CONTEMPORARY ESTATE PLANNING PARADIGMS FOR MARRIED COUPLES

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The American Taxpayer Relief Act of 2012 ("ATRA") fundamentally changed tax planning, especially for wealthy married couples. This short handout offers basic estate planning templates for married couples with small, medium, and large estates, respectively, in light of ATRA.

I. BACKGROUND

A. The Significance of Income Tax Planning

The signature feature of ATRA was permanence; that is, the Act made permanent the lion's share of the various provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (collectively known as the "Bush tax cuts") that had been set to expire at the end of 2012. While the federal income tax system for most taxpayers is thus the same under ATRA as it was for most of the last decade, ATRA did reintroduce the 39.6% bracket for ordinary income and the 20% rate for adjusted net capital gain. The following chart containing the inflation-adjusted tax brackets for unmarried individuals and married couples in play for 2017:

(Adapted from Rev. Proc. 2016-55)

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* Other long-term capital gains could be taxed as high as 25% (building recapture) or 28% (collectibles and §1202 stock).

** Includes employer contribution of 1.45% (§3111(b)(6)), individual contribution of 1.45% (§3101(b)(1)), and additional tax of 0.9% for adjusted gross income over $200,000 for an unmarried individual and $250,000 on a joint return (§3101(b)(2), for years after 2012).
*** Note too that unmarried individuals with adjusted gross incomes in excess of $254,200 and joint filers with adjusted gross incomes in excess of $305,050 are subject to the phase-out of both personal exemptions and itemized deductions.

For couples with high taxable incomes, therefore, ATRA represented a significant increase in federal tax rates. Even couples with more modest incomes might be paying more federal income tax, however, because of the application since 2013 of the 3.8% net investment income surcharge under §1411. Federal income taxes have thus become more significant for many married couples.

B. The (In)Significance of Transfer Tax Planning

ATRA also made permanent the $5,000,000 basic exclusion amount that was introduced in the Tax Relief and Unemployment Insurance Reauthorization and Job Creation Act of 2010 ("TRUIRJCA"). As under TRUIRJCA, the basic exclusion amount is adjusted for inflation after 2011.

For decedents dying in	The basic exclusion amount is
2011	$5,000,000
2012	$5,120,000
2013	$5,250,000
2014	$5,340,000
2015	$5,430,000
2016	$5,450,000
2017	$5,490,000

As a result of TRUIRJCA and ATRA, some married couples have been rendered "statutorily poor:" they used to have taxable estates when the exclusion amount was much lower, but they no longer have taxable estates now that, with only a modicum of planning between the two of them, they can transfer $10.9 million without triggering federal wealth transfer taxes. For these couples, transfer tax planning has obviously become much less significant.

But even wealthy couples with taxable estates may not fear wealth transfer taxes as they once did, for ATRA set the rate of federal estate and gift taxes at a flat 40%. That is less than the 55% maximum rate that would have kicked in had ATRA not imposed a 40% rate. And the 40% rate is awfully close to the marginal tax rates faced by many couples with taxable estates.

Year	Transfer Tax Rate	Highest Income Tax Rate
2010	0%	35% ordinary, 15% capital
2011 – 2012	35%	35% ordinary, 15% capital
2013 - 2017	40%	43.4% ordinary, 23.8% capital

For some couples, therefore, federal wealth transfer tax planning is no more important than federal income tax planning. That is dramatically different than where we were a decade ago.

Year	Transfer Tax Rate	Highest Income Tax Rate
2000	37-55%	39.6% ordinary, 28% capital
2001	37-55%	39.1% ordinary, 20% capital
2002	41-50%	38.6% ordinary, 20% capital
2003	41-49%	35% ordinary, 15% capital
2004	45-48%	35% ordinary, 15% capital
2005	45-47%	35% ordinary, 15% capital

C. The Portability Election

ATRA also made permanent the revised definition of the "applicable exclusion amount" used for federal estate and gift tax purposes. Instead of expressing the applicable exclusion amount as a fixed dollar amount ($2 million in 2006, 2007, and 2008; $3.5 million in 2009; $5 million in 2010), the applicable exclusion amount now is the sum of the basic exclusion amount ($5,000,000 as adjusted for inflation) and the "deceased spousal unused exclusion amount," referred to in the regulations as the "DSUE Amount." Very generally, the DSUE Amount consists of the unused portion of a deceased spouse's basic exclusion amount.

The DSUE Amount is not available automatically; the statute requires an election by the deceased spouse's executor. Regulations finalized in 2015 confirm the statutory requirement that an estate claiming the portability election must file an estate tax return within nine months of the decedent's death (unless an extension of time for filing has been granted), regardless of the size of the gross estate and regardless of whether an estate tax return would otherwise be required to file a return. But in the case of smaller estates, the regulations provide that estates not otherwise required to file a Form 706 may, in lieu of reporting the value of certain property that qualifies for the marital or charitable deduction, instead estimate the total value of the gross estate (including the values of the property that do not have to be reported on the estate tax return under this provision), based on a determination made in good faith and with due diligence regarding the value of all of the assets includible in the gross estate.

Planners and commentators initially dismissed the portability election as a safety net for taxpayers who, for whatever reason, failed to engage in traditional marital deduction planning. It was easy to dismiss the portability election in part because when it was first introduced in late 2010, it was scheduled to last for only two years. Now that the election is more or less a permanent feature of federal wealth transfer tax planning, however, planners cannot dismiss the portability election so easily. Indeed, in some cases the portability election might prove preferable to traditional marital deduction planning.

II. SORTING MARRIED COUPLES – THE "BUCKET" APPROACH

The current structure of the federal income, estate, and gift tax system makes it so no one template can be used for all married couples. Instead, modern tax planning requires married couples to be sorted into one of three "buckets," each with its own template.

BUCKET ONE	BUCKET TWO	BUCKET THREE
Combined net worth less than 1 basic exclusion amount (no more than $5.49 million in 2017)	Combined net worth more than 1 basic exclusion amount but not more than 2 basic exclusion amounts (more than $5.49 million but not more than $10.98 million in 2017)	Combined net worth more than 2 basic exclusion amounts (more than $10.98 million in 2017)

These materials will suggest a possible template for each bucket. Before doing so, two points must be stressed from the outset. First, the application of state estate, gift, and inheritance tax laws may affect the relative size of each bucket and even, perhaps, the total number of buckets in play. Suppose, for example, that a married couple with a $3.5 million combined net worth resides in a state that imposes its own wealth transfer tax with an exclusion amount of only $2 million. The strategies discussed below for Bucket One assume no transfer tax at all will be imposed. If the amount of state estate tax is a concern, the planner in this example might limit the Bucket One template to couples with combined net wealth of $2 million or less and use some of the strategies from Bucket Two in an attempt to plan for the state estate tax. But even that approach requires caution, as state estate tax systems may not permit all of the options described in Bucket Two, most notably QTIP and portability elections. So where state transfer taxes are an issue, the planner will need to give careful consideration as to how these templates may be applied successfully to couples that face liability for such taxes.

Second, just as no two snowflakes are alike, no two estate plans are ever identical. What follows are general templates that a planner can use as a starting point in designing the precise estate plan that will work best for any particular married couple. These templates do not consider the special issues that arise, for example, in planning for a beneficiary with special needs, planning for couples that hear the word "dynasty" and get all atwitter, or planning for couples that intend to leave the bulk of their wealth to one or more charitable organizations. Likely no one will use the exact templates set forth herein, but hopefully they provide a helpful framework for building plans that will actually be implemented.

III. PLANNING FOR BUCKET ONE COUPLES

BUCKET ONE TEMPLATE
• Trust or outright gift upon death of first spouse? • Ensure stepped-up basis for all on death of surviving spouse • Consider protective portability election

There is a three-part template for married couples with a combined net worth not in excess of the basic exclusion amount.

A. Transfer Upon First Spouse's Death: Trust or Outright Gift?

The couple needs to decide how the assets of the first of them to die should pass. For most couples, there are two choices: by outright gift to the surviving spouse or to a trust of which the surviving spouse is a beneficiary. In answering this question, taxes are irrelevant. Clients choosing to use a trust will be doing so for non-tax reasons. Those reasons could include:

* the desire of the first spouse to die to control the disposition of his or her assets after death
* a concern that the surviving spouse may not have the capacity or desire to manage the assets
* a concern that assets in the name of the surviving spouse might be vulnerable to creditors

Of course there are good reasons for clients to prefer an outright gift:

* the desire to avoid the costs of trust formation and administration
* the desire to avoid the complexity of trusts (you can't get much simpler than an outright gift)

Happily, Bucket One couples are free to choose the method that works best for them; taxes do not control any of the decisions here.

B. Ensure All Assets Get Stepped-Up Basis on Survivor's Death

Since transfer tax planning is not an issue for Bucket One couples, it is crucial that planners get the income tax planning piece right. And that means ensuring everything gets a fresh-start, fair market value basis for income tax purposes upon the surviving spouse's death.

Where couples choose to let assets pass to the surviving spouse by **outright gift**, the step-up in basis on the surviving spouse's death is assured since the spouse owns everything. At this point, however, it is worth mention that the fresh-start, fair market value basis on property passing from a decedent can cause a "step-down" in basis as well (as where the property's value at the time of the surviving spouse's death is less than the surviving spouse's adjusted basis in the property). While estate planners are well-trained in making sure such losses are recognized prior to death so they are not lost, clients will sometimes find a way to die before fully purging loss assets from their portfolios. "Step-downs" will thus happen from time to time. But most beneficiaries will benefit from the application of the fair-market-value-at-date-of-death rule.

Obtaining a stepped-up basis for everything on the surviving spouse's death is more complicated where the couple decides to have assets pass from the first spouse to die via a **trust**. If structured as a typical irrevocable trust, the assets of the trust will not receive a stepped-up basis on the death of the surviving spouse because those assets are not included in the surviving spouse's gross estate for estate tax purposes. For Bucket One couples using trusts, therefore, the key is to create a trust causes inclusion of the trust assets in the survivor's gross estate. Gross estate

inclusion is not an adverse result for Bucket One couples, recall, because federal wealth transfer taxes are not an issue: even if everything is included in the surviving spouse's gross estate, the total size of the estate is less than the surviving spouse's basic exclusion amount.

There are at least two ways to structure a trust so that it results in gross estate inclusion, thus assuring that the assets get a stepped-up basis on the surviving spouse's death. First, the trust instrument can give the surviving spouse a testamentary power to appoint all or any portion of the trust estate to the surviving spouse's estate. This is a **general power of appointment**, and property subject to a general power of appointment is generally includible in the gross estate of the power-holder. In order for this approach to get the maximum advantage, the surviving spouse should be entitled to all of the income from the trust (payable at least annually) for the surviving spouse's life. This makes the property passing to the trust eligible for the estate tax marital deduction, thus maximizing the DSUE Amount that can pass to the surviving spouse in the next component of the template. But since estate taxes are not a factor for Bucket One clients, it is not critical that the surviving spouse receive the income. Nor is it crucial that the power be so broad; it is sufficient, for example, that the spouse has a testamentary power to appoint the trust property only to the creditors of the surviving spouse's estate.

Second, the trust can be structured to qualify for the qualified terminable interest property ("**QTIP**") exception to the terminable interest rule. If a trust meets the requirements for a QTIP election and the executor of the estate of the first spouse to die properly makes the QTIP election, the assets remaining in trust upon the death of the surviving spouse will be included in the surviving spouse's gross estate, thus assuring here too that the assets qualify for a stepped-up basis. Some practitioners had been concerned that the Service might disregard QTIP elections made by the estate of a Bucket One deceased spouse on the grounds that the QTIP election was not necessary to avoid imposition of federal estate tax. In Revenue Procedure 2016-49, however, the Service made clear that it would not disregard a valid QTIP election unless requested to do so by the executor.

C. Consider the Protective Portability Election

By definition, estate taxes are not an issue for Bucket One couples. Even if the clients completely bungle the handling of the first spouse's estate, the surviving spouse alone has a basic exclusion amount ample enough to shelter all of the property from federal wealth transfer taxes. Thus one may rightfully wonder why the Bucket One template would consider the need for a portability election.

Planners might consider a portability election upon the death of the first spouse simply because the surviving spouse may come into other, unexpected wealth (prizes, jackpots, punitive damage awards, treasure trove) or may see unexpected surges in the value of assets. In any of those cases, having the DSUE Amount in addition to the basic exclusion amount could prove helpful. Since the only cost to making the portability election is filing a timely estate tax return that would be subject to the relaxed reporting requirements described above, this would likely be cheap insurance.

IV. PLANNING FOR BUCKET TWO COUPLES

BUCKET TWO TEMPLATE
• Trust or outright gift upon death of first spouse?
• If outright gift is preferred, use disclaimer planning
• If trust is preferred, use *Clayton* QTIP

Planning in Bucket Two is perhaps the most challenging. Clearly *some* transfer tax planning is in order; if the planner does nothing and wastes the first spouse's applicable exclusion amount, the surviving spouse will not have sufficient exclusion to cover the couple's combined net worth, even if those assets do not appreciate in value after the death of the first spouse.

The question, though, is what kind of planning makes the most sense. Before 2011, we always used our friend, the credit shelter trust. Even where the credit shelter trust made no sense outside the world of taxes, it was often our only recourse to make sure each spouse's exclusion was utilized fully. Now, however, we also have the portability election at hand. And for clients in Bucket Two, the portability election is usually all we need to make sure federal wealth transfer taxes remain a nullity. So the planner has to consider which is better: using the good, old-fashioned credit shelter trust or the new-fangled portability election.

