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Current Developments in Wealth Planning

Those Crummy *Crummey* Powers
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PLANNING FOR HIGH-NET WORTH INDIVIDUALS

Those Crummy *Crummey* Powers

By Blanche Lark Christerson

I. Mikel[1] is a Tax Court memorandum opinion[2] decided in early April. It is a defeat for the IRS, and emblematic of why the IRS so dislikes "*Crummey* powers."[3] The decision also offers an interesting exercise in analyzing what the IRS might have done differently in this case.

Our Story Begins

Israel and Erna Mikel lived in Brooklyn, New York. They created an irrevocable trust on June 7, 2007. Its beneficiaries were Israel and Erna's lineal descendants and their respective spouses—60 in all, many of whom were under age 18. Each beneficiary had the power, during the year the trust was created and any subsequent year when property was added, "to withdraw property from the Trust including the property transferred." The power of withdrawal was effectively limited to the maximum annual exclusion in effect when the transfer was made. The withdrawal power had to be exercised within 30 days of a beneficiary's receipt of notice of the contribution, which the trustees had to provide within a reasonable time after the contribution was made (i.e., this was a so-called *Crummey* power). If a beneficiary exercised a withdrawal right, the trustees had to immediately distribute to such beneficiary or Guardian (in the case of a minor beneficiary) "the properties allocable to them, free of trust." Distributions could be made in cash or property or by "borrowing funds and distributing such funds in satisfaction of the demand."

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Discretionary Distributions and the *In Terrorem* Clause

The trustees were also empowered to distribute income or principal in their "sole and absolute discretion" for the health, education, maintenance, or support of any beneficiary, and could, in their "absolute and unreviewable discretion," help defray a beneficiary's "reasonable wedding costs," assist a beneficiary with purchasing a primary residence, or entering a trade or profession. The trustees' judgment as to the amounts of such payments and the advisability thereof was "final and conclusive" upon all beneficiaries and other persons interested in the trust. Any dispute over the proper interpretation of the trust was to be submitted to an arbitration panel "consisting of three persons of the Orthodox Jewish faith," or a "*beth din*." The panel was directed to enforce the provisions of the trust and give any party "the rights he is entitled to under New York law." The trust was to be construed to "effectuate the intent of the parties…that they have performed all the necessary requirements for this [trust] to be valid under Jewish law." Finally, the trust had an *in terrorem* clause to discourage beneficiaries from challenging the trustees' distributions to beneficiaries, and provided, in part, that if a trust beneficiary:

> [s]hall directly or indirectly institute, conduct or in any manner whatever take part in or aid in any proceeding to oppose the distribution of the Trust Estate, or files any action in a court of law, or challenges any distribution set forth in this Trust in any court, arbitration panel or any other manner, then…the provision herein made for such beneficiary shall thereupon be revoked and such beneficiary shall be excluded from any participation in the Trust Estate…

And Then What Happened?

- On June 15, 2007, Israel and Erna jointly transferred property to the trust with an asserted value of $3,262,000.
- On October 9, 2007, an attorney acting for the trust mailed to each beneficiary, in his or her individual capacity and as guardian for any minor child, written notice informing the recipient that a contribution had been made to the trust and that "you and each of your children under the age of 18 years as beneficiaries of the Trust have a right to withdraw property or funds up to $24,000.00 each from the Trust," which withdrawal had to be exercised in writing within 30 days of receipt of the letter.

The IRS's broad reading of the trust's in terrorem *clause, to the exclusion of any other argument against the* Crummey *powers, cost them this case.*

- Israel and Erna filed no gift tax returns for 2007.
- At some point (presumably in 2011), the IRS contacted Israel and Erna, presumably inquiring about their 2007 gratuitous transfers of real property.
- On December 15, 2011, as a result of this IRS contact, Israel and Erna submitted separate gift tax returns for their 2007 gifts, which they "split" under Code Sec. 2513 (in other words, the gifts were treated as coming one-half from each of them). Each return reported property transfers of $1,631,000 ($3,262,000 in total), consisting of Israel and Erna's Brooklyn residence, two other properties in Brooklyn (held directly or through a limited liability company), and a condominium in Florida.[4] Israel and Erna each claimed annual exclusions of $720,000, or separate gifts of $12,000 to each of the trust's 60 beneficiaries; because their respective unified credits covered the balance of these 2007 transfers ($911,000 each, or $1,822,000 in total),[5] the returns reported that no gift tax was due.
- The IRS audited Israel and Erna's gift tax returns, and sent them separate notices of deficiency: their claimed annual exclusions were denied, and they were liable for late filing penalties.
- Israel and Erna disagreed and petitioned the Tax Court; their cases were consolidated. Israel and Erna and the IRS both filed motions for partial summary judgment on the question of whether Israel and Erna were eligible to claim annual exclusions under Code Sec. 2503(b).

