such right exists for only a limited period of time (typically 30 days). This proposal would eliminate the present interest requirement for gifts that qualify for the gift tax annual exclusion and impose an annual limit of $50,000 per donor on the donor's transfer of property to a trust.

- **Expand applicability of definition of executor (new).** For estate tax purposes, section 2203 defines executor as the person who is appointed, qualified and acting as an executor or administrator of the decedent's estate, or, if no one is serving in such a role, any person in actual or constructive possession of any property of the decedent. This proposal would make the definition applicable for all tax purposes, not just estate tax purposes. The proposal cites as the reason for the change the need to allow the executor to take care of any tax matters of the decedent including the ability of the executor to resolve tax matters that arose prior to the decedent's death.

- **Require non-surviving spouses to withdraw funds from IRAs and qualified retirement plans within 5 years of the death of the decedent (new).** In general, someone who inherits funds in an individual retirement account or qualified retirement plan must withdraw those funds within 5 years of the death of the owner of the individual retirement account or retirement plan. Exceptions to this rule are for surviving spouses and designated beneficiaries of the account or plan. Designated beneficiaries of these accounts or plans are generally allowed to "stretch" the payment of the remaining balance in the account over their remaining life expectancies. The proposal would generally require any person (other than a surviving spouse) who inherits an individual retirement account or retirement plan to withdraw the balance in the account or plan within 5 years of the death of the individual retirement account owner or plan participant. Exceptions are provided for eligible beneficiaries who are disabled, chronically ill, no more than 10 years younger than the individual retirement account owner or plan participant or a child who has not reached the age of majority.

N. IRS to apply aggregate IRA rollover limit for IRA distributions on or after January 1, 2015

In Announcement 2014-15, 2014-16 I.R.B. 1, the IRS announced that it will interpret section 408(d)(3)(B) as limiting a taxpayer from performing more than one rollover contribution in a one-year period with regards to the taxpayer's aggregate individual retirement accounts. Section 408 governs distributions from individual retirement accounts. Section 408(d) states that any amount distributed from an individual retirement account is includible in the individual's gross income. However, an individual may exclude a distribution from gross income if the entire amount is subsequently repaid to a qualifying individual retirement account, individual retirement annuity, or retirement plan not later than the 60th day after the day on which the individual receives the distribution ("rollover contributions"). Taxpayers may also make partial rollover contributions of less than the full amount of a distribution from an

individual retirement account if any portion of those funds is paid into a qualifying retirement plan not later than the 60th day after the day of receipt of the distribution.

There are limits to this exception. Specifically, section 408(d)(3)(B) limits a taxpayer from performing more than one rollover contribution in a one-year period with regard to individual retirement accounts. The one-year limitation period begins on the date on which a taxpayer withdraws funds from an individual retirement account and has no relation to the calendar year. Thus, for example, a taxpayer may not make a nontaxable rollover on December 31 in one calendar year and make another non-taxable rollover on January 1 of the next calendar year.

In Announcement 2014-15, the IRS announced its intention to follow *Bobrow v. Commissioner*, T.C. Memo 2014-21 (Jan. 28, 2014) and to withdraw Prop. Treas. Reg. section 1.408-4(b)(4)(ii). The IRS also intends to revise Publication 590 to set forth its position that section 408(d)(3)(B) should apply to individual retirement accounts on an aggregate basis. However, because the IRS's interpretation of section 408(d)(3)(B) may require individual retirement account trustees to make changes in the processing of individual retirement account rollovers and in individual retirement account disclosure statements, the IRS will not apply *Bobrow* to any rollover that involves an individual retirement account distribution occurring before January 1, 2015.

O. Ninth Circuit affirms denial of estate's deduction for uncertain litigation claim

Pursuant to section 2053(a), the value of a taxable estate is determined by deducting amounts (such as funeral and administration expenses) from the value of the gross estate. Section 2053(a)(3) allows a deduction for claims against a decedent's estate. Neither section 2053(a) nor the regulations thereunder contain a method for valuing a claim against an estate for estate tax purposes and there has been little consistency among the courts regarding the extent to which post-death events are to be considered in valuing such claims. One line of cases follows a date-of-death valuation approach and another line of cases restricts deductible amounts to those amounts actually paid by the estate in satisfaction of the claim.

Final regulations, effective for estates of decedents dying after October 20, 2009, reflect the IRS's rejection of the date-of-death valuation approach and adoption of rules based on the premise that an estate may only deduct amounts actually paid in settlement of claims against the estate. The final regulations "clarify" that events occurring after a decedent's death are to be considered when determining the amount deductible under all provisions of section 2053 and that such deductions are limited to amounts actually paid by the estate in satisfaction of deductible expenses and claims.

In *Estate of Saunders v. Commissioner*, Docket No. 12-70323 (9th Cir. Mar. 12, 2014) the Ninth Circuit affirmed the Tax Court's decision (136 T. C. No. 18 (Apr. 28, 2011)) that post-death events could be considered in valuing a legal malpractice claim pending against the decedent at the time of his death. The Ninth Circuit and the Tax Court applied the prior regulations that were in effect at the date of the decedent's death.

Under Treas. Reg. section 20.2053-1(b)(3), a deduction for a claim may be taken even though its exact amount is not known provided it is ascertainable with reasonable certainty and will be paid. However, no deduction may be taken upon the basis of a vague or uncertain estimate. That regulation section also provides that if a liability that is not deductible because it is not ascertainable subsequently becomes ascertainable, a deduction may be claimed at a later time.

In *Saunders*, the decedent's estate had a pending claim against it stemming from a malpractice suit against the decedent's previously deceased spouse. The suit claimed damages of $90 million. The estate valued the malpractice claim at $30 million. The claim was ultimately settled for $250,000. The IRS challenged the valuation and allowed a deduction of $1. The Tax Court concluded that the claim was not ascertainable with reasonable certainty and would be deductible only when actually paid. As a result, the $30 million deduction claimed on the estate tax return was reduced to the $250,000, the amount actually paid plus the $289,000 cost of litigation.

P. Conclusion