FEDERAL TAX UPDATE

Important Developments in Federal Income, Estate & Gift Taxation Affecting Individuals

August, 2012 to December, 2013

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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, legislation and other matters from August, 2012, through December, 2013. This update generally does not discuss developments in the areas of qualified plans or the taxation of business entities (except to a very limited extent).

On January 2, 2013, President Obama signed the American Taxpayer Relief Act of 2012 ("ATRA"), which had been approved by both houses of Congress one day earlier. ATRA is notable for averting the tax side of the so-called "fiscal cliff" by extending or making permanent tax legislation passed in 2001, 2003, 2009, and 2010. ATRA is perhaps the most significant tax legislation in nearly 12 years. These materials highlight several of the changes made by ATRA, all signaled with the "ATRA" heading.

Section 1: Tax Imposed

ATRA: Lower Tax Rates Made Permanent, Though Two Old Friends Return. As a result of ATRA, the 10% rate bracket continues and is now "permanent." Similarly, the 25%, 28%, and 33% tax brackets continue and do not revert to 28%, 31%, and 36%, respectively. The 35% bracket continues for individuals, but not for estates and not for trusts. But the 39.6% bracket returns as the maximum marginal tax rate for individuals, estates, and trusts. The preferential rates for net capital gain applicable in 2012 (0% for taxpayers in the 10% and 15% brackets; 15% for other taxpayers) continue, but a new 20% rate applies to taxpayers in the 39.6% bracket. Also, the preferential rates for net capital gain continue to be applied to "qualified dividends," and this too is now "permanent." Finally, repeal of the so-called "marriage penalty" in the 10% and 15% brackets continues and is now permanent. The inflation-adjusted tax brackets for 2013, reflecting all of these "permanent" changes, are set forth on the next page. *Section 1*.

A Visual Guide to the Federal Income Tax Rates for 2014

By Samuel A. Donaldson

(from a format originally prepared by Crowe Horwath)

<table>
<tr><th colspan="2">Taxable Income exceeding</th><th colspan="4">2014 Federal Income Tax Rates for Individuals</th></tr>
<tr><td>Unmarried</td><td>Joint</td><td>Ordinary Income</td><td>Adjusted Net Cap Gain* & Qualified Dividends</td><td>Medicare Surtax on Earned Income (including 1.45% employer contribution)</td><td>Medicare Surtax on Net Investment Income</td></tr>
<tr><td>$0</td><td>$0</td><td>10%</td><td rowspan="2">0%</td><td rowspan="5">2.9%</td><td rowspan="5">0%</td></tr>
<tr><td>$9,075</td><td>$18,150</td><td>15%</td></tr>
<tr><td>$36,900</td><td>$73,800</td><td>25%</td><td rowspan="5">15%</td></tr>
<tr><td>$89,350</td><td>$148,850</td><td>28%</td></tr>
<tr><td>$186,350</td><td>$226,850</td><td rowspan="2">33%</td></tr>
<tr><td>AGI over $200,000**</td><td>AGI over $250,000**</td><td rowspan="3">3.8%</td><td rowspan="3">3.8%</td></tr>
<tr><td>$405,100</td><td>$405,100</td><td>35%</td></tr>
<tr><td>$406,750</td><td>$457,600</td><td>39.6%</td><td>20%</td></tr>
</table>

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

** 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 25A: Hope and Lifetime Learning Credits

ATRA: The American Opportunity Tax Credit Will Stick Around a While. In 2009, the Hope Scholarship Credit was replaced with the American Opportunity Tax Credit. Under the new regime, taxpayers get a credit for the first $2,000 in qualified tuition and related expenses paid for the first four years of undergraduate education plus 25 percent of such expenses in excess of $2,000 but not in excess of $4,000. This means the maximum credit amount is $2,500. The new credit expanded the definition of qualified tuition and related expenses to include course materials (not just tuition and fees). We were set to revive the Hope Scholarship Credit in 2013, but now the American Opportunity Tax Credit will continue through 2017. *Section 25A(i)*.

Section 62: Adjusted Gross Income Defined

ATRA: Above-the-Line Deduction for Teachers' Classroom Expenses Continues. For 2013, 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—read "condoms"), or computer equipment and related services or software. *Sections 62(a)(2)(D) and 62(d).*

Section 108: Income from Discharge of Indebtedness

ATRA: 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 2012 but has been continued through 2013. *Sections 108(a)(1)(E), 108(h)*.

Section 163: Interest

ATRA: 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 2013. *Section 163(h)(3)(E)*.

Section 164: Taxes

ATRA: Sales Tax Deduction Continues. For 2013 only (uh-huh), individuals can continue to elect to deduct either state and local income taxes or state and local general sales taxes. Taxpayers electing to claim their sales taxes may deduct either the actual sales tax paid (as substantiated by all those receipts accumulated in a shoebox) or an amount determined under tables to be prescribed by the Service. The chief beneficiaries of this election are taxpayers living in states without an income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. *Section 164(b)(5)*.

Section 168: Accelerated Cost Recovery System

ATRA: Another Return of 50% Bonus Depreciation. Depreciable tangible personal property and computer software acquired and first placed in service in 2013 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

ATRA: 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 2013. *Section 170(b)(1)(E).*

Basing "After" Value on What the Service Has Okayed in the Past May Not be Invalid Per Se, But It Ain't Great Either. Back in 1997, the taxpayer purchased a townhouse within the Fort Greene Historic District of Brooklyn for $255,000. In 2002, the National Architectural Trust sent a postcard to the taxpayer promoting an upcoming seminar on the possible tax benefits of façade conservation easements. The taxpayer and her accountant attended the seminar, and in 2004 the taxpayer donated a façade conservation easement to the NAT. As part of the deal, the NAT required the taxpayer to include a cash donation of ten percent of the easement's value. The property was encumbered, but the two banks holding mortgages on the townhouse consented to the donation. The taxpayer hired an appraiser from a list of valuation experts furnished by the NAT. The appraiser valued the townhouse at $1,015,000 and the façade easement at $115,000. The valuation was based in part on the range of easement values that the Service had previously found acceptable. The taxpayer sent a check to the NAT for $9,275. On her 2004 return, the taxpayer claimed a $115,000 charitable deduction for the façade easement. Because of the applicable percentage limitations in § 170, however, the taxpayer had to carry over part of this deduction to 2005 and 2006. The Service disallowed all the claimed deductions for 2004, 2005, and 2006, and also imposed § 6662(a) accuracy-related penalties for those years. The Service concluded that the appraisal submitted by the taxpayer failed to include all of the elements required under Regulation § 1.170A-13 and that therefore the taxpayer did not comply with the substantiation requirements. Among other things, that regulation requires a qualified appraisal and the completed Form 8283 to include a description of the property in sufficient detail for a person unfamiliar with the type of property to ascertain that the appraised property is the contributed property, a brief summary of the property's physical condition, the manner and date of acquisition, and the property's cost or other basis. Here, the Form 8283 did not include the manner or date of the property's acquisition or any information as to basis. The Tax Court agreed that the substantiation requirements were not met because of this flaw. Further, the court held that the valuation report was not a qualified appraisal because it determined the "after-easement value" of the property based on the range of values the Service has historically found acceptable and did not appear to consider qualitative factors about the property. According to the court, "the application of a percentage to the fair market value before conveyance of the facade easement, without explanation, cannot constitute a method of valuation as contemplated under" the regulation. The taxpayer argued that there was substantial compliance with the regulation, but the court held that the lack of a recognized methodology or specific basis for the appraiser's calculation of the after-easement value "is too significant for us to ignore under the guise of substantial compliance." The court did, however, abate the accuracy-related penalty on the grounds that the taxpayer was not a tax expert and had relied in good faith on her tax adviser in taking the position she did on her return. On appeal, the Second Circuit reversed on the grounds that a