IRS Argument

The IRS acknowledged that, on its face, the trust gave the beneficiaries an unrestricted and unconditional right to withdraw, during 2007, an amount equal to the then maximum annual exclusion of $12,000 per beneficiary, or $24,000 for married donors, since these were split gifts. Nevertheless, the beneficiaries lacked the requisite "present interest" in the property that would make the 2007 transfers eligible for the annual exclusion. As a practical matter, the beneficiaries' rights were not "legally enforceable": if the trustees refused to honor a withdrawal demand, the beneficiary would have to go before a *beth din*; if the *beth din* sustained the trustees, the beneficiary could still seek redress in a New York Court, but would be reluctant to do so, since the act of enforcing the withdrawal right would trigger the *in terrorem* clause, and cut off the beneficiary's interest in the trust. Accordingly, the beneficiaries' withdrawal rights were "illusory" and did not constitute a "present interest in property."

What the Tax Court Said

The Tax Court rejected the IRS's argument—if a withdrawal right must be legally enforceable to be valid, the withdrawal rights here were certainly that: if the trustees breached their fiduciary duties by refusing a timely withdrawal demand, the beneficiaries could seek justice from

a *beth din*, as well as a state court. Furthermore, the *in terrorem* clause, "while not a paragon of draftsmanship," was designed to discourage challenges to *discretionary* distributions of the Trust Estate, and did not apply to a suit to compel the trustees to honor a timely withdrawal demand; a beneficiary had an unconditional right to that withdrawal, which the trustees could not legally resist. "[P]roperly construed," the *in terrorem* provision would not deter beneficiaries from pursuing judicial relief. The beneficiaries, therefore, had a present interest in the transferred property, and the annual exclusions were valid. The Tax Court thus granted Israel and Erna's motion for summary judgment, and denied the IRS's motion for partial summary judgment.

Mikel seems to encapsulate what the IRS so dislikes about Crummey powers, based on how much property can be transferred under the "guise" of the annual exclusion even when the IRS believes the beneficiaries' present interest in the property is illusory.

Comments

The IRS's broad reading of the trust's *in terrorem* clause, to the exclusion of any other argument against the *Crummey* powers, cost them this case. So what other avenues might have proved more fruitful? Several thoughts come to mind, having to do with both the nature of the property transferred and its appropriate valuation.

First, the property contributed to the trust was illiquid; recall that it was a residence and other real property, some of which was held in a limited liability company. If a beneficiary exercised a timely demand right, it would not have been easy for the trustees to "immediately distribute" the property "allocable" to that beneficiary. The real estate would have to be offered as a fractional interest, which is difficult to value, not worth 100 cents on the dollar and has inherent "fetters" in terms of lack of marketability and control. A similar issue can arise with respect to an interest in a limited liability company in that the interests may be so restricted that the beneficiary is not deemed to have a current economic (or present) interest.[6] And, although the trustees could borrow funds to satisfy a withdrawal demand, loans take time, and the cash may not be instantly available. All of these issues raise a legitimate question regarding whether the beneficiaries had a true "present interest" that would substantiate the annual exclusion for their respective gifts in trust—understanding, of course, that many trusts are in fact composed of illiquid assets and still have valid *Crummey* powers of withdrawal.

The valuation issue is somewhat different, but also relates to the illiquid nature of the property transferred to the trust. On audit, the IRS did not question the valuations of the different properties, but merely the appropriateness of the annual exclusion for the beneficiaries' withdrawal powers. If the IRS had challenged those valuations, Israel and Erna might not have had enough available exclusion to protect the balance of their gifts into the trust. And, if the IRS had been successful with the annual exclusion argument, perhaps along the lines suggested above, it might have successfully argued that Israel and Erna owed gift tax.

So why did the IRS take such a narrow approach in its argument? Although this is pure speculation, here is a possible scenario: the auditors were flabbergasted at the number of *Crummey* beneficiaries (60 in all!) and couldn't believe how much property this allowed Israel and Erna to transfer. Those involved in developing the case fixated on the trust's *in terrorem* language, which addressed a challenge to

ANY distribution from the trust; they hypothesized that this would preclude a beneficiary from enforcing a withdrawal right, which they viewed as a "distribution." Thinking that this argument was unassailable, the IRS looked no further. And the rest is history. (It is currently unclear whether the IRS will further litigate this case.)

Some Post Scripts

Mikel seems to encapsulate what the IRS so dislikes about *Crummey* powers, based on how much property can be transferred under the "guise" of the annual exclusion even when the IRS believes the beneficiaries' present interest in the property is illusory. It is no wonder that President Obama's past several budgets seek to "simplify" annual exclusion gifts and do away with the present interest requirement for annual exclusion gifts—shorthand for effectively eliminating *Crummey* powers.[7] In addition, there is the interesting question of how the IRS knew to contact Israel and Erna regarding their 2007 transfers. It seems likely that the IRS had been checking tax records relating to real property, as part of a compliance initiative that started in about 2008 or 2009 to ferret out unreported gifts of real property.[8] In other words, donors beware!

ENDNOTES

1 109 TCM 1355, CCH Dec. 60,277(M), TC Memo. 2015-64, April 6, 2015.

2 A "memorandum opinion" deals with settled issues of law and how they apply to the given facts of the case.

3 "*Crummey* powers" are named after the taxpayer who litigated the issue (*D. Crummey*, CA-9, 68-2 USTC ¶12,541, 397 F. 2d 82 (1968), *rev'g in part* 25 TCM 772, CCH Dec. 28,012(M), TC Memo. 1966-144).

