

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 June 1, 2014, through August 7, 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%			
\$90,750	\$151,200	28%			
\$189,300	\$230,450	33%	15%	3.8%	3.8%
<i>AGI over \$200,000***</i>	<i>AGI over \$250,000***</i>				
\$411,500	\$411,500	35%	20%		
\$413,200	\$464,850	39.6%			

* 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 72: Annuities; Certain Proceeds of Endowment and Life Insurance Contracts

10% Surcharge is a Tax, Not a Penalty (So Burden is on Taxpayer). The taxpayer received a taxable distribution from his retirement plan account in 2009. But there was no evidence as to whether the 10% "additional tax" applied because, for example, the taxpayer was over age 59-½ or disabled. So who has the burden of proof here? Does the taxpayer have to prove eligibility for an exception to the additional tax, or does the Service have the burden to show that none of the exceptions applies? The answer turns on whether the 10% surcharge is a "tax" (in which case the burden is on the taxpayer) or a "penalty" (in which case the burden is on the Service). The Tax Court held that the surcharge is a tax, noting that §72(t) refers to it as an "additional tax," that other Code provisions refer to it as a tax, and that it appears in subtitle A (income taxes) and not with the penalties in subtitle F. Since the taxpayer submitted no proof as to whether any exception applied, then, the court sustained the Service's assessment of the 10% surcharge. This case reinforces the need for taxpayers to retain records for all transactions with respect to retirement plans, as the burden will always be on the taxpayer for every issue that could arise in a dispute with the Service. *El v. Commissioner*, 144 T.C. No. 9 (March 12, 2015).

Effective Control Over Policy Investments Made Inside Buildup Taxable to Policyholder. Life insurance policies and annuity contracts are tax-favored vehicles because the earnings accruing on them (also known as the "inside buildup") are not taxable to the policyholder (nor, generally, to the insurance company). This allows the cash value of a whole life insurance policy, for instance, to grow much faster. But under the so-called "investor control doctrine," if the policyholder has sufficient incidents of ownership over the policy, the policyholder is treated as the true "owner" of the policy for federal income tax purposes, making the inside buildup presently taxable to the policyholder. Typically the doctrine will be invoked where the policyholder has the power to decide the specific investments to be held in the policy account. But it has also been used where, for example, the taxpayer retained the right to vote securities held in the policy account. In this case, the taxpayer (through a grantor trust) acquired private-placement variable life insurance policies on the lives of two elderly relatives from a life insurance company based in the Cayman Islands. After deducting a mortality risk premium and a service fee, the life insurance company placed the remainder of each premium payment into accounts segregated from the insurance company's general assets and reserves. The accounts were then invested in startup companies with which the taxpayer was closely involved. As the taxpayer expected, the separate accounts appreciated substantially. The taxpayer took the position that the growth of these accounts was tax-free because they were part of life insurance policies. The

taxpayer also claimed that any amounts paid out on the deaths of the insured relatives would also be tax-free as death benefits. The Service, invoking the investor control doctrine, concluded that the taxpayer was the true owner of the accounts and, thus, that the appreciation was currently taxable to the taxpayer. That resulted in cumulative deficiencies of over \$650,000 and penalties of over \$130,000. The Tax Court ruled that the investor control doctrine deserved deference, as it was consistent with well-rooted notions that income should be taxed to its true owner. The court then concluded that the taxpayer indeed had incidents of ownership over the separate accounts. Although the accounts had a nominal investment manager, “In reality, the Investment Manager selected no investments but acted merely as a rubber stamp for [the taxpayer’s] ‘recommendations,’ which we find to have been equivalent to directives.” The court also found the taxpayer effectively made the voting decisions with respect to stocks held by the accounts. The deficiencies were thus upheld. The taxpayer escaped the accuracy-related penalty, however, as the court found the taxpayer reasonably relied on the representations of the estate planning attorney who recommended that the investments be structured through life insurance policies. The taxpayer reported all transactions on the appropriate returns and did not attempt to hide his estate plan from the Service. *Webber v. Commissioner*, 144 T.C. No. 17 (June 30, 2015).

Section 104: Compensation for Injuries or Sickness

The Taxpayer Hatched a Plan to Exclude Payments for Unfertilized Eggs, But They Aren’t Damages. The taxpayer received payments totaling \$20,000 in 2009 as consideration for her agreement to provide unfertilized eggs for use by infertile couples. The contracts involved in this case treated the payments as being for the taxpayer’s time, effort, inconvenience, and pain and suffering (but not in exchange for eggs, so if the eggs proved to be duds she would still get paid). Although the taxpayer received a Form 1099 for the payments, she excluded them from gross income on the grounds that §104(a)(2) applied. The Service contended the payments needed to be included as compensation, and the Tax Court agreed. Although the taxpayer suffered physical pain during the performance of her services under the contracts (she underwent “intrusive physical examinations,” “very painful” hormone injections, and an extraction procedure that led to “mood swings, headaches, nausea, and fatigue”), the payments were not “damages” received on account of physical sickness. “We completely believe [the taxpayer’s] utterly sincere and credible testimony that the series of medical procedures that culminated in the retrieval of her eggs was painful and dangerous to her present and future health,” the court observed. “But what matters is that she voluntarily signed a contract to be paid to endure them. This means that the money she received was not ‘damages.’” *Perez v. Commissioner*, 144 T.C. No. 4 (January 22, 2015).

Accrued Vacation and Sick Pay Isn’t Worker’s Compensation. The taxpayer, a retired Los Angeles Police Department detective, received in 2009 a cash payment that represented his unused vacation time and sick leave. The taxpayer claimed that the portion of the cash payment representing the vacation and sick leave that accrued while the taxpayer was on temporary disability leave was excludable under §104(a)(1) as amounts received under a worker’s compensation act for personal injuries or sickness. The Tax Court rejected this argument, finding

that the vacation and sick leave accrued under a policy that was not a worker's compensation plan. In other words, the leave benefits accrued regardless of whether the taxpayer was on temporary disability leave and thus did not represent compensation for personal injury or sickness. *Speer v. Commissioner*, 144 T.C. No. 14 (April 26, 2015).

No Exclusion for Worker's Compensation Award Paid to Ex-Spouse. The taxpayer administers death, disability, and retirement benefits for state employees. It asked the Service about the federal income tax consequences arising when the taxpayer pays an employee's worker's compensation award to the employee's spouse pursuant to a domestic relations order. The Service ruled that accidental disability retirement benefits paid to former spouses of state employees pursuant to domestic relations orders do not qualify for the §104(a)(1) exclusion and that the entire amount paid to the former spouses is includible in their gross incomes. The Service observed that §104(a)(1), like any exclusion, is strictly construed. The statute makes no reference to payments to an employee's former spouse, and the regulations expressly limit the exclusion to employees and their survivors. *Private Letter Ruling 201521009* (May 22, 2015).

