2017 FEDERAL TAX UPDATE

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

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These materials summarize important developments in the substantive federal income, estate and gift tax laws affecting individual taxpayers and small businesses using the timeframe of August, 2016, through August, 2017. The materials are organized roughly in order of significance. These materials generally do not discuss developments in the areas of deferred compensation or the taxation of business entities (except to a very limited extent).

INDIVIDUAL FEDERAL INCOME TAXES FOR 2017
(Adapted from Rev. Proc. 2016-55)

Taxable Income Exceeding		**2016 Federal Income Tax Rates for Individuals**			
Unmarried	Joint	Ordinary Income	Adjusted Net Cap Gain* & Qualified Dividends	Medicare Surtax on Earned Income**	Medicare Surtax on Net Investment Income
$0	$0	10%			
$9,325	$18,650	15%			
$37,950	$75,900	25%			
$91,900	$153,100	28%			
$191,650	$233,350				
*AGI over $200,000****	*AGI over $250,000****				
$416,700	$416,700	35%			
$418,400	$470,700	39.6%	20%		

* Other long-term capital gains could be taxed as high as 25% (building recapture) or 28% (collectibles and §1202 stock).
** Includes employer contribution of 1.45% (§3111(b)(6)), individual contribution of 1.45% (§3101(b)(1)), and additional tax of 0.9% for adjusted gross income over $200,000 for an unmarried individual and $250,000 on a joint return (§3101(b)(2), for years after 2012).
*** Note too that unmarried individuals with adjusted gross incomes in excess of $254,200 and joint filers with adjusted gross incomes in excess of $305,050 are subject to the phase-out of both personal exemptions and itemized deductions.

A. WILL TAX REFORM EVER HAPPEN?

On September 27, 2017, members of the Trump Administration, the House Ways and Means Committee, and the Senate Finance Committee unveiled the Unified Framework for Fixing Our Broken Tax Code, setting forth the broad themes for tax reform: business tax relief, simplification, and repatriation of foreign capital. A look at the central provisions of those plans might give some indication where the law is heading.

1. Key Provisions of the Unified Framework

Competitiveness and Growth for Job Creators

- Reduce top C corporation income tax rate from 35% to 20%
- Reduce the top rate for “small and family-owned businesses conducted as sole proprietorships, partnerships, and S corporations” from 39.6% to 25%
- Allow immediate expensing of depreciable assets (other than buildings) purchased after September 27, 2017, and keep this rule in place for five years
- “Partially limit” the “deduction for net interest expense incurred by C corporations”

Global Competitiveness

- 100% exemption for dividends paid to United States shareholders that own 10% or more of a foreign subsidiary
- Treat previously accumulated foreign earnings as taxable repatriations taxed over a period of several years, with lower rates on earnings held in illiquid assets
- Tax foreign profits of a United States company at a reduced rate

Relief and Simplification for Individuals

- Consolidate from seven to three (possibly four) brackets
  - 12%
  - 25%
  - 35%
  - “An additional top rate may apply to the highest-income taxpayers to ensure that the reformed tax code is at least as progressive as the existing tax code and does not shift the tax burden from high-income to lower- and middle-income taxpayers”
- Individual standard deduction of $12,000 (as opposed to current $6,300)
  - No personal exemptions
  - Eliminate most itemized deductions but keep the ones for home mortgage interest and charitable contributions
- Increase child tax credit and impose higher thresholds before phaseout
- Repeal the individual alternative minimum tax as well as “the death tax and the generation-skipping transfer tax”

2. The Meaning of "Repeal the Death Tax"

In implementing repeal of "the death tax," Congress will have to consider several important issues, principally including the following:

What is the timing and effective dates of repeal? Will repeal be immediate or something phased in over several years? Will repeal (or a phase-out) be retroactive or prospective? Will repeal be permanent or scheduled to sunset?

Will the gift tax also be repealed? When the estate tax was repealed in 2010, the federal gift tax remained (with a $1 million exemption and 35% tax rate). This suggests the taxes are not as "unified" as their shared credit and tax table might suggest. Indeed, the Unified Framework says nothing about repealing the federal gift tax.

Will there still be a stepped-up basis? In 2010, estates electing out of the application of the estate tax faced a "modified carryover basis" regime under which the estate received an additional $1.3 million of basis to add to the carryover basis of assets passing at death. Perhaps Congress will do something similar if the estate tax is repealed. Even if the stepped-up basis continues, will §1014(b)(9) continue to be relevant? (This is the rule that confers a stepped-up basis to all property included in the decedent's gross estate for estate tax purposes, regardless of whether the estate has to pay gift tax. This has been of great benefit to more modest estates that have used gross estate inclusion to achieve a stepped-up basis for income tax purposes.)

What happens to trusts funded with reference to exclusion amounts or deductions that would no longer exist? If a decedent's will uses the "applicable exclusion amount" to determine the amount passing to a credit shelter trust, for example, but there is no "applicable exclusion amount," how is the trust to be funded?

B. NEW AMNESTY PERIOD FOR PORTABILITY ELECTIONS (*Revenue Procedure 2017-34*, June 9, 2017)

A surviving spouse may add a deceased spouse's unused applicable exclusion amount to his or her own basic exclusion amount for federal estate and gift tax purposes if the deceased spouse's executor timely files a federal estate tax return. If the return is not timely filed, the executor and the surviving spouse may seek §9100 relief, though that requires both a fee and a good excuse. Inundated with requests for relief from the consequences of a late portability election, the Service has announced a policy effective June 9, 2017. Revenue Procedure 2017-34 permits an automatic extension of time to make a portability election until the later of January 2, 2018, or the second anniversary of the deceased spouse's death.

This new timeframe applies only to "portability-only" estate tax returns (i.e., where an estate tax return is not already required because of the size of the gross estate). An estate utilizing this amnesty period must print "FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY

UNDER § 2010(c)(5)(A)" at the top of the estate tax return (to be safe, it should be shouting in ALL CAPS since that's what the guidance provides).

The Revenue Procedure specifically states that the amnesty period does not serve to extend the statute of limitations for purposes of making a refund claim. But if the statute of limitations has not run, the executor of the *surviving spouse's* estate may make a protective claim for refund in anticipation of an estate tax return being filed under this new amnesty regime.

The Revenue Procedure notes that where the amnesty period has passed, the executor may still seek §9100 relief for a late election.

C. SMALLER ESTATES CAN USE QTIP TRUSTS TO OBTAIN STEPPED-UP BASIS (*Revenue Procedure 2016-49*, September 27, 2016)

Married couples with a combined net worth of $5.49 million or less have no federal wealth transfer tax planning issues. For them, it is crucial that planners get the income tax planning piece right. And that means ensuring everything gets a fresh-start, fair market value basis for income tax purposes upon the surviving spouse's death.

Where couples choose to let assets pass to the surviving spouse by **outright gift**, the step-up in basis on the surviving spouse's death is assured since the spouse owns everything. Obtaining a stepped-up basis for everything on the surviving spouse's death is more complicated where the couple decides to have assets pass from the first spouse to die via a **trust**. If structured as a typical irrevocable trust, the assets of the trust will not receive a stepped-up basis on the death of the surviving spouse because those assets are not included in the surviving spouse's gross estate for estate tax purposes. For couples with modest estates using trusts, therefore, the key is to create a trust causes inclusion of the trust assets in the survivor's gross estate. Gross estate inclusion is not an adverse result here, recall, because federal wealth transfer taxes are not an issue: even if everything is included in the surviving spouse's gross estate, the total size of the estate is less than the surviving spouse's basic exclusion amount.

