FEDERAL TAX UPDATE

Important Developments in Federal Income, Estate & Gift Tax

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This update explains several developments in the substantive federal income, estate and gift tax laws affecting individual taxpayers and small businesses. It contains summaries of significant cases, rulings, regulations, and legislation from 2014 and 2015. This update does not discuss developments in the areas of qualified plans or the taxation of business entities (except to a very limited extent).

On December 19, 2014, President Obama signed the Tax Increase Prevention Act of 2014. It extended through 2014 many of the individual and small business tax benefits that the American Taxpayer Relief Act of 2012 had extended only through 2013. Throughout these materials, "TIP" refers to matters contained in this 2014 extender bill.

A Visual Guide to the Federal Tax Rates for 2015

By Samuel A. Donaldson

(from a format originally prepared by Crowe Horwath, using adjustments in Rev. Proc. 2014-61)

Taxable Income Exceeding		**2015 Federal Income Tax Rates for Individuals**			
Unmarried	Joint	Ordinary Income	Adjusted Net Cap Gain* & Qualified Dividends	Medicare Surtax on Earned Income**	Medicare Surtax on Net Investment Income
$0	$0	10%	0%	2.9%	0%
$9,225	$18,450	15%			
$37,450	$74,900	25%	15%		
$90,750	$151,200	28%			
$189,300	$230,450	33%			
*AGI over $200,000****	*AGI over $250,000****			3.8%	3.8%
$411,500	$411,500	35%			
$413,200	$464,850	39.6%	20%		

* 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.

Section 62: Adjusted Gross Income Defined

TIP: Above-the-Line Deduction for Teachers' Classroom Expenses Continues. For 2014, K through 12 teachers can continue to 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), or computer equipment and related services or software. *Sections 62(a)(2)(D) and 62(d).*

Section 67: 2-Percent Floor on Miscellaneous Itemized Deductions

Final Regulations Clarify Application of Haircut to Estates and Trusts. Section 67(e) provides that the so-called "2% haircut" (which limits the deduction for all miscellaneous itemized deductions to that amount by which the aggregate of such deductions for the taxable year exceeds two percent of the taxpayer's adjusted gross income) does not apply to "costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate." Six years ago, the Supreme Court held that investment advisory fees incurred by trusts are generally outside of this exception and thus subject to the 2% haircut. But while that case was pending, Treasury proposed regulations requiring, among other things, that where a trust pays a single fee for both services that are subject to the 2% haircut and services that are not, the trustee must "unbundle" that fee to determine the portion that is subject to the 2% haircut. But Treasury provided relief from this requirement until such time as final regulations are published. That has now happened. The final regulations (effective May 9, 2014, for tax years beginning after May 9, 2014) retain the "unbundling" requirement, but provide that where the single fee "is not computed on an hourly basis," only the "investment advice component" must be unbundled, and the unbundling may be achieved by any "reasonable method." Likewise, legal and accounting fees that are not computed on an hourly basis only must be unbundled for amounts allocable to investment advice. The final regulations contain additional guidance, like the general proposition that a cost is subject to the 2% haircut if it is included in the definition of miscellaneous itemized deductions, is incurred by an estate or a non-grantor trust, and would "commonly or customarily" be incurred by a hypothetical individual holding the same property. The regulations also provide that so-called "ownership costs" (those chargeable to or incurred by an owner of property simply by reason of being the owner of the property, like condo fees, insurance costs, maintenance costs, landscaping, and vehicle registration) are subject to the 2% haircut unless they are deductible under other Code provisions that render them non-miscellaneous itemized deductions. Importantly, the regulations clarify that the costs incurred in connection with preparing estate tax returns, generation-skipping transfer tax returns, fiduciary income tax returns and the decedent's final returns are not subject to the 2% haircut (but the costs for preparing all other tax returns, including gift tax returns, are subject to the haircut). Similarly, appraisal fees to determine the fair market value of assets as of the decedent's date of death (or alternate valuation date), to determine the value of assets for purposes of making distributions, or to prepare the estate's or trust's tax returns are not subject to the 2% haircut. *Regulation §1.67-4* (May 8, 2014).

Section 108: Income from Discharge of Indebtedness

TIP: Exclusion for Discharges of Debt on Principal Residence Continues. 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. It was set to expire at the end of 2013 but has been continued through 2014. *Sections 108(a)(1)(E), 108(h)*.

Section 163: Interest

TIP: Deduction of Mortgage Insurance Premiums Extended. 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. The deduction was set to expire but has now been extended to include premiums paid or accrued in 2014. *Section 163(h)(3)(E)*.

Section 164: Taxes

TIP: Sales Tax Deduction Continues. For 2014 only (uh-huh), individuals can continue to 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. *Section 164(b)(5)*.

Section 168: Accelerated Cost Recovery System

TIP: Another Return of 50% Bonus Depreciation. Depreciable tangible personal property and computer software acquired and first placed in service in 2014 will be 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 will 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 does not apply to assets with a class life in excess of 20 years. *Section 168(k).*

Section 170: Charitable Contributions and Gifts

TIP: Expanded Limitations for Contributions of Qualified Conservation Real Property Extended. 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. These expanded limitations were going to expire but have been extended through 2014. *Section 170(b)(1)(E).*