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 111: Recovery of Tax Benefit Items

State Law Doesn't Control Characterization of Incentive Payments, So Only Inclusionary Arm of Tax Benefit Rule Applies. The taxpayers, a married couple, were members of an LLC that qualified for three targeted economic development payments from the state of New York. New York statutes refer to the payments as "credits" and treat them as refunds for "overpayments" of New York state income tax. Two of the three credits do not factor the amount of past tax actually paid; one can receive payment even where no prior tax has been paid. The taxpayers claimed that none of the payments should be included in gross income because state law defines them as "overpayments," making them the functional equivalent of withheld taxes. Since the taxpayers did not claim deductions for New York income tax on their federal returns, then, the exclusionary arm of the tax benefit rule should apply to exclude the payments. But the Tax Court held that New York's characterization as "overpayments" is not controlling for federal income tax purposes. Regarding the two credits that are available even though no prior tax has been paid,

the court observed that these are really direct subsidies and not refunds of past tax payments. The exclusionary arm of the tax benefit rule thus would not apply to these payments. The third credit, however, is limited to the amount of tax actually paid. And in this case, the LLC had used the tax actually paid to reduce the amount of pass-through income to the taxpayers. Thus the inclusionary arm of the tax benefit rule requires the inclusion of the third credit payment up to the amount actually deducted in the prior years, making that payment taxable as well. *Maines v. Commissioner*, 144 T.C. No. 8 (March 11, 2015).

Section 121: Exclusion of Gain from Sale of Principal Residence

You Have to Live in a Residence to Exclude the Gain. The taxpayers, a married couple, bought their Diamond Bar, California, home in 1994 for \$200,000. They used the home as a group home for disabled persons, an activity they operated as a business. The couple actually resided in a Mulvane, California, home, but the couple claimed the Diamond Bar home as their personal residence when deducting home office expenses. In 2007, they sold the Diamond Bar home for \$600,000 and excluded the gain on their 2007 joint return. But the Tax Court agreed with the Service that the §121 exclusion did not apply since the taxpayers never lived on the property and thus never used it as their principal residence. The taxpayers then tried to claim their basis in the property had been increased by various capital improvements, but the Tax Court found evidence of the improvements (a two-page table prepared by the taxpayers) lacking. *Villegas v. Commissioner*, T.C. Memo. 2015-33 (February 26, 2015).

Section 162: Trade or Business Expenses

Service Takes Another Look at Eye Doctor's Bonus. Doctor Ahmad owned all of the stock in the taxpayer, an Illinois C corporation that operated an ophthalmology surgery and care center during the taxable year at issue, 2007. The taxpayer paid a \$2,000,000 bonus to Dr. Ahmad in 2007. This was on top of his \$780,000 salary. The deduction for the combined salary was enough to wipe out the taxpayer's taxable income (in fact it even resulted in a net loss). The Service disallowed \$1,000,000 of the \$2,780,000 compensation deduction and imposed an accuracy-related penalty. The Tax Court observed that the Seventh Circuit's "independent investor" test for reasonable compensation does not apply here because of the lack of sufficient similarly-situated businesses. It thus wanted to consider comparable salaries, but the taxpayer contended there are no comparable eye doctors, for Dr. Ahmad held several managerial positions and bore the brunt of an increased workload when a colleague quit. Unsurprisingly, the court upheld the deficiency, for the taxpayer did not explain how the bonus was computed or how it tied to the taxpayer's profitability. Absent that evidence, the taxpayer did not meet its burden of proof. The court also upheld the imposition of the penalty, absent any proof of reliance on the return preparer. *Midwest Eye Center, S.C. v. Commissioner*, T.C. Memo. 2015-53 (March 23, 2015).

Horses are Hobbies, But Criminal Defense Expenses for IT Business are Deductible. The taxpayer's 2009 return reported income and expenses for two business activities, an information

technology business (with income of \$65,000 and expenses of just over \$50,000) and a business involving raising and showing horses (with no income but about \$7,500 in expenses). The taxpayer claimed a home office deduction based on 50% of her home, a condo, being used for the IT business. During the taxable year, the taxpayer sued her homeowners association. In a separate proceeding the same year, though, the taxpayer faced misdemeanor criminal charges in connection with her attempt to gather evidence for the lawsuit against the homeowners association. So the taxpayer deducted 50% of her expenses incurred in connection with both proceedings. The Tax Court upheld the claimed deductions, observing that “[t]he dispute giving rise to the legal expenses arose principally on account of [the taxpayer’s] claims of noise and other factors interfering with her enjoyment of the property.” Since the Service did not challenge the 50% home office percentage, the court reasoned that a deduction for 50% of the legal expenses was reasonable. Regarding the equine activity, however, the court concluded that the taxpayer lacked a profit motive. Importantly, the taxpayer did not own a horse and the only asset in the activity was tack. The petitioner had no success in other businesses, and the horse-related expenses were far greater than income from the activity. The taxpayer also had significant income from other sources and derived pleasure from the horse activity, specifically, “an affinity for dressage.” Since the activity was a hobby and not a business, the net losses from the equine activity were not deductible. *McMillan v. Commissioner*, T.C. Memo. 2015-109 (June 11, 2015).

Deduction for Business Expenses of Medical Marijuana Dispensary Go Up in Smoke. The taxpayer operates the Vapor Room Herbal Center in San Francisco, a licensed medical marijuana dispensary. The business, “set up much like a community center,” sells medical marijuana and provides vaporizers, food and drink, yoga, games, movies and counseling at no cost to patrons. The taxpayer claimed business expenses of over \$236,000 in 2004 and over \$417,000 in 2005, but the Service disallowed them after concluding that §280E barred a deduction. Section 280E disallows a deduction for amounts incurred by a business that traffics in a controlled substance. The Tax Court upheld the disallowance, and now the Ninth Circuit has affirmed. The appellate court first held that the taxpayer was carrying on the business of selling marijuana for profit. The taxpayer argued that it did more than peddle medical marijuana (presumably because that would allow it to claim some of the business expenses listed on the return), but the court observed that the taxpayer charged no fee for any of the additional goods and services. The only activity that had a profit motive, therefore, was the sale of medical marijuana. The court then held that medical marijuana remains a controlled substance under federal law, even though state law permits sales like those made by the taxpayer. Section 280E thus clearly applies to the claimed expenses. *Olive v. Commissioner* (9th Cir., July 9, 2015).

Gambler Should Have Known When to Fold in Deducting Gambling Expenses. The taxpayer had a full-time job as a tunnel bridge agent for the New York and New Jersey Port Authority. Though he received mail at a New Jersey post office box, he had no permanent residence. He kept his personal belongings in a storage locker at work. After each work shift, he drove 125 miles to Atlantic City and checked into a casino hotel where he slept and gambled. He did not keep a log of his gambling activities, though the record indicates his preferred game was baccarat. Instead, “he would keep a running ledger in his head.” The taxpayer’s original 2010 tax return reported no gambling winnings or losses. But when the taxpayer’s return was selected for

audit, he filed an amended return claiming \$25,000 in gambling losses and various Schedule C expenses from being a “professional gambler,” including vehicle expenses, insurance, supplies, travel, legal expenses, and meals and entertainment. The Service did not accept the amended return. Before the Tax Court, the taxpayer claimed he was a professional gambler but the Service argued gambling was his hobby. The court observed that the taxpayer kept no written records, made no attempts to improve the profitability of his gambling, did not achieve any particular expertise as a gambler, provided no evidence regarding his history of income or losses from gambling, and derived the bulk of his income from his job at the Port Authority. Considering the facts and circumstances, then, the taxpayer was not a professional gambler. The court thus upheld the disallowance of the claimed gambling expenses. It also upheld disallowance of the claimed net gambling loss, since such losses are only deductible to the extent of gambling gains. The court also upheld an accuracy-related penalty against the taxpayer because there was no showing of reasonable cause for failing to keep adequate records in support of claimed deductions. *Boneparte v. Commissioner*, T.C. Memo. 2015-128 (July 13, 2015).

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)*.