There are at least two ways to structure a trust so that it results in gross estate inclusion, thus assuring that the assets get a stepped-up basis on the surviving spouse's death. First, the trust instrument can give the surviving spouse a testamentary power to appoint all or any portion of the trust estate to the surviving spouse's estate. This is a **general power of appointment**, and property subject to a general power of appointment is generally includible in the gross estate of the power-holder. Second, the trust can be structured to qualify for the qualified terminable interest property ("**QTIP**") exception to the terminable interest rule. If a trust meets the requirements for a QTIP election and the executor of the estate of the first spouse to die properly makes the QTIP election, the assets remaining in trust upon the death of the surviving spouse will be included in the surviving spouse's gross estate, thus assuring here too that the assets qualify for a stepped-up basis.

Some practitioners had been concerned that the Service might disregard QTIP elections made by the estate of a Bucket One deceased spouse on the grounds that the QTIP election was not necessary to avoid imposition of federal estate tax. In **Revenue Procedure 2016-49** (issued September 27, 2016), however, the Service made clear that it would not disregard a valid QTIP election unless requested to do so by the executor. This makes the QTIP trust a safe vehicle for obtaining a stepped-up basis upon the death of the surviving spouse, at least for now.

D. BAD FACTS, BAD ARGUMENTS, AND BAD OPINIONS MAKE FOR, WELL, A BAD RESULT (*Estate of Powell v. Commissioner*, 148 T.C. No. 18, May 18, 2017)

Acting as agent under a power of attorney, Nancy Powell's son caused Nancy's living trust to transfer $10 million in cash and marketable securities to a newly-formed family limited partnership in exchange for a 99-percent limited partner interest. (The opinion doesn't mention this, but rumor has it Nancy's two sons contributed promissory notes in exchange for a one-percent general partner interest.) Nancy's son then cause the living trust to donate the 99-percent limited partner interest to a charitable lead annuity trust (CLAT) that would pay a fixed dollar amount to Nancy's private foundation for Nancy's life. At Nancy's death, the corpus of the CLAT would pass to the two sons in equal shares. The federal gift tax return filed in connection with these events claimed that the 99-percent limited partner interest was worth $7.5 million and the value of the CLAT remainder was $1.66 million.

Problem is, Nancy died seven days later. The Service made several arguments against the transaction, some of which logically are alternative positions: (1) because Nancy was terminally ill, it was improper to use the §7520 tables to value the CLAT remainder; (2) the value of the CLAT remainder was in fact $8.3 million since the limited partnership interest was worth $8.5 million; (3) Nancy's son lacked the power to transfer the partnership interests to the CLAT because the power of attorney permitted him to make only annual exclusion gifts; and (4) Nancy's gross estate should include the full $10 million in assets transferred to the trust because §2036(a) applied.

On the §2036(a) argument, the estate conceded that Nancy effectively retained an interest in the contributed assets. The estate also conceded that the bona fide sale exception (based on having a "substantial non-tax business purpose" for the formation of the entity) did not apply on these facts. Instead, the estate claimed there was no basis for gross estate inclusion since Nancy's trust did not own the partnership interest at death. The Tax Court observed that even if the transfer to the CLAT was valid, §2035(a)'s three-year rule would require inclusion of the limited partner interest. Thus, under either §2035 or §2036(a), there is inclusion in Nancy's gross estate. On this point, the Tax Court was unanimous.

But then comes a division within the court. Judge Halpern's majority opinion establishes a new framework for defining what exactly is included when §2036(a) applies to a family limited partnership. In Judge Halpern's view, there is a concern that where §2036 (or §2035) applies to a family limited partnership, double-inclusion of the partnership assets could result (i.e., that the estate could include both the $10 million in assets *and* the $8.5 million limited partner interest). The majority opinion alleviates any concern by saying Nancy's gross estate includes the value of

the partnership interest ($8.5 million) under §2033 and the amount of the discount ($1.5 million) under §§2035, 2036, and 2043 (§2043, the partial consideration rule, reduces the $10 million value of the contributed assets by the $8.5 million limited partner interest that Nancy's trust received in exchange for the contribution). Thus the total inclusion is $10 million, which is equal to the value of the transferred assets.

The concurring opinion from Judge Lauber doesn't see the need for this new framework. Prior cases applying §2036(a) to family partnerships simply disregard the partnership and include the contributed assets in the decedent's gross estate. Since this gives the same result as the majority's two-step dance in every situation, Judge Lauber thinks it better to stick with existing precedent, especially since neither of the parties mentioned the double-inclusion "concern" throughout their dispute. As Judge Lauber states, the majority's new framework "seems to me a solution in search of a problem."

Judge Halpern's majority opinion had the support of seven other judges (thus, eight total). Six other judges joined Judge Lauber's concurring opinion (seven total). The two remaining judges concurred only in the result and joined neither opinion. As a result, the future of Judge Halpern's "clarifying" two-step approach is uncertain.

E. IN MEMORIAM: PROPOSED §2704 REGULATIONS TOOK AIM AT CERTAIN DISCOUNTS, BUT EVERYONE INSTEAD TOOK AIM AT THE PROPOSED REGULATIONS

1. Introduction and Effective Dates

On August 2, 2016, Treasury issued long-awaited (and long-feared) proposed regulations under §2704. None of these new rules (Proposed Regulation §§25.2704-1 through 25.2704-3) will take effect until the regulations are finalized (indeed, the more controversial provisions have an effective date that is 30 days after the date the regulations are finalized). Given the Trump Administration's freeze on federal regulations and the expected content of tax reform, however, conventional wisdom has it that these proposed regulations are dead. But proposed regulations are like soap opera characters and zombies: they never really die. Practitioners still need to be aware of how the regulations work, just in case they rise from the grave.

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

2. Section 2704(a) Background

Under §2704(a)(1), some lapses in voting, liquidation, or similar rights in a "controlled" corporation or partnership are treated as transfers of those rights by the holder. If the lapse

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

An example might help. Suppose George was a partner in a limited partnership. At his death, George held both a general partner interest and a limited partner interest. The general partner interest carried with it the right to liquidate the partnership; the limited partner interest had no such power. Accordingly, the value of the limited partner interest was $59 million if it was held jointly with the general partner interest but only $33 million if it was held alone. A buy-sell agreement between George and his son, William Henry, required George's estate to sell the general partner interest to William Henry for $750,000. Absent §2704(a), the value of the limited partner interest included in George's estate would be $33 million, for the right to liquidate the partnership lapsed at death due to the obligation to sell the general partner interest to William Henry. This was the holding of *Estate of Harrison v. Commissioner*, T.C. Memo. 1987-8. But now §2704(a) applies, assuming George and members of his family (including William Henry) controlled the partnership before and after George's death. Accordingly, George is treated as having made a transfer of $26 million (the excess of the $59 million value of the limited partner interest assuming the liquidation right was non-lapsing over the $33 million value of the limited partner interest after the lapse) at death, and that extra $26 million is also included in George's gross estate.

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

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

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

> D owns 84 percent of the single class of stock of Corporation Y. The by-laws require at least 70 percent of the vote to liquidate Y. More than three years before D's death, D transfers one-half of D's stock in equal shares to D's three children (14 percent each). Section 2704(a) does not apply to the loss of D's ability to liquidate

Y because the voting rights with respect to the transferred shares are not restricted or eliminated by reason of the transfer, and the transfer occurs more than three years before D's death. However, had the transfers occurred within three years of D's death, the transfers would have been treated as the lapse of D's liquidation right occurring at D's death.

4. Section 2704(b) Background

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

An "applicable restriction" is any limitation on the entity's ability to liquidate that either lapses to any extent after the transfer or can be removed after the transfer by the transferor or any member of the transferor's family. For instance, assume Wendy and Peter, a married couple, own general partner and limited partner interests in a limited partnership. Under their partnership agreement, Wendy and Peter have agreed that the partnership can be liquidated only with the written consent of all partners, though this restriction on liquidation may be removed by a unanimous vote of the partners. Wendy transfers her limited partner interest to her son, Michael. All of the requirements of §2704(b)(1) are met, for Wendy has transferred to her son an interest in the partnership controlled by Wendy and her husband. Thus the value of the limited partner interest transferred to Michael must be determined without regard to the restriction that the partnership may be liquidated only with the consent of all partners, because this restriction can be removed upon the vote of Wendy, Peter, and Michael, all members of the same family.