Highest and Best Use Needs to be Viable, Too. The taxpayer owned 882 acres of undeveloped land in California. He used the property for recreational purposes, including deer hunting. In 2005, he conveyed a conservation easement on the property to the Golden State Land Conservancy. On his 2005 tax return, the taxpayer claimed a $4.7 million charitable contribution deduction in connection with the conservation easement. The Service disallowed the deduction, so the parties found themselves before the Tax Court. In support of the easement's valuation, the taxpayer claimed that the highest and best use of the property prior to the creation of the easement would be for a winery, for subdivision, or both. Alas, the Tax Court didn't buy the testimony of the taxpayer's expert regarding the property's use as a winery. Neither the expert nor the taxpayer established that the property could feasibly be converted into a winery. To access the taxpayer's property, one must pass over federal lands. The taxpayer had a right-of-way over those lands, but only for "single-family use." To use the property as a winery, the owner of the land would need a right-of-way that did not exist. Moreover, the taxpayer could not prove that the property had an adequate water supply for use as a vineyard. Nor could the taxpayer prove that the use of the property as a vineyard would be economically viable. Thus the property's highest and best use before the imposition of the conservation easement could not have been for use as a winery. The court also rejected the position that the property could have been used for residential development prior ro the easement. Applicable state law already precluded subdivision of the taxpayer's property except for transfers to immediate family members. It was thus unrealistic to consider the property's value as a potential site for development. The court held that the property's highest and best use before the easement was for the recreational purposes for which the taxpayer used the property. And since that remains the highest and best use after imposition of the easement, the easement has not caused a decline in the value of the property—and that means the taxpayer gets no deduction. *Mountanos v. Commissioner*, T.C. Memo. 2014-38 (March 6, 2014).

Taxpayers Sometimes Win Conservation Easement Cases. 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. 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 court also determined there was adequate road access for a multiple-unit development as large as that suggested by the taxpayer. Ultimately, then, the court held that the contributed easement was worth $19.9 million, a figure much closer to the taxpayer's original position. *Palmer Ranch Holdings v. Commissioner*, T.C. Memo. 2014-79 (May 6, 2014).

Quid Pro Quo Exchange Precludes Deduction for Conservation Easement. The taxpayer owned adjacent parcels of land in Denver, Colorado. One parcel was used as a parking lot, while the other contained a mosque built in 1907 and listed in the National Register of Historic Places. The taxpayer sought to build a condominium complex on the parking lot site. To obtain the required clearances and relief from an applicable height restriction, the taxpayer agreed to grant conservation easements on the mosque property to Historic Denver, a charitable organization formed to "preserve the historic fabric [and] distinctive architecture and cultural landscapes of Denver." (The City of Denver had selected the charity to hold the easement.) The Service argued, and the Tax Court agreed, that this was a bargained-for exchange and not a charitable contribution. It thus denied the $7.1 million deduction claimed by the taxpayer. Because the taxpayer did not identify the consideration it received in the exchange, it was precluded from any deduction at all. *Seventeen Seventy Sherman Street LLC v. Commissioner*. T.C. Memo. 2014-124 (June 19, 2014).

Failure to Record Deed Postponed Deduction. Marco and his then spouse, Merilyn, decided to contribute a façade conservation easement on their Manhattan townhouse to the National Architectural Trust. They obtained an appraisal claiming the value of the conservation easement to be $660,000 as of July 26, 2004. Sometime on or before September 22, 2004, the taxpayers and the charity signed a conservation deed of easement. The deed, however, was not recorded until January 26, 2005. The taxpayers each claimed a charitable contribution deduction of $330,000 for the easement on their separate 2004 tax returns. Because of the deduction's size, there was carryover to 2005, 2006, and 2007. The Service disallowed the deduction for 2004. The Tax Court upheld the deficiency, concluding that under New York law, the easement was not effective until the deed was recorded. The court further held that the value of the easement was only $157,500. *Zarlengo v. Commissioner*, T.C. Memo. 2014-161 (August 11, 2014).

Subordination Can't Come Two Years Later. The taxpayer, along with her husband, purchased 351 acres in Colorado in a seller-financed transaction in 2001. Under the terms of sale, the taxpayer and her husband paid the seller $83,000 down and agreed to pay the remaining $600,000 over ten years, along with interest. In 2003, the taxpayer and her husband donated a qualified conservation easement in both that property and another parcel of land they owned. The taxpayer claimed a $504,000 deduction on her return. It was not until 2005, however, the taxpayer and her husband secured the agreement of the original seller to subordinate his mortgage to the easement. The Service disallowed the deduction, noting that Regulation §1.170A-14(g)(2) precludes a deduction for encumbered property unless the mortgagee subordinates its rights in the property to the right of the charity to enforce the conservation contribution. Before the Tax Court, the taxpayer argued that the regulation doesn't say *when* the mortgage has to subordinated to the charity's interest and that it was substantial compliance for her and to her husband to obtain the mortgagee's consent two years after the contribution. The Tax Court rejected this argument, concluding that the regulation's subordination requirement has to be met at the time of the gift. The taxpayer then argued that the deduction should be allowed because the probability that she would default on the promissory note and thus place the charity's interest in the property at risk was so remote as to be negligible. The problem with this argument, the court concluded, is that the so-remote-as-to-be-negligible standard appears in Regulation §1.170A-14(g)(3), not in the applicable regulation in this case (Regulation §1.170A-14(g)(2)). The rule in Regulation §1.170A-14(g)(3) is a general one related to remote future events. By separately stating the rule about mortgage subordination in a separate paragraph, the court concluded, "(t)he drafters of [the regulations] saw taxpayers defaulting on their mortgages as more than a remote possibility. Therefore they drafted a specific provision which would absolutely prevent a default from destroying a conservation easement's grant in perpetuity." Thus the Service was right to disallow the deduction even though the taxpayer and her husband have every reason not to default on the mortgage. On appeal to the Tenth Circuit, the taxpayer tried the same arguments to no avail. Further, the court found the risk of repayment not to be negligible. In so doing, the court defined the "so remote as to be negligible" standard to mean "a chance which persons generally would disregard as so highly improbable that it might be ignored with reasonable safety in undertaking a serious business transaction." *Mitchell v. Commissioner* (10th Cir., January 6, 2015).

Section 179: Election to Expense Certain Depreciable Business Assets

***TIP: Large Bonus Depreciation Election Continued One More Year*.** The dollar limitation on the §179 expensing election continues at $500,000 for 2014. (Special thanks to Congress for reinstating the $500,000 limitation for 2014 on December 19, 2014. As with much in life, in this case 'twas better to be lucky than good.) Anyway, as in 2011, 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. Supposedly, the dollar limitation will drop to $25,000 in 2015, with a phase-out that begins once the total amount of §179 property purchased and placed in service during the taxable year exceeds $200,000. *Section 179(b)*.