percentage-based appraisal of the value of the façade easement is sufficiently detailed so as to meet the requirements of the regulation. The taxpayer's appraiser appropriately relied on a 1985 Tax Court case stating that a proper valuation of a façade easement should be between 10% and 15% of the value of the unencumbered land. The appraiser used a figure closer to the lower end of that range due to the property's location and existing historic preservation laws. That made the appraisal good enough to serve as adequate substantiation for the deduction. The court ultimately remanded the case back to the Tax Court for a determination as to whether the taxpayer met other statutory requirements for a deduction (that the contribution was for conservation purposes exclusively and that the easement is perpetual). The Tax Court then determined that the easement had no fair market value, thus precluding a deduction. While the lower court accepted the Second Circuit's directive that an appraisal applying a simple percentage to the property's fair market value does not render the appraisal invalid per se, it determined that the Service's experts, who better considered the actual property at issue, produced a more reliable estimate. The Service's experts used comparables that were geographically and physically similar to the subject property, while the taxpayer's experts used comparables that simply didn't resemble the subject property much at all. *Scheidelman v. Commissioner*, T.C. Memo. 2013-18 (January 16, 2013).

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. *Belk v. Commissioner*, 140 T.C. No. 1 (January 28, 2013).

Conservation Easement "Given" in Exchange for Subdivision Exemption is Not a Donation. The taxpayer purchased land in Colorado with the intent to subdivide it and construct a residence on one of the parcels. Shortly into the process, the taxpayer learned from local officials that he could not subdivide his property absent an exemption from applicable use restrictions granted by the county. The taxpayer filed an application for a subdivision exemption, but the county commissioners insisted that the taxpayer grant a conservation easement to the country before granting the exemption. Eventually that exactly what the taxpayer did, and the taxpayer secured his exemption. When the taxpayer claimed a $1 million deduction for the conservation easement, the Service disallowed it. The Tax Court held that the transaction was a *quid pro quo* exchange and not a charitable contribution to any extent. The county got

the easement and the taxpayer got his exemption. The "price" was negotiated at arms-length. *Pollard v. Commissioner*, T.C. Memo. 2013-38 (February 6, 2013).

This Deduction Reeked. The taxpayer owns a landfill in Tucson, Arizona. The taxpayer's landfill was adjacent to another landfill that had all kinds of odor and drainage problems. The taxpayer and the City of Tucson entered into an agreement to help fix the problems with the neighboring landfill. But eventually a dispute over the agreement arose between the taxpayer and the city, and it got to the point where the city filed civil and criminal charges against the taxpayer. The taxpayer had claims against the city, too. Ultimately, the parties settled their differences in a 2003 agreement. As part of that agreement, the taxpayer agreed to sell fill dirt to the city at a price of $6 per cubic foot. On its 2003 return, the taxpayer took the position that there was a bargain sale of about $1 million worth of dirt for $600,000, so it claimed a $400,000 income tax deduction. On its 2004 return the taxpayer claimed there was a bargain sale of about $1 million for about $300,000, so it claimed a $700,000 income tax deduction. The Service disallowed both deductions on the grounds that there was no bargain sale and that the taxpayer did not meet the substantiation requirements. The Tax Court agreed that neither the settlement agreement itself nor the Forms 8283 attached to the taxpayer's returns qualified as adequate substantiation. Neither set of documents indicated whether the city provided goods or services in consideration for the dirt nor, if so, a good-faith estimate of the value of any goods or services furnished. The taxpayer argued for substantial compliance, but the court stuck with precedent that "the doctrine of substantial compliance does not apply to excuse compliance with the substantiation requirements of section 170." The court went on to hold that even if the taxpayer had provided adequate substantiation for the transactions, there was still no proof that the value of the fill dirt exceeded the value of the consideration received from the city. The court noted that in addition to the cash payments at $6 per cubic foot, the taxpayer received other benefits from the settlement agreement. The city agreed to give the taxpayer a right of entry and a construction easement to build a drainage system, it agreed to pay $450,000 to the taxpayer toward the construction of the drainage system, it agreed to acquire all necessary easements and rights of way for the project, and it agreed to release the taxpayer from any damages, actions, and claims arising from the operation of the landfill. The taxpayer gave no evidence as to the value of this consideration furnished by the city. Moreover, the court tended to agree with the Service's expert that the value of the fill dirt was between $4.72 and $7.87 per cubic foot. And since the taxpayer did not prove the extent to which the value of the fill dirt exceeded the $6 per cubic foot paid by the city, there was no basis for a deduction. *Boone Operations Co., LLC v. Commissioner*, T.C. Memo. 2013-101 (April 11, 2013).

Highest and Best Use Needs to be Viable, Too. The taxpayer owned 882 acres of undeveloped land in California. He used the property for recreational purposes, including deer hunting. In 2005, he conveyed a conservation easement on the property to the Golden State Land Conservancy. On his 2005 tax return, the taxpayer claimed a $4.7 million charitable contribution deduction in connection with the conservation easement. The Service disallowed the deduction, so the parties found themselves before the Tax Court. In support of the easement's valuation, the taxpayer claimed that the highest and best use of the property prior to the creation of the easement would be for a winery, for subdivision, or both. Alas, the Tax Court didn't buy the testimony of the taxpayer's expert regarding the property's use as a winery. Neither the expert nor the taxpayer established that the property could feasibly be converted into a winery. To access the taxpayer's property, one must pass over federal lands. The taxpayer had a right-of-way over those lands, but only for "single-family use." To use the property as a winery, the owner of the land would need a right-of-way that did not exist. Moreover, the taxpayer could not prove that the property had an adequate water supply for use as a vineyard. Nor could the taxpayer prove that the use of the property as a vineyard would be economically viable. Thus the property's highest and best

use before the imposition of the conservation easement could not have been for use as a winery. The court also rejected the position that the property could have been used for residential development prior ro the easement. Applicable state law already precluded subdivision of the taxpayer's property except for transfers to immediate family members. It was thus unrealistic to consider the property's value as a potential site for development. The court held that the property's highest and best use before the easement was for the recreational purposes for which the taxpayer used the property. And since that remains the highest and best use after imposition of the easement, the easement has not caused a decline in the value of the property—and that means the taxpayer gets no deduction. *Mountanos v. Commissioner*, T.C. Memo. 2013-138 (June 3, 2013).