A. When Credit Shelter Trust is Better

In many cases, the credit shelter trust will be the better option. The two principal advantages of credit shelter trusts are these:

1. Asset Appreciation Expected

Unlike the basic exclusion amount, the DSUE Amount does not adjust for inflation. Thus, for example, suppose the executor of the first deceased spouse elects to have a $5 million DSUE Amount pass to the surviving spouse. When the surviving spouse dies 25 years later, the basic exclusion amount will be substantially higher, but the DSUE Amount will still be $5 million.

On the other hand, assets placed in a credit shelter trust will not be subject to estate tax on the death of the surviving spouse no matter how much they may appreciate in value. If the assets owned by the surviving spouse are expected to appreciate substantially before the surviving spouse's death, then, the credit shelter trust will usually be the preferred option.

2. Client Wants to Use the Generation-Skipping Transfer Tax Exemption

While the DSUE Amount applies for both federal estate tax and federal gift tax purposes, it does not apply for purposes of the generation-skipping transfer tax. On the other hand, executors can elect to apply the GSTT exemption to assets placed in a credit shelter trust, permanently shielding the trust assets from the generation-skipping transfer tax. If the couple wants to make significant

provision for grandchildren and other beneficiaries further down the line of descent, the credit shelter trust will be more attractive.

B. When Portability is Better

But there are situations where portability may have the edge over credit shelter trusts. Here are three that come to mind:

1. Some Assets Don't Fit Well in Credit Shelter Trusts

Retirement accounts and residences make for poor assets in a credit shelter trust. For income tax purposes we can generally achieve better results by naming the surviving spouse as beneficiary instead of a trust. For purposes of excluding gain from the sale of a residence, moreover, title in the surviving spouse's name is better since trusts cannot occupy a residence, one of the conditions required for excluding gain.

2. Some Surviving Spouses Don't Survive Long Enough

If the surviving spouse does not live for a meaningful period of time following the first spouse's death, there is little chance that assets inside of a credit shelter trust will have had an opportunity to appreciate in value to any significant extent. So after undergoing the expense, delay, and complexity involved in funding and administering the credit shelter trust, it would do no better than the simple, cost-effective portability election.

3. Stepped-Up Basis May be More Important

Remember that assets owned either outright by the surviving spouse or by a QTIP trust will get a stepped-up basis for income tax purposes on the death of the surviving spouse. Assets inside of a credit shelter trust, however, do not get a step-up in basis. One must therefore check the balance sheets, for if the lurking capital gain in the estate is substantial yet the combined net worth puts the couple just over one basic exclusion amount, the step-up in basis matters much more than the estate tax savings—to the point that a credit shelter trust may be unwise.

C. The Bucket Two Template

So the decision between a credit shelter trust and a portability election, ultimately, comes down to the answers to these five questions: (1) when will the first spouse die?; (2) what assets will the couple have at the time of the first spouse's death?; (3) how much longer will the surviving spouse live after the death of the first spouse ?; (4) what will the basic exclusion amount be when the first spouse dies?; and (5) what will the transfer tax rates be upon the death of the first spouse? If we know this information, we can make the right choice. But few planners will be in a position to answer these questions with any confidence. Accordingly, the important theme for all planning in Bucket Two is **flexibility**. We want a plan that can let the couple choose the right path (credit shelter trust or portability election) when they have better answers to those five questions (i.e.,

after the death of the first spouse) instead of a plan that forces them to commit to one path now when there is so much uncertainty. This template does that.

1. Transfer Upon First Spouse's Death: Trust or Outright Gift?

It all starts with the same question posed to Bucket One couples: if taxes were not an issue, what should happen to the assets when the first spouse dies? Since we can create an effective plan regardless of which option the couple chooses (outright gift or trust), tax consequences have no relevance at this stage. See the Bucket One template for discussion of when couples might prefer outright gifts over trusts and vice versa.

2. Outright Gifts – Disclaimer Planning

If the couple elects to have the assets of the first spouse pass to the survivor by outright gift, then the testamentary document (will or living trust) should contain a provision whereby any gift properly **disclaimed** by the surviving spouse shall pass to a credit shelter trust. This way, we keep both portability and the credit shelter trust on the table, and we need not choose between them until after the death of the first spouse to die.

If, for example, we know after the death of the first spouse that portability is the better option (because the survivor is not expected to live long, or because of the nature of the assets, or because of whatever other reason), the surviving spouse simply accepts the gift. The executor can then file an estate tax return that claims a full marital deduction. This reduces the taxable estate to zero (since all passes to the surviving spouse outright), and then the unused applicable exclusion amount passes to the surviving spouse. But if we decide that a credit shelter trust is the better option, the spouse can disclaim the gift (or disclaim an amount equal to the amount of the first spouse's remaining applicable exclusion amount) and by operation of the instrument the gift will pass to the credit shelter trust.

This structure postpones making the ultimate decision until after the death of the first spouse. Like any plan making use of qualified disclaimers, the planner should discuss with the couple the practical constraints involved. For instance, the surviving spouse must not accept the benefit of any of the deceased spouse's property in order for any disclaimer to be valid. That means funds will need to be available for the surviving spouse so that the survivor is not tempted to accept the benefit of the deceased spouse's property before the final decision whether to make a disclaimer has been made.

3. Trusts – *Clayton* QTIP

If the couple instead opts to have the assets of the first spouse pass to the survivor through a trust, a good vehicle is the so-called *Clayton* QTIP trust. A *Clayton* QTIP is just like a regular QTIP trust in that all income is to be paid at least annually to the surviving spouse and trust distributions during the spouse's lifetime can be made only to the surviving spouse. And like a regular QTIP trust, the executor has to elect to treat assets intended to qualify for the marital

deduction as "qualified terminable interest property." But the *Clayton* QTIP trust contains an additional provision: to the extent the executor does not elect to qualify an asset passing to the trust as qualified terminable interest property, such property shall automatically pass to a credit shelter trust.

An example illustrates the flexibility of this approach. Suppose the deceased spouse's will leaves everything to a *Clayton* QTIP. If the deceased spouse's executor decides that portability is the preferred planning option for whatever reason, the executor will make the QTIP election on a timely filed estate tax return for all of the assets in the trust. The gift will qualify for the unlimited marital deduction, meaning the deceased spouse's taxable estate will be reduced to zero and the full DSUE Amount can port over to the surviving spouse. If the executor instead decides that the credit shelter trust is best, the executor can select assets with a value equal to the deceased spouse's remaining applicable exclusion amount and then make the QTIP election for *all other assets*. The unelected assets will pass automatically to the credit shelter trust.

As with the disclaimer approach, the *Clayton* QTIP allows the couple to defer making the decision between portability and the credit shelter trust until after the first spouse dies. It thus provides the needed flexibility.

V. PLANNING FOR BUCKET THREE COUPLES

BUCKET THREE TEMPLATE
• Traditional high net worth planning
• Caution when transferring interests in S corporation or partnership

Unlike good stories, we have saved the most boring for last. Not much has changed when it comes to advising, say, the $50 million estate. The techniques used prior to ATRA remain attractive now. Choosing between portability and a credit shelter trust alone will not be enough.

A. Traditional High Net Worth Planning

The planner still needs to consider strategies that can reduce the amount of wealth subject to tax while still retaining the desired level of control over and cash flow from the assets in the estate. These strategies include:

- spousal lifetime access trusts (SLATs)
- irrevocable life insurance trusts (ILITs)
- grantor retained annuity trusts (GRATs)
- charitable lead trusts (CLATs and CLUTs)
- charitable remainder trusts (CRATs, CRUTs, NIMCRUTs)
- donor-advised funds, private foundations, pooled income funds
- family limited partnerships (FLPs) and limited liability companies
- installment sales to "defective" grantor trusts
- dynasty trusts

Of course, even some Bucket Two couples may find one or more of the above strategies useful in their own planning as well. But it's now primarily Bucket Three couples that are concerned with gross estate minimization.

B. Transferring Assets in S Corporations and Partnerships

One fairly recent development may affect Bucket Three couples primarily, but even some Bucket Two and Bucket One couples may face this issue too. Before 2013, couples with stock in S corporations or partnerships that operated small businesses often gifted their equity interests to children as part of their succession plan. But for children that do not materially participate in the business, doing so today presents an additional risk: the flow-through income of an S corporation or partnership engaged in an active trade or business is treated as net investment income in the hands of an owner who does not materially participate in the business. In some cases, the flow-through income from the business by itself catapults the beneficiary into a tax bracket high enough to trigger the 3.8% net investment income surcharge.

A better solution is to transfer such equity interests to a grantor trust for the benefit of the non-participating child. The income is taxed to the parents (who presumably remain active in the business) so the flow-through income is not subject to the surcharge. In addition, the payment of tax by the parents is not an additional gift to the trust or the beneficiary.

2016 FEDERAL TAX UPDATE

Recent Developments in Federal Income, Estate and Gift Taxes Affecting Individuals and Small Businesses

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These materials summarize important developments in the substantive federal income, estate and gift tax laws affecting individual taxpayers and small businesses using the timeframe of December, 2015, through August, 2016. The materials are organized roughly in order of significance. These materials generally do not discuss developments in the areas of deferred compensation or the taxation of business entities (except to a very limited extent).

INDIVIDUAL FEDERAL INCOME TAXES FOR 2017

(Adapted from Rev. Proc. 2016-55)

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*** Note too that unmarried individuals with adjusted gross incomes in excess of $254,200 and joint filers with adjusted gross incomes in excess of $305,050 are subject to the phase-out of both personal exemptions and itemized deductions.

A. KEY PROVISIONS OF THE PROTECTING AMERICANS FROM TAX HIKES ACT OF 2015

Signed into law on December 18, 2015, the Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act") revived and made permanent dozens of provisions that had expired at the end of 2014. That these provisions are no longer subject to expiration and extension is welcome news for planners and clients. Still, the PATH Act did not make everything permanent, and some important provisions are now set to expire (again) at the end of 2016. Here is a sample of the newly-permanent benefits of interest to individual taxpayers.

1. Above-the-Line Deduction for Teachers' Classroom Expenses

PERMANENT. K through 12 teachers can deduct up to $250 of unreimbursed expenses in determining adjusted gross income. The expenses must relate to books, equipment, supplies (except for nonathletic supplies used in health or P.E. courses—read "condoms"), or computer equipment and related services or software.

2. Exclusion for Discharges of Debt on Principal Residence

THROUGH 2016. In 2007 Congress created a new exclusion for "qualified principal residence indebtedness" (QPRI), defined as up to $2 million of "acquisition debt" (any debt used to buy, build, or improve a principal residence). A taxpayer need not be insolvent to qualify for this exclusion, but the exclusion will not apply if the debt is discharged on account of services performed for the lender or for any other reason "not directly related to a decline in the value of the residence or to the financial condition of the taxpayer." The taxpayer's basis in the principal residence must be reduced (but not below zero) by the amount excluded from gross income under this rule.

3. Deduction of Mortgage Insurance Premiums

THROUGH 2016. Legislation in 2006 created an itemized deduction for premiums paid or accrued on qualified mortgage insurance. Generally, qualified mortgage insurance is mortgage insurance obtained in connection with acquisition debt on a qualified residence that is provided by the Veterans Administration, the Federal Housing Administration, the Rural Housing Administration, or certain private providers.

4. Sales Tax Deduction

PERMANENT. Individuals may still elect to deduct either state and local income taxes or state and local general sales taxes. Taxpayers electing to claim their sales taxes may deduct either the actual sales tax paid (as substantiated by all those receipts accumulated in a shoebox) or an amount determined under tables to be prescribed by the Service. The chief beneficiaries of this election are taxpayers living in states without an income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.

5. Bonus Depreciation

THROUGH 2019. Under §168(k), depreciable tangible personal property and computer software acquired and first placed in service in 2016 and 2017 is eligible for an additional up-front depreciation deduction equal to the 50% of the asset's adjusted basis after taking into account any §179 election made with respect to the property. The regular depreciation deductions would then be computed based on whatever basis remains after the §179 election and the 50% bonus. This bonus 50% allowance is also available for alternative minimum tax purposes. The 50% bonus does not apply to intangibles amortized under §197 (with the limited exception of computer software), or start-up expenses amortized under §195. The bonus also does not apply to assets with a class life in excess of 20 years. In 2018, the bonus drops to 40%, and it drops to 30% in 2019 before expiring altogether in 2020.

6. §179 Expensing Election

PERMANENT. The dollar limitation on the §179 expensing election continues at $500,000 for 2015 and forward. As before, the $500,000 maximum is not reduced until the total amount of §179 property purchased and placed in service during the taxable year exceeds $2 million.

7. Expanded Limitations for Contributions of Qualified Conservation Real Property

PERMANENT. Prior to 2006, a contribution of qualified conservation real property to a public charity was treated the same as any other contribution to public charity: to the extent the property was capital gain property in the hands of the donor, the most that could be deducted in any one year was 30% of the taxpayer's contribution base (generally, adjusted gross income) with a carryover of up to five years. Legislation in 2006 permitted the current deduction of such contributions up to 50% of the taxpayer's contribution base, and with a carryover of 15 years. Moreover, the 50% limitation was increased to 100% in the case of "qualified farmers and ranchers" (those whose gross income from farming or ranching business exceeds 50% of their total gross incomes), provided the property is restricted to remain generally available for agriculture or livestock production. This has now been made permanent.