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

5. Proposed Regulations Eliminate Comparison to State Law

The current regulations restrict the scope of §2704(b) to limits "on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction." The preamble to the proposed regulations observe that some states have, in response to this regulation, changed their statutes to allow liquidation only upon a unanimous vote of all owners and to

eliminate existing laws that allowed limited partners the right to liquidate their interests in a partnership. That makes Treasury mad. In response, the proposed regulations remove the restriction in the current regulations that limits the definition of "applicable restrictions" to those that are more restrictive than under applicable state law. Indeed, the proposed regulations go on to state that an "applicable restriction" includes any restriction imposed under the entity's governing documents or under local law "regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise."

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

> A provision of law that applies only in the absence of a contrary provision in the governing documents or that may be superseded with regard to a particular entity (whether by the [owners] or otherwise) is not a restriction that is imposed or required to be imposed by federal or state law. A law that is limited in its application to certain narrow classes of entities, particularly those types of entities (such as family-controlled entities) most likely to be subject to transfers described in section 2704, is not a restriction that is imposed or required to be imposed by federal or state law. For example, a law requiring a restriction that may not be removed or superseded and that applies only to family-controlled entities that otherwise would be subject to the rules of section 2704 is an applicable restriction. In addition, a restriction is not imposed or required to be imposed by federal or state law if that law also provides (either at the time the entity was organized or at some subsequent time) an optional provision that does not include the restriction or that allows it to be removed or overridden, or that provides a different statute for the creation and governance of that same type of entity that does not mandate the restriction, makes the restriction optional, or permits the restriction to be superseded, whether by the entity's governing documents or otherwise.

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

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

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

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

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

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

Combine the four disregarded restrictions and it appears that, for example, a limited partner interest subject to §2704(b) would be valued under the assumptions that the holder could cash it in at any time for its full liquidation value, with such amount to be paid in full in cash or other property within six months. At various conferences in the fall of 2016, Treasury officials assured professionals that this was not the intended reading of the proposed regulations.

7. Death to the Proposed Regulations?

Based on the (literally) thousands of comments submitted on the proposed regulations, it seemed quite likely that a new draft of the regulations was in the works. But then, in an Executive Order issued early in his administration, President Trump called for a halt on all federal regulatory projects. That was followed by another Order issued in April instructing the Treasury Secretary to review all "significant tax regulations" issued in 2016 and 2017 and submit two reports. The first one must identify those that "(i) impose an undue financial burden on U.S. taxpayers; (ii) add undue complexity to the Federal tax laws; or (iii) exceed the statutory authority of the Internal Revenue Service." The second one must recommend specific actions to mitigate the burden imposed by the identified regulations.

In *Notice 2017-38*, designed to serve as the first required report, Treasury identified eight such regulations, and the proposed §2704 regulations were on that list. The Notice observed: "Commenters expressed concern that the proposed regulations would eliminate or restrict common discounts, such as minority discounts and discounts for lack of marketability, which would result in increased valuations and transfer tax liability that would increase financial burdens. Commenters were also concerned that the proposed regulations would make

valuations more difficult and that the proposed narrowing of existing regulatory exceptions was arbitrary and capricious."

The Notice ends by soliciting comments, due in early August. One suspects that the second report will recommend withdrawal of the proposed regulations, a recommendation that will likely serve as the coffin's final nail.

F. DIRTY PAINTINGS AREN'T WORTH THAT MUCH LESS (*Estate of Eva Franzen Kollsman v. Commissioner*, T.C. Memo. 2017-40, February 22, 2017)

The decedent owned two 17th-century Old Master paintings at the time of her death in 2005. One, "Dance Around the Maypole," was by Peter Brueghel the Younger; the other, "Orpheus Charming the Animals," was by Jan Brueghel the Elder. On the estate tax return, the estate claimed the value of the Maypole painting was $500,000 and the value of the Orpheus painting was $100,000. But in its notice of deficiency, the Service valued Maypole at $1.7 million and Orpheus at $300,000. And by the time the case reached the Tax Court, the Service argued Maypole was worth $2.1 million and Orpheus was worth $500,000. The increase stemmed largely from a post-death sale of Maypole for $2,100,000.

The estate defended its position by arguing the paintings surged in value after the decedent's death because of the increased demand for works from the Old Masters and because both of the paintings were cleaned. But the court ruled that the appraisal from the estate (prepared by Sotheby's) lowballed the value of the paintings to curry favor with the estate so that the estate would use the appraiser to sell the works. The court found it "remarkable" that the Sotheby's appraisal included no comparables, unlike the appraisal from the Service's expert. Although the court adopted the conclusions of the Service's expert, it did award a modest discount for the cost of cleaning the paintings. That brought the final value of the painting down to $1,995,000. It gave a larger discount to Orpheus (finding a date of death value of $375,000) due mostly to uncertainty as to the authenticity of the work.

G. DEDUCTION FOR DONATION OF AIRCRAFT FLIES OUT THE WINDOW (*Izen v. Commissioner*, 148 T.C. No. 5, March 1, 2017)

Joe and Phillipe purchased a used jet in 2007 for $42,000. Joe's 2010 tax return showed a lot of gross income. During an audit of the 2010 return, Joe claimed for the first time that he and Phillipe donated the jet to the Houston Aeronautical Heritage Society. In 2016, Joe filed an amended return for 2010 claiming the value of his share of the contribution to be $338,000. The Service denied the deduction on the grounds that Joe did not furnish adequate substantiation. Specifically, the Service determined Joe failed to obtain contemporaneous written acknowledgment from the charity. There was a thank you letter, but it was addressed to Phillipe and not to Joe. There was a donation agreement signed by all parties, but that does not constitute an acknowledgment from the charity, in part because it does not indicate whether the charity furnished any goods or services in consideration of the contribution. No documents included Joe's social security number, and there was never any written statement from the charity

indicating its intended use of the plane. For all of these reasons, the Tax Court had little trouble concluding the Service was right to disallow the deduction.

H. SAME-SEX MARRIED COUPLES CAN RETROACTIVELY CLAIM MARITAL DEDUCTIONS AND RECALCULATE GST EXEMPTIONS (*Notice 2017-15*, January 17, 2017)

Prior to 2013, remember, same-sex marriages were not recognized for federal tax purposes. That meant individuals in same-sex marriages could not claim the marital deduction for gifts and bequests, and they could not use the family generational assignments for generation-skipping transfer tax purposes (they instead had to use the relative ages of the donor and donee to determine whether someone was a skip person). But the *Windsor* case recognized valid same-sex marriages for federal tax purposes, and regulations finalized in 2016 redefined "spouses" to include same-sex couples.

The Service has taken the next step, announcing that same sex-couples who were validly married under state law at the time of a gift from one spouse to another can claim the marital deduction for gift tax purposes. In addition, the marital deduction can be claimed for transfers to a same-sex spouse at death. Importantly, spouses can claim the deduction even if the statute of limitations has run on the return reporting the relevant transfer. As a result, the applicable exclusion amount of a transferor spouse, as well as the deceased spousal unused exclusion amount available to the surviving spouse, may be recalculated.

To take advantage of the retroactive deduction, taxpayers who made gifts to a same-sex spouse should file a new or amended federal gift tax return using a new worksheet and instructions that the Service will release for this purpose. Executors may likewise amend or revise any estate tax return for a deceased same-sex spouse, but in order to make a QTIP or QDOT election an executor may have to seek Reg. §301.9100-3 relief if the statutory review period has already lapsed. While this announcement is helpful in restoring lost exclusion amount, same-sex couples may not make a refund claim for taxes paid if the statute of limitations has expired.

The Service also announced that any allocation of generation-skipping transfer tax exemption made in the past that ignored the marital status of same-sex spouses may be voided, and the exemption may be recalculated even if the statute of limitations has run. Here too the recalculation is made on a new or amended Form 709, or on the Form 706 in the case of a decedent.