Always Make Copies of Your Loan Documents, for You Never Know When a Civil War Might Happen. The taxpayers, a married couple, claimed a qualified residence interest deduction of \$73,619 on their 2010 joint return. The husband, along with other family members, purchased a residence in Syria, allegedly subject to a mortgage taken by the Syrian lender. The husband testified that his sister, a citizen and resident of Syria, made the payments on his behalf though he was the obligor on the mortgage. The money for the payments supposedly came from gifts from the husband’s parents. The Service disallowed the deduction and imposed a deficiency of over \$20,000 plus an accuracy-related penalty of over \$4,000. The Tax Court sided with the Service on all counts. The couple never produced a certificate of title, a copy of the mortgage note, or even a loan amortization schedule. The husband claims all those documents were destroyed in 2011 during the Syrian civil war. Conveniently, the mortgage company is now out of business. The husband submitted a letter from an official of the former mortgage company confirming the amounts paid in 2010, but the court determined the letter lacked credibility as it was dated more than two months after the Service first sent the notice of deficiency to the taxpayers. “If one buys an expensive residence in a foreign country, ordinary business care and prudence dictates the advisability of keeping ownership documents in one’s possession. Even where a taxpayer has lost records through no fault of his own, he is not relieved from the burden of substantiation.” *Al-Soufi and Schreitah v. Commissioner*, T.C. Memo. 2015-68 (April 7, 2015).

Unmarried Couples Can Deduct Twice as Much Mortgage Interest as Married Couples.

The taxpayers, Charles and Bruce, together owned their Rancho Mirage, California, home and their Beverly Hills home as joint tenants with rights of survivorship. They are registered domestic partners; they were not married during the taxable years in question (2006 and 2007). In those years, the principal balance for the mortgages on the homes (which qualified as acquisition indebtedness) was about \$2.7 million. On their 2006 and 2007 returns, the taxpayers took the position that they could each deduct the interest on up to \$1.1 million of the mortgage (\$1 million as acquisition indebtedness, \$100,000 as home equity indebtedness), meaning that between the two of them they could deduct interest on the first \$2.2 million of the mortgage. Reasoning that the \$1.1 million limitation applied per residence and not per taxpayer, the Service determined that each taxpayer could only deduct the proportionate share of the interest paid on the first \$1.1 million of the mortgage. The Service determined each taxpayer's deduction according to this formula:

\$1.1 million

----- x total interest paid by the taxpayer = deductible interest paid by the taxpayer

Total debt

The Tax Court agreed with the Service's approach. It noted that the statute uses the phrase "any indebtedness with respect to any qualified residence" in defining both acquisition indebtedness and home equity indebtedness. That phrasing suggests that the limitations should be applied per residence. If Congress intended the limitations to apply per taxpayer and not per residence, the court reasoned, it would have added "of the taxpayer" at the end of that phrase. Moreover, said the court, married couples who co-own their residence and file joint returns must deal with a \$1.1 million limitation, and married couples filing separately see that \$1.1 million figure sliced in half. The taxpayers argued that Congress intended a marriage penalty in this situation, that it's one of the hazards of filing a joint return. But the court found no evidence of Congressional intent for this result, so it upheld the asserted deficiencies. In a divided appeal, however, the Ninth Circuit reversed. The majority observed that the \$550,000 limit for married couples filing separately signals an intent that the dollar limitations apply per taxpayer. "Had Congress wanted to draft the parentheticals in per-residence terms, doing so would not have been particularly difficult. Congress could have written, 'in the case of any qualified residence of a married individual filing a separate return.'" Since the \$550,000 limit applies per spouse, all of the dollar limits should be applied per taxpayer. The majority rejected the Tax Court's focus on the residence in the definitions of acquisition indebtedness and home equity indebtedness as not "particularly compelling." It conceded that this decision effectively operates as a marriage penalty "but we are not particularly troubled." For one thing, the couple can always choose to file separately. And "Congress may very well have good reasons for allowing that result." *Sophy v. Commissioner* (9th Cir., August 7, 2015).

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 165: Losses

Taxpayer's Theft Loss Vaporized. The taxpayer holds a patent for a "smokeless tobacco vaporizer" that he obtained in 2001, long before vaping became a thing. Alas, sales were not as expected. The taxpayer attributes the poor sales to a giant conspiracy among internet search engines, social media platforms, the United States Postal Service, Wikipedia, and various computer hackers. Each of the taxpayer's returns for 2009, 2010, and 2011 claimed a \$1 million theft loss deduction, all based on the premise that the conspiracy's success in hampering the taxpayer's business was effectively a theft. (In fact, the taxpayer claimed the actual theft loss was between \$282 – 284 million annually, but he only claimed a \$1 million deduction in each year to "prevent further victimization.") The Tax Court upheld the Service's disallowance of the theft loss, observing the taxpayer offered no evidence that his patent was infringed or that any activity constituting a theft actually occurred. The court also upheld an accuracy-related penalty. *Sheridan v. Commissioner*, T.C. Memo. 2015-25 (February 18, 2015).

Vacation Home Not Held for Investment, So No Loss Deduction. The taxpayers purchased an oceanfront condo in Florida that they used for personal purposes, frequently spending time there with their daughter. When their daughter died in 2006, the taxpayers stopped using the property. In 2008, they opted to rent the property. They listed the property with a broker and, at the suggestion of a realty company, changed one of the bedrooms into a child's room to appeal to potential renters that were grandparents. They got two (yes, two) nibbles from potential renters, but neither pulled the trigger. So in 2009, the taxpayers listed the property for sale, but they took it off the market by the end of the year. The property finally sold for a \$150,000 loss in 2010. The taxpayers deducted "unspecified deductions" related to the property on their joint returns for 2009 and 2010, together with a long-term capital loss deduction on the 2010 return. The Service denied both deductions, so the taxpayers ran to Tax Court. There, the taxpayers argued for the deductions and claimed that the capital loss should instead be an ordinary loss. The court, considering the facts and circumstances, held that the property was held for personal use and was never converted to rental property. The evidence before the court indicated the taxpayers had done little to rent out the property. Hiring out a rental company was not enough, especially where, as here, the rental company *simply featured the property* in a portfolio kept in the company's office and told prospective buyers that it was available when showing it as a model. Absent a bona fide attempt to rent out the property, it was not held for the production of income, meaning the taxpayers could claim neither the Schedule E deductions nor the loss deduction. *Redisch v. Commissioner*, T.C. Memo. 2015-95 (May 19, 2015).

Loss on Spongetech Stock Not Sponge-Worthy. The taxpayers, a married couple, purchased shares in Spongetech Delivery Systems, Inc., a company that sold soap-filled sponges, but the shares became worthless when executives were convicted of a “pump-and-dump” scheme involving the stock. (In this scheme, the executives fabricated sales to non-existent customers, watched the stock price soar, and then sold their shares before the truth leaked.) After losing some \$569,000 from their investment, they claimed this amount as a theft loss on an amended return for the year at issue (2010). The Service disallowed the deduction, so the taxpayers brought a refund action in district court. At trial, the Service conceded that the taxpayers could deduct their loss as a capital loss, but the taxpayers wanted the loss classified as a theft so it could be claimed against both capital gains and ordinary income. The district court concluded that the loss was not a theft, so it was a capital loss. The court observed that a theft loss requires wrongdoers to act with the specific intent to deprive the taxpayer of property. Further, the wrongdoer must have taken property from the taxpayer. Here, the officers never took the taxpayers’ shares; the losses occurred in the open market. Thus, the stock had not been stolen and the resulting loss could not have been a theft. *Greenberger v. United States* (N.D. Ohio, June 19, 2015).