8. Above-the-Line Deduction for College Tuition

THROUGH 2016. The above-the-line deduction for "qualified tuition and related expenses" continues through 2016. The deduction limit remains at $4,000, and the full deduction is available only to those taxpayers with adjusted gross incomes of $65,000 or less (or $130,000 for married taxpayers filing jointly). Individuals with adjusted gross incomes in excess of $65,000 but not more than $80,000 (and joint filers with adjusted gross incomes in excess of $130,000 but not more than $160,000) may claim a maximum deduction of $2,000. A taxpayer still cannot claim both the deduction and the § 25A credits.

9. Qualified Charitable Distributions from IRAs

PERMANENT. As in past years, individuals age 70½ or older can exclude from gross income up to $100,000 in "qualified charitable distributions" from either a traditional IRA or a Roth IRA. Such distributions are not deductible as charitable contributions, but the exclusion from gross income represents a better result over prior law. Under prior law, the retiree had to include a minimum distribution in gross income but could donate the amount to charity and claim a deduction under §170. The income tax deduction was subject to the overall limitation on itemized deductions, §68, as well as the other limitations applicable to all charitable contributions under §170. In many cases, therefore, the income tax deduction did not offset completely the amount included in gross income even though the entire distribution was paid to charity. The current rule should appeal to those required to take minimum distributions that have sufficient funds from other sources to meet their living needs. A qualified charitable distribution is any distribution from an IRA made by the trustee directly to a public charity (i.e., one described in §170(b)(1)(A)) to the extent such distribution would be includible in gross income if paid to the account holder. The distribution may be made on or after the date the account holder reaches age 70½.

10. 100% Exclusion on Gains from Sales of Section 1202 Stock

PERMANENT. We all know that § 1202(a)(1) generally excludes half of the gain from the sale or exchange of "qualified small business stock" (generally, stock in a domestic C corporation originally issued after August 10, 1993, but only if such stock was acquired by the shareholder either as compensation for services provided to the corporation or in exchange for money or other non-stock property, and only if the corporation is engaged in an active business and has aggregate gross assets of $50 million or less) held for more than five years. The other half of such gain is subject to a preferential tax rate of 28 percent under §1(h)(1)(F). In effect, then, the entirety of such gain is taxed at a rate of 14 percent (half of the gain is taxed at 28 percent, half of the gain is not taxed at all). But for qualified small business stock acquired in 2013 or later, a 100% exclusion applies. This gives §1202 some much-needed bite.

11. Stock Basis Adjustments for Charitable Contributions by S Corporations

PERMANENT. When an S corporation contributes property to charity, the corresponding charitable deduction, like all deduction items, passes through to the shareholders. Generally, a shareholder's basis in S corporation stock is reduced by the amount of deductions passing through, but an S corporation's charitable contribution will only cause a shareholder's stock basis to be reduced by the shareholder's pro rata share of the adjusted basis of the contributed property. Thus, for example, if an S corporation with two equal shareholders donated to charity real property worth $100 in which the corporation's basis was $40, each shareholder could be eligible to claim a $50 charitable contribution (half of the $100 value) while only reducing stock basis by $20 (half of the $40 basis). This offers a tremendous benefit to S corporation shareholders, especially where the contributed property would have triggered liability for tax under §1374 as built-in gain property. Charitable contributions of such property do not trigger

the §1374 tax, and now also have the chance to carry out a fair market value deduction to the shareholders at a cost equal only to the basis of the contributed property.

12. Five-Year Recognition Period for S Corporation Built-in Gains Tax

PERMANENT. When a C corporation makes an S election, the §1374 tax looms. This corporate-level tax applies to any "net recognized built-in gains" during the "recognition period" (generally, the first ten years following the former C corporation's subchapter S election). For 2009 and 2010, however, the recognition period was shortened to seven years. Then, the recognition period was shortened to five years in 2011. This shorter recognition period has now been made permanent. So if the corporation made its S election effective for 2011, any net recognized built-in gains in 2016 will not be subject to the tax.

B. BASIS REPORTING AND THE DUTY OF CONSISTENCY

1. Background

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (signed on July 31, 2015) created two new income tax provisions as revenue raisers. First, new §6035(a)(1) requires executors of estates required to file a federal estate tax return to provide "a statement identifying the value of each interest in" property included in the decedent's gross estate. The statement must be furnished to the Service and to "each person acquiring any interest" in such property within 30 days of the date on which the estate tax return is filed for due (including extensions), whichever is earlier. Section 6035(b) authorizes legislative regulations to enforce this new requirement, and it directs Treasury to consider, among other things, the application of this requirement to cases where no estate tax return is required to be filed. A conforming amendment to §6724(d)(1) makes the failure to furnish this statement subject to a $250 penalty.

Second, new §1014(f) provides that the basis in property acquired from a decedent cannot exceed the final value that has been "determined" for federal estate tax purposes. Where there has not yet been a "determination" of the property's value, the basis cannot exceed the amount provided in the §6035 statement. Basis is "determined" for federal estate tax purposes where the value is shown on the federal estate tax return and the Service does not contest it before expiration of the statute of limitations. If the Service does timely contest the value and the executor relents, the basis of the property will be "determined" as the value set by the Service. Of course, basis can also be "determined" by a court or through a settlement agreement between the Service and the estate.

The new rules, which effectively prohibit claiming property has a lower value for estate tax purposes and a higher value for income tax purposes, are applicable to property "with respect to which an estate tax return is filed" after July 31, 2015. That gave Treasury little time to implement the new regime. In *Notice 2015-57* (issued on August 21, 2015), Treasury indicated that for §6035 statements required to filed or furnished to a beneficiary before February 29, 2016, the due date

is postponed to February 29, 2016. This was supposed to give Treasury time to issue guidance implementing these new rules and, ideally, a form. Indeed, the notice told executors and others required to furnish §6035 statements not to do so "until the issuance of forms or further guidance by the Treasury."

2. Form 8971

On January 29, 2016, Treasury released the final version of Form 8971, Information Regarding Beneficiaries Acquiring Property From a Decedent, together with instructions. The Form asks for general information about the decedent and executor, as well as the name, taxpayer identification number, and address of each beneficiary. The Form includes a Schedule A, the page to be furnished to each beneficiary of the estate. The schedule must provide a "description of property acquired from the decedent," along with an indication of where the item is reported on the estate's Form 706. The schedule must indicate whether the asset increased estate tax liability, the valuation date for the asset, and the "estate tax value (in U.S. dollars)." The Schedule A includes this notice to beneficiaries: "You have received this schedule to inform you of the value of property you received from the estate of the decedent named above. **Retain this schedule for tax reporting purposes.** If the property increased the estate tax liability, Internal Revenue Code section 1014(f) applies, requiring the consistent reporting of basis information. For more information on determining basis, see IRC section 1014 and/or consult a tax professional."

Instructions accompanying the form indicate that if final distributions have not been made by the time the Form 8971 is due, "the executor must list all items of property that could be used, in whole or in part, to fund the beneficiary's distribution on that beneficiary's Schedule A. (This means that the same property may be reflected on more than one Schedule A.) A supplemental Form 8971 and corresponding Schedule(s) A should be filed once the distribution to each such beneficiary has been made." As Steve Akers observed in a February, 2016 report, "This [will] cause real heartburn for some estates. Executors may be reluctant to provide full information about all estate assets to beneficiaries who are only entitled to receive a general bequest that may represent a fairly small portion of the estate. Furthermore, it will be burdensome. In effect, *each* beneficiary who has not already been funded by the 30 day due date will receive a report that may be about as long as the Form 706–including a list of all assets listed on the return that have not yet been sold or distributed and that could be distributed to the beneficiary."

In *Notice 2016-19* (issued February 11, 2016), Treasury extended the first deadline for §6035 statements (Forms 8971) from February 29, 2016, to March 31, 2016. Then, in *Notice 2016-27* (issued March 23, 2016), Treasury again extended the deadline for Form 8971 filings to June 30, 2016.

3. Proposed Regulations

On March 4, 2016, Treasury issued proposed regulations offering guidance on the application of §§1014(f) and 6035. The proposed regulations offer a number of clarifications. First, they clarify

that while §1014(f) caps the initial basis a beneficiary takes in property, subsequent adjustments to basis for improvements, depreciation, and the like will still be allowed.

Second, the clarify that §1014(f) applies to property the inclusion of which in the decedent's gross estate actually increases the estate's liability for federal estate taxes; so property eligible for the marital and charitable deductions is not subject to §1014(f), nor is any tangible personal property for which an appraisal is not already required under the estate tax regulations. But all other property included in the gross estate is subject to §1014(f) if any federal estate tax liability is incurred.

Third, the proposed regulations address property discovered after the filing of the Form 706 and property omitted from the Form 706 (herein, "omitted property"). If the omitted property is reported before the expiration of the statute of limitations on the assessment of estate tax, the regular rules for determining the final value of property shall apply. But if the omitted property is reported after expiration of the statute of limitations, it will have a final value of zero. Likewise, if no estate tax return is ever filed, the final value of all property includible in the gross estate that is subject to §1014(f) is deemed to be zero.

Fourth, the proposed regulations clarify that the §6035 reporting requirement does not apply where an estate tax return is filed solely for purposes of making a portability election or a generation-skipping transfer tax exemption allocation.

Fifth, the proposed regulations exempt the following assets from §6035 reporting: cash, income in respect of a decedent, items of tangible personal property for which an appraisal is not required under the estate tax regulations, and property that will not be distributed to a beneficiary because it has been sold or otherwise disposed of by the estate in a taxable transaction.

Sixth, the proposed regulations make clear that where the executor is also a beneficiary, the executor must still furnish a Schedule A to Form 8971 to himself or herself. If the beneficiary is an estate, trust, or business entity, the notice is to be delivered to the entity and not its beneficiaries or owners. If the executor cannot locate a beneficiary in time, the Form 8971 is to explain the efforts taken to locate the beneficiary.

Finally, the proposed regulations provide that where the recipient of property reported on the Form 8971 transfers all or any portion of the property to a related party, the transferor must file a supplemental Form 8971 documenting the new ownership if the transferee's basis is to be determined with reference to the transferor's basis.

C. PROPOSED §2704 REGULATIONS TAKE AIM AT CERTAIN DISCOUNTS

1. Introduction and Effective Dates

On August 2, 2016, Treasury issued long-awaited (and long-feared) proposed regulations under §2704. The most important thing to understand up front is that none of these new rules (Proposed Regulation §§25.2704-1 through 25.2704-3) will take effect until the regulations are finalized (indeed, the more controversial provisions have an effective date that is 30 days after the date the regulations are finalized). The hearing on the proposed regulations has been scheduled for December 1, 2016. Most likely, then, none of these rules will apply until sometime in 2017, if at all. That gives planners and clients some time to consider how the new rules might affect current and future arrangements regarding closely-held family entities.

A short primer on §2704 (cribbed largely from the new 4th edition of FEDERAL WEALTH TRANSFER TAXATION by Kevin M. Yamamoto and Samuel A. Donaldson) will provide some context for the new regulations. Section 2704 contains two sets of rules for measuring the value of transferred interests in a corporation or partnership among family members. The first set of rules, in §2704(a), considers the effect of lapsing rights. The second set of rules, in §2704(b), relates to whether certain restrictions on liquidation of the entity will be respected for valuation purposes.

2. Section 2704(a) Background

Under §2704(a)(1), some lapses in voting, liquidation, or similar rights in a "controlled" corporation or partnership are treated as transfers of those rights by the holder. If the lapse occurs while the holder of the right is alive, the transfer is a gift. If the lapse occurs upon the death of the holder of the right, the transfer is deemed to occur at death and thus is included in the decedent's gross estate. There are thus two elements to the application of §2704(a)(1). First, there must be a lapse of voting or liquidation right in a corporation or partnership. Second, the holder of the lapsed right and members of his or her family must control the entity both before and after the lapse. Under §2704(a)(2), the amount of the transfer (or the amount included in the gross estate, as the case may be) is the excess of the value of all interests in the entity held by the holder immediately before the lapse (determined as if the lapsed rights were non-lapsing) over the value of such interests immediately after the lapse.

An example might help. Suppose George was a partner in a limited partnership. At his death, George held both a general partner interest and a limited partner interest. The general partner interest carried with it the right to liquidate the partnership; the limited partner interest had no such power. Accordingly, the value of the limited partner interest was $59 million if it was held jointly with the general partner interest but only $33 million if it was held alone. A buy-sell agreement between George and his son, William Henry, required George's estate to sell the general partner interest to William Henry for $750,000. Absent §2704(a), the value of the limited partner interest included in George's estate would be $33 million, for the right to liquidate the partnership lapsed at death due to the obligation to sell the general partner interest to William Henry. This was the holding of *Estate of Harrison v. Commissioner*, T.C. Memo. 1987-8. But now

§2704(a) applies, assuming George and members of his family (including William Henry) controlled the partnership before and after George's death. Accordingly, George is treated as having made a transfer of $26 million (the excess of the $59 million value of the limited partner interest assuming the liquidation right was non-lapsing over the $33 million value of the limited partner interest after the lapse) at death, and that extra $26 million is also included in George's gross estate.

The regulations already contain an exception to the application of §2704(a). Under this exception, the deemed gift or deemed gross estate inclusion does not occur where the liquidation rights with respect to a transferred interest are not restricted or terminated. Because of this exception, most inter-vivos transfers of a minority interest by a controlling partner or shareholder do not trigger the deemed gift rule of §2704(a).