Seriously, You Guys, Just Drop the "Floating Easement" Thing. Following their loss in *Belk v. Commissioner*, described above, the taxpayers asked the Tax Court to reconsider its decision. They claimed the first decision committed three errors, but only one of the alleged errors had any real weight. The taxpayers claimed that the court's decision that a conservation easement must attach to specific property in perpetuity effectively makes a charitable deduction impossible. Under applicable state law (North Carolina), you see, the taxpayers and the charity still have the power to modify the terms of the donation contract by mutual agreement. Since all such donation agreements have that implied power, there is no way to ensure that a conservation easement will forever attach to a specific parcel of land—the subject property can always change by agreement. The Tax Court was not persuaded. All that matters in this case, it said, is that the conservation easement agreement contained a provision that allowed the taxpayers to substitute the donated property with other land, and that was sufficient proof that the taxpayers did not agree to restrict their use of the subject property in perpetuity. *Belk v. Commissioner*, T.C. Memo. 2013-154 (June 19, 2013).

Side Agreement Providing for Return of Easement Upon Denial of Deduction Dooms the Deduction. In 2004, the taxpayers, a married couple, donated a façade easement in property located in a historic preservation district within New York City to the National Architecture Trust (NAT). At the time, NAT had been soliciting façade easements throughout the country. It asked the taxpayers for both the façade easement and a cash contribution to help NAT enforce its right under the easement. The taxpayer was aware that a neighbor had contributed a façade easement to NAT and obtained a "side letter" from NAT providing that if the charitable contribution in connection with the easement was disallowed, NAT would return the contributed easement and any associated cash contribution. No dummies, the taxpayers insisted on a similar arrangement, to which NAT consented. Since an appraisal showed the value of the easement was $990,000, the taxpayers also donated $99,000 to NAT (NAT's policy was to ask for a cash contribution equal to ten percent of the appraised value of the easement). The taxpayers deducted both the easement and the cash contribution on their 2004 return, but the Service disallowed them as conditional gifts. The Service reasoned that the side agreement effectively rendered both the easement and the cash contribution contingent on the allowance of an income tax deduction. The taxpayers argued that New York law would not enforce the side agreement because it was not included or referenced in the recorded deed. But the Tax Court held that the side letter was "not a nullity" but instead an important component of the donation arrangement. The taxpayers then insisted that the odds that the NAT would have to refund any portion of either the cash contribution or the easement were so remote as to be negligible, and that, accordingly, the court should ignore the conditions. But the court figured that if the odds were indeed so remote, the taxpayers would not have insisted so emphatically that the side agreement be a part of their arrangement with NAT. By the time of the contribution, cases had emerged that questioned the legitimacy of façade easements, and the Service had notified taxpayers that such donations would be subject to greater scrutiny. This supports the conclusion that the taxpayers anticipated that the provisions of the side agreement really could

become operative. Although the side agreement was not recorded with the deed, the deed gives NAT the power to abandon the easement, which would allow it to honor its obligations under the side agreement. *Graev v. Commissioner*, 140 T.C. No. 17 (June 24, 2013).

Neither Side Scores Summary Judgment in Conservation Easement Case. The Nature Conservancy, a nonprofit organization ("TNC"), inherited property to the south of three parcels of undeveloped land. When the owners of those parcels expressed interest in developing the properties, TNC objected. Ultimately, it obtained an option to purchase the three parcels for $1.6 million. Enter taxpayers, a married couple. Through a series of transactions, the taxpayers paid TNC $50,000 for the option. They then exercised the option and purchased the three lots for $1.6 million. TNC agreed to give them an easement for ingress and egress over the property it owned, and in turn the taxpayers agreed to construct a single-family home on one of the parcels (with a maximum height restriction of 25 feet on all structures) and nothing on the other two lots. Nine years later, the taxpayers granted to TNC a conservation easement in the parcels. The easements restricted development to one single-family residence and a guest house, both not to exceed 30 feet in height. Five days after granting the easement, the taxpayers sold the three parcels (subject to the conservation easement) for $6.9 million. On their tax returns, the taxpayers claimed a total charitable contribution deduction of over $3 million in connection with the conservation easement. The Service alleged, among other things, that the conservation easement was a *quid pro quo* transaction with TNC and that the appraisal supporting the deduction was flawed. The court refused to grant the summary judgment motions from both sides as to whether there was a *quid pro quo*, partly because there appears to be no case in which a court ever made such a determination in summary judgment. Further, although there was correspondence from the taxpayers' attorney indicating that the option transaction and the conservation easement were part of the same transaction, none of the documents from each step references the other. While there may be evidence of a *quid pro quo*, there is not enough of it to grant the Service's motion for summary judgment. The court likewise found a genuine issue of material fact as to whether the taxpayers' appraisal complied with regulatory requirements and, assuming they did not, whether the taxpayers should be excused from those requirements for reasonable cause. *Pesky v. United States* (D. Idaho, July 8, 2013).

Termination Provision in Conservation Easement Agreement Spoils Deduction. In December, 2003, the taxpayer and others conveyed a conservation easement in a parcel of Colorado land owned by a limited liability company to Greenlands, a charitable organization. The conservation easement deed contained the following provision about extinguishment: "If circumstances arise in the future such that render the purpose of this Conservation Easement impossible to accomplish, this Conservation Easement can be terminated or extinguished, whether in whole or in part, by judicial proceedings, or by mutual written agreement of both parties, provided no other parties will be impacted and no laws or regulations are violated by such termination." The taxpayer claimed a $385,600 charitable contribution deduction on her federal income tax return, but the Service disallowed the deduction on the grounds that the extinguishment clause violated the requirement that a conservation easement be granted in perpetuity. In a 2012 case, the Tax Court decided that the Service was right on this point, so it upheld the alleged deficiency. The taxpayer (and the other members of the limited liability company) moved for reconsideration. The taxpayer argued that the First Circuit's 2012 decision in *Kaufman v. Commissioner* warranted reconsideration of the case at bar. *Kaufman* held that a conservation easement placed on encumbered property could in fact qualify for an income tax deduction even though the regulations require the charitable organization to have an immediate property right worth at least the proportionate value that the easement bears to the value of the property as a whole. The Tax Court had read that rule to mean that if, upon a sale of the property, the charity would receive something less than