The Notice only covers same-sex couples that were validly married at the time of transfer. Couples in registered domestic partnerships, civil unions or other non-marital relationships are not eligible for retroactive application of the marital deduction or recalculation of the GSTT exemption.

I. RULE REQUIRING REGULATIONS IS NOT SELF-EXECUTING, SO TAXPAYER'S MOTION FOR SUMMARY JUDGMENT DENIED IN CASE INVOLVING $64.5 MILLION DEDUCTION (*15 West 17th Street LLC v. Commissioner*, 147 T.C. No. 19, December 22, 2016)

The taxpayer donated a conservation easement in a Manhattan building to the Trust for Architectural Easements (a qualified charity), and claimed a charitable contribution deduction of $64,490,000 on its 2007 return. Because the deduction exceeded $250, the taxpayer had to obtain a "contemporaneous written acknowledgment" from the donee stating, among other things, whether the donee provided the donor with any goods or services in consideration of the gift. The taxpayer received an acknowledgment letter, but the letter did not state whether the charity had provided any goods or services in exchange for the easement. That's troubling. But §170(f)(8)(D) provides that a contemporaneous written acknowledgment is not required "if the donee organization files a return, on such form and in accordance with such regulations as the Secretary may prescribe," that includes the information required to be shown on a contemporaneous written acknowledgement.

The taxpayer's 2007 was selected for examination. The Service likely smelled a rat given the taxpayer acquired the building just over two years before the contribution for $10 million and now claimed a charitable deduction of over $64 million. It denied the taxpayer's deduction on the grounds that the taxpayer did not have a contemporaneous written acknowledgment from the charity.

After the taxpayer filed its petition with the Tax Court, the charity filed an amended 2007 return that disclosed the taxpayer's gift and included a statement that the charity had no provided no goods or services in consideration (the original 2007 return from the charity made no mention of the taxpayer's transfer). Believing this amended return complied with §170(f)(8)(D) and thus eliminated the need for a contemporaneous written acknowledgement, the taxpayer filed for a partial summary judgment.

The Service argued that §170(f)(8)(D) is not "self-executing." In other words, said the Service, it will only come to life if and when Treasury publishes the regulations to which the statute refers. Since there are no regulations under §170(f)(8)(D) in effect (proposed regulations issued in 2015 were withdrawn in 2016), this option is not open. The Tax Court (11-6) agreed, finding the rulemaking authority in §170(f)(8)(D) to be discretionary and not manadatory. Had the statute made the rulemaking authority mandatory ("the Secretary shall prescribe regulations…"), observed the Tax Court majority, there is authority for the position that the statute would be self-executing. Concludes the majority, there is "no case in which a court has held to be self-executing a Code provision containing a discretionary delegation that refers to regulations that the Secretary 'may prescribe.' Conversely, every judicial decision that has held a Code provision to be self-executing in the absence of regulations has involved a mandatory delegation that included the word 'shall.'" Since §170(f)(8)(D) is thus not yet in effect, the taxpayer could not rely on the amended 2007 return from the charity to substitute for the requirement of a contemporaneous written acknowledgment.

In dissent, Judge Foley claims the discretionary grant of regulatory authority applies only to *how* a charity may file a return that can substitute for a contemporaneous written acknowledgement and not to *whether* a charity may do so. Thus he reads §170(f)(8)(D) as in existence, subject only to Treasury's ability to dictate the form of the charity's report. And since Treasury has not yet done so, the charity here did the best it could to comply with the statute. As Judge Gustafson added in a separate dissent, the Tax Court "should not give to Treasury the power to veto §170(f)(8)(D) by regulatory inaction—a power that Congress did not grant—and thereby deprive taxpayers of a means that Congress did grant."

J. HOW DID A $33 MILLION DONATION GET DISALLOWED? IT'S ALL ABOUT THAT BASIS (*Reri Holdings I, LLC*, 149 T.C. No. 1, July 3, 2017).

The taxpayer, a limited liability company, purchased a remainder interest in real property for just under $3 million in 2002. The next year, it donated the remainder interest to the University of Michigan. The LLC's tax return claimed a $33 million deduction for the donation. Alas, the Form 8283 appraisal summary attached to the 2003 return showed no amount in the space provided for the "Donor's cost or other adjusted basis." The Service denied the deduction for lack of adequate substantiation.

The Tax Court held that the Service was right to disallow the deduction. The taxpayer claimed that it had substantially complied with the substantiation requirements, but the court was unmoved. Had the taxpayer disclosed the $3 million basis in the property, reasoned the court, the Service would have been alerted to a potential overvaluation of the property. Leaving off the basis information prevented the Form 8283 from fulfilling its intended purpose, so there was no grounds for claiming substantial compliance.

But it gets worse. The court also upheld application of a gross valuation misstatement penalty, finding that the value of the donated remainder was about $3.4 million instead of the claimed $33 million. The taxpayer argued for a reasonable cause exception to the penalty but the court found the taxpayer did not make a good faith investigation into the property's value. "The taxpayer must do more than simply accept the result of a qualified appraisal."

K. NEW EXCLUSION FOR OLYMPIC MEDALS AND RELATED PRIZE MONEY (Public Law 114-239, October 7, 2016)

Section 74(a) generally requires the inclusion of a prize or award in gross income. The statute contains isolated exceptions for things like employee achievement awards and prizes that are donated to charity in advance of receipt. But prior to 2016 there was no exclusion for Olympic medals. The United States Appreciation for Olympians and Paralympians Act of 2016 added the following new §74(d), applicable to prizes and awards received after 2015:

(d) EXCEPTION FOR OLYMPIS AND PARALYMPIC MEDALS AND PRIZES.—

(1) IN GENERAL.—Gross income shall not include the value of any medal awarded in, or any prize money received from the United States Olympic Committee on account of, competition in the Olympic Games or Paralympic Games.

(2) LIMITATION BASED ON ADJUSTED GROSS INCOME.—

(A) IN GENERAL.—Paragraph (1) shall not apply to any taxpayer for any taxable year if the adjusted gross income (determined without regard to this subsection) of such taxpayer for such taxable year exceeds $1,000,000 (half of such amount in the case of a married individual filing a separate return).

(B) COORDINATION WITH OTHER LIMITATIONS.—For purposes of sections 86, 135, 137, 199, 219, 221, 222, and 469, adjusted gross income shall be determined after the application of paragraph (1) and before the application of subparagraph (A).

L. *GRAEGIN* LOAN GONE WRONG: UNNECESSARY LOANS DON'T GENERATE INTEREST EXPENSE DEDUCTIONS, AND "DONE DEAL" REDEMPTIONS AFFECT VALUE OF DECEDENT'S INTEREST (*Estate of Koons v. Commissioner*, 11th Circuit, April 27, 2017)

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.

On appeal, the Eleventh Circuit affirmed. While the *Estate of Graegin* case generally permits estates to claim an estate tax deduction for future interest payment expenses, it requires that the loan be "actually and necessarily" incurred to help the estate meet its expenses. Here, not only did the estate have plenty of liquid assets, but it secured a loan that would eventually be repaid using the very same liquid assets that could have been used to pay the tax liability. The appellate court observed that the result might have been different if the estate had structured the loan using a more commercially reasonable repayment schedule, or if it had a better explanation for why the $200 million in assets was so vital to the company's future.

M. BARGAIN SALE YIELDED NO CHARITABLE CONTRIBUTION DEDUCTION (*Fakiris v. Commissioner*, T.C. Memo. 2017-126, June 28, 2017).