3. Proposed Regulations Restrict Scope of Regulatory Exception to §2704(a)

The proposed regulations limit the regulatory exception to inter-vivos transfers made more than three years before death. Any transfers made within three years of death would trigger gross estate inclusion under §2704(a) upon the transferor's death. The following example from the proposed regulations illustrates how this new rule would work:

> D owns 84 percent of the single class of stock of Corporation Y. The by-laws require at least 70 percent of the vote to liquidate Y. More than three years before D's death, D transfers one-half of D's stock in equal shares to D's three children (14 percent each). Section 2704(a) does not apply to the loss of D's ability to liquidate Y because the voting rights with respect to the transferred shares are not restricted or eliminated by reason of the transfer, and the transfer occurs more than three years before D's death. However, had the transfers occurred within three years of D's death, the transfers would have been treated as the lapse of D's liquidation right occurring at D's death.

4. Section 2704(b) Background

Section 2704(b) relates to restrictions imposed on a power to liquidate a corporation or partnership. Under §2704(b)(1), if three requirements are met, any "applicable restrictions" are to be disregarded when valuing a transferred interest in the entity. These requirements are: (1) a transfer of an interest in a corporation or partnership (2) to or for the benefit of a member of the transferor's family (3) where the transferor and the members of the transferor's family control the entity immediately before the transfer.

An "applicable restriction" is any limitation on the entity's ability to liquidate that either lapses to any extent after the transfer or can be removed after the transfer by the transferor or any member of the transferor's family. For instance, assume Wendy and Peter, a married couple, own general partner and limited partner interests in a limited partnership. Under their partnership agreement, Wendy and Peter have agreed that the partnership can be liquidated

only with the written consent of all partners, though this restriction on liquidation may be removed by a unanimous vote of the partners. Wendy transfers her limited partner interest to her son, Michael. All of the requirements of §2704(b)(1) are met, for Wendy has transferred to her son an interest in the partnership controlled by Wendy and her husband. Thus the value of the limited partner interest transferred to Michael must be determined without regard to the restriction that the partnership may be liquidated only with the consent of all partners, because this restriction can be removed upon the vote of Wendy, Peter, and Michael, all members of the same family.

The statute provides that certain restrictions on liquidation are not to be disregarded even where the elements of §2704(b)(1) are met. Commercially reasonable restrictions on liquidation arising from a financing transaction with an unrelated party, for example, are not subject to §2704. In addition, §2704(b)(3)(B) provides that restrictions on liquidation imposed by state or federal law do not trigger §2704(b). In effect, then, only those liquidation restrictions that are more stringent than those under applicable federal and state laws or those found in commercially reasonable financing transactions will be disregarded.

5. Proposed Regulations Eliminate Comparison to State Law

The current regulations restrict the scope of §2704(b) to limits "on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction." The preamble to the proposed regulations observe that some states have, in response to this regulation, changed their statutes to allow liquidation only upon a unanimous vote of all owners and to eliminate existing laws that allowed limited partners the right to liquidate their interests in a partnership. That makes Treasury mad. In response, the proposed regulations remove the restriction in the current regulations that limits the definition of "applicable restrictions" to those that are more restrictive than under applicable state law. Indeed, the proposed regulations go on to state that an "applicable restriction" includes any restriction imposed under the entity's governing documents or under local law "regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise."

Lest you think that's contrary to §2704(b)(3)(B), the proposed regulations state that the statutory exception is limited to restrictions imposed or required to be imposed by federal or state law. The proposed regulations go on to explain:

> A provision of law that applies only in the absence of a contrary provision in the governing documents or that may be superseded with regard to a particular entity (whether by the [owners] or otherwise) is not a restriction that is imposed or required to be imposed by federal or state law. A law that is limited in its application to certain narrow classes of entities, particularly those types of entities (such as family-controlled entities) most likely to be subject to transfers described in section 2704, is not a restriction that is imposed or required to be imposed by federal or state law. For example, a law requiring a restriction that may not be

removed or superseded and that applies only to family-controlled entities that otherwise would be subject to the rules of section 2704 is an applicable restriction. In addition, a restriction is not imposed or required to be imposed by federal or state law if that law also provides (either at the time the entity was organized or at some subsequent time) an optional provision that does not include the restriction or that allows it to be removed or overridden, or that provides a different statute for the creation and governance of that same type of entity that does not mandate the restriction, makes the restriction optional, or permits the restriction to be superseded, whether by the entity's governing documents or otherwise.

6. There's More – Proposed Regulations Create More Disregarded Restrictions

Section 2704(b)(4) authorizes regulations providing that "other 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 but does not ultimately reduce the value of such interest to the transferee." In each of 2009, 2010, 2011, and 2012, President Obama's budget called for legislation that would have broadened the scope of §2704(b) to include as disregarded restrictions "limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard to be identified in regulations." That this idea never caught traction didn't stop Treasury in issuing the proposed regulations.

New Proposed Regulation §25.2704-3(b) lists four restrictions that will be disregarded in valuing an interest in a corporation or partnership transferred to or for the benefit of one of the transferor's family where the transferor and members of the transferor's family control the entity immediately before the transfer.

The first restriction to be disregarded is one that limits the ability of the holder of the interest to liquidate the interest. Thus, for example, when a parent transfers a limited partner interest to a child, the child's inability to liquidate the transferred interest is to be disregarded when valuing the interest.

The second restriction to be disregarded is one that limits the liquidation proceeds to an amount less than "minimum value," defined in the proposed regulations as the interest's share of the "net value" of the entity at the time of liquidation (net value, in turn, is generally defined as the net asset value of the entity). So any restriction that would pay the holder less than the liquidation value of the interest is to be disregarded under this rule.

The third restriction to be disregarded is one that defers the payment of liquidation proceeds for more than six months. The final restriction to be disregarded is one that permits payment of the liquidation proceeds in any form other than cash, property, or certain notes.

Combine the four disregarded restrictions and it appears that, for example, a limited partner interest subject to §2704(b) would be valued under the assumptions that the holder could cash it in at any time for its full liquidation value, with such amount to be paid in full in cash or other property within six months.

7. Preliminary Thoughts

For planners who worry that the proposed regulations spell the end of certain strategies related to family-owned entities, the message is clear: you have a few months remaining to implement those strategies before the regulations take effect. For those who insist the proposed regulations exceed the scope of the statute or, indeed, violate the statute, it might be best to remember the high degree of deference accorded to agency interpretation of statutes under the current common law. The burden of proof on those alleging legislative regulations to be invalid is, to put it mildly, high. While it may well come to pass that final regulations will be more diluted than the proposed regulations, planners should probably proceed under the assumption that the proposed regulations will take effect and listen for updates as the proposed regulations undergo the comment stage.

D. NONTAX REASONS FOR FAMILY LIMITED PARTNERSHIP REJECTED AS AFTER-THE-FACT JUSTIFICATIONS (*Estate of Holliday v. Commissioner,* T.C. Memo. 2016-51, March 17, 2016)

Late in 2006, Sarah Holliday (through a power of attorney held by her sons, Dr. Doug Holliday and Joe Holliday) formed a family limited partnership with $5.9 million in marketable securities. The sons owned all of the membership interests in the limited liability company that served as the general partner owning a 0.1% interest in the partnership. Sarah owned the remaining 99.9% interest as the sole limited partner. After formation, Sarah gifted a 10% limited partner interest to an irrevocable trust. At her death in January, 2009, Sarah still owned her 89.9% partnership interest. Alas, the marketable securities held by the partnership were worth only $4 million as of the alternate valuation date (July, 2009). The estate tax return reported the value of Sarah's 89.9% limited partnership interest at $2.4 million, reflecting an aggregate minority interest and marketability discount of about 33%.

The Service argued that the partnership should be ignored and that the full $4 million of partnership assets should be included in Sarah's gross estate under §2036(a). Section 2036(a) applies where the decedent made a transfer of property in which the decedent retained the right to income, possession, or enjoyment for life (or for a period not ascertainable without reference to the decedent's death or for a period that does not in fact end before the decedent's death). The Service argued that Sarah retained the right to income from the marketable securities contributed to the partnership because the partnership agreement required periodic pro-rata distributions of net cash flows. Moreover, Joe's testimony indicated that the partnership was prepared to make a distribution to Sarah if she needed it. On these facts, the Tax Court had little trouble upholding the Service's determination that Sarah had effectively retained the right to income from the partnership.

But §2036(a) does not apply in the case of a bona fide sale for a full and adequate consideration in money or money's worth. To determine whether the transfer of the securities to the partnership in exchange for the partnership interest was a bona fide sale, the Tax Court stuck to its precedent from the 2005 decision in *Estate of Bongard v. Commissioner*. Under *Bongard*, the formation of a partnership satisfies the "bona fide sale" exception to §2036(a) only where there is "a legitimate and significant nontax reason for creating the family limited partnership" and that "[a] significant purpose must be an actual motivation, not a theoretical justification." In this case, the estate proffered three nontax purposes for the partnership, but the court ultimately rejected them as theoretical justifications.

The estate first contended that the partnership was formed to protect Sarah's assets from "trial attorney extortion." Apparently there was a concern that Sarah could be sued and that a judgment creditor could attach assets that were not in the partnership. But the court observed that Sarah had never been sued and that no such suits were imminent. And if protecting assets from judgment creditors was a concern, said the court, Sarah would have transferred substantially more than just the $5.9 million in marketable securities that were actually contributed to the entity.

The estate then argued that the partnership was created to protect Sarah's assets from the undue influence of caregivers. There was evidence that Sarah's dead husband had been abused and taken advantage of by his caregivers late in life. But Sarah was never consulted about the formation of the partnership, and Dr. Holliday's weekly visits were an adequate safeguard to make sure assets were not stolen. More importantly, the court was not convinced that the formation of a partnership would protect an asset from theft. Besides, marketable securities are not exactly the type of assets in-home caregivers are apt to pilfer.

Finally, the estate argued that the partnership was formed to preserve assets for the benefit of the family. Again, however, the fact that Sarah was not consulted about the formation of the partnership belies this asserted purpose. Too, Sarah's husband had done the bulk of his planning through trusts, and there was never an issue as to whether trusts were an effective vehicle for the preservation of family assets.

That the partnership did not maintain all of the required records and never paid compensation to its general partner (both required under the partnership agreement) was not helpful to the estate in making its case. Ultimately, this is another case where the Service prevails under facts overwhelmingly in its favor. The planning lessons here are several. Among them: (1) partnership agreements probably should not contain provisions requiring periodic distributions to the partners; (2) those acting under a power of attorney should consult with their principals as to the reasons for the formation of the entity; (3) all parties should be prepared to respect the formalities of the entity and the provisions of the partnership agreement; and (4) the parties should be careful to identify and articulate the reasons for using the family partnership structure in advance of any actual transfers.

E. SETTLEMENT OF CASES INVOLVING INSTALLMENT SALE TO DEFECTIVE GRANTOR TRUST USING DEFINED VALUE CLAUSE (*Estate of Donald Woelbing v. Commissioner*, stipulated decision entered March 26, 2016; *Estate of Marion Woelbing v. Commissioner*, stipulated decision entered March 29, 2016)

In 2006, Donald sold all of his nonvoting stock in a closely-held business to an irrevocable life insurance trust in exchange for a promissory note with a face value of about $59 million with interest payable at the applicable federal rate. The purchase and sale agreement contained a defined value clause providing that what was sold was $59 million "worth" of stock and that the number of shares sold would be adjusted if the Service or a court determined that the per-share value of the stock was different from that set forth in an independent appraisal. Two of Donald and Marion's children gave personal guarantees to the trust; the combined value of the guarantees was worth 10% of the purchase price of the stock. This gave the trust "substantial financial capability" to pay the installment note to Donald. Donald and Marion filed gift tax returns for 2006 in which they elected to split gifts. He died in 2009 and she died in 2013 (two days after receiving a gift tax notice of deficiency in the amount of $32 million!).

The Service assessed both gift tax and estate tax deficiencies against Donald's estate and Marion's estate. The gift tax deficiencies resulted from the Service's position that the note has a value of zero and that the stock transferred was worth $116.8 million instead of $59 million. The zero value for the note stems from the Service's application of §2702—apparently the Service viewed the note as a retained equity interest in the stock that was sold, triggering the zero-value rule. The Service argued in the alternative that if the note was not worth zero, then Donald and Marion still made taxable gifts to the extent the value of the stock transferred exceeded the face value of the note.

On the estate tax side, the Service alleged that under both §§2036 and 2038, Donald's gross estate should include not the note but the date-of-death value of the stock sold to the trust ($162.2 million, per the Service). We don't know the exact rationale behind the application of §§2036 and 2038, but some have speculated that the trust lacked sufficient equity to be able to buy such a large amount of stock in exchange for a note bearing interest only at the applicable federal rate.

Planners worried what a Service victory in these cases could mean for installment sale transactions, gift-splitting, and the use of defined value clauses. But the Service and Donald's estate settled with no additional gift or estate tax due. A few days later, the Service and Marion's estate settled with no gift tax due, but the Service could still argue that her estate owes estate tax. That the Service walked away from a claim to over $150 million in taxes, interest, and penalties means this settlement is important, but its exact meaning going forward defies easy description. Alas, we will have stay tuned for further developments.