Section 222: Qualified Tuition and Related Expenses

TIP: Tuition Still Deductible Above the Line. The above-the-line deduction for "qualified tuition and related expenses" continues through 2014. 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) can claim a maximum deduction of $2,000. A taxpayer still cannot claim both the deduction and the § 25A credits. *Section 222.*

Section 408: Individual Retirement Accounts

TIP: Qualified Charitable Distributions from IRAs Revived. 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 completed in 2014. 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. *Section 408(d)(8).*

Section 469: Passive Activity Losses and Credits Limited

Trustee's Work as Employee of Trust's Business Not Imputed to the Trust for Purposes of Material Participation Requirement. Passive income is considered net investment income, and the statute defines passive income with reference to the passive loss allowance rules of IRC §469. Recall that under IRC §469, passive income is the income from a passive activity, and a passive activity is one in which the taxpayer does not "materially participate." Regulations under §469 explain in detail how an individual can "materially participate" in an activity. Those regulations are silent when it comes to trusts. The Service's position has long been that a trust materially participates only if the trustee personally does so. If a trust will hold an interest in a closely-held pass-through business, then, consideration should be given to naming an individual who materially participates in the business as a co-trustee. In this ruling, however, the strategy did not work. But the co-trustee in this ruling was a "special trustee" whose fiduciary power was limited to voting and selling the closely-held business's stock. Moreover, while the co-trustee was president of the company and actively involved in its operation, those activities could not be imputed to the trust. Just as a sole proprietor cannot count the activities of his or her employees to satisfy the material participation requirement, the work of someone serving as co-trustee and president "was as an employee of [the company] and not in [his] role as a fiduciary" and thus "does not count for purposes of determining whether [the trust] materially participated in the trade of business activities" of the company. Note that the Service treats individuals differently. A shareholder who works for the corporation can count those hours as employee toward the material participation threshold, but a trustee who works for the corporation cannot do so. There seems to be little basis for treating individuals and trusts differently on this point, but it's the position of the Service. *Technical Advice Memorandum 201317010* (April 26, 2013).

But the Tax Court Feels Differently. The Tax Court has held that services performed by individual trustees on behalf of a trust may be treated as personal services performed by the trust, allowing the trust to qualify for the rental exception in §469(c)(7). The case involved a trust with six trustees, three of whom were full-time employees of a limited liability company wholly owned by the trust. The LLC managed rental real estate. The trust had net losses for 2005 and 2006, which the Service disallowed in part on the grounds that the real estate activities of the trust were passive activities. Section §469(c)(2) treats any rental activity as a passive activity, but §469(c)(7) offers an exception from that rule where more than half of the "personal services" performed in trades or businesses during the year is performed in real-property trades or businesses in which the taxpayer materially participates and where the taxpayer performs more than 750 hours of services during the year in real-property trades or businesses in which the taxpayer materially participates. The Service argued that a trust cannot perform "personal services," citing the regulation defining personal services as "work performed by an individual in connection with a trade or business." (Reg. §1.469-9(b)(4).) But the Tax Court rejected this contention, holding that "If the trustees are individuals, and they work on a trade or business as part of their trustee duties, their work can be considered" as personal services. If the §469(c)(7) exception was supposed to be available only to individuals, reasoned the court, it would be limited to "any natural person," like other exceptions within §469 that are so limited. The court further held that the trust in the case at bar materially participated in the rental real estate activities. It observed that because the regulations do not yet explain how a trust materially participates in an activity, "we must make the determination … in the absence of regulatory guidance." It went on to conclude that "the activities of the trustees--including their activities as employees of [the] LLC--should be considered in determining whether the trust materially participated in its real-estate operations." Just as trustees who also serve as directors of a corporation owned by the trust cannot divorce their actions as directors from their actions as trustees, said the court, trustees who are employees of an LLC owned by the trust cannot separate their services performed as employees from their work as trustees. Thus the services performed by the employee-trustees count toward determining whether the trust materially participated. Under that rationale, the trust easily qualified for the §469(c)(7) exception. Pending promulgation of regulations explaining how trusts materially participate, then, practitioners can rely on this case in imputing the services of a trustee-employee to the trust. *Frank Aragona Trust v. Commissioner*, 142 T.C. No. 9 (March 27, 2014).

Section 529A: Qualified ABLE Programs

Meet the Latest Gadget in the Special Needs Toolbox: ABLE Accounts. A companion to the TIP Act, the Achieving a Better Life Experience ("ABLE") Act created new §529A, which authorizes states to create so-called "qualified ABLE programs" under which one may make contributions to a tax-exempt account for the benefit of a disabled individual. A disabled person (defined as one who would qualify as blind or disabled under Social Security Administration rules) may have a single account to which total annual contributions may not exceed the federal gift tax annual exclusion amount (currently $14,000). Income from the account is exempt from federal income tax, and distributions made to the beneficiary for "qualified disability expenses" are likewise tax-free. Qualified disability expenses are defined broadly to include education, housing, transportation, employment training, assistive technology, health, wellness, financial management, and legal expenses (some of which are not already covered by Medicaid and OASDI benefits). Any other distributions, however, will be subject to a 10% penalty and will count as resources for purposes of the beneficiary's Medicaid exemption. There is no income tax deduction for contributions to the account, and any such contributions from third parties are treated as completed gifts of present interests to the beneficiary. Assets inside of an ABLE account do not count as "resources" of the beneficiary for purposes of qualifying for federal assistance. If, however, the account balance ever exceeds $100,000, the beneficiary will be denied eligibility for SSI benefits. Furthermore, any assets inside of the account upon the beneficiary's death are subject to Medicaid payback rules. Given these significant limitations, the traditional special needs trust may remain the preferred strategy in this context. ABLE accounts may make the most sense in these situations: (1) the beneficiary has a job that pays low wages and the individual wants a tax-exempt account to save up for a car, the down payment on a home, or other expenditures; (2) the beneficiary's disability has the potential to resolve itself before the beneficiary's death; (3) the amount of money involved is too small to make a complex special needs trust worthwhile; or (4) the disabled beneficiary is about to turn 18 and will be entitled to funds from UTMA or UGMA account that will jeopardize the beneficiary's eligibility for federal assistance. *Section 529A*.

