

RECENT DEVELOPMENTS 2011

May 25, 2011

The Essex County Estate Planning Council

Presentation given by:

Stuart M. Gladstone, Esq.

Outline prepared by:

Stuart M. Gladstone, Esq.

Bonnie Leibowitz-Carchi, Esq.

Brach Eichler, L.L.C.
101 Eisenhower Parkway
Roseland, NJ 07068
973.228.5700 (phone)
973.228.7852 (fax)
sgladstone@bracheichler.com

I. Notice 2011-37, (April 13, 2011) Provides Guidance on IRC Sec. 67 and the 2% floor:

- A. Knight v. Commissioner, 552 US 181 (2008) held that investment advisory fees were deductible only to extent that they exceeded two percent of a trust's adjusted gross income.
- B. The IRS and Treasury Department anticipate issuing regulations consistent with the Knight holding.
- C. Notice 2011-37 provides interim guidance that taxpayers will not be required to determine the portion of investment advisory costs and other costs that are integrated as part of one commission or fee paid to a trustee or executor, referred to as “Bundled Fiduciary Fee” that are subject to the 2% floor under I.R.C. § 67.
- D. Taxpayers may deduct the full amount of the Bundled Fiduciary Fee without apportionment. However, payments made by the fiduciary for expenses subject to the 2% floor which are readily identifiable are subject to such floor.
- E. The guidance applies to any taxable beginning year prior to the date that the final regulations are published in the Federal Register. Notice 2011-37 supersedes Notice 2010-32.

II. CLAT as a planning technique in a low interest rate environment.

- A. A Charitable Lead Annuity Trust (“CLAT”) provides a stream of payments to a charity of your choosing for a fixed period after which any growth passes to your heirs at a reduced transfer tax cost. This is a great technique in a low interest rate environment if your client is charitably inclined. This technique is an extremely effective way to leverage a high net worth client’s applicable exclusion amount.
- B. Example: Take the case of Robert. Robert is divorced and has three children, one of his children is severely autistic. Robert is committed to the treatment and study of autism. Robert currently has a net worth of \$15 Million dollars. Robert would like to benefit his favorite charity devoted to Autism. Robert intends to leave the bulk of his estate to his three children.
- C. Suggestion: Robert could establish a CLAT to benefit autism. Assume Robert contributes \$5 Million to a CLAT and pays an 8% annuity (\$400,000) to the charity for 10 years. The gift made to his children is valued at \$1,552,840 based upon a 7520 rate of 2.8%. Assuming 6% growth per year in the trust assets, at the end of 10 years, Robert’s children will receive \$3,681,920. At such time, no further estate or gift tax would be due. At the end of the CLAT, Robert will have removed \$5 Million of assets from his taxable estate while at the same time benefiting a cause close to his heart.

- D. The lower the 7520 rate, the lower the gift tax value of the remainder interest. CLAT must outperform the 7520 rate to pass appreciation on to heirs. For example, if the 7520 rate were 4%, then the gift value of the remainder interest for gift tax purposes would be \$1,755,640.
- E. Can be set up as a Grantor or Non-Grantor Trust.
- F. A CLAT can be established during one's lifetime or in a Will. However, with a Will, the 7520 rate is not determined until death. This creates uncertainties and includes the risk that the 7520 rate may rise.
- G. Not a great vehicle for transferring wealth to grandchildren because you cannot allocate GST tax exemption until the end of the estate tax inclusion period "ETIP."
- H. Now is the time to encourage clients to use this technique as interest rates are low. The 7520 rate for June is 2.8%. A higher 7520 rate will create a larger gift to heirs, hence more gift tax will be incurred or more of the client's applicable exclusion amount will be used.

III. Proposed Regulation 154159-09 Discharge of Indebtedness Income of Grantor Trusts and Disregarded Entities:

- A. Generally, discharge of indebtedness income is includable in gross income under I.R.C. § 61(a)(12). There is a limited exception if the discharge of indebtedness income is a result of filing for Title 11 bankruptcy or if the taxpayer is insolvent at the time of discharge.
- B. The proposed regulation clarifies who the taxpayer is for purposes of the limited exception where there is discharge of indebtedness income of a grantor trust or a disregarded entity.
- C. The proposed regulation provides that in applying the exception to discharge of indebtedness income of a grantor trust or disregarded entity, the term "taxpayer" refers to the owner of the grantor trust or disregarded entity. The grantor trust or disregarded entity itself is not to be considered an owner.
- D. The insolvency exception is available only to the extent that the owner is insolvent.
- E. In the case of a partnership, the owner rules apply at the partner level to the partners of the partnership to whom the discharge of indebtedness income is allocable.