In 2001, the taxpayer's LLC paid $700,000 to purchase a dilapidated movie theater in Staten Island. The taxpayer had wanted to tear down the theater and replace it with a highrise building, but he encountered substantial community opposition. Along came the Richmond Dance Ensemble, a nonprofit organization that had yet to obtain its tax-exempt status as a charity. The taxpayer was willing to make a bargain sale of the theater to the Richmond Dance Ensemble but was nervous that the organization was not yet tax-exempt. So the parties worked out an arrangement through which the LLC would convey the property to another charity, WEMGO Charitable Trust, which would then convey the property to the Richmond Dance Ensemble. That transaction went down in 2004, with WEMGO paying $470,000 to the LLC.

One provision of the bargain sale contract stated that WEMGO "shall be prohibited from selling the premises for the first five (5) years after delivery of the deed. Notwithstanding the aforesaid, Seller may transfer the premises to Richmond Dance Ensemble Inc. once it receives its 501C(3) [sic] status from the Internal Revenue Service. The provisions of this paragraph shall survive closing." Relying on this provision, the Service determined that the transfer was not a completed gift because of the seller's retained ability to redirect transfer of the property to Richmond Dance

Ensemble. That meant the taxpayer was not entitled to a charitable contribution deduction, and that the taxpayer faced an accuracy-related penalty.

The Tax Court held that the Service was right. After noting that the quoted provision of the sale contract contained an internal contradiction (how can WEMGO be prohibited from selling the premises if during that time the taxpayer can force the transfer to Richmond Dance Ensemble?), the court concluded that the parties intended "that, for the first five years after delivery of the deed to WEMGO, [the LLC] could direct WEMGO to convey the [theater] to Richmond Dance in the event the latter was recognized by the IRS as tax exempt…." That rendered the gift transfer conditional, meaning no deductible charitable contribution was made. The court then upheld the application of an accuracy-related penalty.

N. CONSERVATION EASEMENT CASES

Deed Served as Contemporaneous Written Acknowledgment (*310 Retail, LLC v. Commissioner*, T.C. Memo. 2017-164, August 24, 2017). The taxpayer owns the Metropolitan Tower (formerly known as the Strauss Building), located on Michigan Avenue in Chicago. In 2005, the taxpayer donated a façade easement in the building to the Landmarks Preservation Council of Illinois, a qualified charitable organization. The taxpayer claimed a $26.7 million deduction for the value of the easement.

A donation that large requires a contemporaneous written acknowledgment from the charity that indicates, among other things, whether the charity furnished any goods or services in exchange for the contribution. Here, the charity furnished a letter 3.5 years (yes, *years*) after the donation. The Service concluded this was not a contemporaneous written acknowledgment and thus disallowed the deduction.

The charity then filed an amended Form 990 for its fiscal year ending 2006. The amended return referred to the taxpayer's easement and stated that no goods or services were furnished in exchange. But the Service concluded that this was ineffective since §170(f)(8)(D) had not yet taken effect (that section provides a contemporaneous written acknowledgment is not required "if the donee organization files a return, on such form and in accordance with such regulations as the Secretary may prescribe," that includes the information required to be shown on a contemporaneous written acknowledgement). Since there were no regulations under §170(f)(8)(D) in effect at the time, §170(f)(8)(D) cannot apply.

The taxpayer went to Tax Court, hoping the court would see things differently. But while the taxpayer's motion for summary judgment was pending, the court held in a different case that §170(f)(8)(D) was not self-executing, so the taxpayer could not rely on the charity's amended Form 990 to cure the lack of a contemporaneous written acknowledgment. Happily for the taxpayer, however, the court held that the deed of easement contained the information necessary to serve as a contemporaneous written acknowledgment. The deed was executed and recorded in 2005, thus qualifying as a "contemporaneous" acknowledgment. Further, the deed provided that it represented the "entire agreement" among the parties and that any prior

writings related to the donation were null and void upon the deed's execution. The deed stated that the conveyance was for "consideration of One Dollar ($1.00) … and other good and valuable consideration," but the court held that this was "boilerplate language" with "no legal effect for purposes of §170(f)(8)." So when taken as a whole, the deed "included the required affirmative indication that [the charity] supplied [the taxpayer] with no goods or services in exchange for its contribution." The court thus granted the taxpayer's summary judgment motion.

Four days after this case, the Tax Court reached the same result under similar facts in ***Big River Development LP v. Commissioner*****, T.C. Memo. 2017-66 (August 28, 2017)**.

Fifth Circuit Upholds Deduction Despite Power to Modify Boundaries of Conservation Easement by Agreement (*BC Ranch II, L.P. v. Commissioner* (5th Circuit, August 11, 2017)). In December of 2005, the taxpayer donated a conservation easement on Texas real estate that included the habitat of a golden-cheeked warbler, an endangered bird species, to the North American Land Trust, a charity. The easement agreement allowed the parties to modify the property subject to the easement to the extent needed to modify the boundaries of the five-acre homesite parcels within the property. The taxpayer claimed a charitable contribution deduction of $8.4 million on its 2005 return. The Service disallowed the deduction and imposed a 40% valuation misstatement penalty on the grounds that the provision allowing modification to the subject property's boundaries violated the requirement that the easement encumbers the property "in perpetuity."

The taxpayer argued that because the charity would have to consent to any modification, the total amount of real estate subject to the easement would always be at least the same as that of the initial contribution. But the Tax Court, upholding the disallowance, found that irrelevant. "As a result of the boundary modifications, property protected by the [easement at the time it was granted] could subsequently lose this protection. Thus, the restrictions on the use of the property were not granted in perpetuity." The court also upheld the application of the penalty, finding "slipshod preparation of the baseline documentation" insufficient to uphold a claim for acting reasonably and in good faith.

On appeal, however, a divided Fifth Circuit reversed. Importantly, observed the court, the easement only permits changes to the interior boundaries of the parcels within the total acreage covered by the easement. "Thus, neither the exterior boundaries nor the total acreage of the instant (easement) will ever change." This isn't a case where the easement can be removed from one property and placed on another. "Only discrete five-acre residential parcels, entirely within the exterior boundaries of the easement property, could be moved – for example, to account for locations subsequently chosen as nesting sites by the warblers." Because modification would never be to the benefit of the donors, then, the majority was satisfied that there is a perpetual easement on the property. Besides, the majority reasoned, there is no reason to strictly construe the requirements for a conservation easement deduction since the pressure for the deduction came from conservationists, not landowners. Interpreting the deduction generously, as here, assists conservation efforts.

In dissent, Judge Dennis questions the court's "impermissibly lax standard when reviewing the claimed deduction," citing the traditional doctrine that deductions are a matter of legislative grace and must therefore be strictly construed. "I am sensitive to the majority opinion's implication that a broader interpretation of §170(h) would assist conservation efforts by encouraging the donation of conservation easements. However, all tax deductions are designed to serve some public good and yet are narrowly and strictly construed. It is not our domain to decide that the goal served by this deduction is more important than that served by any other." Judge Dennis would have affirmed the Tax Court, citing precedent that the perpetual use restriction must attach to a defined parcel of property. Here, Judge Dennis observed, "the forty-seven five-acre homesites that may be substituted with initially-protected land represent 6.69 percent of the 3,509-acre easement tract—a significant portion of the total." Besides, nothing in the agreement requires that boundary changes be made solely for conservation purposes.

Sale of Farmland in Year of Donation Thwarts Farmers (*Rutkoske v. Commissioner*, 149 T.C. No. 6, August 7, 2017). The taxpayers, two brothers, were members of an LLC that owned 355 acres leased as farmland. In 2009, the LLC conveyed a conservation easement to the Eastern Shore Land Conservancy, a charitable organization, in exchange for just over $1.5 million cash. An appraisal determined that the unencumbered value of the farmland was $4.97 million but the post-easement value of the land was $2.13 million. The LLC then sold the property to an unrelated purchaser for just under $2 million, resulting in a capital gain of just over $1.75 million.

In addition to reporting their shares of LLC's gain from the sale of the land, the taxpayers reported their shares of the gift element from the bargain sale (about $1.34 million) as a charitable contribution. The taxpayers classified themselves as "qualified farmers" thus entitled to a deduction from the contribution equal to 100% of their "contribution bases" (essentially, their adjusted gross incomes) instead of the 50% limit normally applicable to donations of conservation easements.