F. REVERSE LIKE-KIND EXCHANGES OUTSIDE THE SAFE HARBOR ARE POSSIBLE (*Estate of Bartell v. Commissioner*, 147 T.C. No. 5, August 10, 2016)

Bartell Drug Co., an S corporation owned by the decedent and his two children, owns and operates a chain of retail drugstores in western Washington. The company decided to acquire a new parcel of real estate in Lynwood, Washington, on which to construct and operate a new retail location. But it also wanted to do via a §1031 exchange where possible. Accordingly, after negotiating the purchase of the Lynwood location, the company assigned all of its rights in the purchase agreement to a third-party exchange facilitator. A subsequent agreement between the company and the facilitator provided that the facilitator would buy the property and give the company the right to buy for a set price for a stated period. Using bank financing guaranteed by the company, the facilitator acquired title to the Lynwood property in August, 2000. The company then constructed a drugstore on the property, and when construction finished in June, 2001, the company leased the store from the facilitator from that time until December, 2001, when the facilitator conveyed the property to the company after receiving full payment as provided under their agreement (and as explained more fully below).

Meanwhile, in 2001, the company entered into a contract to sell an existing parcel of property in Everett, Washington, to another, unrelated buyer. The company then entered into a different exchange agreement with a different qualified intermediary and assigned its rights under the sale agreement (along with its rights under the earlier agreement with the facilitator) to that intermediary. The intermediary then sold the Everett property, used the proceeds of that sale to buy the Lynwood property, and conveyed the Lynwood property to the company.

The company realized a $2.8 million gain on the sale of the Everett property, but it took the position that the gain was excluded under §1031 because these events essentially equated to a like-kind exchange of the Everett property for the Lynwood property. The statute, you see, covers not only "simultaneous" swaps of land for land, but also "deferred" exchanges. In the typical ("forward") exchange, the taxpayer sells a parcel of land and uses the proceeds to buy another parcel of land within a particular timeframe. But in the case, the taxpayers are seeking to qualify a "reverse" exchange, for the Lynwood property had been identified and acquired before the Everett property was sold.

While the regulations are silent about "reverse" exchanges, the Service has established a safe harbor under Revenue Procedure 2000-37 under which some reverse exchanges can work. But the safe harbor can only apply to arrangements made with an "exchange accommodation titleholder" on or after September 15, 2000, and the company's arrangement with the intermediary in this case preceded this date. Because the revenue procedure did not apply, then, the parties had to figure out whether a legitimate "exchange" took place that could qualify for nonrecognition.

The Service argued that the company already owned the Lynwood property by the time the Everett property was sold. It was thus too late to engage in a like-kind exchange of the Everett property, for an exchange requires "that the taxpayer not have owned the property purportedly

received in the exchange before the exchange occurs; if he has, he has engaged in a nonreciprocal exchange with himself." The Service claimed that the company (not the facilitator) owned the Lynwood property and thus had all the benefits and burdens of ownership in the Lynwood property by the time the Everett property was sold. The facilitator, it argued, had no equity interest in the property, made no economic outlay to acquire the property, was not at risk with respect to the property, and had no interest in the improvements made (and funded) by the company.

But the taxpayers pointed to controlling precedent establishing that the facilitator need not assume the benefits and burdens of ownership to have title to the property. That precedent said one like the facilitator could obtain title "solely for the purpose of the exchange" and thus preclude a prohibited "self-exchange." The Tax Court agreed, and while it observed that this precedent does indeed elevate form over substance, it works to qualify transactions like the one at issue in this case. The Service pointed to more recent precedent emphasizing the benefits and burdens of ownership, but the court found important distinctions: the Service's precedent involved a case where the taxpayer itself acquired the replacement property first (obviously different from the case here where the company did not have title until all aspects of the exchange were complete), and it came from a non-controlling jurisdiction.

The court observed that while this transaction spanned 17 months, a period far longer than any of those from the precedents favorable to the taxpayer, "the caselaw provides no specific time limit on the period in which a third-party exchange facilitator may hold title to the replacement property before the titles to the relinquished property and replacements properties are transferred in a reverse exchange."

G. ECONOMIC BENEFIT REGIME APPLIED TO INTERGENERATIONAL SPLIT-DOLLAR ARRANGEMENT (*Estate of Morrissette v. Commissioner*, 146 T.C. No. 11, April 13, 2016)

In 2006, Clara's revocable living trust entered into two split-dollar life insurance arrangements with three separate dynasty trusts, one for each of her three sons and their families. Each dynasty trust bought two universal life insurance policies, one on the life of each of the other brothers. To fund these policies, the dynasty trusts and Clara's revocable trust entered into a split-dollar arrangement. Under the arrangement, Clara's trust would transfer about $10 million to each dynasty trust, and the trustees of those trusts would use the funds to pay the premiums on the policies. Upon the death of a son, Clara's revocable trust would receive a portion of the death benefits from the policies on the life of the deceased son. With respect to each policy, the amount payable to Clara's revocable trust would be the greater of the cash surrender value of the policy or the total premium payments made on the policy. The dynasty trusts owning the policies would then receive the balance of the death benefits, to be used to buy stock owned by (or held in trust for the benefit of) the deceased son. If the split-dollar arrangement terminated before the death of a son, Clara's revocable trust would still be entitled to receive the "greater of" amount described above.

This is a so-called "intergenerational split-dollar arrangement." Howard Zaritsky explains:

> Intergenerational split-dollar involves using the economic benefit regime with a collateral assignment non-equity split-dollar agreement, to avoid both gift and GST taxes and to reduce estate taxes. Under this arrangement, a senior-generation member (in this case, Clara's revocable trust) pays that part of the premiums on the policies insuring the lives of one or more middle-generation members (in this case, Clara's sons). The death benefits are payable to a trust for the benefit of lower-generation members (in this case, the three dynasty trusts). Typically, the senior-generation family member pays the portion of the premium equal to the value of the present insurance coverage, determined under Table 2002 (IRS Notice 2002-8), or the insurer's alternative term rate, if lower.
>
> Proponents of this concept argue that the senior generation makes no taxable gifts by paying these premiums; rather, he or she is advancing funds with a full right to recover the greater of the cash value or the total premiums paid from the policy death benefits. Moreover, when the senior generation family member dies, the value of the right of recovery in his or her estate is merely a "collateralized receivable" that must be paid at the insured child's death. The economic benefit regime impairs the value of these receivables, potentially reducing their value for estate tax purposes. The receivables are mere unsecured promises to pay uncertain amounts at an uncertain time, with no current return on their value and with ongoing tax liabilities.

Consistent with this strategy, Clara filed federal gift tax returns reporting gifts to each dynasty trust using the economic benefit regime under Regulation §1.61-22. Under that approach, the gift is equal to the cost of the current life insurance protection as determined under Table 2001 minus the amount of the premium paid by the dynasty trust. That reduced the total annual gifts from 2006 to 2009 to amounts ranging from just over $64,000 a little over $206,000. Following Clara's death in 2009, the estate valued the revocable trust's right to receive future repayments from the dynasty trusts at about $7.5 million.

But the Service determined that the entire $30 million transferred to the dynasty trusts in 2006 was a gift. That sent the estate to Tax Court, where it argued that the economic benefit regime should apply in determining the amount of the gift. In a reviewed opinion, the Tax Court granted the estate's motion for partial summary judgment on this issue. Clara's trust was entitled to recover all of the premiums paid on the policies (at a minimum), and that recovery was secured by the death benefits. The transaction was thus a valid split-dollar arrangement.

The key remaining issue, then, is whether the loan regime or economic benefit regime applies to this arrangement. Because the dynasty trusts were the owners of the policies, one would think the loan regime would apply. But the regulations provide that the donor is the deemed owner of the policies where the arrangement is donative in nature and the donee receives only the current life insurance protection from the policies. The court determined this exception applied here, especially after noting that the preamble to the regulation contains an example explaining this

exception that uses facts nearly identical to those in the case at bar. Because Clara's trust retained the greater of the total premiums paid or the cash surrender value of the policies, the dynasty trusts did not have any additional economic benefit. The dynasty trusts had no access to the cash values of the policies. Thus the economic benefit regime properly applies to this arrangement.

Note that this is only a decision on a summary judgment motion. There is still the issue of the value of the right to repayment that is included in Clara's gross estate. If the estate prevails there, notice that the arrangement will have worked to remove about $22.5 million from transfer tax ($30 million transferred to the trusts less $7.5 million included in Clara's gross estate).

H. SERVICE SUPPLIES SAMPLE LANGUAGE TO AVOID THE "PROBABILITY OF EXHAUSTION" TEST FOR CHARITABLE REMAINDER ANNUITY TRUSTS (Revenue Procedure 2016-42, August 8, 2016)

Regulations governing charitable remainder trusts provide that no income, estate, or gift tax deduction is available if the charity's interest "would be defeated by the subsequent performance of some act or the happening of some event," unless the possibility of such occurrence is "so remote as to be negligible." In a 1970 revenue ruling, the Service stated that "if there is a greater than 5 percent probability that payment of the annuity will defeat the charity's interest by exhausting the trust assets by the end of the trust term, then the possibility that the charitable transfer will not become effective is not so remote as to be negligible." This is referred to as the "probability of exhaustion test." It was specifically made applicable to charitable remainder annuity trusts (CRATs) in a 1977 ruling.

As the Service explains, in the case of a CRAT, the probability of exhaustion is calculated "first by applying the §7520 assumed rate of return on CRAT assets (§7250 rate) against the amount of the annuity payment to determine when the CRAT assets will be exhausted. Then, a mortality table (Mortality Table 2000CM, found in [Regulation] §20.2031-7(d)(7)) is used to determine the probability that the income beneficiary or beneficiaries will survive exhaustion of the CRAT assets. If the probability that the life beneficiary or beneficiaries will survive exhaustion of the CRAT assets is greater than 5 percent, then the charitable remainder interest of the CRAT does not qualify for an income, gift, or estate tax charitable deduction and the CRAT is not exempt from income tax under §664(c). If the §7520 rate at creation of the trust is equal to or greater than the percentage used to determine the annuity payment, then exhaustion will never occur under this test."

The Service has noticed that in today's environment of low interest rates, this calculation leads to weird results. "For example, in May of 2016, the §7520 rate was 1.8 percent. At this interest rate, the sole life beneficiary of a CRAT that provides for the payment of the minimum allowable annuity (equal to 5 percent of the initial FMV of the trust assets) must be at least 72 years old at the creation of the trust for the trust to satisfy the probability of exhaustion test. The §7520 rate has not exceeded the minimum 5 percent annuity payout rate since December of 2007, which has necessitated testing for the probability of exhaustion for every CRAT created since that time."

Accordingly, the Service has offered sample form language. Any trust created after August 8, 2016, containing this form language and providing for annuity payments covering one or more measuring lives will qualify to have that language treated as a "qualifying contingency," meaning it would be exempt from the probably of exhaustion test. "A CRAT that contains a substantive provision similar but not identical to [the Service's sample language] will not necessarily be disqualified, but neither will such a provision be assured of treatment as a qualified contingency."

The sample language essentially forces the early termination of a CRAT "immediately before the date on which any annuity payment would be made, if the payment of that annuity amount would result in the value of the trust corpus, when multiplied by a specified discount factor, being less than 10 percent of the value of the initial trust corpus." The assets would then pass immediately to the charitable remainder beneficiary.

I. MORE IN THE WAR ON CONSERVATION EASEMENTS AND FAÇADE EASEMENTS

The Service continues to monitor carefully transactions involving the donation of qualified conservation real property, usually in the form of a "conservation easement" (where the taxpayer attaches a perpetual restriction on real property that precludes any change to existing use without the consent of the charitable organization that receives the easement) of a "façade easement" (where the taxpayer attaches a perpetual restriction that the exterior of any structures on real property cannot be changed absent the consent of the charity that holds the easement). As the following litany of recent cases illustrates, taxpayers must be careful about the valuation of the easement, ensuring the easement attaches to property in perpetuity, complying with substantiation requirements, and both disclosing and valuing any consideration received in exchange for the donation.

Failure to Obtain Written Subordination from Banks Doomed Deduction (*RP Golf LLC v. Commissioner*, T.C. Memo. 2016-80, April 28, 2016). The taxpayer owns two private golf courses in Kansas City. In 2003, it conveyed a conservation easement over the courses to the Platte County Land Trust, a charitable organization. On its 2003 return, the taxpayer claimed a $16.4 million deduction, pursuant to an appraisal that found the pre-contribution value of the courses to be $17.4 million and the post-contribution value to be $1 million.

Interestingly, though, the court never got to the issue of this valuation. You see, two banks were mortgagees on loans made to the taxpayer. Regulation §1.170A-14(g)(2) precludes a conservation easement deduction for encumbered property "unless the mortgagee subordinates its rights in the property to the right of the qualified organization to enforce the conservation purposes of the gift in perpetuity." Here, while the easements were conveyed on December 29, 2003, consents were not executed until April 14, 2004, nor recorded until April 15, 2004. The Service claimed that because the consents were not given contemporaneously with the donation, the taxpayer was not entitled to a deduction. The Tax Court agreed, pointing to recent case law indicating that the subordination must be in place at the time of the transfer. The taxpayer

argued that it had oral consents from both banks, but the court found that an oral consent would not be binding under applicable state (Missouri) law.

Fair Market Value of Easement is Not Always the Same as the Deduction Amount, a Distinction that Foiled a Deduction (*Carroll v. Commissioner*, 146 T.C. No. 13, April 27, 2016). On December 15, 2005, the taxpayers contributed a conservation easement on nearly 26 acres of Maryland land jointly to the Maryland Environmental Trust and the Land Preservation Trust. The taxpayers claimed the easement was worth $1.2 million, and thus claimed charitable contribution deductions for each of 2005, 2006, 2007, and 2008.