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)*.

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, Marilyn, 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).

Deductible Conservation Easements Don’t Have Swap Powers. The taxpayers donated a conservation easement to the Smoky Mountain National Land Trust. The easement related to some 180 acres that was used as a golf course. The easement prohibited the land from being used for residential, commercial, industrial or agricultural purposes; it was to be at all times a golf course. But the agreement between the taxpayers and the charity provided that the taxpayers could substitute other, contiguous property for the subject property, provided the new property was similarly suitable as a golf course. The taxpayers claimed a \$10.5 million charitable contribution deduction on their joint return, and that got the Service’s attention. The Service disallowed the deduction, and that sent the taxpayers marching to the Tax Court. The Tax Court agreed with the Service, noting that the statute requires that the easement be “an interest in real property that is subject to a use restriction granted in perpetuity.” Because the taxpayers could substitute other property for the property initially conveyed, no property is subject to the restriction in perpetuity. “While the regulations permit property to be substituted when continued use is impossible or impractical, there is nothing in the regulations to suggest that taxpayers may substitute property for other reasons. The conservation easement agreement in

this case does not limit substitutions to circumstances where use is impossible or impractical but allows petitioners to substitute property for any reason.” It was not enough that *some* property would be subject to the easement in perpetuity, as the statute requires specific property to be so subject. The taxpayers asserted that a savings clause in the agreement should be used to render the swap power ineffective while retaining the conservation easement (and thus the deduction), but the court refused to allow a general savings clause to void a specifically retained swap power. On appeal, the Fourth Circuit affirmed. It found the power to substitute property rendered the appraisal that substantiated the claimed deduction meaningless. Likewise, the savings clause could not rescue the deduction because it would, in essence, allow the taxpayers to rewrite the easement in response to the court’s holding. That’s contrary to public policy. *Belk v. Commissioner* (4th Cir., December 16, 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 be 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).

Right to Change Conservation Easement Boundaries Doms Deduction. The taxpayer granted a perpetual conservation easement on a 22-acre parcel of land in North Carolina to the North American Land Trust, a nonprofit organization. The easement agreement gave the taxpayer the right to “make minor alternations to the boundary” of the contributed property for up to five years after the initial contribution. But the agreement provided that in no event could the total size of the contributed parcel be reduced and that any additional land must be contiguous with the original parcel. The taxpayer claimed a deduction for the easement but the Service disallowed it. The Tax Court upheld the disallowance, citing a 2013 case in which the court held that a conservation easement is not deductible if the easement agreement permits the grantor to change the property subject to the easement. The taxpayer argued that the prior case could be distinguished, but the court concluded that the distinction made no difference. It also declined the taxpayer’s (presumably polite) invitation to overrule the 2013 case. To be clear, then, it is important that a taxpayer donate an easement in “an identifiable, specific piece of real property” in order to qualify for the income tax deduction. *Balsam Mountain Investments LLC v. Commissioner*, T.C. Memo. 2015-43 (March 12, 2015).

An Expensive Reminder of the Need for Substantiation. The taxpayers, a married couple, claim to have donated \$8,000 in books, \$1,303 in household items, \$1,000 in clothing, \$822 in toys, \$800 in telescopes, \$780 in jewelry, and \$410 in furniture to their church’s 2011 flea market. They also claim to have donated \$20,920 in clothing, \$2,680 in furniture, \$350 in household items, and \$250 in toys to three other charities that same year. That’s \$37,315 in total noncash donations, all of which the taxpayers deducted on their joint return. The Service disallowed the deduction for lack of substantiation. Even by the time they came to the Tax Court, the taxpayers did not have a receipt or acknowledgment from any of the charities. They had no photos of the donated property, and the only documentation in the record was a spreadsheet prepared while the Service conducted its audit. The Tax Court had little trouble agreeing with the Service. Since each category of gifts exceeded \$500, the taxpayers needed not only a contemporaneous written acknowledgment from the charities but also “reliable written records” (like a record of the date and manner of acquisition, a detailed description, the basis, and the fair market value and method for computing such value) with respect to each item of donated property. The couple here had none of this. The court had “no doubt that [the couple] did donate some property to charitable organizations during 2011,” but they simply did not meet the substantial requirements imposed by the Code. Finding no reasonable cause for their failure to keep records, the court also upheld the application of an accuracy-related penalty of nearly \$2,500. *Kunkel v. Commissioner*, T.C. Memo. 2015-71 (April 8, 2015).

Façade Easement Sends Taxpayers on Long and Winding Road that Leads to Penalty. In 2003, the taxpayers, a married couple, granted a façade easement on a single-family row house located in a historic preservation district in Boston to the National Architectural Trust (NAT). NAT required that the taxpayers also donate a certain amount of cash (calculated as a percentage of the estimated value of the easement) for monitoring and administration of the easement, so the taxpayers contributed \$16,840 late in 2003. The taxpayers claimed a deduction of \$220,800 for the contribution of the easement, but they could only use \$103,377 of that amount in 2003, so the balance (\$117,423) carried over to 2004. They also deducted \$16,870 as a cash contribution

on the 2003 return (don't ask me where the extra \$30 came from). When the Service denied all of these deductions, the taxpayers filed suit in Tax Court. The Service moved for summary judgment on the whole matter. In an April, 2010, decision, the Tax Court granted the motion as to the donation of the easement but not as to the cash contribution. The court agreed that the taxpayers did not meet all of the requirements for a deduction of the easement. Among other things, the regulations require that "at the time of the gift, the donor must agree that the donation of the perpetual conservation restriction gives rise to a property right, immediately vested in the donee organization, with a fair market value that, at the time of the gift, is at least equal to the proportionate value that the perpetual conservation restriction bears to the value of the property as a whole." The taxpayers could not meet this requirement because the row house was encumbered by a mortgage. "Petitioners concede that ... the bank retained a 'prior claim' to all proceeds of condemnation and to all insurance proceeds as a result of any casualty, hazard, or accident occurring to or about the property. Moreover, petitioners do not dispute that the bank was entitled to those proceeds 'in preference' to NAT until the mortgage was satisfied and discharged. The right of NAT to its proportionate share of future proceeds was thus not guaranteed." Seeing no issue of material fact here, the court granted summary judgment on this issue to the Service. The court would not grant summary judgment with respect to the cash contribution, however. On that point, the Service's position is that the cash contribution was a conditional gift in violation of the regulations and that it was a given as part of a quid pro quo, but the court agreed with the taxpayers that there is a genuine issue of material fact as to whether there was such an arrangement between the taxpayers and NAT. At trial, the Service argued that the cash payment was a prohibited conditional payment because the agreement between the taxpayers and NAT was that the cash would be refunded if the appraisal showed a zero value for the façade easement. The Tax Court agreed, concluding the taxpayers did not prove that by the end of 2003 that "the possibility of a zero appraisal value was not so remote as to be negligible." Thus the cash payment could not be deducted on the 2003 return because it was a contingent payment. However, the court rejected the Service's claim the cash payment represented a quid pro quo payment for services, as it saw no benefit to the taxpayers personally from the payment. The court did not view the cash donation as a payment made to enlist NAT's help in generating a deduction for the taxpayers. Ultimately, the court concluded that the taxpayers could claim a deduction for the cash payment in 2004, the year in which the conditions under which the payment would be refunded finally expired. On appeal, the First Circuit focused its inquiry on whether the Tax Court correctly applied the regulation requiring subordination of a preexisting mortgage. The First Circuit found the Tax Court's interpretation of the regulation effectively made it so that no façade easements on encumbered properties could qualify for a deduction, and that was "surely contrary to the purpose of Congress." The taxpayers lacked any power to make the lender agree to subordinate the mortgage, yet the Tax Court's interpretation of the regulation would deny the taxpayers a deduction for a reason beyond their control. Besides, the court reasoned, tax liens could potentially trump the charity's right to funds upon extinguishment of the easement. The Tax Court's conclusion that the charity must have an "absolute right" to any proceeds as a condition to a deduction is therefore impracticable. The court sent the case back to the Tax Court to determine the proper value of the easement, with the instruction that the Tax Court consider the fact that the row house was already subject to neighborhood landmark district rules. Those portions of the Tax Court's decision related to the