The problem is that to be a "qualified farmer," more than 50% of one's gross income must be from the trade or business of farming. The taxpayers were farmers alright, but if you fold in their shares of the LLC's gain from the sale of the farm, less than half of their incomes came from their farming activities. The brothers claimed the gain from the sale of the farm should count as gross income for farming, but the Tax Court held that the sale of the property is not a farming activity, so the gain from the sale is not gross income from a farming business. As a result, the taxpayers could only deduct an amount equal to 50% of their respective contribution bases; the rest must be carried over to later taxable years. The court observed that "We recognize that the statute makes it difficult for a farmer to receive a maximum charitable contribution deduction by disposing of a portion of property in a year in which he/she donates a conservation easement, especially in a State with high land values. But it is not our task to rewrite a statute."

Failure to Obtain Written Subordination from Banks Doomed Deduction (*RP Golf LLC v. Commissioner* (8th Circuit, June 26, 2017)). The taxpayer owns two private golf courses in Kansas City. In 2003, it conveyed a conservation easement over the courses to the Platte County Land Trust, a charitable organization. On its 2003 return, the taxpayer claimed a $16.4 million

deduction, pursuant to an appraisal that found the pre-contribution value of the courses to be $17.4 million and the post-contribution value to be $1 million.

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

On appeal, the Eight Circuit affirmed. It noted decisions from two other circuits finding that the plain meaning of the regulation at issue requires subordination as a prerequisite to a deduction. The court went on to say that even if the regulation was ambiguous as to when the mortgage must be subordinated, the Service's interpretation requiring subordination in advance of the conveyance is reasonable. The taxpayer also challenged the Tax Court's decision related to the oral consent of the banks, but the Eighth Circuit held that the lower court's fact findings on this point were not clearly erroneous.

If It Walks Like a Conservation Easement and Quacks Like a Conservation Easement, Then It's a Conservation Easement (*Ten Twenty Six Investors v. Commissioner*, T.C. Memo. 2017-115, June 15, 2017). Late in 2004, the taxpayer, a partnership, donated a façade easement in a Cass Gilbert-designed ten-story New York City warehouse to the National Architectural Trust, a charity (the NAT). The deed conveying the easement was not recorded until 2006. But the partnership claimed a charitable contribution deduction of over $11.3 million on its 2004 return for the easement (along with another contribution of about $500,000 cash to the NAT). The Service disallowed both deductions and asserted a penalty, claiming the contribution had no legal effect under applicable state law until the deed was recorded; that would mean the deduction might be proper in 2006 but not for 2004.

Before the Tax Court, the partnership argued that what it gave to the NAT was a restrictive covenant but *not* a conservation easement. New York's law requiring a recorded deed to be effective only applies to conservation easements and not to other property transfers. Under the partnership's train of thought, the restrictive covenant was effective upon delivery of the deed, so the 2004 deduction would be proper.

The Tax Court rejected this argument, citing a 2016 district court case on nearly identical facts that found the deed ineffective until recorded. Moreover, the deed in question was titled "Conservation Deed of Easement" and purported to convey a "Façade Conservation Easement" on the property. This suggests the parties intended a conservation easement, so applying the

New York law requiring recording is appropriate. The court thus granted the Service's motion for partial summary judgment on the issue.

O. ESTATE NOT ENTITLED TO DEDUCTION FOR GIFT TAXES DUE ON NET GIFTS (*Estate of Sommers v. Commissioner*, 149 T.C. No. 8, August 22, 2017)

In December of 2001 and January of 2002, the decedent made gifts to his nieces under the condition that they pay the associated federal gift tax liability. The decedent died ten months later. Because of this, the gift tax due on the gifts (stipulated to be just under $274,000) is included in the decedent's gross estate under §2035(b).

The decedent's estate claimed a federal estate tax deduction under §2053 for the gift tax owed at death. The Service disallowed the deduction, and the Tax Court agreed that because the estate's payment of gift taxes attributable to net gifts would give rise to a claim for reimbursement from the nieces, no deduction under §2053 is proper. Citing other cases, the court observed that a §2053 deduction for gift taxes is limited to amount in excess of any right to reimbursement.

The decedent's probate and nonprobate estates passed to his surviving spouse. The estate claimed that some of the federal estate should be apportioned to the nieces because of the inclusion of gift tax under §2035(b). The court granted summary judgment in favor of the nieces, finding that under the applicable state apportionment act (New Jersey), no portion of the estate tax liability could be allocated to the nieces. That act apportions estate tax to "recipients of property included in the decedent's gross estate." The nieces did not "receive" the gift taxes included in the gross estate under §2035(b). The gifted property the nieces *did* receive was not pulled back into the gross estate, so there is no basis to apportion estate tax liability to them.

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

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

As the Service explains, in the case of a CRAT, the probability of exhaustion is calculated "first by applying the §7520 assumed rate of return on CRAT assets (§7250 rate) against the amount of

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

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

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

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

Q. SETTLEMENT DATE EXTENSIONS DID NOT CONSTITUTE AN EXCHANGE OF VARIABLE PREPAID FORWARD CONTRACTS (*Estate of Andrew McKelvey v. Commissioner*, 148 T.C. No. 13, April 19, 2017).

In 2007, the decedent, the founder and CEO of the job search website monster.com, entered into two "variable prepaid forward contracts" ("VPFCs"), one with Bank of America and one with Morgan Stanley. Under the VPFCs, the decedent received lump sum cash payments totaling about $193.5 million in exchange for his agreement to transfer shares of stock in Monster Worldwide, Inc., beginning in 2008. The exact number of shares to be delivered to each bank depended on the per-share value of the stock as of the settlement dates. When 2008 came, but before the scheduled settlement dates, the decedent paid cash consideration totaling about $11.5 million to the banks in exchange for their agreements to extend the settlement dates until

2010. A few months later, the decedent died. (Hey, you write checks for $11.5 million and see what it does to your blood pressure.)

In auditing the decedent's 2008 federal income tax return, the Service took the position that the decedent recognized a capital gain of nearly $201 million upon execution of the extension agreements. The gain, said the Service, consisted of $88 million in short-term gain from swapping the old VPFCs for new VPFCs and nearly $113 million in long-term gain from the constructive sale of the Monster shares under the VPFCs.

The estate challenged the assessment, arguing that Revenue Ruling 2003-7 allowed the estate to treat the VPFCs as "open transactions," meaning there is no recognized gain or loss until stock is transferred at the settlement date(s). The open transaction doctrine applies because "a taxpayer entering into a VPFC does not know the identity or amount of property that will be delivered until the future settlement date arrives and delivery is made." But the Service does not contest that the original transactions qualified for the open transaction doctrine. The dispute is whether the execution of the extension agreements resulted in taxable exchanges of old VPFCs for new VPFCs. The estate claimed that the extensions only served to postpone the settlement dates, while the Service equated the extensions to swapping one VPFC contract (with settlement date in 2008) for another (with a settlement date in 2010). Since there is no case authority on point here, the Tax Court was charting new waters.

Regulation §1.1001-1(a) says that an exchange is not a taxable event unless the properties swapped "differ materially either in kind or in extent." The Tax Court thus reasoned that the extensions were taxable exchanges only if the VPFCs were "property" of the decedent and, further, only if what the decedent held after the extensions was materially different from what he held before the extensions. The estate argued that the VPFCs were not "property" of the decedent at the time of the extensions since at that time all he had was an obligation to deliver the requisite number of shares to each bank. In other words, an "obligation" is not "property." The Tax Court agreed. "Although the original VPFCs did provide decedent with a right to receive cash prepayments," wrote the court, "once those prepayments were received … decedent was left only with obligations to deliver under the terms of the VPFCs and retained no further property rights with respect to the contracts." This analysis, said the court, is consistent with the open transaction treatment provided under Revenue Ruling 2003-7.