IV. Recent Decisions:

A. In re Barker, No. 822324 (NY Tax App. Jan. 13, 2011).

- The issue in the case was whether John and Laura Barker maintained a permanent place of abode in New York State and spent in the aggregate more than 183 days in New York State during the year so that they could be taxed as statutory New York Residents for income tax purposes.
- John and Laura Barker were Connecticut domiciliaries. The Barkers lived in New Canaan, CT. Mr. Barker worked for Neuberger Berman in New York City as an investment banker. He commuted to the city. Mr. Barker spent more than 183 days in NY at his place of employment.
- The Barkers bought a vacation home in the area of the Hamptons in NY. The vacation home was 138 miles from the Barker's CT home. The property was purchased to accommodate the family during their brief beach vacations during the summer months. The Barkers led busy lives in CT and as a result the Barkers could only travel to the vacation home for short vacations sporadically. The Barkers spent less than 20 days a year at the summer property.
- Mrs. Barker's parents fully enjoyed their daughter's vacation home by utilizing the house several days a week during the summer and on many weekends the remainder of the year.
- The auditor focused on the number of days spent in NY and the permanent place of abode in the state.
- Tax Law § 601 imposes New York state personal income tax on "resident individuals." A resident individual is defined as someone who is domiciled in NY or "who is not domiciled in this state but maintains a permanent place of abode in this state and spends in aggregate more than one hundred eighty-three days of the taxable year in this state." Tax Law Section 605(b)(1).
- The issue centered around what constituted a permanent place of abode. The regulations provide that a permanent place of abode means:

"Permanent place of abode. (1) A permanent place of abode means a dwelling place permanently maintained by the taxpayer, whether or not owned by such taxpayer, and will generally include a dwelling place owned or leased by such taxpayer's spouse. However, a mere camp or cottage, which is suitable and used only for vacations, is not a permanent place of abode. Furthermore, a barracks or any construction which does not contain facilities ordinarily found in a dwelling, such as facilities for cooking, bathing, etc., will generally not be deemed a permanent place of abode."

- The New York State Tax Appeals Tribunal held that the Barkers are residents for purposes of the statutory residence statute and hence taxable in NY on income from all sources.
- Query: What if the Barkers had rented the home to the parents?
- New Jersey has a statutory residence statute like NY.
- This case is problematic for taxpayers who are domiciliary of states who have lower tax rates and who cannot receive a credit in his or her state for taxes paid to another state.
- This case could mean that if someone works in NY, owns residential property in NY and maintains the property, by exerting dominion and control, he or she will be subject to NY state income tax.

B. Estate of Sylvia Riese v. Commissioner, TC Memo 2011-60, (March 15, 2011)

- Silva Riese, whose husband predeceased her, created a three year Qualified Personal Residence Trust (“QPRT”).
- Ms. Riese was advised by her estate planning attorney that establishing a QPRT would result in estate tax savings, but the tradeoff was paying a gift tax and paying rent to live in the residence after the QPRT term expires as Ms. Riese would no longer own the residence.
- The QPRT provided that if Ms. Riese survives the termination date of the QPRT the balance would be poured over 50 percent each to two existing trusts for the benefit of her daughters.
- Ms. Riese survived the QPRT term, and the QPRT terminated pursuant to its terms. Ms. Riese continued to occupy the residence until her death.
- During a 6 month period between the QPRT’s termination and Ms. Riese’s death, Ms. Riese paid all the carrying charges for the residence. Ms. Riese, however, did not pay rent or sign a lease agreement, although there were multiple discussions and allegedly an agreement to pay fair market rent. Evidence included that Ms. Riese was advised on a number of occasions about the necessity to pay rent. Ms. Riese acted on the advice of counsel to wait until the end of the year in which the QPRT terminated to start paying rent.
- A US Estate Tax return was filed, however the residence was not included in the calculation of the gross estate.
- The IRS audited the estate tax return and included in the gross estate the value of the residence.

- The IRS argued that Ms. Riese retained a life estate in the residence –lifetime transfer with retained life estate and that the entire residence should be pulled into her estate under I.R.C. § 2036(a)(1). The IRS argued that an implied agreement existed amongst the parties.
- The court held for the estate. The court reasoned that the evidence showed that the parties had an understanding that Ms. Riese would pay fair market rent by the year end in which the QPRT terminated. The court accepted the party’s good faith testimony that it was intended that Ms. Riese would commence paying rent by the end of the year.
- Such issues could have been avoided if:
 - (1) The amount of rent had been determined prior to QPRT termination; and
 - (2) A lease agreement executed.