its fractional share (the numerator of which is the value of the easement and the denominator of which is the full fair market value of the property), then no deduction would be allowed. The First Circuit reversed that holding, however, and declared that what matters is that the charity would have a claim against the taxpayer for its share of the proceeds. The taxpayer in the case at bar argued that *Kaufman* applies in her case, too, for Colorado law provides that if extinguishment were to occur, "Greenlands would receive its proportionate share of any proceeds from such extinguishment, that Greenlands is bound by law to discharge its exempt purpose upon receipt of such proceeds, and thus any such proceeds are protected in perpetuity, which is the goal of the law." But the Tax Court held that *Kaufman* was about the priority of competing claims to the same property, not the applicability of an extinguishment clause exercisable by mutual consent of donor and donee. Since *Kaufman* did not apply in the case, the motion for reconsideration was denied. *Carpenter v. Commissioner*, T.C. Memo. 2013-172 (July 25, 2013).

Section 179: Election to Expense Certain Depreciable Business Assets

***ATRA: Large Bonus Depreciation Election Continued One More Year*.** The dollar limitation on the §179 expensing election continues at $500,000 for 2012 and 2013. (Special thanks to Congress for reinstating the $500,000 limitation for 2012 on January 1, 2013. Throughout 2012, taxpayers were led to believe the maximum §179 election amount was $139,000. By the time they learned it was really $500,000, it was already 2013. 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 2014, with a phase-out that begins once the total amount of §179 property purchased and placed in service during the taxable year exceeds $200,000. *Section 179(b)*.

Section 222: Qualified Tuition and Related Expenses

ATRA: Tuition Still Deductible Above the Line. The above-the-line deduction for "qualified tuition and related expenses" continues through 2013. 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

ATRA: 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 2013. 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 901: Taxes of Foreign Countries and of Possessions of United States

Taxpayer's Windfall: United Kingdom's Windfall Profits Tax Creditable. The taxpayer, a "global energy company," produces and sells electricity. Through an indirect subsidiary, the taxpayer distributed electricity to about 1.5 million customers in the United Kingdom. The subsidiary was originally a governmentally-run electronic company. It was "privatized" in 1990 through a public share offering. The subsidiary and other "privatized utilities were able to increase efficiency and reduce operating costs to a greater degree than had been expected when the initial price controls were established. That ability led to higher-than-anticipated profits, which, in turn, led to higher-than-anticipated dividends and share price increases for the privatized utilities." In the wake of public outrage over the excessive profits earned by these newly-privatized companies, the United Kingdom introduced a "windfall profits tax," a "one-time (or, in U.K. parlance, a 'one-off') tax on the 'windfall' to the privatized utilities on privatization. The approach would be to impute a value to each company at privatization, using an appropriate price-to-earnings ratio for each company's profits during the first 5 years after [the initial public offering], recognize the 'windfall' (the difference between the imputed value and the [initial public offering] price) as value forgone by taxpayers, and tax the privatized utilities on that 'windfall' using established principles from capital gains tax legislation." (The tax was set at 23% of the windfall.) The taxpayer paid this tax and wanted to claim a foreign tax credit for United States purposes. The Service balked, concluding that the windfall profits tax was not an income tax and thus not creditable. The Service reasoned that the tax was not computed on the basis of gross receipts, net income, or some realization event; instead, it was based "on the difference between two company values." But the Tax Court held that the windfall tax is creditable because its predominant character is that of an income tax in the United States sense. The court observed that the windfall tax was conceived as a vehicle for recouping excessive profits earned by the privatized utilities and would correct for the undervaluation of those companies at the time of their public offerings. "Because both the design and effect of the windfall tax was to tax an amount that, under U.S. tax principles, may be considered excess profits realized by the vast majority of the windfall tax companies, we find that it did, in fact, 'reach net gain in the normal circumstances in which it [applied]', and, therefore, that its 'predominant character' was 'that of an income tax in the U.S. sense.'" On appeal, however, the Third Circuit reversed. The court crunched the numbers to determine that the base against which the 23% tax was applied was an amount equal to 2.25 times the taxpayer's profits, an amount that would prove greater than the taxpayer's gross receipts. But an "income tax in the United States sense" requires that the tax be imposed on "gross receipts or an amount not greater than gross receipts," and that's simply not the case here. Accordingly, the court had little trouble concluding that the tax was not creditable after all. Yet the Supreme Court (in a 9-0 decision) rejected this position, concluding that the tax was creditable after all. The formula used to compute the tax showed that the tax was "economically equivalent to the difference between the profits each company *actually* earned and the amount the [British] government believed it *should* have earned given its flotation value." Most of the subject taxpayers paid a tax equal to 51.71% on all profits above a given threshold, and that, said the Court, is "classic excess profits tax." *PPL Corporation v. Commissioner* (U.S. S.Ct., May 20, 2013).

Section 1001: Determination of Amount of and Recognition of Gain or Loss

Stock Loan Program Treated As Sale. Acting on the advice of his financial advisor, the taxpayer, an IBM employee, entered into a "90% stock loan program" with an LLC called Derivium Capital. The taxpayer transferred 990 of his IBM shares (worth $105,445 and with a basis of $21,171) to Derivium in exchange for $93,586. The agreement between the taxpayer and Derivium characterized the transaction as a three-year loan of 90% of the value of the IBM stock, with the stock pledged as collateral. The agreement allowed Derivium to sell the stock (which it did immediately upon receipt). The loan's terms were nonrecourse as to the taxpayer (recourse against collateral only), with dividends to be received by Derivium as cash payments against the interest due (the interest rate was 10% compounded annually). The balance of the interest was to accrue until the loan's maturity date, and the loan was non-callable before maturity. The arrangement provided for no prepayment before maturity. At maturity, the taxpayer had the option of either paying the balance due and having an equivalent amount of IBM stock returned to him, renewing the purported loan for an additional term, or simply surrendering any right to receive IBM stock. When the repayment obligation matured in 2004, the balance due on the loan was almost $41,000 more than the value of the IBM stock at that time, so the taxpayer elected to surrender any right to get the IBM stock back. The taxpayer did not report the amount he received from Derivium on his 2001 return, and he did not report the termination of the transaction on his 2004 return. The Service took the position that this was in effect a sale of the IBM stock and not a loan. The Tax Court agreed that this transaction was in fact a sale of the stock in 2001. A number of factors pointed to a disguised sale. Derivium was authorized the sell the stock immediately upon receipt without having to give notice to the taxpayer. The taxpayer never reported dividends paid on the stock while the "loan" was outstanding. Once the taxpayer got his $93,000 and change from Derivium, he bore no risk of loss if the value of the IBM stock decreased. The court observed its decision was consistent with those of two other federal courts in recent cases. On appeal, the Eleventh Circuit affirmed. The appellate court looked primarily to the terms of the agreement between the taxpayer and Derivium. They gave Derivium ownership rights in the stock like possession, the right to equity, and the right to receive the profits from either holding or disposing of the stock. The nonrecourse provision of the loan essentially ensured that any risk of market downturn was born by Derivium. It also made it unlikely that the taxpayer would repay the loan and reclaim his collateral. The stock would have had to appreciate significantly before it would be economically viable to pay off the loan. All of these features were unlike a typical loan. Usually, a lender does not enjoy unfettered use of the collateral as was the case here (usually a lender just holds the collateral in case of default). The lender is most arrangements foes not have the full array of ownership rights that Derivium had here. *Calloway v. Commissioner* (11th Cir., August 23, 2012).