4 The Brooklyn residence's reported value was based on the market value reflected on the 2007/08 New York City Real Property Tax Assessment Rolls; the other properties' values were based on appraisals included with the returns.

5 In 2007, the maximum applicable exclusion amount against estate tax was $2 million per individual, while it was only $1 million per individual for gift tax purposes.

6 The IRS successfully denied the annual exclusion for gifts of membership units in a limited liability company in *A. Hackl*, CA-7, 2003-2 USTC ¶60,465; 335 F.3d 664 (2003), *aff'g* 118 T.C. 279, CCH Dec. 54,686, (2002). The LLC agreement provided that members of the LLC could not transfer their LLC units without the consent of the LLC's Manager, whose consent could be "given or withheld, conditioned or delayed" as the Manager determined in his "sole discretion." The Tax Court and the U.S. Court of Appeals for the Ninth Circuit agreed that the beneficiaries did not have a current "substantial economic or financial benefit," and, therefore, upheld the IRS's denial of the annual exclusion for these gifts.

7 The Treasury Department's *General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals*, issued on February 2, 2015, explains that there would be a new category of transfers that would allow a donor to give away up to $50,000 gift-tax free. This new category would be a further limit on annual exclusion gifts, so that if the donor gave away more than $50,000 in this new category (the number would be indexed for inflation after 2016), the gift would be taxable and therefore erode the donor's available exclusion amount ($5.43 million in 2015). See, Sanford J. Schlesinger and Martin R. Goodman, "*Proposed Transfer Tax Reform Redux: The Obama Administration's Fiscal Year 2016 Proposals*," ESTATE PLANNING REVIEW—THE JOURNAL, April 23, 2015, p. 66.

8 See Scott D. Michel and Beth Shapiro Kaufman, "*Unreported Gifts of Real Property: Time for a Voluntary Disclosure?*," TAX NOTES, August 1, 2011, pp. 513-519.

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Tax Topics

05/31/15

2015-05

Wynne wins

On May 18, 2015, the Supreme Court issued its decision in *Comptroller of the Treasury of Maryland v. Wynne* (No. 13-485). It is a victory for Brian Wynne and his wife – and other similarly situated Maryland residents. It could also have ramifications beyond Maryland's borders.

Background. Maryland residents currently pay state as well as county (or "local") income tax on all of their taxable income, regardless of its source; non-residents pay Maryland state income tax on income generated in Maryland, as well as a "special non-resident tax." Maryland's Comptroller collects the taxes, and distributes the county tax to the relevant county; the non-resident tax goes to the state's general fund. Residents with out-of-state "source" income that has been taxed in that other state can claim a credit for such tax against their Maryland *state*, but NOT county, income tax. *Wynne* involved this credit. Before getting into the case, some additional background on Maryland's income tax structure might be helpful:

- Initially, Maryland only had a state income tax.
- As of 1939, Maryland allowed a credit against a resident's state income tax for income taxes paid to another state on income generated in that other state.
- In 1967, Maryland mandated that its counties and the City of Baltimore impose a local income tax (the rate was up to the municipalities, subject to various limitations). Litigation arose over whether the credit also applied against this local tax. In 1974, the Maryland Court of Appeals held that it did, in *Stern v. Comptroller* (271 Md. 310).
- In early 1975 (presumably in response to *Stern*), Maryland enacted legislation providing that the credit only applied against the *state* income tax, and not the county or local income tax. Litigation arose over this limitation, which the Maryland Court of Appeals upheld in 2006, in *Comptroller v. Blanton*, on the basis of the "plain language" of the statute (390 Md. 528); no constitutional issues were raised.
- As of 2004, the special non-resident tax took effect; its rate matches the lowest county tax (1.25%). Litigation arose over whether this tax unconstitutionally discriminated against non-residents. In 2011, the Maryland Court of Appeals held that it did not, in *Frey v. Comptroller*; the court likened the tax to the

county tax that applies to residents, and affirmed that the county tax is in fact a "state" tax for constitutional purposes (422 Md. 111).

Phew! Now to *Wynne.*

The facts. Brian and Karen Wynne lived in Howard County, Maryland, with their five children. During 2006, Brian Wynne was the President of Maxim Healthcare Services, Inc., and one of its seven owners. Maxim had its headquarters in Howard County, and was an "S Corporation" for federal income tax purposes – meaning that its income "passed through" to its owners, and was not taxable to the entity. Because Maxim earned much of its income in states other than Maryland (it was a nationwide business), it filed income tax returns in 39 states: in states that recognized the Maxim's "S" status, Maxim filed "composite" returns on behalf of the shareholders (this way, the shareholders didn't have to file separately in the state, and were allocated a pro rata share of the state income tax Maxim paid on their behalf); in states that didn't recognize Maxim's S status, Maxim filed a separate corporate return. In 2006, the Wynnes had $2.67 million of taxable income (much of it from their 2.4% ownership in Maxim); through a combination of composite and corporate returns, the Wynnes paid their out-of-state taxes, which totaled nearly $85,000. The Wynnes claimed a full credit for these taxes, applying it to both their state and county tax which totaled, before credits, nearly $210,000.