cash contribution were affirmed. But when the case came back on remand, the Tax Court found that the value of the easement was zero and that the taxpayers were liable for the 40% accuracy-related penalty. The zero value was appropriate, said the Tax Court, because the hypothetical willing buyer would find the façade easement no more burdensome than other use restrictions that were already in place. On a second appeal to the First Circuit, the taxpayers concede the zero valuation but challenge the assessed accuracy-related penalty. Alas, the appellate court affirmed imposition of the penalty. There was no clear error in the lower court's finding that "there is no evidence, other than consulting [an official with NAT]—who in fact told them that the donation of the easement would not reduce the value of their home—the [taxpayers] 'made any independent investigation of the value of the façade easement, much less an investigation confirming that its value was the value they reported' on their tax returns. The Tax Court did not insist that the taxpayers conduct an exhaustive investigation. "It merely required that the [taxpayers] do some basic inquiry into the validity of an appraisal whose result was squarely contradicted by other available evidence glaringly in front of them." *Kaufman v. Commissioner* (1st Cir., April 24, 2015).

Lack of Substantiation and Lack of a Gift Doom Deduction for Conservation Easement.

The taxpayers own a big farm in Howard County, Maryland. Pursuant to its program to preserve existing farmlands within its jurisdiction, the county agreed to let the taxpayers sell "development rights" with respect to the farm in exchange for a conservation easement on the farm. While the taxpayers could not develop the farm, they could sell the rights to develop to a third-party buyer, who could then add those rights to another parcel of land the third-party buyer already owned (effectively letting the third-party buyer develop the property to a higher density than what would otherwise be allowed). The taxpayers claimed a \$5.5 million deduction for the value of the conservation easement, but they ran into two obstacles. First, the Service determined that the deduction lacked the required substantiation. The Tax Court agreed that the appraisal supporting the deduction valued only the farm and not the easement itself. The appraisal did not indicate the date of contribution (indeed, it indicated there were no easements on the property!). Furthermore, as there was never an acknowledgement received from the county, there was no evidence of the estimated value of the development rights the taxpayers could sell as a result of the bargain. That led to the other obstacle: without evidence of the value of the development rights, there is no evidence that the value of the easement exceeds what the taxpayers received in return. The taxpayers argued that the transaction should be treated as a bargain sale, meaning the transaction should be treated as if they sold the right to develop the farm to the county. But the court declined the invitation, finding the transaction was not, in substance, a bargain sale but instead a *quid pro quo* transaction. The court thus upheld the application of a 20% substantial valuation understatement penalty against the taxpayers. *Costello v. Commissioner*, T.C. Memo. 2015-87 (May 6, 2015).

Inadmissible Appraisal and Failure to Obtain Acknowledgment Make Deduction Extinct.

The taxpayer, a veterinarian, donated four trilobite fossils to the California Academy of Sciences, a charitable organization, late in 2006. He donated eight more fossils late in 2007. He claimed a deduction of \$136,500 for the first donation and \$109,800 for the second donation. The Service disallowed the deductions for lack of substantiation. The taxpayer claimed to have an appraisal

of the fossils but the Tax Court did not admit the appraisals into evidence because the taxpayer could not prove the identity of the appraisal's author. Even if the appraisals had been admitted into evidence, the court observed that the taxpayer failed to secure a written acknowledgment from the recipient organization, as required for gifts in excess of \$250. Accordingly, the court held the Service's disallowance proper. *Isaacs v. Commissioner*, T.C. Memo. 2015-121 (June 30, 2015).

Power to Modify Boundaries of Conservation Easement by Agreement Cheep-ens Deduction. In December of 2005, the taxpayer donated a conservation easement on Texas real estate that included the habitat of a golden-cheeked warbler, and endangered bird species, to the North American Land Trust, a charity. The easement agreement allowed the parties to modify the boundaries of the property subject to the easement. The taxpayer claimed a charitable contribution deduction of \$8.4 million on its 2005 return. The Service disallowed the deduction and imposed a 40% valuation misstatement penalty on the grounds that the provision allowing modification to the subject property's boundaries violated the requirement that the easement encumbers the property "in perpetuity." The taxpayer argued that because the charity would have to consent to any modification, the total amount of real estate subject to the easement would always be at least the same as that of the initial contribution. But the Tax Court, upholding the disallowance, found that irrelevant. "As a result of the boundary modifications, property protected by the [easement at the time it was granted] could subsequently lose this protection. Thus, the restrictions on the use of the property were not granted in perpetuity." The court also upheld the application of the penalty, finding "slipshod preparation of the baseline documentation" insufficient to uphold a claim for acting reasonably and in good faith. *Bosque Canyon Ranch, L.P. v. Commissioner*, T.C. Memo. 2015-130 (July 14, 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 183: Activities Not Engaged in for Profit

Just Because it's a Hobby Store Doesn't Mean It's a Hobby Activity. During the years at issue (2010 and 2011), the taxpayer was an art teacher in Nevada. She inherited her father's hobby store that specialized in selling model airplanes. The store was in Idaho, but it was literally next door to property the taxpayer owned and used as a residence. The taxpayer moved to the Idaho property to assist with the business, but a full-time volunteer oversaw daily operations. Although the store was open daily from 8am to 5pm, it generated small losses (\$5,540 in 2010 and \$2,628 in 2011). The Service asserted these were hobby losses and thus disallowed the net loss deductions the taxpayer claimed on her individual income tax return. But after reviewing the factors in Regulation §1.183-2(b), the Tax Court concluded the taxpayer operated the hobby store for profit and that it was a business activity. The taxpayer "does not derive personal pleasure from operating [the store] and does not have substantial income to absorb recurring losses. Although [she] did not provide evidence of profits..., the tax benefit to her is not significant; and we do not think she would have continued to run the business without an honest expectation of profit." *Savello v. Commissioner*, T.C. Memo. 2015-24 (February 12, 2015).

Don't Look in the Mouth of This Gift Horse: Horsing Around for Profit Pays Off. The taxpayers, a married couple, became millionaires when the family baking company was sold to a foreign concern. Specifically, they received some \$22 million as their share of the buyout. They celebrated by buying their first Arabian horse. Two years later, when the price for Arabians was at an all-time low, the taxpayers formed Silver Maple Farm, Inc., an S corporation, to operate a horse farm. The business started in Iowa but moved four years later to Naples, Florida. After some unsuccessful years there, they relocated the business to the Santa Ynez Valley in California. Alas, the business continued to generate losses. Big ones. For the taxable years at issue (2004 – 2007), the annual ordinary losses ran from \$1.28 million to \$1.34 million. In fact, the business was only profitable in one of the 18 years the taxpayers operated the business, and that was thanks to a sale of farmland. The Service disallowed the net losses on the grounds that the horse operation was a hobby instead of a business. But after analyzing all of the required factors from the regulations, the Tax Court held that the activity was a business, for the taxpayers operated the company with the intent to make a profit. They kept records in a businesslike manner, they had legal representation for their contracts, they had a written business plan, they engaged in extensive promotional efforts, they made efforts to improve business operations when losses kept mounting, they took active roles in the industry and thus became experts in the field, and they worked full time on the activity during the years at issue. Sure, the losses were huge, but that was common to the industry during the years at issue. "Horse farming a speculative venture," observed the court. "More horses are duds than champions, but a few do command multimillion-dollar syndication fees. ... Even one multimillion-dollar payoff would take care of covering around five years of SMF's average losses, and those losses appear to be trending down." Considering all of the facts, then, the taxpayers were entitled to the net losses. *Metz v. Commissioner*, T.C. Memo. 2015-54 (March 23, 2015).