Of the many requirements for a deduction, one is that the conservation purpose must be protected in perpetuity. Regulation §1.170A-14(g)(6)(ii) provides that "when a change in conditions give rise to the extinguishment of a perpetual conservation easement restriction…, the done organization, on a subsequent sale, exchange, or involuntary conversion of the subject property, must be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction." The conservation easement in this case, however, provided that the charities' fractional share of any extinguishment proceeds would be equal to a fraction the numerator of which is the amount allowable as a federal income tax deduction to the taxpayers and the denominator of which is the fair market value of the whole property at the time of the donation. As the Tax Court observed, that's different than the fraction required by the regulations—the numerator needs to be the value of the easement, not the deduction allowed to the taxpayers.

Sure, in many cases those two figures will be the same (the deduction amount is, generally, the value of the easement). But not always: "For example, if the…Service denies petitioners' charitable contribution deduction for Federal income tax purposes for reasons other than valuation and the easement is extinguished in a subsequent judicial proceeding, the numerator [under] the conservation easement will be zero, and [the charities] will not receive a proportionate share of extinguishment proceeds." Alas, this is fatal to the taxpayers' claim for a deduction, for case law has established that the "perpetuity" element for a conservation easement deduction must be construed strictly.

Don't Forget the Written Acknowledgment (*French v. Commissioner*, T.C. Memo. 2016-53, March 23, 2016). The taxpayer was a beneficiary of a trust that, on December 29, 2005, donated a conservation easement on four contiguous parcels to the Montana Land Reliance. The trustees obtained an appraisal indicating the easement was worth $1.1 million, and the taxpayer's share of that deduction would be almost $351,000.

The first 2005 return filed by the taxpayer did not claim any deduction for the easement. But an amended return, filed before April 15, 2006, claimed a charitable contribution deduction of nearly $57,000. The taxpayer then carried over the remaining deduction to 2006 (nearly $45,000), 2007 (just over $57,000), and 2008 (almost $32,000). The Service initially determined that the total value of the easement was $432,000, but in this case before the Tax Court it went

a step further and claimed the taxpayer gets no deduction at all for lack of receiving a contemporaneous written acknowledgement from the charitable donee.

The taxpayer argued that two documents could serve as the acknowledgement. The first was a letter from a representative of the organization dated June 6, 2006, stating no goods or services were furnished in exchange for the donation. The problem, though, is that this letter is not "contemporaneous" with the donation because it was not received by April 15, 2006. The second was the donation agreement itself, in the form of a conservation deed recorded on the day of the donation. The Tax Court observed that a conservation deed can work as an acknowledgment where the deed states whether the donee provided goods or services in exchange for the contribution. Even where such express language is missing, the court will still "look to the deed as a whole" to determine whether the donee furnished consideration for the donation.

Here, though, the deed said nothing about consideration furnished by the donee, and the court did not find an absence of consideration from the deed as a whole: "Although the conservation deed includes provisions stating that the intent of the parties is to preserve the property, those provisions do not confirm that the preservation of the property was the only consideration because the deed did not include a provision stating that it is the entire agreement of the parties. Without such a provision, the IRS could not have determined by reviewing the conservation deed whether petitioners received consideration in exchange for the contribution of the conservation easement. We conclude, therefore, that the conservation deed taken as a whole is insufficient to satisfy section 170(f)(8)(B)(ii)."

Taxpayers Do Sometimes Prevail in These Cases (*Palmer Ranch Holdings v. Commissioner*, 11th Cir., February 5, 2016). The taxpayer, a partnership, donated a conservation easement on an 82-acre parcel of real property (home to an eagle's nest, it should be noted) to Sarasota County, Florida. The taxpayer claimed a $23.9 million deduction for the contribution, but the Service concluded that maximum deduction amount should be $7 million. The taxpayer argued that the highest and best use of the property would be the development of a 360-unit residential complex. But the Service said the best use was limited to 41 units based on the property's current zoning designation. The Service noted an extensive history of failed rezoning requests, environmental concerns, limited road access, and strong neighborhood opposition to development as proof that the taxpayer would never be able to build more than the currently allowable number of residential units on the property.

But the Tax Court rejected the Service's position, observing that several of the failed rezoning requests were close votes and that while the property contains a "wildlife corridor," the corridor does not preclude development along the lines suggested by the taxpayer. The lower court also determined there was adequate road access for a multiple-unit development as large as that suggested by the taxpayer. Ultimately, then, the Tax Court held that the contributed easement was worth $19.9 million, a figure much closer to the taxpayer's original position.

On appeal, the Eleventh Circuit affirmed the Tax Court's determination of the property's "highest and best use" but reversed the determination of the amount deductible. The court agreed that

a rezoning request would have a “reasonable probability” of approval. The Service argued that the proposed highest and best use was not likely to be needed shortly after the date of the donation, and while the appellate court agreed, it found that the Tax Court’s error in not considering this fact to be harmless. “The evidence clearly shows that, in 2006, the market for…development was bullish.” Where the lower court went wrong, said the Eleventh Circuit, was in reducing the “highest and best use” valuation offered by the taxpayer. The lower court based its valuation on its own assumptions about market activity at the time and not on comparable sales. “The tax court must at a minimum explain why it departed from the comparable-sales method” in valuing the property at its highest and best use. Thus the court remanded the case for further determination, with these instructions: “On remand, then, the tax court must either stick with the comparable-sales analysis or explain its departure. Whatever the tax court chooses to do, the court must keep its sights set strictly on the evidentiary record for purposes of selecting an appreciation rate, and ensure that it crunches the numbers correctly.” Stay tuned for further developments.

Don’t Forget to Attach the Qualified Appraisal! (*Gemperle v. Commissioner*, T.C. Memo. 2016-1, January 4, 2016). In 2007, the taxpayers donated a façade easement on their Chicago home to the Landmarks Preservation Council of Illinois. A contemporaneous appraisal found the easement worth $108,000 (about 12% of the unencumbered value of the home). The taxpayers deducted this amount on their 2007 and 2008 returns. They did not attach the appraisal to the return, however, and §170(h)(4)(B)(iii)(I) conditions a deduction on the attachment of a qualified appraisal with the federal income tax return. Thus the Tax Court had little trouble sustaining the Service’s adjustment disallowing the charitable contribution deduction in both years.

But it doesn’t end there. Because the taxpayers did not make their expert available for cross-examination at trial, the court did not admit the appraisal into evidence because the statements were hearsay. That left the couple with no evidence to support the value of the easement, which in turn led to the imposition of a 40% gross valuation misstatement penalty.

J. FOLLOWING ORDERS, TAX COURT IGNORES ASSETS IN VALUING A GOING CONCERN (*Estate of Giustina v. Commissioner*, T.C. Memo. 2016-114, June 13, 2016)

The decedent died in 2005 with a 41.128% limited partner interest in Giustina Land & Timber Co. Limited Partnership, an entity that owns and operates nearly 48,000 of timberland as an active business. The timberland alone was worth $143 million at the decedent’s death; the entity’s total asset value at the time was just over $150.6 million. In a 2011 decision, the Tax Court valued the decedent’s partnership interest by giving 25% weight to the entity’s asset value and 75% weight to the entity’s income stream. It based this allocation on its conclusion that there was a 25% chance the partnership would liquidate after the transfer of the decedent’s interest to a hypothetical third-party willing buyer.

In 2014, however, the Ninth Circuit reversed, concluding the Tax Court’s finding of a 25% chance of liquidation was clearly erroneous. The appellate court reasoned a third-party buyer who intended to dissolve the partnership would not be admitted by the general partners, so focusing

on the asset value of the entity was the wrong approach. The court sent the case back to the Tax Court with instructions to disregard the assets in valuing the entity as a going concern.

The Tax Court did so, adjusting the value of the decedent's limited partnership interest from about $27.4 million to about $13.9 million, a value much closer to that offered by the estate's expert (roughly $13 million) than the Service's expert ($33.5 million). The court based its final value on the present value of the entity's cashflows using a long-term growth rate of 4% and a capitalization rate of 14%.

K. POST-DEATH EVENTS, WHILE VALID, REDUCED CHARITABLE DEDUCTION AMOUNT (*Estate of Dieringer v. Commissioner*, 146 T.C. No. 8, March 30, 2016)

The decedent owned a controlling interest in a closely-held real property management corporation that managed a number of commercial and residential properties in Portland, Oregon (oh, and a Wendy's franchise in Texas). The decedent's revocable living trust provided that the closely-held stock was to pass to a private foundation the decedent had created during her lifetime. Her estate claimed a charitable contribution deduction for the value of the stock as of the date of death, with no minority or marketability discounts.

The Service reduced the amount of the deduction, however, as it concluded a series of post-death events undermined the decedent's intent to transfer control of the company to the foundation. The company elected to be taxed under subchapter S but didn't want the foundation to be subject to unrelated business income tax. So the company made arrangements to redeem all the decedent's voting stock and most of the nonvoting stock in exchange for a note. The thinking was this was good for the foundation since it converted the foundation from shareholder to creditor, giving it higher status in the liquidation food chain. To give the company cash to pay off the notes, the decedent's sons made capital contributions in exchange for more stock.

The Tax Court agreed that while these post-death events occurred for valid, non-tax business reasons, the effectively served to reduce substantially the actual amount passing to the foundation. The redemption agreements valued the foundation's stock using a 15% minority interest discount and a 35% marketability discount. Ultimately, the per-share price of the stock was much less than the value of the stock at the date of the decedent's death. One son testified the decline in value was due to the poor business climate at the time (2009). But the Tax Court held the decline was due to the son's instruction to the appraisers value the decedent's stock as a minority interest. Ultimately, said the court, the sons "thwarted decedent's testamentary plan by altering the date-of-death value of decedent's intended donation through the redemption of a majority interest as a minority interest." So the estate tax deduction was reduced the amount used in the redemption appraisal. The instruction to value the decedent's stock as a minority interest was then used by the court as grounds for upholding the Service's assessment of a negligence penalty.

L. TERMINATION OF POLICY RESULTS IN CANCELATION OF DEBT INCOME (*Mallory v. Commissioner*, T.C. Memo. 2016-110, June 6, 2016)

In 1987, the taxpayer paid $87,500 to buy a single-premium variable life insurance policy on his life, naming his spouse as the beneficiary. Through the end of 2001, the taxpayer had taken 25 loans against the policy totaling $133,800. The taxpayer paid no interest on these loans, but luckily the cash value of the policy grew substantially over this time. By late 2011, however, the cumulative debt exceeded the cash value. The insurance company told the taxpayer to fork out over $26,000 or the policy would be terminated. The taxpayer made no payment, so the policy terminated.

The insurance company sent the taxpayer a Form 1099-R showing a gross distribution of $237,897.25, $150,397.25 of which was taxable. That income never made its way onto the taxpayer's 2011 return, but the filed return did attach the Form 1099-R along with this handwritten note: "*Paid hundreds of $. No one knows how to compute this using the 1099R from Monarch--IRS could not help when called--Pls send me a corrected 1040 explanation + how much is owed. Thank you.*"

Unsurprisingly, the Service concluded the taxpayer had $150,397.25 of gain from the cancelation of his policy debt. The taxpayer ran to Tax Court, arguing that there could be no income absent an actual payment of cash and that the various amounts received from the insurance company over the years were payments of the cash value and not loans. The court rejected these claims. Every distribution from the insurance company was accompanied by a "loan activity confirmation," and the company annually sent notices requesting payment of interest. By using the cash value to extinguish the debt amount, there was a constructive distribution of $237,897.25 to the taxpayer.

The court also upheld a 20% substantial understatement penalty. It found no reasonable basis for failing to include the distribution amount in gross income. It didn't help that the insurance company specifically flagged the includible amount both in correspondence and in the Form 1099-R. As Howard Zaritsky observes, "This issue keeps coming before the courts … because so many policy owners simply do not read or understand the notices that insurers send them regarding policy loans. Typically, there will be at least several notices before a policy is terminated. An owner who does not receive cash on the policy termination will usually assume that there cannot be income. In fact, they have received the cash on which the tax is being imposed in the form of policy loans which now never will be repaid. The taxable income merely reflects the 'day of reckoning' that ultimately must occur, unless the loans are repaid."

M. SERVICE HAS BURDEN OF PROOF IN CASES OF EXECUTOR LIABILITY FOR UNPAID ESTATE TAXES (*Singer v. Commissioner,* T.C. Memo. 2016-48, March 14, 2016)

Under the federal claims statute, 31 USC §3713(b), and the case law interpreting it, an executor is personally liable for the payment of unpaid federal estate tax where an executor with notice of the unpaid tax liability distributes assets when the estate is insolvent (or is rendered insolvent as a result of the distribution). This case involves Scott Singer, the executor of the estate of Melvin Sacks. Sacks was an attorney who at his death left behind a spouse, two girlfriends, and a $4

million income tax deficiency. During the course of administration, Singer secured the release of some $750,000 from brokerage accounts that were subject to a restraining order imposed by the local court when it appeared the estate would lack sufficient assets to pay off all creditors. A portion of the amount was earmarked to be paid to the Service in satisfaction of the decedent's tax liabilities, but the rest (about $422,000) was paid to other creditors (the spouse and the State of New York). But the Service invoked the federal claims statute to claim that Singer was now on the hook for the $422,000 paid to others.