Section 642: Special Rules for Credits and Deductions

No Income Tax Deduction for Residuary Gift to Charity When Litigation Expenses Chew Up the Residue. The decedent's will directed the residue of her estate to be divided as follows: $50,000 to the decedent's brother and the rest to the Columbus Jewish Foundation, a charity. The estate consisted of a residence in Ohio, a California condo in which the decedent's brother resided, and a retirement account worth over $243,000, all of which, of course, was income in respect of a decedent. The decedent's brother sought to stay in the condo, but the estate's executor asked him to vacate. Litigation ensued. Meanwhile, the retirement plan administrator distributed just over $219,000 to the estate, and the estate's income tax return claimed a charitable deduction for that same amount, although that amount had not been paid to the charity. In fact, the estate had used some of the distribution to pay for the litigation expenses in connection with the brother' claim. The Service disallowed the charitable deduction because §642(c) requires the contribution amount either to be paid to or "permanently set aside" for the charity. Before the Tax Court, the estate claimed that the brother's claim was not reasonably foreseeable and thus should not preclude a deduction. But the Service maintained that the estate was "on notice that a prolonged legal fight was more than just a remote possibility at the time they claimed the charitable deduction." The Tax Court agreed with the Service. By the time the income tax return was filed, the estate knew of the brother's claim and knew enough to know that prolonged litigation was not "so remote as to be negligible." Thus, the claimed deduction was improper. *Estate of Belmont v. Commissioner*, 144 T.C. No. 6 (February 19, 2015).

Section 671: Trust Income, Deductions, and Credits Attributable to Grantors and Others as Substantial Owners

NINGs and DINGs Get the Green Light. The "Nevada Incomplete (Gift) Non-Grantor trust" ("NING trust") and its kissing cousin, the "Delaware Incomplete (Gift) Non-Grantor trust" ("DING trust"), are vehicles generally used to minimize state income tax. In the typical example, it is a self-settled trust created for the benefit of the grantor and other beneficiaries. The grantor may receive distributions of income and principal as determined by a distribution committee composed of the grantor and adverse parties (namely, the other discretionary beneficiaries). In addition, the grantor retains a limited power to appoint the trust property by will or other testamentary instrument. If it works, the trust is treated as separate taxable entity for income tax purposes but transfers to the trust are not completed gifts for gift tax purposes. If the trust sits in a state where there is no state income tax, then, a grantor can avoid state income tax liability on assets contributed to the trust while retaining some form of access to those assets. In a series of ten nearly identical rulings, the Service said the NING indeed works. Specifically, it ruled that trusts structured as described above are treated as separate taxpayers for income tax purposes and that transfers to such trusts are incomplete gifts for gift tax purposes because of the retained power of appointment. The Service also ruled that distributions to the grantor would not be considered as gifts by any member of the distribution committee, but distributions to other beneficiaries would be completed gifts by the grantor. Finally, because the gift is incomplete, the assets of any such trust are includible in the grantor's gross estate. Because Nevada does not impose a state income tax, this structure is helpful for income-producing assets where the grantor resides in a state that imposes income tax. Thus, for example, a New York resident could transfer income-producing assets to a Nevada trust and avoid the liability for New York state income tax since the assets are owned by the trust and not by the grantor. The structure would also work well where the grantor anticipates a sale of the subject property and wants to minimize the state income tax burden associated with the sale. There is also some thinking that NINGs and DINGs are also helpful as creditor protection devices, as they are established as domestic asset protection trusts. *Private Letter Rulings 201410001 – 201410010* (March 7, 2014).

Section 752: Treatment of Certain Liabilities

Proposed Regulations Portend Ominous Changes to Debt Allocations. A partner's share of partnership liabilities is added to a partner's outside basis (the partner's basis in the partnership interest). Logically, then, when a partner's share of partnership debt is reduced, the reduction is treated as a cash distribution to the partner. The rules for determining a partner's share of partnership liabilities depend on whether the debt is recourse or nonrecourse. Currently, recourse debt is allocated to the partner(s) who bear(s) the economic risk of loss under a constructive-liquidation test. The constructive-liquidation test assumes the partnership's assets become worthless and all partnership liabilities become payable in full. The partner's share of a recourse debt is the amount the partner would be obligated to pay upon the constructive liquidation. But proposed regulations would make three changes to this regime. First, a partner would have to satisfy the following requirements in order for the partner's payment obligation to be recognized: (1) the partner must maintain a commercially reasonable net worth throughout the term of the payment obligation or be subject to commercially reasonable contractual restrictions on transfers of assets for inadequate consideration; (2) the partner must periodically provide commercially reasonable documentation regarding the partner's financial condition; (3) the term of the payment obligation must not end prior to the term of the partnership liability; (4) the payment obligation must not require the obligor to hold money or other liquid assets in an amount in excess of the obligor's reasonable needs; (5) the partner must receive arm's-length consideration for assuming the payment obligation; (6) in the case of a guarantee or similar arrangement, the partner must be liable up to the full amount of the partner's payment obligation if the guarantee is called upon; and (7) in the case of an indemnity, reimbursement agreement, or similar arrangement, the partner must be liable up to the full amount of the partner's payment obligation if the indemnification is cashed in. Second, the proposed regulations would require a partner's payment obligation to be reduced by any right of reimbursement from any person. Third, the proposed regulations would apply the "net value" requirement (which currently applies only to disregarded entities) to all partners (including grantor trusts) other than individuals and decedents' estates, for payment obligations associated with liabilities that are not trade payables. Different rules apply for nonrecourse debt. A partner's share of nonrecourse debt is the sum of: (1) the partner's share of partnership minimum gain, and (2) the gain that would be allocated to the partner under § 704(c) if the partnership disposed of all property subject to nonrecourse debt for no consideration other than full satisfaction of the debt. Any remaining nonrecourse debt (known as "excess nonrecourse liability") is allocated based on the partner's share of partnership profits. Currently, the partnership agreement can specify a partner's interest in the partnership profits for purposes of allocating the excess nonrecourse liabilities as long as the specified profit interest has substantial economic effect under Sec. 704(b) and is consistent with allocations of some other significant item of partnership income or gain (the "significant-item" method). Alternatively, excess nonrecourse liabilities can be allocated in the same proportion as deductions attributable to those nonrecourse liabilities, as long as the deduction allocation is reasonable (the "alternative" method). The proposed regulations would eliminate the significant-item and alternative methods and replace them with a "liquidation-value" method. A partner's liquidation-value percentage is the ratio of the liquidation value of the partner's interest in the partnership to the aggregate liquidation value of all the partners' interests in the partnership. The liquidation value of a partner's interest in a partnership is the cash amount the partner would receive with respect to the interest if, immediately after the formation of the partnership, the partnership sold all its assets for fair market value, paid off all its liabilities, and then liquidated. The proposed regulations would be effective on partnership debt incurred or assumed once the regulations are finalized. *Proposed Regulation §§ 1.752-2(b)(3); 1.752-3(a)(3)* (January 29, 2014).