C. Baccei v. US, 107 AFTR 2d 2011-898, (February 16, 2011)

- The executor of the Estate of Baccei retained an accountant to prepare the estate tax return.
- The accountant filed a Form 4768 “Application for Extension of Time to File a Return and/or Pay US Estate Taxes”.
- Form 4768 contains four parts. The accountant only completed three of the four parts. The accountant failed to complete the section entitled “Extension of Time to Pay,” he failed to enter an extension period in the space labeled “extension date requested” and he failed to check the box indicating that a payment extension was needed.
- The accountant reported that the estimated amount of estate tax due to be \$131,327. The actual tax due however was substantially more -- \$1,684,408.
- The accountant included the following explanation:

I believe the tax due is the sum of \$131,327, but the amount cannot be paid at this time for the following reason: There are more than adequate liquid assets in the Estate to pay the tax. However, due to the litigation, letters testamentary appointing Mr. Ronald B. Baccei were only approved on May 17, 2006. They were promptly delivered to the bank wherein most of the liquid assets are on deposit. The bank, however, has to date not approved the release of funds to Mr. Baccei as trustee so that the tax could be paid as such. We seek this extension of time to pay as well as asking that no penalty be asserted. The trustee has done all in his power to comply.

- The IRS determined that the payment was late and imposed a penalty of \$58,954 and interest of \$69,801.
- The taxpayer made several arguments in favor of penalty abatement:
 1. Doctrine of substantial compliance;
 2. Collateral estoppel; and
 3. Reliance on accountant—not due to reasonable cause and not due to willful neglect (I.R.C. § 6651(a)(2)).
- The court dismissed the taxpayer's and upheld the penalty.
- The court wrote that the taxpayer cannot rely on the substantial compliance doctrine to excuse his failure to properly request an extension of time to pay the estate tax because doing so would defeat the policies of the underlying regulatory provision. The regulation mandates that the application containing a request for an extension of time for paying the estate tax shall state the period of the extension requested.
- The taxpayer complained that the IRS should have notified him as to the deficiency of his request. However, the court states that IRS did not deny any payment extension request as the taxpayer never properly requested a payment extension in the first place.
- The court shot down the taxpayers "due to reasonable cause" argument as well. The failure to make a timely filing of a tax return is not excused by the taxpayer's reliance on an agent and such reliance does not constitute "reasonable cause."
- Lesson: complete the entire form.

D. Nathel v. Commissioner, 105 AFTR 2d 2010-2699 (June 2, 2010) cert denied (April 25, 2011).

- In Nathel, two brothers, Ira and Sheldon Nathel, along with Gary Wishnatzki, organized three corporations that elected to be taxed under Subchapter S. The three S corporations were organized to operate food distribution businesses in New York, Florida, and California. The Nathels each owned twenty-five percent of the corporations and Mr. Wishnatzki owned fifty percent.
- Capital Contributions increase stock basis not shareholder loan basis.
- Generally, S Corporation shareholders receive a stock basis equal to the amount of their capital contribution and when shareholders lend money to the S corporations the loan basis is equal to the amount loaned.

- Stock basis under I.R.C. § 1367 is increased pro rata per shareholder for items of income (including tax exempt) and decreased for losses (not below 0). If the stock basis is 0, loss items will decrease the loan basis, if there is income in excess of losses, then the loan basis is increased first. A distribution to a shareholder in excess of basis creates capital gain but a loan repayment in excess of basis results in ordinary income.
- The Nathels (“taxpayers”) and Mr. Wishnatzki personally guaranteed \$2.5 million in loans made by two banks. Ira and Sheldon Nathel each made personal loans in the amount of \$649,775 to one of the S Corps. The Nathels each had a zero basis in their stock. They each had a basis of \$116,000 in loans they made to the S corp.
- The Nathels received a combined total of \$1,622,050 in loan repayments from the two corporations and made a combined total of \$1,437,248 in capital contributions. The payment was made as part of a reorganization.
- The taxpayers argued that the capital contributions they made to two S corporations should be treated as items of "tax-exempt income" to the corporations for the purpose of restoring the reduced basis in loans they made to the corporations. As a result, the increased basis in the loans offset any ordinary income that would have received when the S corporations repaid the loans.
- Taxpayers further argued that because they made the capital contributions to obtain releases from personal loan guarantees made to one of the corporations, the capital contributions should be deductible as ordinary losses incurred in a transaction entered into for profit.
- The court decided in favor of the IRS and held that capital contributions to the S corporations did not constitute income to the S corporations and that such capital contributions did not restore or increase the brother's tax basis in their loans to the S corporations.
- The court also denied the taxpayers’ claim to characterize the capital contributions to the one corporation as losses incurred in a transaction entered into for profit.
- Supreme Court declined to grant certification.