The issue is whether the estate was insolvent at the time of the payment to the others. If it was, Singer would be personally liable for paying the $422,000 to the federal government. If not, there would be no personal liability. On this issue, the Tax Court held that the Service has the burden of proof. Further, in determining the estate's solvency, the court held that countable assets include the probate estate, nonprobate assets, and contribution rights the estate has against any beneficiaries. On these facts, the court held that the Service did not establish the estate's insolvency at the time of the distribution. Accordingly, Singer was not personally liable for the payment of estate taxes.

N. NO SPOUSAL ROLLOVER OF COMMUNITY PROPERTY INTEREST FROM INHERITED IRAs (Private Letter Ruling 201623001, June 3, 2016)

The decedent and the decedent's spouse resided in a community property state. The decedent named a child (not the spouse) as the beneficiary of the decedent's three individual retirement accounts. The spouse filed a claim against the decedent's estate for the spouse's share of the community property in the decedent's name, which included the IRAs. A state court approved a settlement agreement under which a fixed dollar amount was to be transferred to the spouse "as a spousal rollover IRA."

One of these parties (likely the spouse or the child) sought a ruling that the spouse be treated as the payee of the decedent's IRAs so that the spousal rollover would work. But the Service concluded that because the child was the beneficiary regardless of the operation of any state community property laws, there could be no spousal rollover. Consequently, any amounts placed into an IRA by the spouse will be subject to the IRA contribution limits and any assignment of the inherited IRAs to the spouse will be treated as a taxable distribution to the child. Oops.

O. LATE TRANSFER OF BUSINESS INTEREST BETWEEN EXES WAS STILL "INCIDENT TO THE DIVORCE" (*Belot v. Commissioner*, T.C. Memo. 2016-113, June 13, 2016)

The taxpayer and his ex-wife operated three businesses during their marriage: dance studios, retail sale of dancewear, and real estate holding. The couple divorced, and their January, 2007, settlement agreement provided they would continue to operate the businesses as equal partners. But in September, 2007, the ex filed suit seeking to force the taxpayer to sell his interests to her. That litigation resulted in an April, 2008, settlement agreement pursuant to which the ex agreed to buy out the taxpayer's interests in the businesses for $1.58 million, $900,000 payable at closing and $680,000 payable under a ten-year, 5% note. But since this

transfer was more than one year after the divorce, the taxpayer's gain from the sale will qualify for nonrecognition under §1041 only if the transfer is "related to the cessation of the marriage."

The Service said it did not, since the sale transfer was not pursuant to the original divorce instrument but instead pursuant to separate litigation. But the Tax Court rejected this reasoning. Yes, the regulations contain a presumption that §1041 does not apply to transfers "not pursuant to a divorce or separation instrument," but that same regulation states the presumption can be rebutted by "showing the transfer was made to effect the division of property owned by the former spouses at the time" of their divorce. On the record, the court determined that the sale of the interests was made to "effect the division of property owned by former spouses" and were thus "related to the cessation of the marriage."

P. POSNER HAS A FIELD DAY WITH THE HOBBY LOSS REGULATIONS (*Roberts v. Commissioner*, 7th Cir., April 15, 2016).

The taxpayer built a fortune through restaurants and bars in Indianapolis. In the late 1990s he developed an interest in horse racing. In 2005, he spent a good chunk of change on a horse training facility and then $1 million on a 180-acre tract of land for his horse operation. He then spent another half-million making improvements on the property. He worked eight hours a day on the activity, and up to 12 hours per day on race days. The Service alleged that the activity was a hobby in 2005 and 2006, and thus disallowed the expenses he deducted on his personal income tax return. Interestingly, the Service never challenged the activity as a business from 2007 on. The Tax Court applied the nine-factor test in Regulation §1.183-2 to conclude the horse racing activity was a hobby, so it upheld the deficiency.

But the Seventh Circuit, in an opinion by Judge Richard Posner, reversed. "We musn't be too hard on the Tax Court," he observed. "It felt itself imprisoned by a goofy regulation." Judge Posner noted the regulation lists nine non-exclusive factors to consider in determining whether an activity is merely a hobby instead of a trade or business. Ironically, perhaps, "the test is open-ended—which means the Tax Court was not actually required to apply all of those factors to Roberts' horse-racing enterprise." Nonetheless, the Seventh Circuit applied the factors itself and reached the opposite conclusion. The court concluded with some advice:

> Considering that most commercial enterprises are not hobbies, the Tax Court would be better off if rather than wading through the nine factors it said simply that a business that is in an industry known to attract hobbyists (and horse racing is that business par excellence), and that loses large sums of money year after year that the owner of the business deducts from a very large income that he derives from other (and genuine) businesses or from trusts or other conventional sources of income, is a presumptively a hobby, though before deciding for sure the court must listed to the owner's protestations of business motive.

Q. INNOCENT SPOUSE RELIEF CASES

Equitable Relief from Penalties and Interest Possible Even Where Underpayment is Attributable to Requesting Spouse's Income (*Boyle v. Commissioner*, T.C. Memo. 2016-87, May 2, 2016). Joe had a business selling new and refurbished printer cartridges. His wife, Pat, handled all the finances for the business and for the couple's personal matters. She even arranged for their 2003 joint return to be prepared. She had Joe sign the return but she never filed it. It was only after Pat's death in 2006 that Joe first discovered no return had been filed, and he promptly filed one. The Service assessed deficiencies, penalties, and interest with respect to the late return. Joe wants equitable relief from the penalties and interest, saying the failure to file was Pat's fault.

The Service would not grant the relief because the underpayment at issue was related to Joe's income, not to Pat's (she had no income for 2003). But the Tax Court observed that Joe wasn't asking for forgiveness from the underpayment—he just wants relief from the penalties and interest. To deny Joe relief just because the underlying deficiency relates to his income "runs counter to our mandate…'to determine the appropriate relief available'." The court went on to find that Joe had been deceived by Pat in signing the dummy 2003 return that was never filed. On the whole, it was convinced that equitable relief from the penalties and interest was appropriate.

Not Questioning Returns and Enjoying the Good Life Preclude Innocent Spouse Relief (*Arobo v. Commissioner*, T.C. Memo. 2016-66, April 14, 2016). Larry and Sletta were married for the taxable years in question (2004 – 2007). Larry ran a mortgage origination company while Sletta worked in education. While Sletta paid the couple's bills, Larry kept their financial records and presented Sletta with joint returns for her to sign, which she did without question. It's just that Larry never filed them until after the Service started investigating the couple. The returns contained unsubstantiated business expenses and failed to include about $1.5 million in gross receipts from Larry's business.

Sletta wanted innocent spouse relief, but the Service did not grant her petition. The Tax Court agreed, finding she had reason to know of the understatements of income on each return. She "should have suspected that something might be amiss" when the 2004 return showed a $58,000 loss from Larry's business. "Even a cursory review of each year's tax return would have revealed that [Larry]'s mortgage origination business had reported (on line 12 of the first page of each return) substantial losses for 2004 and 2005 and that no business income or loss was reported for 2006 and 2007." Given Sletta paid the couple's bills, she knew first-hand that these "losses" were not impacting their standard of living.

The Tax Court also refused to extend equitable relief to Sletta. Sletta did not show how making her jointly and severally liable would cause her to suffer economic hardship. She had reason to know of the understatements and has not claimed to be a victim of abuse. She has not alleged Larry restricted her access to financial information. Perhaps most importantly, there was no change in the couple's standard of living, so she "received the benefit of paying no tax on hundreds of thousands of dollars."

R. SURVIVING SPOUSE CANNOT USE DECEASED SPOUSE'S AMT CREDIT CARRYFORWARD (*Vichich v. Commissioner*, 146 T.C. No. 12, April 21, 2016).

Nadine married Bill in 2002. It was his second marriage—his divorce from Marla was final just eight months before he tied the knot with Nadine. On their 1998 joint return, Bill and Marla paid alternative minimum tax of over $708,000 in connection with the exercise of Bill's incentive stock options. That tax payment resulted in an AMT credit carryforward.

On their 2003 joint return, Bill and Nadine claimed over $304,000 of the carryforward. Bill died in 2004, and on the 2004 joint return filed by Nadine none of the carryforward was used. Things were quite for a while, until Nadine started claiming the remaining carryforward on her own individual returns starting in 2007. It worked for a while until the Service caught on, at which point it stopped issuing refunds and started sending deficiency notices with respect to the prior years.

The Tax Court agreed with the Service that Nadine could not use Bill's AMT carryforward as his surviving spouse. Although this was a case of first impression, the court looked to decisions holding that deductions do not pass to surviving spouses at death. "Marriage affords its entrants certain benefits, among them the option of filing joint returns. The Code treats married taxpayers who file jointly as one taxable unit; however, it does not convert two spouses into one single taxpayer. Joint filing allows spouses to aggregate their income and deductions but 'does not create a new tax personality.'" In effect, then, the carryover died with Bill.

S. THIS IS WHY YOU DON'T LOAN MONEY TO FRIENDS (*Riley v. Commissioner*, T.C. Memo. 2016-46, March 10, 2016)

A few years before her divorce, Kaylan worked at a Blockbuster video rental store (remember those?). There she met Frank, a fellow from the same neighborhood whose kids attended the same school as Kaylan's kids. "Their relationship blossomed." In 2002, Kaylan divorced her husband. As part of the divorce decree she received a pension plan and an IRA, each worth about $1 million, along with monthly alimony payments of $4,300. Soon thereafter, Frank told Kaylan he had invented a device that allowed cell phones to act as remote controls for television sets—just point your phone at the TV and you're surfing channels in no time. If only he could find an investor, he lamented. Over the next five years, then, Kaylan wrote checks totaling over $1.3 million, usually payable to Frank and once to his business, and sometimes in exchange for a note and sometimes not.

Kaylan noticed that Frank started dressing better and that he drove a nicer car. Her friend, Wendy, went to work at Frank's company in 2010 and soon reported to Kaylan that things weren't right with the company. Kaylan started to realize that maybe she had been duped. She hired an attorney to write a demand letter to Frank, but that did no good. She found another law firm willing to take her case on a contingency but she didn't hire them because they asked for a $10,000 retainer. On her 2010 federal income tax return, Kaylan claimed a $1.33 million theft loss deduction that created a large net operating loss carryback. She them amended her 2008

return to claim the carryback, but the Service denied her requested refund on the grounds that she did not sustain a theft.

The Tax Court considered whether the facts gave rise to a theft loss, a bad debt deduction, or a worthless securities deduction. In each scenario the court found no basis for a deduction. She did not establish a theft because the only proof of misleading statements was her conversations with Frank and Wendy, neither of whom testified at trial. That rendered those statements inadmissible as hearsay (the court admitted them only to prove Kaylan's state of mind). So without any proof as to Frank's statements or his own state of mind, Kaylan can't prove a false representation was made with intent to defraud her.

As for the bad debt deduction, the court reasoned that even if Kaylan could make a case for a bad debt, it would be a nonbusiness bad debt since the advances to Frank were not part of any business activity of Kaylan. Nonbusiness bad debts are deductible as capital losses, and there is no carryback for capital losses. So that argument would not work for her 2008 return. The same goes for the worthless securities deduction, for it too would generate a capital loss that cannot be carried back. On top of that, said the court, Kaylan has not shown she lacks a reasonable chance of recovery. Heck, she found a law firm that would take her case on contingency. Frank is still around, and Kaylan still keeps in contact with him. She might have a bad debt or worthless security at some point, but not yet.

T. STATUTE OF LIMITATIONS CAN'T BE USED TO AVOID REPORTING INCOME (*Squeri v. Commissioner,* T.C. Memo. 2016-116, June 15, 2016)

The taxpayers own an S corporation that operates a "full-service janitorial business." The company reported its gross receipts based on deposits made into its bank accounts during the calendar year, regardless of when the checks were received. The Service recalculated the company's gross receipts based on when checks were received instead of when they were deposited, and this resulted in deficiencies for each of 2009, 2010, and 2011. In computing the tax due for 2009, however, the Service did not exclude checks that had been received in 2008 and deposited in 2009. The taxpayers claimed the Service needed to do this, because those amounts were actually received in 2008 and the statute of limitation precluded the Service from making adjustments related to 2008.

But the Tax Court agreed with the Service that if the taxpayers were right, they would never pay tax on the income originally reported in 2009 but properly allocable to 2008, a now-time-barred year. The common law "duty of consistency" precludes taxpayers "from benefiting in a later year from an error or omission in an earlier year which cannot be corrected because the limitations period for the earlier year has expired." The court found that allowing the taxpayers to recharacterize the income as attributable to 2008 "would harm the Commissioner; it would allow petitioners to avoid tax on $1,634,720."

U. FORFEITURE OF INSIDER TRADING PROFITS IS A NONDEDUCTIBLE PENALTY (*Nacchio v. United States*, Fed. Cir., June 13, 2016)

The taxpayer was CEO of Qwest Communications International when, in 2001, he sold a large block of stock in the company for a $44.6 million gain. He paid almost $18 million in tax on the gain. In 2007 the taxpayer was convicted of insider trading. After several appeals, in 2010 the taxpayer was forced to forfeit his $44.6 million gain from the 2001 sale. So now the taxpayer wants credit for the $18 million in tax paid on this sum. 2001 is a closed year, of course, but the taxpayer wants to use §1341 for relief. That section allows a taxpayer either a current deduction for the repayment of an amount previously included in income or a current credit equal to the extra tax paid from the prior inclusion.