Section 1202: Partial Exclusion for Gain from Certain Small Business Stock

TIP: Section 1202 Stock Remains Bullish. 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 2014, a 100% exclusion applies. This gives § 1202 some much-needed bite. Of course, it won't be until 2019 before taxpayers begin to feel the benefit of this increased exclusion. *§ 1202(a)(3).*

Section 1367: Adjustments to Basis of Stock of Shareholders, Etc.

TIP: Charitable Contributions By S Corporations Continue to Look Really Hot. 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 prior law provided that 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). TIP revived this rule and extended it through 2014. This presents 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. *Section 1367(a)(2).*

Section 1374: Tax Imposed on Certain Built-In Gains

TIP: Recognition Period Temporarily Reduced to Five Years. 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, for 2011, 2012, and 2013, the recognition period was shortened to five years. TIP has extended the five-year recognition period through 2014. So if the corporation made its S election effective for 2009, any net recognized built-in gains in 2014 will not be subject to the tax. Curiously, however, any net recognized built-in gains in 2015, the seventh year of S corporation status, would be subject to the tax. *Section 1374 (d)(7)(B).*

Section 2010: Unified Credit Against Estate Tax

Only Those Who Died in the First Quarter of 2014 are Losers. Since 2011, the unused exclusion of a deceased spouse is "portable," i.e., transferable to the surviving spouse for use by the surviving spouse. In order for a surviving spouse to claim the deceased spouse's unused exclusion amount (what the regulations refer to as the "DSUE amount"), the deceased spouse's executor must timely file a Form 706. Normally, of course, the estate has nine months from the date of the decedent's death to file the Form 706. But an executor may claim an automatic six-month extension, effectively postponing the deadline to 15 months after the date of the decedent's death. Regulations issued in 2012 surprised some practitioners because they confirmed that a federal estate tax return is required to claim the DSUE amount, even though a return would not otherwise be required. (Some had concluded that where an estate tax return was not otherwise due, there was no formal deadline for making a so-called "portability election.") Since then, the Service has provided a number of ad hoc extensions under its broad discretion to offer so-called "9100 relief" under Regulation §301.9100-3. Now, the Service has provided a simple method for obtaining an extension of time to make the portability election with respect to the estate of a decedent who died in 2011, 2012, or 2013 with a surviving spouse. Estates qualifying for this simple method need not make a formal case for 9100 relief. The relief only applies to decedents dying in 2011, 2012, or 2013. For these decedents, a late election is allowed by filing a Form 706 on or before December 31, 2014, with the words "FILED PURSUANT TO REVENUE PROCEDURE 2014-18 TO ELECT PORTABILITY UNDER § 2010(c)(5)(A)" written across the top. If the estate does not have an executor or administrator, the election can be made by "any person in actual or constructive possession of any property of the decedent." The Revenue Procedure does not apply to decedents dying in 2014. Thus, the normal deadlines will apply to decedents dying in 2014. Where no extension elections are made, then, it appears that the portability window for decedents dying in January and February of 2014 will close before that of decedents dying as early as 2011, an odd result to be sure. Of course, those estates of 2014 decedents that miss the deadline and fail to request an extension can still seek 9100 relief. One group that benefits greatly from the Revenue Procedure are surviving spouses of same-sex marriages where the deceased spouse died in 2011, 2012, or 2013. The executors of these estates would not have made portability elections because it was not until the United States Supreme Court's decision in *United States v. Windsor* in June, 2013, that we even knew that same-sex couples were eligible for the federal portability election. *Revenue Procedure 2014-18* (January 27, 2014).

Section 2031: Definition of Gross Estate

Net Asset Value Method Strongly Preferred for Holding Company Valuation, and Built-In Gains Discount Applies. At the decedent's death in 2005, she owned a 23.44% interest in a personal holding company that owned $52.1 million in dividend-producing marketable securities. The estate originally claimed that the decedent's interest in the company was worth about $3.15 million (though at trial it claimed the value was about $5 million). The Service assessed a deficiency when it concluded the value of the decedent's holdings to be about $9.22 million. In addition to a $2.8 million deficiency, the Service asserted a $1.1 million "gross valuation misstatement" penalty. At trial, the Service's expert set the value of the decedent's interest at roughly $7.3 million. The Tax Court concluded that the decedent's interest was worth just over $6.5 million. This valuation included a 15% built-in gains discount, a 7.75% minority interest discount, and a 32.1% marketability discount. The court found too many faults with the taxpayer's valuation, including the fact it was never finalized, that it was prepared by an individual who, although a certified public accountant and certified financial planner, was not an expert appraiser, and that the valuation used the "capitalization of dividends" method instead of the court's preferred "net asset value" method. The estate wanted a dollar-for-dollar reduction in the valuation for the built-in gains lurking in the company's portfolio. Instead, the Tax Court gave a discount for the present value of the future capital gains tax liability. And though the Service pointed to the company's history of exceptionally long holding periods for its investments (we're talking 70 years here), the court instead observed that the fair market value definition requires use of hypothetical parties that would rationally seek to diversify its portfolio and thus employ somewhat shorter holding periods, like say 20 – 30 years. That supports the 15% built-in gains discount. As for a penalty, the court imposed a 20% accuracy-related penalty since the amount reported on the estate tax return was less than 65% of the correct value. It was not reasonable for the estate to rely on a draft appraisal from one lacking credentials of a professional appraiser. "In order to be able to invoke 'reasonable cause' in case of this difficulty and magnitude, the estate needed to have the decedent's interest … appraised by a certified appraiser. It did not." *Estate of Richmond v. Commissioner*, T.C. Memo. 2014-26 (February 11, 2014).