The court rejected the Service's position that the extensions closed the original VPFCs and thus triggered realization of gain. The court observed that the extensions "did not clarify the uncertainty of which property decedent would ultimately deliver to settle the contracts. … Because decedent's obligation to deliver a variable number of shares (or the cash equivalent) was controlling, it remained uncertain whether decedent would realize a gain or loss upon discharge of his obligations, not to mention the characterization of such gain or loss."

The Service also argued that the extensions constituted a constructive sale of the stock under §1259. But the court observed that §1259 only applies to forward contracts where the amount of property to be delivered is "substantially fixed." The number of shares deliverable here, by

contrast, could not be known until each settlement date. Moreover, reasoned the court, the Service already stipulated that Revenue Ruling 2003-7 applies to the VPRCs at issue, a position inconsistent with the argument that §1259 applies to treat the transactions as realization events.

R. DEFINED BENEFIT PLAN IS NOT AN "ASSET" FOR PURPOSES OF APPLYING THE INSOLVENCY EXCLUSION (*Schieber v. Commissioner*, T.C. Memo. 2017-32, February 9, 2017)

The taxpayers, a married couple, had about $906,000 of debt attached to a parcel of investment real estate. The creditor, a bank, cancelled about $418,000 of the debt together with accrued interest. On their joint federal income tax return, the taxpayers took the position that a portion of the cancelled debt was excluded under §108(a)(1)(B). This provision excludes the cancellation of indebtedness from gross income if (and to the extent) the taxpayer was insolvent immediately prior to the cancellation. The taxpayers claimed to have assets totaling about $925,000 and liabilities totaling about $1,218,000 (including the debt that was partially cancelled by the creditor), leaving them insolvent to the tune of about $293,000 immediately before the creditor's action.

On the return, the taxpayers excluded $346,000 of the $418,000 debt cancellation from gross income, and no one seems to know how the taxpayers arrived at that conclusion. The Service claimed that the entire $418,000 of debt discharge income should be included in the couple's gross income because the taxpayers were not insolvent immediately before the discharge. In reaching this conclusion, the Service included a defined benefit pension plan held by one of the taxpayers in connection with her employment. If the defined benefit plan counts as an asset, the Service would be correct in requiring the couple to report the entire amount of the cancelled debt in gross income.

But the Tax Court agreed with the taxpayers that a defined benefit plan is not an "asset" for purposes of determining whether (and to what extent) a taxpayer is insolvent. Although the Code supplies no definition of an "asset" for purposes of the insolvency exclusion, there is case law indicating that assets exempt from creditor claims count as assets under §108 because even assets exempt from creditor claims can still give a taxpayer "the ability to pay an immediate tax on income" from cancelled debt. Yet the Tax Court observed that a defined benefit plan is not such an asset. The taxpayers "could not use their interest in the pension plan to immediately pay a tax liability because they were entitled only to monthly payments under the plan and could not convert their interest in the plan to a lump-sum cash amount, sell the interest, assign the interest, borrow against the interest, or borrow from the plan." Accordingly, the court ruled the taxpayers were insolvent by about $293,000 before the debt was cancelled, so they could exclude that portion of the cancelled debt from gross income.

S. REVERSE LIKE-KIND EXCHANGES OUTSIDE THE SAFE HARBOR ARE POSSIBLE, BUT SERVICE DOESN'T LIKE IT (*Estate of Bartell v. Commissioner*, 147 T.C. No. 5, August 10, 2016; *Action on Decision 2017-06*, August 14, 2017)

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

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

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

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

The Service argued that the company already owned the Lynwood property by the time the Everett property was sold. It was thus too late to engage in a like-kind exchange of the Everett

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

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

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

Nearly a year after the Tax Court's decision, the Service issued a nonacquiescence, stating "the Service does not follow the court opinions that take the view that for §1031 purposes an exchange facilitator may be treated as the owner of replacement property regardless of whether it has the benefits and burdens of ownership. … Taxpayers that use accommodating parties outside the scope of [the Revenue Procedure] have not engaged in an exchange if the taxpayer, rather than the accommodating party, acquires the benefits and burdens of ownership of the replacement property before the taxpayer transfers the relinquished property."

T. JUSTICE DOESN'T ALWAYS PREVAIL (*Smyth v. Commissioner*, T.C. Memo. 2017-29, February 7, 2017)

"Grisel Smyth," wrote Judge Holmes, "is a loving grandmother who provided a home and care for her two young grandchildren. On her 2012 tax return she claimed them as her dependents and asked the IRS to send her a check for almost $5,300—a refund of over $2,900 for the taxes withheld on her income plus almost $2,400 in refundable credits. The Commissioner denied her claim. The reason? Smyth's unemployed son had already claimed the children on his tax return, gotten a check from the government, and cashed it to spend on drugs."

The Service maintained that while the result may not be fair, it's required by the statute. Judge Holmes reluctantly agreed. Smyth argued that her son did not file an original return for 2012, but she had no evidence to back up this claim. Besides, if he had not done so, the Service would not have flagged Smyth's return for claiming the same dependents. And while the son signed an amended 2012 return that did not claim the dependents, there is no proof that return was appropriately "filed," as it was simply delivered to IRS counsel. So it was clear that the taxpayer had to lose. As Judge Holmes concludes: "It is difficult for us to explain to a hardworking taxpayer like Smyth why this should be so, except to say that we are bound by the law. And it is impossible for us to convince ourselves that the result we reach today—that the IRS was right to send money meant to help those who care for small children to someone who spent it on drugs instead—is in any way just. Except for the theory of justice that requires a judge to follow the law as it is but explain his decision in writing so that those responsible for changing it might notice."

U. PASS THE SUGAR – PREGAME MEALS ARE FULLY DEDUCTIBLE (*Jacobs v. Commissioner*, 148 T.C. No. 24, June 26, 2017)

The taxpayers, owners of the NHL's Boston Bruins, provided pregame meals to players and personnel during away games throughout the taxable years at issue (2009 and 2010). The taxpayers deducted the full cost of the meals, but the Service argued that the §274(n)(1) applies to limit the deduction to 50% of the cost. But the Tax Court held that the provision of meals before away games is a *de minimis* fringe and thus not subject to the 50% limitation.

Regulations explain that employee meals provided in a nondiscriminatory manner qualify as a de minimis fringe: (1) the eating facility is owned or leased by the employer; (2) the facility is operated by the employer; (3) the facility is located on or near the business premises of the employer; (4) the meals furnished at the facility are provided during, or immediately before or after, the employee's workday; and (5) the annual revenue derived from the facility normally equals or exceeds the direct operating costs of the facility (the revenue/operating cost test). Here the pregame meals met these conditions, as the taxpayers contracted out for the provision of meals at hotels and arenas. Though they did not own the hotels or arenas, the court observed that under the regulations it is sufficient if the taxpayers "contract with another to operate an eating facility for its employees." The meals are provided to help players perform well, so they are given for a substantial non-compensatory business reason.

V. MARRIED TAXPAYERS FILING SEPARATELY CANNOT CLAIM EARNED INCOME CREDIT EVEN IF THE TAX COURT ALLOWS IT (*Action on Decision 2017-05*, July 10, 2017)

Yosef Tsehay worked as a custodian at a community college in Washington. His 2013 federal income tax return, prepared by a third party, claimed "head of household" filing status. The return also claimed a dependency exemption for four kids, a child tax credit for four kids, and an earned income credit for three kids. The Service changed Yosef's filing status to "unmarried" and disallowed the claimed exemptions and credits. The Service determined that Yosef, who had previously separated from his spouse and ordered to pay child support, was a noncustodial parent and therefore eligible for the dependency exemption only if the custodial parent signed a

written declaration releasing her claim to the exemption (which had not happened, it seemed). But in a 2016 memorandum decision, the Tax Court found credible evidence to suggest Yosef and his spouse were married throughout 2013 and lived together with their five children. It thus held that Yosef was entitled to the dependency exemptions, the child tax credit, and the earned income tax credit. In the process, the court held that Yosef's filing status should be "married filing separately."