To qualify for §1341, however, the taxpayer must be able to claim a deduction for the repaid amount. That's where the taxpayer's claim gets tricky. The Service disallowed the taxpayer's §1341 claim on the grounds that his forfeiture was a nondeductible fine or penalty. It also contended that the taxpayer was estopped from using §1341 because of his criminal conviction. The Court of Federal Claims rejected these contentions, finding the taxpayer could deduct his forfeiture payment as a loss under §165 (but not as a business expense under §162(a) because of §162(f)) and that he was not collaterally estopped from using §1341 just because he was convicted of a criminal offense. It thus granted the taxpayer's summary judgment motion on these points.

On appeal, though, the Federal Circuit reversed the lower court's grant of summary judgment. The appellate court held that §165 is subject to a public policy exception, citing a line of cases affirming that this exception applies both to §165 losses and to §162(a) business expenses. Moreover, the forfeiture was clearly in the nature of a fine or penalty. "We further understand [the taxpayer's] argument that not being allowed to deduct his forfeited income from his taxes would result in a sort of "double sting": both giving up his ill-gotten gains and paying taxes on them. But in this case, the relevant statutes, regulations, and body of relevant case law lead us to conclude that [his] criminal forfeiture must be paid with after-tax dollars, just as fines are paid with after-tax dollars." Since there is no income tax deduction for the forfeiture, §1341 cannot apply. The court thus did not reach the argument as to whether the taxpayer was estopped from using §1341 because of his conviction.

V. DEDUCTING LAW SCHOOL TUITION

German Lawyer Working as Apartment Manager Cannot Deduct Tuition to Attend United States Law School (*O'Connor and Tracy v. Commissioner*, 10th Cir., June 28, 2016). The taxpayer had been admitted to practice law in Germany in 2007. In 2009, after two years of working as an apartment building manager, the taxpayer started the J.D. program at San Diego. His 2010 and 2011 returns claimed deductions for his law school expenses. The Service disallowed the deductions because the course of study was not required to maintain or improve his job skills. The Tax Court agreed, finding the taxpayer was not established in the legal profession in the United States and thus the law school degree qualified him for a new trade or business. On appeal, the Tenth Circuit affirmed. The taxpayer argued that he was using his skills as a lawyer in his work, but that didn't cut the mustard. "For purposes of deductibility, courts

have held that a person who is admitted to practice law in one jurisdiction, but then incurs expenses to become qualified to practice in another jurisdiction, is considered to be entering a new trade or business."

The Tax Court also upheld the imposition of 20% negligence penalty, which the Tenth Circuit also affirmed. "Appellants' failure to heed relevant precedent regarding [the regulations and case law], without any indication that such precedent has been superseded or overruled, supports the imposition of accuracy-related penalties."

Accountant Can't Deduct Law School Tuition (Nor Read Precedent, It Seems) (*Santos v. Commissioner*, T.C. Memo. 2016-100, May 17, 2016). The taxpayer worked as an accountant for 20 years before enrolling in law school. The taxpayer paid $20,275 in tuition for the 2010 taxable year and deducted that amount as a business expense on his Schedule C. There's just one problem: Regulation §1.162-5(b)(3)(ii), Example (1) expressly provides that law school costs for "a self-employed individual practicing a profession other than law" are not deductible "because this course of study qualifies him for a new trade or business."

Before the Tax Court, the taxpayer argued the regulation was invalid. But the Tax Court had already upheld the validity of the regulation in a 1971 case, and the underlying law on which the regulation was based has not changed in the interim. In fact, there is a long line of cases applying the regulation and denying a deduction in similar circumstances. This decision is yet another.

W. DISCRIMINATION AWARD TAXABLE SINCE NOT ATTRIBUTABLE TO PHYSICAL INJURY OR SICKNESS (*Barbato v. Commissioner*, T.C. Memo. 2016-23, February 16, 2016)

The taxpayer worked as a letter carrier when, in 1991, she sustained back and neck injuries in a work-related automobile accident. The injuries forced her to accept a new at the Post Office answering telephones and helping customers. In 2004, her branch got a new manager. The new manager assigned the taxpayer to resume work as a letter carrier. The taxpayer tried to comply, but the pain was too much. She noticed the new manager and other supervisors retaliated against her when she requested medical accommodations, thus creating a hostile work environment. Eventually the taxpayer filed a complaint with the Equal Employment Opportunity Commission.

An EEOC administrative judge ruled that the taxpayer was "entitled to non-pecuniary damages in the amount of $70,000, for the emotional distress which she established was proximately caused by the discrimination" she suffered. The judge found the taxpayer suffered from depression, anxiety, sleep problems, and post-traumatic stress disorder, all conditions caused or exacerbated by the discriminatory actions. But the judge also found that the taxpayer's physical pain was not the result of discrimination. The United States Postal Service paid the $70,000 damage award to the taxpayer in 2011, but she did not include this amount on her 2011 tax return.

The Service concluded that the award was taxable, and the Tax Court agreed. The court concluded the damages paid to the taxpayer were for emotional distress attributable to discrimination and not to physical injury or physical sickness. Yes, the discrimination exacerbated her distress and pain, but it did not cause them.

X. CAPITAL GAINS STILL REQUIRE THE SALE OR EXCHANGE OF A CAPITAL ASSET (*Duffy v. United States*, Fed. Cir., January 8, 2016)

The taxpayer worked for United Commercial Bank as Tax Director and First Vice President. In that job, he was supposed to make sure the bank complied with the financial disclosure requirements of the Sarbanes-Oxley Act. In 2006, the taxpayer informed bank management of instances of noncompliance. His reward? The bank placed him on administrative leave and then terminated his employment. So the taxpayer filed a claim with the Department of Labor alleging that the bank fired him for whistleblowing and refusing to participate in the bank's illegal conduct. The taxpayer and the bank settled when the bank agreed to pay him $50,000 and pay $25,000 to his attorneys on his behalf. In exchange, the taxpayer agreed to accept his termination and withdraw his claim with the Department of Labor. The settlement agreement expressly provided it was "for the exclusive purpose of avoiding the expense and inconvenience of further litigation."

The taxpayer's original return included the $50,000 as "other taxable income," but he then amended the return and excluded it on the grounds it was either excludable under §104(a)(2) as compensation for physical injury or subject to tax at a reduced rate as a capital gain from the loss of goodwill to his separate financial consulting business.

The Service disallowed the refund, which sent the taxpayer to the Court of Federal Claims. That court found no capital gain income because there was no sale or exchange of a capital asset. Moreover, §104(a)(2) did not apply because there was no physical injury. So it upheld the Service's denial of the taxpayer's refund claim.

The taxpayer didn't stop there, appealing the capital gain ruling to the Federal Circuit. But the appellate court affirmed. Even if the taxpayer could show that the goodwill in his separate consulting business was a capital asset, there was no sale or exchange of that asset. No property was transferred to the bank and any goodwill in the business remained with the taxpayer. The settlement agreement made no mention of the goodwill either.

Y. RALPH LAUREN SALESMAN CANNOT DEDUCT COST OF CLOTHING REQUIRED FOR HIS JOB (*Barnes v. Commissioner*, T.C. Memo. 2016-79, April 27, 2016).

In 2010 the taxpayer took a sales job with Ralph Lauren. The employer required sales staff to wear Ralph Lauren clothing while representing the company. The taxpayer tried to deduct the cost of the Ralph Lauren clothes he purchased as an unreimbursed employee expense, but the Service tore the deduction to shreds, citing the long line of precedent that clothing suitable for ordinary wear away from the job is not a deductible business expense. The Tax Court agreed, and even upheld the imposition of a 20% negligence penalty.

The more interesting issue in the case relates to the contribution of used clothing and household items to the Salvation Army in that same year. The taxpayer got receipts, all describing the various contributions (e.g., "4 box of clothes," "1 printer"). But the receipts did not reflect the value of the donated goods. When the Service disallowed the deductions, the taxpayer produced "summary sheets" listing the values at the time of donation. Most of these amounts were calculated with reference to the Salvation Army's "Donation Value Guide." But the summary sheets list assets not reflected on any of the receipts. The Tax Court held these sheets, together with the receipts, did not constitute adequate substantiation for the $5,030 in claimed charitable donations. It thus upheld the assessed deficiency but waived the application of the 20% negligence penalty as to the charitable contribution deduction, for while the documentation submitted did not provide adequate substantiation, it offered proof of the taxpayer's good faith attempt to comply with the law.

Z. RELATIONSHIP ISSUES

Payments for Sex are Gross Income (*United States v. Fairchild*, 8th Cir., March 17, 2016). The taxpayer was sentenced to 33 months in prison for making a false tax return. This is an appeal of her conviction, in which she claims there was insufficient evidence that she willfully underreported her gross income. For the years at issue, the taxpayer reported gross income ranging from $120,000 to just over $150,000 from her work as a professional adult entertainer. But bank records suggest the taxpayer received 37 checks from one man (not her husband or any other related party) totaling over $1 million, plus six checks from another guy totaling $50,000. None of these payments made their way onto any tax returns. The taxpayer said she gave private dances to the men making the payments but insisted they were all gifts. The free private dances were her way of thanking the men for their payments. Interestingly, there was one year in which some of the payments were reported as income. That, according to the taxpayer, was to relieve the man of having to pay gift tax on the transfers. The men told a different story, both of them testifying that the payments were in exchange for sex.

The Eighth Circuit found that there was sufficient evidence to support the jury's finding that the taxpayer willfully filed false tax returns by not including all of the payments in gross income. Although the taxpayer testified she truly believed she accurately reported the portions of the payments that were compensation, "they jury was free to disregard [her] statements as not credible." The court also rejected claims that the jury instructions were improper and that the sentence is unreasonably long.

Using the 1099-MISC as a Post-Breakup Weapon (*Blagaich v. Commissioner*, T.C. Memo. 2016-2, January 4, 2016). Lewis (age 72) and Diane (age 54) dated for about 18 months. During that time, Lewis provided Diane with cash and property (including a Corvette) worth over $743,000. Late in the relationship they entered into an agreement whereby Lewis agreed to provide financial accommodation to Diane and whereby both parties agreed to remain monogamous. When Diane moved out after the termination of their relationship, Lewis sent her

a notice of termination of their agreement. Some time later, Lewis came to believe Diane was dating another man.

In 2011, Lewis sued Diane seeking repayment of the cash and property transferred to her. He also filed a 1099-MISC reporting that he had paid over $743,000 to Diane. The lawsuit ended in 2013 when the court found Diane liable for fraudulent inducement. It ordered her to pay $400,000 to Lewis's estate; the rest of the payments made to Diane (including the car) were "clearly gifts" that she was entitled to keep. So Lewis's estate filed a revised 1099-MISC for 2010 reporting $400,000 as compensation paid to Diane.

The Service increased Diane's 2010 gross income by the $743,000 reported on the original 1099-MISC. That led to the deficiency and accuracy-related penalty that was the subject of this case before the Tax Court. At this point we are at the summary judgment phase, and Diane has Diane argued that the modified 1099-MISC should be controlling such that only $400,000 is at issue, and she further claimed the state court's determination that the $400,000 was a gift should be binding here. But the Tax Court noted that the Service was not a party to the state court action, so it is not estopped by the state court's determination as to how much, if any, of the amount paid to Diane was a gift.

Diane then argued that although she received the $743,000 in 2010, she should not have income because of the repayment obligation. But the court noted that the obligation to repay any portion of the $743,000 did not arise until 2013, so the doctrine of rescission could not apply to supplant application of the claim of right doctrine.

AA. DAMAGE RESULTING FROM GRADUAL DETERIORATION NOT A CASUALTY (*Alphonso v. Commissioner*, T.C. Memo. 2016-130, July 14, 2016).

The taxpayer owned stock in a cooperative housing corporation that owned properties in upper Manhattan. She leased an apartment in a building owned by the co-op. In 2005, a retaining wall owned by the co-op collapsed, causing substantial damage. The co-op levied an assessment against each of its shareholder-tenants for repairs. The taxpayer paid her portion of the assessment ($26,390) and then deducted this amount on her 2005 income tax return as a casualty loss. After applying the $100 floor and the 10%-of-AGI limit, her net deduction was $23,188.

The Service disallowed the deduction, concluding that the collapse of the retaining wall was a result of gradual weakening, and therefore was not a casualty. The Service then maintained that any casualty loss deduction would be claimed by the co-op and not by its shareholders. It was on this latter point that the Tax Court denied the deduction in a 2011 case. The taxpayer did not have a property interest in the co-op's grounds (she didn't lease the retaining wall, she didn't have an easement over that wall, she didn't have any kind of property interest in the wall or any of the co-op's grounds) so she could not claim the payment as a casualty loss deduction. The taxpayer argued she should be able to deduct the payment under §216(a), which allows shareholder-tenants of co-ops to deduct their shares of the co-op's taxes and interest expenses.

The Tax Court rejected this argument, noting that §216(a) is simply designed to put co-op shareholder-tenants on an even keel with homeowners as regards taxes and interest expenses. It does not cover casualty losses or expenses of the kind incurred here.

On appeal, however, the Second Circuit reversed. It held that under applicable state law (New York), the taxpayer had a property interest, namely the right to use the grounds, though shared with other residents of the cooperative. It thus remanded the case back to the Tax Court for a determination as to whether the damage was the result of a sudden "casualty" or just gradual weakening.

The taxpayer said the damage was the result of five consecutive months of excessive rainfall, but the Tax Court was unimpressed with the taxpayer's expert. It found the Service's expert more persuasive, thus adopting his conclusion that the cause was more likely due to "tension cracks" formed at and shortly after construction. Thus, the damage resulted from progressive deterioration and not from a casualty.