Fifth Circuit Upholds Claimed Fractional Interest Discount to Artwork. The decedent and his wife owned 64 works of contemporary art, including works by Pablo Picasso, Paul Cezanne, Jackson Pollock, and Jasper Johns. In 1990, they each created a ten-year grantor-retained income trust (GRIT) to which each contributed his or her community property share of three works: a Picasso drawing, a Pollock painting, and a Henry Moore sculpture. The decedent's wife died in

1999, before the termination of her GRIT. Under the terms of her GRIT agreement, her share of the works held in trust passed to the decedent. The decedent survived his GRIT term, however, meaning his original one-half share of the works passed in equal shares to his three children. At the time of his death, therefore, the decedent held an undivided 50% interest (the share that had been placed in his spouse's trust in the three works. The children then leased to the decedent their interests in two of these works (the Picasso drawing and the Pollock painting). The lease agreement gave the decedent possession of the works in exchange for a monthly rent that was left blank. The agreement also restricted the sale of ownership interests in any of the works unless all owners agreed to sell a work in its entirety. As for the other 61 works, the decedent disclaimed a portion of the undivided 50% interest left to him by his spouse. The disclaimed portion passed in equal shares to the three children. At the time of his death, therefore, the decedent had roughly a 73% interest in each of these remaining 61 works of art (his own 50% interest plus the roughly 23% interest from his spouse that the decedent did not disclaim). Following the disclaimer, the decedent and the children executed a "cotenant's agreement" under which they agreed to share the use of (and maintenance expenses related to) the works proportionate to their ownership interests. They also agreed that none of the works could be sold without their unanimous consent. In valuing the decedent's share of these various works of art, the estate claimed a 44.75% "combined fractional interest discount" reflecting both a minority interest discount and a marketability discount. (Heck, at trial the estate offered witnesses to support its new claim for a 67% discount!) The Service claimed that no discount was proper, based in part on its assertion that the restrictions on sale of the works should be disregarded under §2703. It also claimed that no fractional interest discount should be applied to art because "the proper market in which to determine the fair market value of fractional interests in works of art is the retail market in which the entire work (consisting of all fractional interests) is commonly sold at full fair market value." And since a fractional interest holder would receive a full share of the proceeds, no discount should apply. Because the parties agreed to the undiscounted value of the artwork (a total of just over $35.1 million), the only issue was whether a discount was appropriate and, if so, the amount of such discount. The Tax Court held that §2703(a) applied and that the restriction on sales in the lease agreement and the cotenant's agreement should therefore be disregarded. But as it turned out, disregarding the restriction on sales "makes little or no difference to our conclusion as to the value of the art." Instead, the court was much more concerned with the appropriate discount to apply to a fractional interest in artwork. The court acknowledged that other cases have applied nominal discounts to fractional interests in artwork. But here, the court observed, "we are presented with unchallenged facts demonstrating that the [decedent's] children had strong sentimental and emotional ties to each of the 64 works of art so that they treated the art as 'part of the family.' Those facts strongly suggest that a hypothetical buyer of decedent's fractional interests in the art would be confronted by co-owners who were resistant to any sale of the art, in whole or in part, to a new owner, a resistance that the [decedent's] children specifically communicated. … That being so, the hypothetical seller and buyer necessarily would be faced with uncertainties regarding the latter's ability to monetize his or her investment in the art." Those uncertainties, said the court, warrant a discount. The Service argued that a fractional interest discount here would be inconsistent with its traditional position that fractional interests are not discounted for purposes of the § 170 deduction for charitable contributions when one donates fractional interests to charity. But the court held that the lack of discounts in the income tax context is not relevant given the support in the case law for fractional interest discounts in the estate tax context. So everything came down to the proper discount to apply. The large discount claimed by the estate was based on analysis that failed "to consider not only the [decedent's] children's opposition to selling any of the art but also their ownership position vis-a-vis that of the hypothetical willing buyer and the impact that the … ownership split would have on the negotiations between seller and buyer. Both experts should have considered the fact that the Elkins children, cumulatively, were entitled to possession [for a portion of] each year. The relatively brief period of annual possession and the expense and inconvenience of annually moving the art from the hypothetical buyer's premises back to Houston most likely would have caused the [decedent's] children to reassess their professed desire to cling, at all costs, to the ownership status quo existing after decedent's death. Thus, the hypothetical buyer would be in an excellent position to persuade the children, who, together, had the financial wherewithal to do so, to buy the buyer's interest in any or all of the works, thereby enabling them to continue to maintain absolute ownership and possession of the art." The court continued: "We believe that a hypothetical willing buyer and seller of decedent's interests in the art would agree upon a price at or fairly close to the pro rata fair market value of those interests. Because the hypothetical seller and buyer could not be certain, however, regarding the children's intentions, i.e., because they could not be certain that the children would seek to purchase the hypothetical buyer's interests in the art rather than be content with their existing fractional interests, and because they could not be certain that, if the children did seek to repurchase decedent's interests in the art, they would agree to pay the full pro rata fair market value for those interests, we conclude that a nominal discount from full pro rata fair market value is appropriate. We hold that, in order to account for the foregoing uncertainties, a hypothetical buyer and seller of all or a portion of decedent's interests in the art would agree to a 10% discount from pro rata fair market value in arriving at a purchase price for those interests. We believe that a 10% discount would enable a hypothetical buyer to assure himself or herself of a reasonable profit on a resale of those interests to the Elkins children." On appeal, the Fifth Circuit reversed, finding that the claimed 44.75% discount proper and entitling the decedent's estate to a refund in excess of $14.3 million. The appeals court found the only credible evidence of the discount had been proffered by the taxpayer. It concluded the Tax Court's 10% discount was too arbitrary. *Elkins v. Commissioner* (5th Cir., September 15, 2014).