E. Brown v. Commissioner, TC Memo 2011-83, (April 12, 2011)

- Mr. Brown owned a life insurance policy which accumulated cash value.
- The policy permitted Mr. Brown to borrow against the cash value. Any loan carried an interest charge of 8% per year. Any unpaid interest was capitalized.

- Mr. Brown paid several premiums by taking loans against the policy's cash value.
- After a number of years, the policy debt exceeded the cash value. The insurance carrier terminated the policy using the cash value to pay policy debt.
- Form 1099-R reported a distribution of \$ 37,365.06 and a taxable amount of \$29,093.30. Although the Browns received a 1099-R from the insurance carrier, the Browns did not report any gain or loss as a result of the policy's termination on their tax return. Mrs. Brown, who holds an LLM in tax, concluded that the 1099-R was received in error on the theory that there was no forgiveness of debt by the policy issuer.
- The IRS sent a deficiency notice concluding that the Brown's had taxable gain on the termination of the policy and also assessed an accuracy related penalty.
- First, the court held that the proceeds used to satisfy the debt against the policy were constructively received by the Browns. Next, the Browns argued that I.R.C. § 72(e)(2)(B) applied but the court said such amounts would not be excluded from gross income as the amount received was not in nature of a dividend or similar distribution but rather the policy's cash value. The court further determined that I.R.C. § 72(e)(5) applies which provides that amounts received under a life insurance contract are includable in gross income to the extent it exceeds the investment in the contract . (Note: investment in the contract is defined as the total premiums or other consideration paid less the total amount received under the contract to the extent such amounts were excludable from gross income.)

F. Sanders v. Commissioner, TC Memo, 2010-279, (December 20, 2010)

- In Sanders, the taxpayer's policy allowed loans up to the policy's cash value using the policy as security. Interest on the policy accrued at 8% per year and any accrued unpaid interest was capitalized. The policy terminated if any unpaid loan including accumulated interest exceeded the cash value and any dividends.
- The taxpayer borrowed against the policy and used the loans proceeds for personal purposes. The taxpayer did not repay the outstanding loan amount.
- The insurer terminated the contract using the entire cash value to pay the policy debt.
- The issue in dispute is whether a constructive distribution from a life insurance policy is income to the policy holder.
- The court found that the taxpayer had taxable income under I.R.C. § 72 to the extent that the policy loans and accrued interest exceeded the investment in the contract. The investment in the contract is defined generally as the aggregate amount of premiums or other consideration paid for the contract less aggregate

amounts previously received under the contract, to the extent they were excludable from gross income. I.R.C. § 72(e)(6). The court said that such event is equivalent to paying the taxpayer the policy proceeds and using the proceeds to pay off the outstanding loan.

V. The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 ("TRA")

A. TRA was signed into law on December 17, 2010 and contains estate, gift and generation skipping transfer tax provisions as well as income and employment tax provisions. The act covers the years of 2010 through 2012. On December 31, 2012, at the stroke of midnight, the act sunsets.

1. Overview of Key Transfer Tax, Income and Employment Tax Changes:

a. Transfer Tax Provisions: Gift, Estate and Generation Skipping Transfer ("GST") Tax

(1) 2010

- (a) The gift tax lifetime exemption amount is \$1M, with a 35% gift tax rate. Annual exclusion gifting is still available and is \$13,000 per donee per year.
- (b) The federal estate tax has been retroactively reinstated for 2010 but with an increased exemption of \$5 million, a maximum estate tax rate of 35% and a step-up in basis.
- (c) For estates with decedents who died in 2010, the executors of such estates have a choice—they can proceed under the new provisions (\$5 million exemption, 35% estate tax rate and receive a full “step-up” in basis for the estate assets) or may elect to proceed under the prior 2010 provisions (no estate tax and “carry over basis” provisions with some “step-up” in basis provisions). Executors have 9 months from the date of enactment of the Tax Relief Act to make such an election (except those who died in 2010 after the date of enactment) and should consult with their attorneys to determine the best course of action.
- (d) GST taxable transfers have a \$5M exemption and a tax rate of 0%.