The Comptroller denied the credit against the county tax, and issued an assessment for the resulting tax deficiency; the Wynnes appealed. The Appeals Section of the Comptroller's Office affirmed the assessment, with a slight adjustment. The Wynnes then appealed to the Maryland Tax Court, where they argued, for the first time, that limiting the credit to state tax discriminated against interstate commerce, in violation of the Commerce Clause. The Tax Court rejected that argument and affirmed the assessment in late 2009. The Wynnes appealed to the Circuit Court for Howard County, which reversed the Tax Court in July of 2011 (No. 13-C-10-80987). The Circuit Court held that limiting the credit to state income tax was indeed unconstitutional, and remanded the case to the Tax Court for further factual development and "an appropriate credit for out-of-state income taxes paid" on Maxim's income. An appeal to the Court of Special Appeals was noted; before that court heard the case, the Comptroller appealed to the Maryland Court of Appeals.

In early 2013, the Court of Appeals affirmed the Circuit Court, stating that while both the county income tax and the credit were constitutional, the application of the credit – "or lack thereof" – to the county income tax was not. The court noted that the credit previously applied to the county income tax, and "was only eliminated from the computation and application of the credit by a 1975 amendment of the tax code…that amendment, when applied to particular circumstances of taxpayers like the Wynnes…contravenes the Constitution." (431 Md. 147). The Comptroller appealed to the Supreme Court.

In a 5-4 decision, the Supreme Court affirmed the decision of the Maryland Court of Appeals, and held that Maryland's "personal income tax scheme" was unconstitutional. Justice Samuel Alito wrote the Court's opinion, which Justices John Roberts, Anthony Kennedy, Stephen Breyer and Sonia Sotomayor joined. Justices Antonin Scalia and Clarence Thomas filed separate dissenting opinions; Justice Ruth Bader Ginsberg filed a dissent, which Justices Scalia and Elena Kagan joined.

What Justice Alito said. In a nutshell, Justice Alito said that because Maryland does not offer a full credit for income taxes that residents pay to other jurisdictions for income "earned" within those other jurisdictions, some of that income can be taxed twice; because "Maryland's scheme creates an incentive for taxpayers to opt for intrastate rather than interstate economic activity," it violates the dormant Commerce Clause.

Time out: what is the "dormant Commerce Clause"? The Commerce Clause is found at Article I, Sec. 8, clause three of the Constitution. It provides that Congress has the power to "regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." In addition to being an express grant of Congressional authority, the clause has also come to mean (through case law) that states can't discriminate against interstate trade by, for example, imposing a tax that gives a direct commercial advantage to local business or subjects interstate commerce to "multiple taxation." This implicit command is known as the "dormant" (or negative) Commerce Clause.

Justice Alito analyzed some prior Supreme Court cases decided under the dormant Commerce Clause: these held that it was unconstitutional for a state to tax the out-of-state income of a resident corporation; why, he queried, should individuals have any less protection under that clause? He refuted the Comptroller's argument that because States provide their residents with many services, such as local roads, local police and protection and local public schools, they should have a free hand to tax their residents' out-of-state income; corporations, too, "benefit heavily" from state and local services, such as local roads to transport their goods, and local police and fire departments to protect their facilities. "Thus, disparate treatment of corporate and personal income cannot be justified based on the state services enjoyed by these two groups of taxpayers." And the Comptroller's "notion that the victims of such discrimination have a complete remedy at the polls is fanciful....It is even more farfetched to suggest that natural persons with out-of-state income are better able to influence state lawmakers than large corporations headquartered in the State."

Although the Constitution's Due Process Clause of the Fourteenth Amendment allows a State to tax *all* of a resident's income, even what is earned outside of the taxing jurisdiction, the State's imposition of the tax may still violate the Commerce Clause. Here, Maryland's tax scheme failed the "internal consistency" test. In other words, if every state did what Maryland did, and only gave a partial credit for out-of-state taxes, interstate commerce would be at a disadvantage compared to *intra*state commerce because that out-of-state income could be taxed twice. "Maryland's tax scheme is inherently discriminatory and operates as a tariff."

In response to the Comptroller's observation that Maryland receives less from residents who earn income from interstate, rather than intrastate, commerce, Justice Alito stated, "This argument is a red herring. The critical point is that the total tax burden on interstate commerce is higher, not that Maryland may receive more or less tax revenue from a particular taxpayer." While Maryland could cure the problem with its current system by granting a credit for taxes paid to other States, "we do not foreclose the possibility that it could comply with the Commerce Clause in some other way." The constitutionality of such a "hypothetical tax scheme that Maryland might adopt" was not before the Court, however. "That Maryland's existing tax unconstitutionally discriminates against interstate commerce is enough to decide this case."

Justice Scalia's dissent. Justice Scalia criticized the majority for invoking the "negative Commerce Clause," which he characterized as "a judge-invented rule" and a "judicial fraud" that allows judges to set aside state laws "*they believe* burden commerce" [italics in original]; he noted that there is no "negative" Commerce Clause in the Constitution, only the Commerce Clause. Justice Scalia observed that although Maryland's refusal to give residents full tax credits against income taxes paid to other states threatens double taxation and encourages residents to work in Maryland, it also allows the State to collect "equal revenue from taxpayers with equal incomes, avoids the administrative burdens of verifying tax payments to other States, and ensures that every resident pays the State at least some income tax."