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

ATRA: 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 2013, a 100% exclusion applies. This gives § 1202 some much-needed bite. Of course, it won't be until 2018 before taxpayers begin to feel the benefit of this increased exclusion. *§ 1202(a)(3).*

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

ATRA: 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). ATRA revived this rule and extended it through 2013. 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

ATRA: 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 and 2012, the recognition period was shortened to five years. ATRA has extended the five-year recognition period through 2013. So if the corporation made its S election effective for 2008, any net recognized built-in gains in 2013 will not be subject to the tax. Curiously, however, any net recognized built-in gains in 2014, the seventh year of S corporation status, would be subject to the tax. *Section 1374 (d)(7)(B).*

Section 2031: Definition of Gross Estate

Tax Court Applies Ten-Percent Fractional Interest Discount to Artwork. The decedent and his wife owned 64 works of contemporary art, including works by Pablo Picasso, Paul Cezanne, Jackson Pollock, and Jasper Johns. In 1990, they each created a ten-year grantor-retained income trust (GRIT) to which each contributed his or her community property share of three works: a Picasso drawing, a Pollock painting, and a Henry Moore sculpture. The decedent's wife died in 1999, before the termination of her GRIT. Under the terms of her GRIT agreement, her share of the works held in trust passed to the decedent. The decedent survived his GRIT term, however, meaning his original one-half share of the works passed in equal shares to his three children. At the time of his death, therefore, the decedent held an undivided 50% interest (the share that had been placed in his spouse's trust in the

three works. The children then leased to the decedent their interests in two of these works (the Picasso drawing and the Pollock painting). The lease agreement gave the decedent possession of the works in exchange for a monthly rent that was left blank. The agreement also restricted the sale of ownership interests in any of the works unless all owners agreed to sell a work in its entirety. As for the other 61 works, the decedent disclaimed a portion of the undivided 50% interest left to him by his spouse. The disclaimed portion passed in equal shares to the three children. At the time of his death, therefore, the decedent had roughly a 73% interest in each of these remaining 61 works of art (his own 50% interest plus the roughly 23% interest from his spouse that the decedent did not disclaim). Following the disclaimer, the decedent and the children executed a "cotenant's agreement" under which they agreed to share the use of (and maintenance expenses related to) the works proportionate to their ownership interests. They also agreed that none of the works could be sold without their unanimous consent. In valuing the decedent's share of these various works of art, the estate claimed a 44.75% "combined fractional interest discount" reflecting both a minority interest discount and a marketability discount. (Heck, at trial the estate offered witnesses to support its new claim for a 67% discount!) The Service claimed that no discount was proper, based in part on its assertion that the restrictions on sale of the works should be disregarded under §2703. It also claimed that no fractional interest discount should be applied to art because "the proper market in which to determine the fair market value of fractional interests in works of art is the retail market in which the entire work (consisting of all fractional interests) is commonly sold at full fair market value." And since a fractional interest holder would receive a full share of the proceeds, no discount should apply. Because the parties agreed to the undiscounted value of the artwork (a total of just over $35.1 million), the only issue was whether a discount was appropriate and, if so, the amount of such discount. The Tax Court held that §2703(a) applied and that the restriction on sales in the lease agreement and the cotenant's agreement should therefore be disregarded. But as it turned out, disregarding the restriction on sales "makes little or no difference to our conclusion as to the value of the art." Instead, the court was much more concerned with the appropriate discount to apply to a fractional interest in artwork. The court acknowledged that other cases have applied nominal discounts to fractional interests in artwork. But here, the court observed, "we are presented with unchallenged facts demonstrating that the [decedent's] children had strong sentimental and emotional ties to each of the 64 works of art so that they treated the art as 'part of the family.' Those facts strongly suggest that a hypothetical buyer of decedent's fractional interests in the art would be confronted by co-owners who were resistant to any sale of the art, in whole or in part, to a new owner, a resistance that the [decedent's] children specifically communicated. … That being so, the hypothetical seller and buyer necessarily would be faced with uncertainties regarding the latter's ability to monetize his or her investment in the art." Those uncertainties, said the court, warrant a discount. The Service argued that a fractional interest discount here would be inconsistent with its traditional position that fractional interests are not discounted for purposes of the § 170 deduction for charitable contributions when one donates fractional interests to charity. But the court held that the lack of discounts in the income tax context is not relevant given the support in the case law for fractional interest discounts in the estate tax context. So everything came down to the proper discount to apply. The large discount claimed by the estate was based on analysis that failed "to consider not only the [decedent's] children's opposition to selling any of the art but also their ownership position vis-a-vis that of the hypothetical willing buyer and the impact that the … ownership split would have on the negotiations between seller and buyer. Both experts should have considered the fact that the Elkins children, cumulatively, were entitled to possession [for a portion of] each year. The relatively brief period of annual possession and the expense and inconvenience of annually moving the art from the hypothetical buyer's premises back to Houston most likely would have caused the [decedent's] children to reassess their professed desire to cling, at all costs, to the ownership status quo existing after decedent's death. Thus, the hypothetical buyer would be in an excellent position to persuade the

children, who, together, had the financial wherewithal to do so, to buy the buyer's interest in any or all of the works, thereby enabling them to continue to maintain absolute ownership and possession of the art." The court continued: "We believe that a hypothetical willing buyer and seller of decedent's interests in the art would agree upon a price at or fairly close to the pro rata fair market value of those interests. Because the hypothetical seller and buyer could not be certain, however, regarding the children's intentions, i.e., because they could not be certain that the children would seek to purchase the hypothetical buyer's interests in the art rather than be content with their existing fractional interests, and because they could not be certain that, if the children did seek to repurchase decedent's interests in the art, they would agree to pay the full pro rata fair market value for those interests, we conclude that a nominal discount from full pro rata fair market value is appropriate. We hold that, in order to account for the foregoing uncertainties, a hypothetical buyer and seller of all or a portion of decedent's interests in the art would agree to a 10% discount from pro rata fair market value in arriving at a purchase price for those interests. We believe that a 10% discount would enable a hypothetical buyer to assure himself or herself of a reasonable profit on a resale of those interests to the Elkins children." *Elkins v. Commissioner*, 140 T.C. No. 5 (March 11, 2013).