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 467: Certain Payments for the Use of Property or Services

Lessee’s Payment to Reduce Rent is Rental Income to Lessor. The taxpayers, a married couple, constructed a commercial office building. They leased the property to a tenant under a ten-year lease that, among other things, required the tenant to pay “project costs” incurred by the taxpayers in developing the subject property. The lease gave the tenant the option to make a one-time cash payment at any time to eliminate the “project costs” portion of the monthly rental payments. The tenant exercised this option by making a \$1 million payment to the taxpayers in 2008. They did not include this payment in gross income, so the Service assessed a deficiency. Before the Tax Court, the taxpayers claimed the payment was not income at all but instead a reimbursement for leasehold improvements made by the taxpayers. The Tax Court rejected this argument, concluding that a lessee’s reimbursement of a lessor’s expense is income to the lessor under Regulation §1.61-8(c). Alternatively, the taxpayers claimed the \$1 million payment could be pro-rated over the remainder of the lease agreement pursuant to §467. But

the court rejected this position too. If it applied, §467 would permit the taxpayers to use the accrual method for reporting their rental income. But §467(b)(1)(A) provides that the accrual is to be made “by allocating rents in accordance with the agreement.” And regulations explain that a lease does not specifically allocate rents by stating only when rent is payable; in fact, under the regulations, if a lease agreement does not provide for a specific allocation of rent, “the amount of fixed rent allocated to a rental period is the amount of fixed rent payable during that period.” Here, the lease agreement did not specifically allocate the \$1 million option payment; thus, under the regulations, it accrued when it was payable (i.e., as a lump sum and not ratably over the remainder of the lease). For similar reasons, the court also rejected the taxpayer’s argument that the \$1 million was prepaid rent that could be deferred. The court also upheld the imposition of a penalty against the taxpayers, finding their reliance on their CPA was no excuse to review their returns only “briefly.” *Stough v. Commissioner*, 144 T.C. No. 16 (June 2, 2015).

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's 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 707: Transactions Between Partner and Partnership

Proposed Regulations Provide Test for Identifying Disguised Payments. Section 707(a)(2)(A) provides that if "(i) a partner performs services for a partnership or transfers property to a partnership, (ii) there is a related direct or indirect allocation and distribution to such partner, and (iii) the performance of such services (or such transfer) and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership, such allocation and distribution shall be [so] treated." Treasury has issued proposed regulations that provide guidance on the application of this rule. Under the proposed regulations, the nature of a transaction between a partner and the partnership will be tested as of the time the parties enter into or modify it, not when income is allocated and when money or property is distributed. The proposed regulations also presume, for purposes of the second statutory requirement identified above, that the provision of an income allocation also includes a provision for an associated distribution. Most importantly, the proposed regulations provide a framework for determining whether an arrangement constitutes a payment for services. Under this framework, one first asks whether the payment is subject to "significant entrepreneurial risk," as to both the amount and fact of payment. If an arrangement lacks significant entrepreneurial risk, it will be treated as a disguised payment for services. (Happily, the proposed regulations provide examples of arrangements that presumptively lack significant entrepreneurial risk.) If an

arrangement has significant entrepreneurial risk, then one must consider these five factors to determine whether there is a disguised payment for services: (1) whether the service provider holds (or is expected to hold), a transitory partnership interest; (2) whether the service provider receives an allocation and distribution in a timeframe similar to the timeframe that a non-partner service provider would typically receive payment; (3) whether the service provider became a partner primarily to obtain tax benefits which would not have been available if the services were rendered to the partnership in a third party capacity; (4) whether the value of the service provider's interest in partnership profits is small in relation to the allocation and distribution; and (5) whether the arrangement provides for different allocations or distributions with respect to different services received. Here too, the proposed regulations provide examples showing how these five factors would be applied. The regulations will be effective when finalized and will apply to any arrangement entered into or modified on or after that date. *Proposed Regulation §1.707-2* (July 22, 2015).

Section 1014: Basis of Property Acquired from a Decedent

New Reporting Requirement and Basis Consistency Rule Attempt to Thwart Whipsaws.

The Surface Transportation and Veterans Health Care Choice Improvement Act of 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. *Section 1014(f)* (July 31, 2015).

Section 1015: Basis of Property Acquired by Gifts

Gift to Nonresident Spouse Did Not Create Basis. Ian worked as a CPA for KPMG. During the relevant years, he worked in England though he is a United States citizen. In 1999, KPMG spun off its consulting business to a new corporation, KCI. Ian had a substantial interest in KCI even though he contributed no funds in connection with KCI's formation. At the time, Ian disclosed his KCI interest during his divorce proceedings but claimed the value of the interest could not be ascertained because there was no public market for KCI stock. By late 2000, Ian worried that if the KCI shares were sold in the near future, his ex-wife would claim a share of the sale proceeds. So he gave at least some portion of KCI shares to Vanessa, his new (non-citizen) wife. Ian consulted with a British lawyer in making the conveyance via a gift deed. The lawyer told him the transaction would be tax-free under British law, and Ian figured the transaction wouldn't be taxable by the United States either. In 2001, the KCI shares sold and Ian's share came to about \$1.2 million. He originally took the position that all of this was taxable as capital gain. But on an amended return he claimed that the transfer of the shares to Vanessa was a taxable event that gave his wife a stepped-up basis in the shares. He based this new position on §1041(d), which denies nonrecognition on spousal transfers where one of the spouses is a nonresident alien. The new reporting position was also based under a provision of the income tax treaty with the United Kingdom that made him subject to capital gains tax only in Britain. The Service rejected the position on the amended return. The Tax Court agreed, holding that even if §1041 nonrecognition did not apply, Vanessa would have had a zero basis in the shares under §1015(a) since the transfer was still a gift. The court went on to uphold penalties assessed against Ian, finding that there was no way Ian, a tax expert, could have misunderstood the law on this point. *Hughes v. Commissioner*, T.C. Memo. 2015-89 (May 11, 2015).