Justice Thomas's dissent. Justice Thomas commented that the Court's opinion "proves just how far our negative Commerce Clause jurisprudence has departed from the actual Commerce Clause." The majority of the Court holds that Maryland's failure to give a full credit for taxes paid to other states violates the

Commerce Clause – "[t]hat news would have come as a surprise to those who penned and ratified the Constitution." He said that he doubted that the majority's application of the negative Commerce Clause was correct under the Court's precedents, and was "certain that the majority's result is incorrect under our Constitution."

Justice Ginsberg's dissent. Justice Ginsberg noted that a state may tax *all* of a resident's income – yet under dormant Commerce Clause jurisprudence, "the Court decides, a State is not really empowered to tax a resident's income from whatever source derived." Because more is given to residents of a State than to those who reside elsewhere, more may be demanded of them – and the cost of services that are only available to residents is substantial. Although it was true that some of the Wynnes' income was taxed twice, the Wynnes "enjoyed equal access" to the State's services; now, with the Court's decision, they "will have paid $25,000 less [presumably the amount of the credit against their county tax] to cover the costs of those services than similarly situated neighbors who earned their income entirely within the State."

Justice Ginsberg summed things up this way: "This case is, at bottom, about policy choices: Should States prioritize ensuring that all who live or work within the State shoulder their fair share of the costs of government? Or must States prioritize avoidance of double taxation?" She said she would leave that choice to state legislatures and not the Court, and therefore would reverse the lower court decision.

Comments. *Wynne* is a big deal – and Maryland residents who have previously only received a credit against their Maryland *state* income tax for out-of-state taxes paid for "source" income in those other states are presumably now entitled to a credit against their *county* tax as well (residents who have been following the case closely have been filing protective refund claims to preserve their rights if Maryland lost in the Supreme Court; apparently there are already some 8,000 refund claims totaling $200 million). Going forward, then, Maryland needs to adjust its tax law, and counties will presumably receive fewer tax dollars, which could necessitate some difficult choices.

What does *Wynne* mean for taxpayers in other states? That remains to be seen. The Court viewed Maryland as an "outlier" because it doesn't give a full "state" credit for out-of-state income taxes that Maryland residents pay to other jurisdictions on out-of-state income. In other words, the Court (like the Maryland Court of Appeals) views the state and county taxes as "State" taxes, and not as separate taxes. Thus, even though Maryland gives a full credit against the "state" portion of the State tax and gives no credit against the county tax, the Court still views that as a partial credit, which potentially subjects the out-of-state income to double taxation and thereby violates the dormant Commerce Clause.

Yet does Maryland really have such an "unusual tax scheme"? Without doing an exhaustive study of the 40+ states with income taxes, it is hard to say. But it is interesting to see what the International Municipal Lawyers Association (IMLA) said in its *amicus* (or "friend of the court") brief in *Wynne*, namely: "Many other state and local governments have made similar choices to provide residents partial credits for foreign income taxes paid." And: "Many municipal governments impose taxes on residents' net income without a full credit for taxes paid in other states." As an example, the IMLA brief cites New York State, where two cities – New York City and Yonkers – impose an income tax: "And although a foreign tax credit is provided against the state-level income tax, no credit is provided against this municipal income tax."

So how might *Wynne* play out in New York? Let's look at this example: Sally is a New York City resident, and is therefore subject to both New York State *and* City income tax on all of her taxable income. She inherits her deceased mother's California home and sells it in 2014. Sally pays California income tax on the gains, which are also subject to New York State and City income tax. On her 2014 New York State return, Sally claims a New York *State* credit for some of that California tax, but can't claim a New York City credit for it – meaning that because she doesn't get a full New York credit for the California tax she paid, some of her

gain is taxed twice at the state level. Is this structure constitutional in light of *Wynne*…and does it matter that Sally's gain is from out-of-state real property rather than income from an out-of-state business, as with the Wynnes? Assuming that *Wynne* stands for the proposition that double taxation of out-of-state income is unconstitutional, that distinction should not matter. Accordingly, if Sally now files a refund claim for the "missing" New York City credit, will New York State comply, or is Sally looking at what could be very costly litigation? The answer is unknown, although litigation would not be a surprising outcome.

To echo Justice Ginsberg's observation, *Wynne* really is about policy decisions and a state's ability to tax its residents. It is undisputed that residents enjoy benefits, many of which are only available to residents; in *Wynne,* the result is that a resident taxpayer will now get a full credit for out-of-state taxes, and thereby pay less for local benefits than a neighbor with the same amount of taxable – purely in-state – income. Yet taxes always involve competing equities, which can never be fully reconciled. With *Wynne*, the Court held that the overriding equity is to prevent out-of-state income from being taxed twice.