Section 2036: Transfers with Retained Life Estate

Death Doesn't Stop Formation and Funding of Family Partnership. The decedent, Mrs. Williams, was diagnosed with cancer in March, 2000. Around that same time, Mrs. Williams and her advisors discussed the creation of a family limited partnership. Mrs. Williams was "an impeccably shrewd businesswoman and frugal heiress. … Of particular concern to Mrs. Williams as she worked to protect the family's interests was the risk of losing control of significant family assets through divorces." On May 9, 2000, Mrs. Williams signed the documents required to form the partnership and a limited liability company that would serve as general partner of the partnership. The partnership's two limited partners were trusts of which Mrs. Williams was trustee. Mrs. Williams intended to transfer about $250 million in bonds, securities and cash owned by the trusts to the partnership. (Mrs. Williams would herself still have more than $110 million of other assets outside of the partnership.) The decedent's advisors then set to filing the necessary paperwork with the state and obtaining tax identification numbers for the new entities. But then, on May 15, 2000, before completion of the partnership's formation and the transfer of assets to the partnership, Mrs. Williams died. Accordingly, her advisors stopped any further action to form the partnership or complete the transfer of assets. Initially taking the position that the partnership had not been created and funded prior to the decedent's death, the estate paid estate taxes of about $148 million. Thereafter, the decedent's advisors learned at an estate planning seminar that the partnership may have been validly created and funded after all. So they quickly completed formation of the partnership and assignment documents, then got the estate to bring a claim for refund to the tune of about $40 million plus interest. When the Service did not answer the claim, the estate sued. The district court held that under applicable state law (Texas), "the intent of an owner to make an asset partnership property will cause the asset to be property of the partnership," and it does not matter whether legal title has been transferred. The court found that Mrs. Williams had entered into an enforceable agreement with her descendants that obligated her estate to go through with the formation and funding of the partnership. Accordingly, the minority interest and lack of marketability discounts claimed by the estate were proper. The district court held that the partnership assets were not includible in Mrs. Williams's estate under either § 2036 or § 2038 because the formation and funding activities constituted a sale for an adequate and full consideration. The transaction constituted a sale, said the court, for a number of reasons. "First, the lengthy discussions that went into creating the Partnership Agreement, which Mrs. Williams signed, provide sufficient objective evidence

that the Partnership transaction was 'real, actual, genuine, and not feigned.' Second, the primary purpose underlying the Partnership's formation was to protect family assets from depletion by ex-spouses through divorce proceedings. This was accomplished by creating an entity that, by altering the legal relationship between Mrs. Williams and her heirs, could facilitate the administration of significant family assets. In other words, the creation and funding of the Partnership was undertaken for a legitimate business purpose and not the mere 'recycling' of wealth. Finally, the fact that Mrs. Williams had a significant collection of assets outside of the Partnership—well over $100 million—further supports the conclusion that the transfer was made pursuant to a bona fide sale." As for proof that the transaction was for a full and adequate consideration, the court noted several facts: "First, the … Partnership Agreement provides that the percentage interests of the partners are proportionate to their respective contributions. The Agreement also sets forth the capital accounts in which the contributions of a partner are credited to the respective capital account of the partner. Finally, the Partnership agreement provides that, upon liquidation, the partners are to receive their capital accounts in accordance with their percentage interests." Accordingly, the estate's claim for refund was upheld. On appeal, the Fifth Circuit agreed that Mrs. Williams had the intent to form the partnership before her death and this intent was controlling. The Service focused its appeal on whether the assets transferred to the partnership were done so effectively under applicable provisions of the Texas Revised Limited Partnership Act. But the Fifth Circuit held that even if there were glitches under applicable state partnership laws, the decedent's intent to transfer the assets to the partnership is still the controlling fact. It thus upheld the refund claim. *Keller v. United States* (5th Cir., September 25, 2012).

Section 2053: Expenses, Indebtedness and Taxes

"Done Deal" Redemptions Affect Value of Decedent's Interest, and Unnecessary Loans Don't Generate Interest Expense Deductions. The decedent was President and CEO of a corporation that bottled Pepsi Cola and sold food and beverages from vending machines. In 2004, following a long dispute with Pepsi, the corporation agreed to sell at least its soft-drink business to another bottler. During the negotiations, the decedent executed a pour-over will that directed his entire estate to be paid to a living trust he established five years earlier. When the stock purchase agreement was signed late in 2004, the decedent held about 47% of the company's voting stock and 51.5% of the company's non-voting stock. The agreement required the company to spin off assets unrelated to the bottling and vending machine businesses, and the purchase price was set at about $340 million. The deal closed early in 2005. At that time, the spun-off entity held the $340 million cash, an additional $50 million in cash from settlement of a lawsuit against Pepsi, and various assets unrelated to the vending machine and bottling businesses. Shortly thereafter, the spun-off entity began making cash distributions to shareholders. When the decedent died in March, 2005, the entity had a net asset value of about $318 million. The principal asset of the decedent's trust was its holdings in the spun-off entity, so the trust borrowed $10.75 million from the company in order to pay estate and gift tax liabilities. The estate's Form 706 reported the value of the living trust's interest in the spun-off company to be just over $117 million; it also claimed a deduction for the $71.5 million in deferred interest that the trust would be paying to the company between 2024 and 2031. The Tax Court denied the interest deduction, finding that the trust did not need to incur the loan to pay estate and gift taxes. The trust had the power to force the company to make a proportionate distribution to the shareholders, making the loan arrangement unnecessary. The estate argued that a distribution would strip the company of cash, but the court observed that the loan likewise depleted the company of cash. Besides, the trust will be looking to the company for distributions to repay the loan. Ultimately, then, distributions will be required. The court then turned to the valuation of the trust's holdings in the spun-off company. The

court observed that the liquidation value of the trust's interest at the date of death was about $160.5 million. The estate wanted a 31.7% marketability discount so that the value of the interest would be about $109.6 million, but the Service insisted that a 7.5% discount was sufficient (that would bring the value of the trust's interest to about $148.5 million). The Tax Court held that the 7.5% discount was proper. Part of the reason for the difference was because the taxpayer's expert did not consider the effects of redemptions that occurred after the decedent's death. But the court observed that the redemption agreements were finalized prior to the decedent's death; thus it was certainty at the decedent's death that the trust's interest in the company would soon be substantially larger. "The holder of the 50.50% interest in [the spun-off company], whose voting power would increase from 46.94 to 70.42% after the redemptions, could receive about $140 million in a distribution. Thus, $140 million is the minimum sale price of the 50.50% interest." Since the Service's expert was closer to that number than the taxpayer's expert, the Service's expert was more persuasive. *Estate of Koons v. Commissioner*, T.C. Memo. 2013-94 (April 8, 2013).