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 1221: Capital Asset Defined

Ongoing Development Efforts Result in Ordinary Income Upon Sale. The taxpayers conducted a number of real estate investments through various corporations and partnerships of which they were the sole owners. In 1988, they paid \$2.7 million to acquire a leasehold in a two-acre parcel of property in La Jolla, California, on which they planned to develop an apartment complex and retail space. The original lease was set to expire in 2008, but they paid another \$900,000 to get the lease extended through 2042. But soon after acquisition, snags arose that precluded immediate development. For one, the local real estate market plummeted in the early 1990s—to the point the taxpayers were able to buy the property in fee simple in 1997 for \$1.75 million. By 2001, the taxpayers and their partnership had spent some \$1.8 million in developing the property for residential use. In 2001, an unrelated party offered to buy the property for \$16 million. The property finally sold in 2002 for \$14.5 million and a portion of the profits from anticipated sales of the residential units to be built on the property. The Service said the gain from the sale was ordinary income but the taxpayers claimed it was long-term capital gain. The Tax Court recited a well-known octet of factors to be considered in determining whether a sale of real property gives rise to ordinary income or capital gain: (1) the purpose for which the property was initially acquired (here, for development); (2) the purpose for which the property was subsequently held (here, the court said that was still development even though the taxpayers argued it was “to allow the market to recover”); (3) the extent of improvements to the property (here, there was little); (4) the frequency, number, and continuity of sales (here, the court decides to look at just the partnership and not all of the property investments of the taxpayers, concluding this factor favored capital gain treatment because the partnership itself was not regularly selling properties); (5) the extent and nature of the transactions involved (here, the sale was the only transaction); (6) the extent of advertising or other efforts to solicit buyers (here, the offer from the buyer was unsolicited and the taxpayers made no efforts to sell the property); (7) the listing of the property with brokers (it was); and (8) the purpose for which the property was held at sale (here, it was clearly development, as in the three years prior to the sale the taxpayers had spent over \$1 million in development efforts). While some factors favored the taxpayers, the court concluded that the most important factors indicated the property was still held for development and thus was an ordinary asset in the hands of the taxpayers. *Fargo and King v. Commissioner*, T.C. Memo. 2015-96 (May 26, 2015).

Section 1341: Computation of Tax Where Taxpayer Restores Substantial Amount Held Under Claim of Right

Transferee Liability Suit Not Res Judicata in Individual Tax Liability Matter; Settlement Payments Made by Estate Did Not Qualify for §1341 Credit. The decedent was the sole shareholder of a corporation engaged in the aviation business. In 1999, the decedent sold all of his stock to an unrelated buyer for nearly \$502 million, consisting in part of a promissory note for \$150 million. The note was secured by the corporation’s assets. The decedent retained an option to purchase back some of the corporation’s assets; the parties agreed that if the decedent exercised the option, the balance of the note would be reduced by the negotiated price for each

option asset. In 1999 and 2000, the decedent received a total of about \$156 million, consisting of cash, other items, and the option assets that the decedent decided to reacquire. The decedent treated all of these sums as payments on the note. He thus reported the entire amount received in 1999 as capital gain. For 2000, he reported \$19 million of the \$25 million he received as capital gain and \$6 million as ordinary interest income. Meanwhile, when the corporation went into involuntary bankruptcy, the Service, in a separate proceeding, sought to collect about \$100 million in unpaid corporate tax liabilities from the decedent under a theory of transferee liability. In that proceeding, the parties litigated (among other things) the value of the corporate stock, the value of the corporation's assets, and the amounts paid to the decedent from the sale. The decedent's estate ultimately prevailed in that matter, though that proceeding did not establish the value of the option assets. In this case, the Service claimed that some of the proceeds received in 1999 should have been characterized as interest income and that the assets acquired under the option had been undervalued by some \$23.5 million. The estate argued that *res judicata* precluded the Service from trying to (once again) determine the character of the sale transaction. The lower court agreed with the estate, but the Eleventh Circuit reversed. It held that the subject matter of the corporate transferee liability suit was not the same as the personal income tax suit now at issue. "[W]hat matters for *res judicata* purposes is not whether one common factual issue exists across two distinct tax liabilities, but whether the two suits constitute the same cause of action." The corporate transferee liability issue turned (in part) on facts like the corporation's alleged use of a tax shelter scheme and its solvency before and after the transfer. Neither of these facts affected the computation of the decedent's personal income tax liability. Also at issue in the case was some \$41 million in settlement payments the decedent's estate made in 2004 in connection with four civil lawsuits stemming from the stock sale. The estate claimed a §2053 estate tax deduction for the payments and then claimed an \$8.3 million credit under §1341 on its 2005 income tax return for the same payments. The Service disallowed the §1341 credit on the grounds that because the estate had already claimed the settlement payments as an estate tax deduction, the estate could not use the same payments to reduce income tax liability. The lower court agreed with the Service, as did the Eleventh Circuit. The appellate court observed that while the payment was clearly deductible under §2053 as a claim against the estate, there was no other "code section [that] would provide a deduction for the item in the current year" as required under §1341. Specifically, the estate did not prove that the expense was allowable under §691(b) (i.e., a permissible income tax deduction under §§162, 163, 164, 212, or 611). *Batchelor-Robjohns v. United States* (11th Cir., June 5, 2015).

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)*.

A Visual Guide to Federal Wealth Transfer Taxes and Marital Planning Paradigms in 2015

By Samuel A. Donaldson

The Three Fundamental Concepts of Federal Wealth Transfer Tax

Basic Exclusion Amount	Tax Rate	“Portability” Election
2011 → \$5,000,000 2012 → \$5,120,000 2013 → \$5,250,000 2014 → \$5,340,000 2015 → \$5,430,000 2016 → ??	Flat 40%	Surviving spouse may add the “deceased spousal unused exclusion amount” (“DSUE amount”) to the Basic Exclusion Amount if the deceased spouse’s executor timely files estate tax return DSUE Amount → unused portion of last deceased spouse’s “applicable exclusion amount” (NTE the basic exclusion amount)

Basic Marital Planning Paradigms in 2015

Combined Net Worth < \$5.43M	Combined Net Worth \$5.43-10.68M	Combined Net Worth > \$10.68M
<ul style="list-style-type: none"> • Trust or no trust on death of first spouse? • Ensure stepped-up basis for all on death of surviving spouse • Consider protective portability election 	<ul style="list-style-type: none"> • Credit shelter trust or portability election? • Disclaimer planning? • Clayton QTIP planning? 	<ul style="list-style-type: none"> • Leveraged wealth transfer strategies • Valuation reduction strategies

Section 2010: Unified Credit Against Estate Tax

Final Portability Regulations a Mix of Good, Bad, and Mysterious. Just in the nick of time, Treasury issued final regulations that change little from the temporary regulations issued on June 12, 2012. 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.”) The final regulations make clear that late elections will not be allowed in cases where an estate tax return is required since the statute contains this firm deadline. The preamble to the final regulations, however, remind us that §9100 relief may be available for a late election in situations where an estate tax return is not otherwise required. The final regulations and the preamble also clarify other aspects of the portability election: (1) only executors can make a portability election, so a return filed by a surviving spouse who is not the executor, for example, will not be effective to claim the deceased spouse’s unused exclusion amount; (2) Treasury continues to resist the pressure to publish a “Form 706-EZ” or similar document that would allow a simplified election procedure; (3) the application of the deceased spousal unused exclusion amount to qualified domestic trusts and to non-citizen spouses who later become United States citizens; and (4) . Perhaps ominously, the final regulations delete an example wherein a decedent’s estate makes both a portability election and a QTIP election. The preamble declares that “The Treasury Department and the IRS intend to provide guidance ... to clarify whether a QTIP election made under §2056(b)(7) may be disregarded and treated as null and void when an executor has elected portability of the DSUE amount.” Recall that *Revenue Procedure 2001-38* provides relief in cases of unnecessary QTIP elections by allowing the Service to ignore the unnecessary election. Some practitioners have worried that the Service would use this authority to ignore a QTIP election made by a more modest estate in order to obtain a stepped-up basis for assets held in a marital trust upon the death of the surviving spouse. The temporary portability regulations suggested the Service would not do so since they contained the example that has now been deleted from the final regulations. By deleting the example and announcing that other guidance on the issue would be forthcoming, those worried about disregarded QTIP elections may feel even more concerned. The final regulations apply to estates of decedents dying after June 12, 2015. *T.D. 9725* (June 12, 2015).