Post-*Wynne*, states and municipalities are bound to be looking carefully at their tax laws to see whether they need to change those laws or anticipate challenges to them. And taxpayers who feel that their particular situation may fall within the *Wynne* parameters might want to consider making a protective refund claim so that the statute of limitations does not run out on that claim – in anticipation of their home state providing clarity on the issue. *Wynne* raises many questions that have yet to be answered. Stay tuned.

p.s. What about "statutory residency" and portfolio income? Suppose two states claim someone as a resident and tax *all* of the taxpayer's income, with no credit to the other state for taxes paid on, say, portfolio income, such as dividends and capital gains. Does *Wynne* now preclude this result? Let's look at this example:

John has a substantial brokerage account that generates significant income for him. He lives in New Jersey but works in New York City, where he maintains an apartment. Because John is in New York City for more than 183 days *and* maintains a permanent place of abode there, he is what's known as a "statutory resident" – of both New York State and City. As such, he is subject to New York State and City income tax on *all* of his income, and not just on what he earns there (his "source income"). New Jersey gives him a credit for the New York tax he pays on his source income, but not for the New York tax on his portfolio income; New York will not give him a credit for the New Jersey tax on any of his income. Result: John is taxed twice on his portfolio income.

Doesn't this double taxation run afoul of the Commerce Clause and burden interstate commerce? John Tamagni, whose facts are outlined above, certainly thought so. He argued his case all the way to New York's highest court, the Court of Appeals, and lost nearly 20 years ago (the Supreme Court declined to hear his case). Would John still lose today? Arguably yes. The Court of Appeals said that the New York tax to which John was subjected on all of his income had nothing to do with his daily commute and economic activities in New York, but was strictly a function of the statutory residency rules: i.e., his presence in New York, coupled with his maintaining a permanent place of abode in New York. "Indeed, the fact that commuters who do not own or lease property in New York are not subject to this tax demonstrates that the tax is completely indifferent" to interstate activities, and therefore does not implicate the Commerce Clause. *Tamagni v. Tax Appeals Tribunal of the State of New York*, 91 N.Y.2d 530 (1998).

Statutory residency can thus catch "intangible property," such as stocks and bonds, and the income such property generates. In other words, intangible property is deemed to "reside" with its owner and is not considered to have a state "situs" (unlike, say, real estate and tangible personal property) *unless* it has to do with a trade or business conducted in that state. Accordingly, income from intangible property is typically taxable in the state in which its owner resides; if two states claim that owner as a resident – namely, the

domiciliary state and the state where the owner tripped the statutory residency rules – both states can tax that income, with no offsetting credits for what the other state charges. So yes, double taxation can happen.

Does *Wynne* give taxpayers caught in this unfortunate situation new hope? Never say never, but the statutory residency rules, which simply look to a taxpayer's "presence" in a jurisdiction, seem different from the issue in *Wynne*: namely, whether the dormant Commerce Clause precludes the double-taxation of out-of-state income.

June 7520 rate

The IRS has issued the June 2015 applicable federal rates: the June 7520 rate is 2.0%, a 0.20% (20 basis points) increase from May's 1.8% 7520 rate. The June mid-term rates are: 1.60% (annual), 1.59% (semiannual and quarterly) and 1.58% (monthly). The May mid-term rates were: 1.53% (annual) and 1.52% (semiannual, quarterly and monthly).

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Tax Topics

04/24/15

2015-04

Round up

April 15th is just behind us, leaving many taxpayers a little less flush after paying off the balance of their 2014 income tax obligations. In honor of "Tax Day," we wanted to mention a few bills that the House of Representatives passed on April 16th, mostly along party lines: H.R. 622, the "State and Local Sales Tax Deduction Fairness Act of 2015," and H.R. 1105, the "Death Tax Repeal Act of 2015." Although it is unclear if and when the Senate might take up these bills, it matters not: President Obama has promised to veto both of them if they end up on his desk. Here's what the bills would do:

- **H.R. 622, the "State and Local Sales Tax Deduction Fairness Act of 2015."** This bill would make permanent a taxpayer's ability to deduct state and local sales taxes in lieu of state and local income taxes (taxpayers must itemize their deductions to take advantage of this provision, and typically live in states without an income tax). The bill has no offsets to pay for it, and the Joint Committee on Taxation (JCT) projects its cost at about $42 billion over 10 years. The vote was 272 to 152, with 238 Republicans and 34 Democrats in favor of the bill, and 151 Democrats and one Republican against it.

  Comments. Although there is bipartisan support for this provision (it expired – again – at the end of 2014), most Democrats opposed the bill because it had no "pay-fors" and would have added to the long-term deficit. This is the same objection that Democrats have had to other Republican attempts to make permanent certain other popular "extenders" – temporary provisions that Congress regularly renews at one- to two-year intervals, including the now-expired charitable IRA rollover provision. Republicans view the sales tax deduction as a simple question of tax fairness that should be made permanent so that taxpayers know what to expect. (Note that extenders are generally easier to pass than permanent provisions because they are viewed as less costly from a budget perspective: revenue estimators must assume that temporary provisions actually expire, no matter how improbable that is as a matter of tax policy.)