Section 2056: Bequests, Etc., to Surviving Spouse

Surviving Spouse of Same-Sex Marriage Prevails in Claim for Estate Tax Marital Deduction. Edie and Thea (both of New York) started a committed relationship in 1963. In 1993, they registered as domestic partners in New York City, and in 2007 they married in Canada. Thea died in 2009, and her estate passed for the benefit of Edie. Because Thea's bequest did not qualify for the unlimited marital deduction her estate was required to pay $263,053 in federal estate tax. Two years after Thea's death, New York recognized same-sex marriages. Edie filed a refund action claiming that section 3 of the Defense of Marriage Act ("DOMA"), which defined "marriage" as between one man and one woman) violates the Equal Protection Clause of the Fifth Amendment of the United States Constitution. In February 2011, recall, the Justice Department announced that it would no longer defend DOMA's constitutionality. It reasoned that a heightened standard of scrutiny should apply to classifications based on sexual orientation and that section 3 is unconstitutional under that standard. That led the Bipartisan Legal Advisory Group of the U.S. House of Representatives ("BLAG") to intervene in this case to defend the constitutionality of the statute. The U.S. District Court for the Southern District of New York granted summary judgment in favor of Edie, holding that the application of DOMA to deny the estate tax marital deduction was unconstitutional. The court held that it did not need to determine the standard appropriate for testing legislation that discriminates against homosexuals (rational basis, intermediate scrutiny, or strict scrutiny) because DOMA failed even the rational basis test. A divided Court of Appeals for the Second Circuit affirmed. The Second Circuit first determined that Edie had standing to bring the suit because New York would have recognized a Canadian same-sex marriage, even though New York did not license such unions at the time. The court noted that the highest court of New York had not ruled on the issue, but intermediate courts of appeals had uniformly upheld such foreign same-sex marriages. Turning to the merits, the Second Circuit (unlike the lower court) was unafraid to pick a standard of scrutiny, opting for intermediate scrutiny. Considering that homosexuals historically have been subjected to discrimination and have been "a minority or politically powerless," the court determined that homosexuals are a "quasi-suspect" class and that, therefore, legislation restricting their rights can be upheld only if it is substantially related to an important government interest. The court then rejected claims that DOMA advanced important government interests. On appeal, the Supreme Court affirmed, though it never seemed to get around to picking a standard of scrutiny. Instead, the majority, in an opinion by Justice Kennedy, stated that section 3 of the statute was "a deprivation of the liberty of the person protected by the Fifth Amendment." The majority opinion concluded that states, rather than the federal government, have historically regulated and defined "marriage," as when states

establish minimum ages for marriage. And some states, as we know, have sanctioned same-sex marriages. Section 3 of DOMA, by preventing the federal government from recognizing a state-sanctioned marriage, therefore, unconstitutionally discriminated against same-sex marriages. The majority opinion does not make clear on what grounds, exactly, section 3 of DOMA is unconstitutional. Indeed, as Justice Scalia observed in dissent, "[t]he sum of all the Court's nonspecific hand-waving is that this law is invalid (maybe on substantive-due-process grounds, and perhaps with some amorphous federalism component playing a role)." It is important to note, moreover, that the Court did not conclude that there is a constitutional right to same-sex marriage. For now, it seems, the status of the law is this: states are free to define marriage as they wish, and the federal government must respect all state-sanctioned marriages. *United States v. Windsor* (U.S. S.Ct., June 26, 2013).

Section 2511: Transfers in General

Is the State Income Tax Dodge Still Viable? DING! DING! DING! Delaware has this cool statute that does not impose state income tax on income accumulated in trust for ultimate distribution to nonresident beneficiaries. So if the beneficiaries live in a state that does not tax trust income based on the beneficiaries' residence (some notable examples include New York, New Jersey, Kentucky, Michigan and Missouri), it's possible to avoid state income tax altogether. Some folks combine this technique with a domestic asset protection trust also formed under Delaware law, and the result has been labeled a "Delaware Income Gift Non-Grantor Trust," erroneously abbreviated to the smarmy "DING trust." Under the traditional DING trust, the grantor creates an irrevocable trust taxed as a separate entity under Delaware law, funds it with assets through incomplete gifts, but retains the right to discretionary distributions from the trustee. The basic structure was upheld in a series of private letter rulings, but in 2010, DING trusts were effectively outlawed when section 2511(c) was added to the Code. It provided that any transfer to a non-grantor trust would be treated as a completed gift. This provision died with the rest of the 2010 Act, however, so some want to test the waters again. In this ruling, a trust would be formed pursuant to which the trustee would make distributions of income and principal as directed: (1) by a majority vote of a "Distribution Committee," provided the grantor has consented; (2) by the unanimous vote of the Distribution Committee members other than the grantor; or (3) by the grantor as the grantor deems necessary for the maintenance, education, support and health of the grantor's issue. (Yes, Virginia, the grantor is a member of the Distribution Committee.) The Service ruled that this would not be a grantor trust, and none of the members of the Distribution Committee would be deemed owners of any portion of the trust either. Further, because the members of the Distribution Committee are not adverse to the grantor, the grantor's retained power to distribute property back to himself with the consent of the Distribution Committee means that all property transfers from the grantor will be incomplete gifts. Sure, the trust assets are includible in the grantor's gross estate, but note that the grantor has successfully managed to avoid application of state income taxes. *Private Letter Ruling 201310002* (March 8, 2013).

Section 2519: Dispositions of Certain Life Estates

Later Sale of Distributed QTIP Trust Assets Are Deemed Gift. The decedent was the income beneficiary of two qualified terminable interest property (QTIP) trusts, a marital deduction trust, and a revocable living trust. In 2001 the QTIP trusts and the marital deduction trust were liquidated, and the trusts' assets (interests in a family limited partnership) were transferred to the decedent's revocable living trust. The living trust then sold the family partnership interests to the decedent's children in

exchange for various 10-year deferred private annuities. The decedent's estate tax return included neither the partnership interests not the annuities in the gross estate, but the Service took the position that the sale of the partnership interests was a disguised gift because they were sold for less than their fair market values. Though the parties to the annuity transactions used actuarial tables to determine the selling prices, the Service believed that there was no real expectation of payment since the decedent was pretty ill at the time of the transactions. But the Tax Court held that the estate submitted sufficient evidence that the decedent really would live long enough that computation of the sale price under the mortality tables was legitimate. The Service then argued that the annuity transaction was in substance a disposition of the decedent's qualifying income interest in the two QTIP trusts, triggering a deemed gift under section 2519. Here the Tax Court agreed with the Service, as clearly the decedent transferred her qualifying income interest in the QTIP trusts in the private annuity transactions. The Service then argued that the decedent made a gift through the release of a general power of appointment in the marital deduction trust by transferring the partnership interests to the living trust, but the court rejected this claim. *Estate of Kite v. Commissioner*, T.C. Memo. 2013-43 (February 7, 2013).