Section 2053: Expenses, Indebtedness and Taxes

No Deduction for Contingent Claim, But Deduction for Settlement Amount Allowed. The decedent was the surviving spouse of an attorney who was accused of acting as a secret informant for the Service against the interests of one of his clients. The survivors of the client brought a $90 million malpractice action against the attorney's estate for breach of confidence, breach of the duty of loyalty, and fraudulent concealment. The lawsuit was brought only 64 days before the decedent's death in November, 2004. The attorney's estate engaged in ongoing settlement conferences, but the case ultimately went to trial. In 2007, the jury determined that the attorney had breached duties to the client but that these breaches were not a legal cause of injury or damage to the client or the client's estate. The client's estate appealed, but the attorney's estate paid $250,000 in attorney's fee to the client's estate in exchange for a full settlement and mutual release of all claims. On its federal estate tax return, filed in 2006, the decedent's estate claimed a $30 million deduction for the malpractice claim. In its notice of deficiency, the Service reduced the amount of the deduction to $1 (yes, one dollar), and this led the Service to assess a $14.4 million deficiency. The decedent's estate ran to the Tax Court to determine the deductibility of the contingent liability. Regulations finalized in 2009 make clear that a deduction will only be allowed for claims actually paid (for amounts that are paid after the date the estate tax return is filed, the regulations permit the filing of a protective claim for refund). But the applicable regulations in effect at the decedent's death provided that a contingent claim could be deducted even "though its exact amount is not then known, provided it is ascertainable with reasonable certainty, and will be paid." The Tax Court decided to pay no attention to the actual result of the litigation but to instead focus on the value of the claim as of the date of the decedent's death. The three appraisals submitted by the estate presented an array of different values, proving that the amount of the claim was not determinable with reasonable certainty. One report that valued the claim at $30 million was "fraught with vague and uncertain guesstimates, without any objectively reliable discussion of the strength of the defense." Further, there was no proof "that the $30 million claimed on the estate tax return or any specific lesser amount would be paid, as required by the applicable regulation." Thus the Tax Court limited the deduction to the amount actually paid during the administration of the decedent's estate ($250,000). On appeal, the Ninth Circuit affirmed. Because the claim was in dispute at the decedent's death, observed the court, the lower court properly considered the post-death settlement amount in computing the value of the deduction. The court observed that the wide disparity of the valuations given by the estate's expert was a "prima facie indication of the lack of reasonable certainty" that the contingent claim had a definite value at the date of the decedent's death. Again, if these facts arose today, the correct approach would be to deduct the amounts actually paid before the filing of the estate tax return, accompanied by a protective claim for refund in case more amounts are paid thereafter. Under the regulations, the protective refund claim generally may be filed any time before the expiration of the regular "three-two" statute of limitations (three years from when the return was filed or two years from when the estate tax is paid). The claim is filed by attaching a Schedule PC to the estate's Form 706. If the estate tax return has already been filed, the executor can file a Form 843 with the notation "Protective Claim for Refund under Section 2053" written across the top of the first page of the form. *Estate of Saunders v. Commissioner* (9th Cir., March 12, 2014).

Section 2511: Transfers in General

Personal Goodwill is the New Black. Bross Trucking is a corporation engaged in hauling equipment and materials for road construction projects. It leased most of its trucking equipment from a related company. All of Bross Trucking's stock was held by Chester Bross through his revocable trust. Starting in the late 1990s, the company was audited by a state motor carrier safety agency. The agency found that the company failed to collect required information about its drivers, and ultimately the agency gave the company an "unsatisfactory" safety rating. Such a rating meant the company could have lost its hauling authority within the state. As a result of this “negative attention” from regulators, Chester decided to cease Bross Trucking operations. A few years later, Chester’s three sons organized a new trucking business. None of the new company’s assets was transferred from Bross Trucking, as the new company acquired all of its own equipment and licenses. Were it not for the fact that the new company hired several of the former employees of Bross Trucking, there would be no connection at all between the two entities. After formation, the new company started leasing most of the trucking equipment that had been leased by Bross Trucking. The new company also branched out into other operations, including the provision of GPS products to construction contractors and repair services to unrelated third parties. The Service took the position that Bross Trucking distributed its goodwill (specifically, a revenue stream, customer base, established workforce, and supplier relationships) to Chester in a taxable distribution, followed by Chester’s gift of those same assets to his sons. But the Tax Court observed that “[a] business can distribute only corporate assets and cannot distribute … intangible assets that are individually owned by its shareholders.” Here, said the court, Bross Trucking’s goodwill was primarily that of Chester because of his personal relationships. Thus “the company could not transfer any corporate goodwill” to him. Although the workforce belonged to the company and not to Chester, the court held that the value of any corporate goodwill was near zero by the time of the supposed transfer to Chester. There was good evidence that Bross Trucking was seen as a cursed brand, for the sons’ new company wanted immediately to remove the Bross Trucking name from the trucks it leased so that they would not be stopped and subject to random inspection. If anything, the new company was trying to hide any alleged relationship with Bross Trucking. Further, it could not be argued that Chester transferred his personal goodwill to Bross Trucking as there was no employment agreement or noncompete agreement in place. Finally, there was evidence that new company had assembled its workforce independently and that there was no transfer of that workforce from Bross Trucking at all. Thus, there was no transfer from Bross Trucking to Chester. Further, ruled the court, there was no transfer of personal goodwill from Chester to his sons. Chester was not involved in managing the new company. There was no evidence that the new company used Chester’s relationships; instead, it appears that the sons leveraged their own, likewise close relationships with suppliers and customers to build their own brand. Note, then, the difference between transferring assets and rights (taxable) and allowing junior family members to launch their own enterprises based on their own relationships with those dealing with the senior family members and their businesses. The case provides a helpful blueprint for transitioning a goodwill-laden business. *Bross Trucking, Inc. v. Commissioner*, T.C. Memo. 2014-17 (June 5, 2014).