There's just one problem. Section 32(d) provides that a taxpayer claiming "married filing separately" status is ineligible for the earned income credit. The Tax Court's opinion makes no reference to this provision, suggesting it simply missed this rule. Not surprisingly, then, the Service indicated its nonacquiescence with the court's holding related to the earned income credit, citing §32(d).

W. PARTNERSHIP INTEREST WAS SOLD, NOT ABANDONED, AND NO AMORTIZABLE INTANGIBLE WAS CREATED EITHER (*Watts v. Commissioner*, T.C. Memo. 2017-114, June 14, 2017).

The taxpayers sold their interests in a partnership that owned and operated retail golf stores. The tax return claimed the transaction gave rise to a $750,000 loss, which the return treated as an ordinary loss on the basis that the partnership interests were abandoned and not sold. The Service, not surprisingly, maintained that the transaction was a sale of the partnership interests and that the ensuing loss was a capital loss under §741.

At trial, the taxpayers conceded that the abandonment loss claim was erroneous. Instead, the taxpayers argued that the substance of the transaction was not a sale that generated capital loss but rather a transaction creating an amortizable §197 intangible that generated ordinary deductions. Specifically, they maintained the transaction (in which the taxpayers received no payment for their interests but continued to have rights to property leased by the acquiring party) created a "right to recovery of basis" that's amortizable under §197. The Tax Court rejected this intent to recharacterize the deal, noting that the transaction was—in form and substance—a sale structured such that the taxpayers had no immediate rights to payments.

Instead of accepting the loss, however, the taxpayers then returned to the theory that the partnership interests had been abandoned. But the court rejected this theory too, noting that under the Code there are only two situations where a partnership interest is "abandoned" as opposed to "sold:" (1) where the partner was not personally liable for the partnership's recourse debts, or (2) where the partner had limited liability and had no economic risk of loss for the partnership's nonrecourse debts. Since the taxpayers submitted no evidence as to the applicability of either exception, the court applied the general rule that treats the disposition as a sale or exchange of the partnership interest.

X. HOW NOT TO MAINTAIN A MILEAGE DIARY (*Taylor v. Commissioner*, T.C. Memo. 2017-99, June 1, 2007)

The taxpayers, a married couple, each held jobs: Avery had a recycling business and Katrina worked at a local hospital. Katrina also claimed to operate a bill collecting business on the side. Their 2012 joint return claimed a total deduction in excess of $74,000 for vehicle mileage expense. The Service disallowed the deduction for lack of adequate substantiation.

The taxpayers at trial produced a spreadsheet documenting the mileage expense with respect to four vehicles that they claimed were used for business and personal use (though the original return only mentions two vehicles and states they were used entirely for business purposes). The spreadsheet purported to show 132,456 miles in business travel for 144 different trips, but the court noticed a few inconsistencies. First, the spreadsheets were created only after the matter came to the Tax Court. Second, no entry shows the actual time spent at one destination or what specific tasks were performed there; instead, all 144 entries state that the trip was to "Distribute Informational Brochures/Market." Third, in several cases the ending odometer reading for one trip is higher than the beginning reading for the next trip. Fourth (and best of all), the entry for March 10 claims Katrina drove 1,696 miles that day. By the court's computations, that meant "she would have had to drive at an average speed of 70 miles per hour for 24 consecutive hours while still squeezing in time for rest stops and a client meeting." Finally, the average length of each trip was 920 miles, which would consume a full day. "We are not persuaded," wrote the court, "that Mrs. Taylor could have taken 144 full-day trips of this length while concurrently holding a full-time job at [the] Hospital."

The court also upheld the assessement of a negligence penalty against the couple, despite Katrina's insistence that the spreadsheet entries were accurate.

Y. SERVICE ABUSED DISCRETION IN NOT GRANTING HARDSHIP WAIVER FROM 60-DAY ROLLOVER RULE (*Trimmer v. Commissioner*, 148 T.C. No. 14, April 20, 2017)

John retired from the New York Police Department in 2011. He planned to work as a security guard following retirement but the job fell through at the last minute. Shortly thereafter, John started to suffer from a major depressive disorder. He stopped communicating with family and friends, stopped leaving the house, and even let his hygiene go. During this period, he received two distribution checks from his NYPD retirement accounts. The checks, totaling over $100,000, sat on the dresser at his house for over a month before he deposited them into the joint checking account he held with his wife.

It wasn't until several months later, when his return preparer started to work on the 2011 return, that John learned of the 60-day rollover requirement. He immediately rolled the funds into an IRA. The funds deposited into the joint account had never been used for anyone's benefit.

When the Service examined the 2011 return and mentioned the need to include the distributions in gross income, John wrote a letter to the Service requesting a hardship waiver from the 60-day

rollover requirement. This is available under §402(c)(3)(B), but John did not cite the statute. The Service denied the request and assessed a deficiency.

Before the Tax Court, the Service argued that the examination agent lacked the authority to consider a hardship waiver because John did not request and pay for a private ruling on the request, as is standard operating procedure. But the Tax Court observed that a 2016 revenue procedure expressly authorizes the Service to grant hardship relief during the examination phase even where no private ruling is requested, and this authority was made retroactive to 2003. So the court rejected the Service's argument that the agent lacked authority to grant the waiver.

The Service then argued that the court lacked jurisdiction to review the Service's exercise of discretion in denying a hardship waiver, but the court quickly rejected this position, noting the well-accepted doctrine that judicial review is available for acts of administrative discretion. On the merits, the court held that that Service should have granted John's request for a hardship waiver. It found that John's failure to meet the rollover requirement was attributable to his disability. "If anything," noted the court, "the fact that he left two checks totaling over $100,000 on his dresser at home for over a month before depositing them in the bank vividly evidences his impaired mental condition." The court thus concluded that the two distributions should be excluded from gross income and that the 10% penalties under §72(t) should not apply.

Z. THE TAX BENEFIT RULE DOES NOT APPLY WHERE DECEDENT DEDUCTED EXPENSES THAT THE BENEFICIARY SUBSEQUENTLY DEDUCTED AS WELL (*Estate of Backemeyer v. Commissioner*, 147 T.C. No. 17, December 8, 2016)

Steve was a corn and soybean farmer in Nebraska until his death in 2011. In 2010, Steve purchased about $235,000 in "farm inputs" (seed, chemicals, fertilizer, and fuel) which he deducted on the 2010 joint return he filed with his wife, Julie. At his death in March, 2011, though, Steve had not used any of these inputs. Steve's will provided for everything to pass to a trust for the benefit of Julie. After Steve's death, Julie took up the farming business. She used the inputs later in 2011 to grow crops that were harvested and sold in 2011 and 2012. On her 2011 return, Julie deducted an amount equal to the value of the farm inputs she inherited from Steve.

The Service thought it was an impermissible double deduction that both Steve and Julie could separately deduct the same cost, so it took the position that the tax benefit rule required Steve to recapture the previously deducted amounts as gross income. But the Tax Court held that the tax benefit rule does not apply in this context. The inputs have been included in Steve's gross estate for estate tax purposes, and it would be "double taxation of the value of the farm imputs" to force Steve's estate now to include that same value in gross income for income tax purposes.

The court had no problem with the fact that both Steve and Julie got to deduct the same cost. Such is the consequence of a stepped-up basis: "The sole cause for the allowance of two deductions here is section 1014(a), which steps up the basis of property acquired from a decedent. Were section 1014 not to apply, the [Julie] would have received the farm inputs with a zero basis and therefore been unable to deduct them. We find it unlikely that [the Service]

would have pursued his tax benefit rule argument were that the case." Yes, Steve and Julie each got their income tax deductions, in two separate years, for a cost that was paid for only once. But such would be the case anytime a beneficiary inherits deductible property with a stepped-up basis.