- **H.R. 1105, the "Death Tax Repeal Act of 2015."** This bill would repeal the estate tax and generation-skipping transfer tax (GST) as of the Act's enactment, although distributions from qualified domestic trusts (QDOTs) would still be subject to estate tax for 10 years after the bill's enactment (QDOTs are trusts for non-citizen surviving spouses, and postpone estate tax at the first spouse's death). The gift tax would remain, with a 35% tax rate and a $5 million exclusion, annually indexed for inflation. Lifetime gifts into trusts would be treated as taxable gifts unless the trust was a "grantor trust" (grantors are responsible for paying the income taxes of such trusts). The JCT projects the bill's cost at about $269 billion over 10 years. The vote was 240 to 179, with 233 Republicans and 7 Democrats in favor of the bill, and 176 Democrats and 3 Republicans against it.

  Comments. The Death Tax Repeal Act is essentially the same as the estate tax and GST repeal that took effect in 2010, with one notable exception: it does not have the modified carryover basis regime that also took effect in 2010 and generally passed along a decedent's built-in capital gains to heirs, subject to a limited basis step-up of $1.3 million, plus an additional $3 million for property passing to a surviving spouse. (Repeal was itself retroactively repealed in late 2010; estates of 2010 decedents could opt out of the estate tax in favor of the modified carryover basis regime.) In other words, the Death Tax Repeal Act not only eliminates transfer tax at death, but retains the stepped-up basis rules that eliminate built-in capital gains on a decedent's appreciated property. (Retention of these rules could account for a good deal of the bill's projected cost.)

  Not surprisingly, the Administration has stated that it "strongly opposes" the bill. This position is consistent with various proposals in Mr. Obama's Fiscal Year 2016 Budget, including: 1) reverting to the 2009 transfer tax regime in 2016: $3.5 million estate tax exclusion and GST exemption, $1 million gift tax exclusion, and top estate and gift tax and GST rate of 45%; and 2) treating most transfers of appreciated property – whether by lifetime gift or at death – as deemed sales that trigger capital gains tax.

  It goes without saying that the estate tax – or "death tax," as the bill refers to it – is a true hot-button item that engenders fierce debate: on one side, are those who feel passionately that death should not be a "taxable event" and that it is wrong to tax the family farm or business, or a lifetime of savings; on the other side, are those who feel just as passionately that eliminating the estate tax would create a monied aristocracy, exacerbate wealth inequality and deficits, and be a boon to the wealthiest of the wealthy. However one comes out on the issue, it is a fact that the nearly 100 year-old federal estate tax now affects fewer and fewer people: the inflation-indexed $5 million exclusion means that in 2015, an individual can protect $5.43 million from gift and estate tax ($10.86 million per married couple); according to the Center on Budget and Policy Priorities, this means that the federal estate tax only affects about 2 out of every 1,000 decedents (0.20%). This exclusion, along with the current basis step-up rules, mean that many estates pass free of both federal estate tax and any built-in income tax liability (note that *state* estate tax/inheritantance tax might still apply, and that the basis step-up rules don't apply to assets such as retirement accounts).

  One way of looking at Mr. Obama's proposals (more robust transfer taxes and what amounts to a capital gains tax at death) and the Death Tax Repeal Act is that they represent two extremes: the possibility of property being taxed twice at death, or not at all. Does either approach have a chance of currently being enacted? No. But after the 2016 elections? That's a different question.

  Right now, both parties are basically at a stalemate – at least as to anything remotely ideological – and are trying to score political points while setting the stage for the 2016 elections. The most obvious change these elections will bring is a new occupant of the White House. As to Congress, the current House of Representatives has 244 Republicans, 188 Democrats and 3 vacancies; the current Senate has 54 Republicans, 44 Democrats and 2 Independents, both of whom caucus with the Democrats. In

2016, the entire House is up for re-election, of course, as is one-third of the Senate. Of that one-third, 10 are Democrats, three of whom are retiring (Barbara Boxer (CA), Barbara Mikulski (MD) and Harry Reid (NV)); the other 24 seats are currently held by Republicans (note that Marco Rubio (FL) is running for President and is not running for re-election). Although the gap between the number of Republicans and Democrats in the Senate is much narrower than the gap in the House, Democrats have their work cut out for them if they hope to retake control of both houses of Congress.

What the looming 2016 elections presumably mean for tax legislation is that while the current Congress will need to address certain provisions – such as the 50+ extenders that expired at the end of 2014, including the sales tax deduction – *major* legislation that requires bipartisan cooperation seems unlikely until at least 2017, assuming it happens.

Nightmare on Elm Street

Imagine the following scenario: Dad is a very successful insurance broker. He has deferred compensation arrangements with Company, pension benefits and a 401(k); he also has life insurance, and an IRA. He marries Wife in 1990, and names her as sole beneficiary of some of these assets, and as co-beneficiary of others. (We'll assume that Son, presumably from a prior marriage, is the other co-beneficiary). Dad divorces Wife in 2006. Pursuant to his divorce decree, Dad agrees to keep $1 million of insurance on his life for Ex-Wife's benefit. Dad dies in 2009, never having changed any of his beneficiary designations.