Personal Goodwill – Is There Anything It Can’t Do? The decedent’s revocable trust owned all of the stock in a C corporation that provided uplink equipment used in television broadcasting. The decedent’s son was the company president and, by all accounts, the reason the company succeeded, though the company never had in place an employment agreement or noncompete agreement with the son. As a result of the son’s relationship with assorted religious leaders, the decedent and his son formed “The Word,” a nonprofit entity devoted to providing religious broadcasting. The Word became the company’s only customer, and the company charged The Word 95% of The Word’s net programming revenue for one month or its actual cost to provide services to The Word, whichever was less. Lots and lots of money flowed from The Word to the company, and the decedent’s salary from the company was, to put it mildly, large.

The company provided various personal benefits to the decedent and his son, including lavish cars and the payment of personal judgments. Anyway, the decedent's estate valued the stock in the company at $9.3 million on the original estate tax return, but then on an amended return valued the stock at $4.3 million. In part the valuation was based on the appraiser's application of an "economic charge of $8 million to $12 million" attributable to the son's personal goodwill. The Service's initial appraisal was slightly higher: $92.2 million. At trial, it argued for a valuation of $26.3 million. The Tax Court determined that the Service's appraisal lowballed the value of the son's personal goodwill. The company was successful because of the son's relationships with The Word and its constituents. Further, the son's goodwill had not been transferred to the corporation and thus was not a corporate asset. "The ministers conducted business with [the son] because they trusted him personally, not because he was a representative or employee of [the company]. In other words, [the company] could not own [the son's] goodwill because the customers did not readily realize that [the son] actually worked for [the company]. Thus, he cultivated personal goodwill with these professionals and he independently owned the asset of personal goodwill, not [the company]." The court also observed that because there were no employment agreements or noncompete agreements in place, the son was free to leave the company and use his relationships to compete against the company. This was further proof that the goodwill did not belong to the entity. *Estate of Adell v. Commissioner*, T.C. Memo. 2014-155 (August 4, 2014).

Section 6075: Time for Filing Estate and Gift Tax Returns

Spouse's Last-Minute Citizenship is One Thing, But Waiting Until All Claims are Settled Before Filing is Quite Another. We all know that the estate tax marital deduction is disallowed where the surviving spouse is not a United State citizen. A rarely-used Code provision, section 2056(d)(4), provides that if the surviving spouse *becomes* a United States citizen before the estate tax return is filed, the marital deduction is allowed, so long as the spouse was a resident of the United States at all times after the decedent's death and before becoming a United States citizen. In this case, the decedent's surviving spouse was a United States resident but a citizen of Bolivia. When the decedent's estate tax return was due, the estate obtained an extension. Then, shortly before the extended return deadline, the spouse informed the executor that she intended to become a United States citizen. The executor was told by the estate's attorney that if the estate files the return before the spouse became a United States citizen, the marital deduction could not apply. So the advice was to file a late return, after the spouse became a citizen. Fourteen months later, the spouse became a United States citizen. You'd think the estate would then promptly filed an estate tax return. But no—the estate waited until after all of the spouse's claims against the estate had been settled before filing the return, and that was nine months after she became a United States citizen. Apparently the same attorney thought it would be better for the estate to file an accurate return that showed the precise amounts passing to the spouse, and this wouldn't be knowable until after her claims against the estate had been resolved. Not surprisingly, the Service imposed a penalty for the late filing. (When you're 23 months late on a deadline that was already extended, that kind of thing happens.) When the Service denied the estate's claim for refund, the estate sued in the Court of Federal Claims. The court held that while the executor reasonably relied on the attorney's advice regarding waiting to file until after the spouse had become a United States citizen, there was no reasonable cause to wait another nine months following the spouse's awarding of citizenship before filing the estate tax return. On that issue, the attorney's advice was clearly wrong, so relying on that advice by definition cannot serve as reasonable cause. On appeal, the Federal Circuit affirmed without dissent. *Estate of Liftin v. United States* (Fed. Cir., June 10, 2014).

11 U.S.C. §522

Inherited IRA Not Exempt from Bankruptcy Estate as "Retirement Funds." Section 522 of the Bankruptcy Code permits debtors to exclude from the bankruptcy estate "retirement funds to the extent those funds are in a fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code." At issue in this case is whether an IRA inherited from another individual qualifies for this exclusion. In 2000, Ruth established a traditional IRA that named her daughter, Heidi, as the beneficiary. Ruth died in 2001, at which time Heidi elected to take monthly distributions from the account (which was then worth about $450,000). In 2010, Heidi and her husband declared bankruptcy. The inherited IRA at that time was worth about $300,000. The Supreme Court held that the IRA was part of the bankruptcy estate and that the exclusion did not apply. Inherited IRAs, ruled the Court, are unlike the types of funds listed within the exclusion. Unlike traditional and Roth IRAs, the Court noted, one cannot make contributions to an inherited IRA. Holders of an inherited IRA must withdraw the funds regardless of whether they have retired or reached the age of retirement. And distributions from an inherited IRA are not subject to the 10% penalty that applies to pre-retirement distributions from a traditional or Roth IRA. In light of the Court's holding, one contemplating a bequest of an IRA to a credit-challenged beneficiary should consider creating an "accumulation trust" with spendthrift provisions to hold the account instead. *Clark v. Rameker* (U.S. S.Ct., June 12, 2014).