- (e) Extension of time to file returns and make disclaimers. There is also an extension of time to pay the 2010 estate tax.
- (2) 2011-2012
 - (a) New Exemption Amount and Rate: \$5 M Basic Exclusion Amount for Gift, Estate and GST Tax. The maximum federal gift, estate and GST tax rate is 35%.
 - (b) Reunification of the Gift and Estate Tax.
 - (c) Portability of Exclusion Amount for Gift and Estate Tax with spouse.
 - (d) Step up in basis on death.
 - (e) Indexing the basic exclusion amount for inflation starting in 2012.
 - (f) Annual exclusion gifts of \$13,000 per donee, per year.
- (3) 2013 (If Congress does not act)
 - (a) TRA sunsets
 - (b) \$1M exemption amount
 - (c) Gift, estate and GST tax rate of 55%
 - (d) Portability disappears
- b. Miscellaneous Tax Provisions under TRA (Income and Employment Tax)
 - (1) Income Tax:
 - (a) The current, favorable income tax rates will be retained for two years (2011 and 2012), with a top tax of 35% on ordinary income and 15% on qualified dividends and long-term capital gains.
 - (b) Key tax credits for working families that were enacted or expanded in the American Recovery and Reinvestment Act of 2009 are retained. For example, the new law extends for two years (a) the

\$1,000 child tax credit (and maintains its expanded refundability), and (b) the American Opportunity tax credit for higher education, and its partial refundability.

- (c) Two crackdowns on deductions for higher-income people have been deferred. For 2011 and 2012, higher-income individuals will not face a reduction in their itemized deductions or a phase out of personal exemptions.
- (d) A two-year AMT “patch” for 2010 and 2011 provides a modest increase in AMT exemption amounts and allows personal nonrefundable credits to offset AMT as well as regular tax. The patch does not carry forward to 2012.
- (e) IRA Charitable Rollover is extended for two years through 2011. This provision allows taxpayers over 70 ½ years of age who are charitably minded to transfer up to \$100,000 of their IRA to a qualified public charity. There is no income tax triggered (so there is no income tax deduction). The transfer can also be counted as a minimum required distribution.
- (f) Businesses now have certain opportunities with respect to the purchasing of property for their businesses in 2011 and 2012 due to increased exemption amounts under Code Section 179 and also with respect to first year bonus depreciation on such business property. Business owners should consult with us with respect to the advantages of purchasing business property in 2011 and 2012.

(2) Payroll Tax

- (a) Employees and self-employed workers receive a reduction of two percentage points in Social Security tax in 2011, bringing the rate down from 6.2% to 4.2% for employees, and from 12.4% to 10.4% for the self-employed.
- (b) There is no like reduction for Employers.

2. Key Provisions :

a. Portability:

Deceased spousal unused exclusion amount.

I.R.C. § 2010(c)(4).

For purposes of this subsection , with respect to a surviving spouse of a deceased spouse dying after December 31, 2010, the term “deceased spousal unused exclusion amount” means the lesser of—

(A) the basic exclusion amount, or

(B) the excess of—

(i) the basic exclusion amount of the last such deceased spouse of such surviving spouse, over

(ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse.

- (1) Election to achieve “portability” of the estate tax exemption between spouses.
- (2) Effective for estates of decedent's dying after December 31, 2010. Unless Congress acts, portability only applies in 2011 and 2012.
- (3) The executor must make an election on the first spouse’s death to use such deceased spouse’s remaining exemption amount (even if a Federal estate tax return is not otherwise required, one should be filed making this election). This means that if the first spouse dies and does not use all of his or her \$5 million exemption, the decedent spouse’s estate may elect on a timely filed Form 706 to permit the surviving spouse’s estate to use any remaining exemption. For example, if husband dies and only \$3 million of exemption is used in his estate, when the surviving wife dies, wife's estate not only has wife’s \$5 million of exemption available, it also has deceased husband’s remaining exemption of \$2 million for a total of \$7 million. However, if the surviving spouse remarries and her new spouse dies, she only receives the last deceased spouse's remaining exemption amount. She is not allowed to use her first deceased spouse's remaining exemption amount.
- (4) For those who have not done any estate tax planning, it offers an opportunity to use a prior spouse's unused exemption amount.

- (5) Assets will receive a step-up in basis upon the surviving spouse's death.
- (6) A downside however, is that any appreciation in such assets are fully taxable on the surviving spouse's death. Whereas assets held in a by pass/credit shelter trust that passed on the death of the second spouse are free from estate tax. Any appreciation build-up between deaths is not taxed.
- (7) Assets are not protected from creditors or a second spouse if a surviving spouse should remarry. If the spouse owns all assets outright, the surviving spouse can dispose of them to whomever he or she pleases.
- (8) Relying solely on portability as an estate planning technique can result in the loss of first spouse's generation skipping transfer tax exemption. Portability is not available for the GST Tax. It may be used for gift taxes however.