Section 2522: Charitable and Similar Gifts

Reformed CRUT Qualifies for Gift Tax and Income Tax Deductions. So this married couple created and funded a charitable remainder unitrust with a term interest that would continue until the death of the surviving spouse. The trust names a charity to receive the remainder, but the trust also gives the surviving spouse a power to change the remainder beneficiary to another charitable organization. Now the spouses have effectively waived their rights to change the remainder beneficiary, so they sought a ruling that their transfers to the trust will qualify for both gift tax and income tax deductions. They got the desired rulings. The Service said the taxpayers would get both a gift tax deduction and an income tax deduction for the value of the charity's remainder interest, as the gifs to the charity are now complete. *Private Letter Ruling 201321012* (May 14, 2013).

Section 6075: Time for Filing Estate and Gift Tax Returns

Spouse's Last-Minute Citizenship is One Thing, But Waiting Until All Claims are Settled Before Filing is Quite Another. We all know that the estate tax marital deduction is disallowed where the surviving spouse is not a United State citizen. A rarely-used Code provision, section 2056(d)(4), provides that if the surviving spouse *becomes* a United States citizen before the estate tax return is filed, the marital deduction is allowed, so long as the spouse was a resident of the United States at all times after the decedent's death and before becoming a United States citizen. In this case, the decedent's surviving spouse was a United States resident but a citizen of Bolivia. When the decedent's estate tax return was due, the estate obtained an extension. Then, shortly before the extended return deadline, the spouse informed the executor that she intended to become a United States citizen. The executor was told by the estate's attorney that if the estate files the return before the spouse became a United States citizen, the marital deduction could not apply. So the advice was to file a late return, after the spouse became a citizen. Fourteen months later, the spouse became a United States citizen. You'd think the estate would then promptly filed an estate tax return. But no—the estate waited until after all of the spouse's claims against the estate had been settled before filing the return, and that was nine months after she became a United States citizen. Apparently the same attorney thought it would be better for the estate to file an accurate return that showed the precise amounts passing to the spouse, and this wouldn't be knowable until after her claims against the estate had been resolved. Not surprisingly, the Service imposed a

penalty for the late filing. (When you're 23 months late on a deadline that was already extended, that kind of thing happens.) When the Service denied the estate's claim for refund, the estate sued in the Court of Federal Claims. The court held that while the executor reasonably relied on the attorney's advice regarding waiting to file until after the spouse had become a United States citizen, there was no reasonable cause to wait another nine months following the spouse's awarding of citizenship before filing the estate tax return. On that issue, the attorney's advice was clearly wrong, so relying on that advice by definition cannot serve as reasonable cause. *Estate of Liftin v. United States* (Ct. Fed. Cl., March 29, 2013).

Section 6324: Special Liens for Estate and Gift Taxes

Ten-Year Statute of Limitations for Transferee Liability Upheld. The decedent died in 2000, and the estate's Form 706 showed a net estate tax liability of over $2.6 million. In 2003, the net estate tax due was reduced to just under $2.5 million following an audit. The estate received six extensions for the payment of tax, allegedly because the bulk of the assets consisted of depressed marketable securities held through a living trust. The idea was that the estate would hold the securities until their values rebounded, at which they could be liquidated for payment of the tax. But go figure: the co-executors and co-trustees engaged in the active trading of the securities during the extension periods. In 2006, the Service served a levy notice on the estate. The estate challenged the levy but both a lower court and an appellate court upheld the levy. By this point, the estate has become insolvent, and the current balance due exceeds $3 million. So the Service has gone after one of the decedent's daughters (who also served as a co-executor and co-trustee), asserting transferee liability under section 6324. Specifically, the Service seeks to recover the daughter's $416,438 share of the decedent's IRA that was distributed to the decedent's beneficiaries immediately after his death. The daughter asked the court to dismiss the case, claiming that the Service only had four years to assert transferee liability under section 6901. But the court rejected this argument, observing that while there is normally a four-year statute of limitations transferee liability under section 6901, section 6324 provides a ten-year limitations period for transferee liability for liens on the assets of the gross estate. Several cases have held that the Service does not need to comply with section 6901 when asserting transferee liability under section 6324, and the daughter's argument that those cases were flawed did not prevail. Since the estate requested several extensions for the payment of tax, the ten-year limitations period will not expire until 2014, meaning the Service's claim against the daughter is still timely. *United States v. Mangiardi* (D. Fla., July 19, 2013).

Section 7701: Definitions

Married Couples of the Same Sex Now Considered Married for Federal Tax Purposes. In light of the June, 2013, decision in *United States v. Windsor*, the Service had to implement the United States Supreme Court's holding that section 3 of the Defense of Marriage Act was unconstitutional. According to the Service's count, there are more than 200 provisions in the Code and regulations using the terms "spouse," "husband," "wife," "husband and wife," and "married." The Service has ruled that these terms now include individuals lawfully married under state law to others of the same sex. Those who are members of a registered domestic partnership, civil union, or other formal relationship that is recognized under state law but which state law does not denominate as a marriage are not "married" for federal tax purposes. Importantly, the Service also adopted the much-anticipated "state-of-ceremony rule" under which 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 recognizes same-sex marriages. The Service determined that a "state-of-domicile rule" would be too administratively cumbersome, both for taxpayers and their employers. The "state-of-ceremony rule" is also more consistent with a 1958 ruling in which the Service determined that it would recognize individuals who entered into a common-law marriage as married for federal tax purposes, regardless of where the couple now resides. The ruling is effective prospectively as of September 16, 2013, but the Service noted that taxpayers may rely on the ruling for purposes of filing amended returns with respect to matters that are still open under the applicable statute of limitations. Those that would amend returns for purposes of correcting employment tax and income tax matters related to employer-provided health coverage and other fringe benefits should note that the Service will permit amended returns only with respect to benefits excludable under sections 106, 117(d), 119, 129, or 132. Planning for "federal-only" married couples will be cumbersome. While they can file a joint federal income tax return, they will likely need to file separate state income tax returns. In states that impose state estate and/or gift taxes, traditional marital deduction estate planning techniques will likely be unavailable. To the extent states impose wealth transfer taxes at a rate less than the federal 40-percent rate, "federal-only" couples may opt to plan for the federal marital deduction even though it may result in the imposition of state wealth transfer taxes. *Revenue Ruling 2013-17* (August 28, 2013).