Section 2031: Definition of Gross Estate

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 "covenant'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 covenant'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 2503: Taxable Gifts

This Generation’s Crummey Case. Israel and Erna, a married couple, gave \$3.262 million to an irrevocable trust in 2007. Each of them claimed \$720,000 in federal gift tax annual exclusions (a full \$12,000 annual exclusion for each of 60 beneficiaries, their children and grandchildren) on their 2007 federal gift tax returns. The trust instrument gave each of the beneficiaries a limited period of time to withdraw their aliquot shares of contributions to the trust, but the maximum amount subject to the withdrawal right was limited to the federal gift

tax annual exclusion amount in effect at the time of the transfer. The trust instrument required the trustee to give notice to the beneficiaries upon any contribution to the trust, which the trustee did in a timely fashion. Although this would seem to be a straightforward application of *Crummey* powers (albeit in a case of an extremely large family), the Service argued that the withdrawal rights were not legally enforceable and thus the beneficiaries did not have a “present interest” in the trust sufficient to claim the annual exclusion. In claiming that the withdrawal rights were not enforceable, the Service focused on two provisions of the trust. The first provision required a beneficiary first to seek recourse via arbitration with a *beth din* (a panel of three Orthodox Jews) before commencing a lawsuit. The Service argued that provision effectively thwarts a beneficiary’s ability to compel the trustee to make a distribution pursuant to the exercise of the withdrawal right. But the Tax Court observed that the *beth din* requirement was like any other mandatory arbitration clause. It did not preclude a lawsuit and did not make the withdrawal right unenforceable. The second provision was an *in terrorem* clause (also known as a “no-contest clause”) whereby a beneficiary forfeits his or her beneficial interest should the beneficiary “directly or indirectly institute, conduct or in any manner whatever take part in or aid in any proceeding to oppose the distribution of the Trust Estate, or [file] any action in a court of law, or [challenge] any distribution set forth in this Trust.” The Service argued the no-contest clause has the effect of chilling any action to enforce a withdrawal right since a beneficiary would be “filing an action in a court of law” and thus lose the beneficiary’s entire interest in the trust. The court admitted that the no-contest clause was “not a paragon of draftsmanship,” but it concluded that the no-contest clause was pretty clearly limited to situations where a beneficiary challenged the trustee’s exercise of discretion. The trustee has no discretion when it comes to the withdrawal right, however—the trustee must make the distribution upon demand of the beneficiary. Thus, a beneficiary seeking the help of a court to enforce the withdrawal right would not trigger the no-contest clause. Consequently, the taxpayers were allowed the annual exclusions claimed on their gift tax returns. *Mikel v. Commissioner*, T.C. Memo. 2015-64 (April 6, 2015).

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 2513: Gifts by Husband or Wife to Third Party

Defective Election to Split Gifts Still Respected Since Limitations Period Has Passed. A husband created a family trust for the benefit of his wife and their descendants. The trust agreement permits the trustee to make discretionary distributions of income and principal as needed for the maintenance, education, support, and health of the husband's descendants and also to make discretionary distributions to the wife and the husband's descendants as is "desirable for their respective welfare and best interests." In the same year, the husband created two short-term GRATs, the remainders of which would pass to the family trusts. On their gift tax returns, the husband and wife elected to split the gifts to the family trust and the two GRATs. The Service ruled that because the wife's interests in the income and principal of the family trust are not susceptible of determination, the wife's interests "are not severable from the interests that the other beneficiaries have" in the family trust. Normally, that would doom the election to split gifts, but here the statute of limitations for determining the validity of the election to split gifts has already passed, so the election will be respected. The same result does not follow for gifts made in subsequent years that are still open under statute of limitations, however. *Private Letter Ruling 201523003* (June 5, 2015).

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 file 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).

Section 7520: Valuation Tables

Late Election to Use Prior Month Interest Rate Allowed. The taxpayer transferred property on two different dates to two separate charitable lead annuity trusts, cleverly referred to in the ruling as CLAT 1 and CLAT 2. In the federal gift tax return reporting the transfers, the taxpayer reported the value of the gift of the remainder interest using the §7520 rate for the month that was two months prior to each transfer. That's usually fine, as Regulation §25.7520-2(b) allows a taxpayer to use the §7520 from a prior month by attaching a statement identifying the elected month to the gift tax return. But here taxpayer's return did not include this statement. Oops. So now the taxpayer is asking for an extension of time to file an amended gift tax return in order to include the required statement. The Service granted §9100 relief in this case, concluding the taxpayer relied in good faith on the advice of his attorney and CPA. It gave the taxpayer a 120-day extension to file the amended gift tax return with the required election statement. *Private Letter Ruling 201518007* (May 1, 2015).

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).

United States Constitution, Amendment XIV

Same-Sex Couples Have Fundamental Right to Marry. Some states had statutes and/or constitutional provisions that defined marriage as a union between one man and one woman. In this case, 14 same-sex couples and two survivors of deceased same-sex partners filed suits challenging such laws in the four states of the Sixth Circuit (Michigan, Kentucky, Ohio, and Tennessee). The lower courts all held that the laws violated the Fourteenth Amendment by denying either the right to marry or the right to have marriages lawfully performed in another state recognized. But in a consolidated appeal, the Sixth Circuit reversed. The Supreme Court (5-4) reversed the Sixth Circuit, holding that the Fourteenth Amendment requires a state to license a marriage between same-sex individuals and to recognize marriages lawfully performed in another state. "The Court, in this decision, holds same-sex couples may exercise the fundamental right to marry in all States. It follows that the Court also must hold—and it now does hold—that there is no lawful basis for a State to refuse to recognize a lawful same-sex marriage performed in another State on the ground of its same-sex character." As a result of this dual holding, legally married same-sex spouses have the same rights and benefits as legally married opposite-sex couples, including the power to make emergency medical decisions, rights in divorce, inheritance rights, and the evidentiary privilege extended to married persons. But the federal tax implications of this decision are much less dramatic. Exactly two years earlier, in *United States v. Windsor*, the Court (in a case involving a lesbian couple's claim for the federal estate tax marital deduction) struck down a provision of the federal Defense of Marriage Act that defined "marriage" as between one man and one woman. *Revenue Ruling 2013-17* then confirmed that the provisions in the Code and regulations using the terms "spouse," "husband," "wife," "husband and wife," and "married" included individuals lawfully married under state law to others of the same sex. Further, the Service announced that a same-sex couple residing in a state that does not recognize same-sex marriages will still be considered married for federal tax purposes if the couple entered into a valid marriage in a state that recognized same-sex marriages. From a tax planning perspective, then, the Court's latest decision simply extends this regime to all same-sex couples who have married, regardless of where the ceremony occurred. The decision should make it

easier for the non-genetic parent in a same-sex marriage to establish a parent-child relationship with children born during the marriage, which in turn should make it easier for those taxpayers to claim the child tax credit and dependency exemptions. The decision has a greater impact on tax planning at the state level in jurisdictions that previously did not recognize same-sex marriages. Same-sex couples residing in those states should consider filing amended state income, estate, and gift tax returns if they were legally married in another state during the taxable years at issue in those open years. They may also be eligible for refunds of property taxes paid on conveyances from one spouse to the other. *Obergefell v. Hodges* (U.S. S.Ct., June 26, 2015).