Son, Dad's executor, and Ex-Wife both present claims to Company regarding the deferred compensation and pension benefits payable at Dad's death. Son says that under the divorce settlement agreement, Ex-Wife waived any rights or expectancy interests in these assets; Ex-Wife insists that she didn't. Company files an interpleader action, and asks the local district court to decide who gets the property: Dad's estate or Ex-Wife? The District Court finds for Ex-Wife, who "*never had any claims against her former husband to waive"* [italics in original]; her claims didn't arise – against Company – until Dad's death, since Dad could have changed the beneficiary designations at any time after his divorce, but didn't. *New York Life Insurance Company v. Smoot and Smoot*, Southern District Court of Georgia, CV 209-047, 11/30/09.

Act II begins with Son going back to the same District Court to get reimbursed from Ex-Wife for the estate tax dollars attributable to the $5.4 million worth of property she received (Son received $2.2 million from Dad's estate and Dad's former business partner received about $100,000). Son argues that Ex-Wife owes nearly $1 million of the nearly $1.5 million in estate taxes that Son has already paid to the IRS from Dad's estate. (In the meantime, Ex-Wife pointed out that because Dad was required to maintain $1 million worth of life insurance coverage for her benefit, part of what she received was a legitimate claim on the estate, and therefore deductible; the IRS agreed and reduced the estate tax bill.)

Back in the District Court, Son makes two arguments for why Ex-Wife should pay her share of tax: 1) the tax law allows the executor to recover tax from beneficiaries of life insurance policies (IRC Sec. 2206, for tax mavens); and 2) the tax apportionment clause in Dad's will says that "[a]ll transfer, estate, inheritance, succession and other death taxes which shall become payable by reason of my death…shall be charged against and paid by the recipient of such property or from the property to be received."

Ex-Wife argues that she is not liable for the $350,000+ of tax attributable to the non-life insurance assets she received (i.e., the deferred compensation, the IRA, the 401(k) and the annuity, none of which are covered under IRC Sec. 2206) for two reasons: 1) Georgia (where this all took place) does not provide for a right of contribution for taxes; and 2) even if there were such a right, her divorce from Dad makes the terms of his will inapplicable to her.

The District Court again agrees with Ex-Wife. It says that it doesn't even need to consider Ex-Wife's first argument, since Georgia law is quite clear in stating that "[a]ll provisions of a will made prior to a testator's final divorce…in which no provision is made in contemplation of such event shall take effect as if the former spouse had predeceased the testator." Because the tax apportionment clause is a "provision" like any other, it doesn't apply to Ex-Wife: she and Dad divorced after he executed his will, and his will didn't contemplate divorce; Ex-Wife is therefore treated as having predeceased Dad. While this may be an unintended outcome of Georgia's probate code, that statute is unambiguous, and also applies to the tax apportionment clause. Son appears to be caught "in a gap between the two systems" – having to pay the taxes on his father's estate and being precluded from collecting tax because of Georgia's probate code; this outcome, the court says, is "inescapable." *Smoot v. Smoot*, Southern District Court of Georgia, No. 2:13-cv-0040, 3/31/15.

Comments. Wow. Not only does Ex-Wife get the property that still names her as beneficiary, she also doesn't have to pay any estate tax on it! So what might have been done differently to prevent this outcome? Although it is true that Georgia law does not have a default provision that allocates estate taxes to beneficiaries, that would not have mattered if Dad had simply updated his beneficiary designations after his divorce to name someone other than Ex-Wife.

As a practical matter, many states have laws that would at least have mitigated this result: an ex-spouse may be barred from taking property via a "stale" beneficiary designation, and default tax apportionment laws may require beneficiaries to pay their pro rata share of estate tax, subject to a contrary provision in the decedent's will (or revocable trust). Yet while state law may come to the rescue and preclude a now ex-spouse from taking, say, life insurance or an annuity, it will not necessarily work with respect to retirement accounts, which are typically governed by federal law (ERISA).

But rather than having to litigate a matter or hope that state law is on the decedent's side, wouldn't it be better to regularly check planning documents – including beneficiay designations – to make sure that they still accomplish their desired purpose? This is especially true if there has been a major life event, such as marriage, divorce, death, or the birth of a child. Judging by the number of cases dealing with ex-spouses and "stale" beneficiary designations, however, such periodic planning checks don't happen nearly enough.

May 7520 rate

The IRS has issued the May 2015 applicable federal rates: the May 7520 rate is 1.8%, a 0.20% (20 basis points) decrease from April's 2.0% 7520 rate. The May mid-term rates are: 1.53% (annual) and 1.52% (semiannual, quarterly and monthly). The April mid-term rates were: 1.70% (annual), 1.69% (semiannual and quarterly), and 1.68% (monthly).

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Tax Topics

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It's been several years since we did an estate planning glossary. On the theory that it never hurts to be reminded of things, here is a current version of that effort, along with selected income tax and retirement plan terms.

Estate Planning & Tax Glossary

Adjusted Gross Income (AGI) – AGI equals all income that is taxable minus "above-the-line" deductions, such as those for alimony and one-half of the self-employment tax. Taxpayers with AGI above a threshold amount (e.g., $309,900 for married couples filing jointly in 2015) will start to see many of their itemized deductions reduced (see Pease Limitation) and could lose *all* of their personal exemptions (see PEP).

Adjusted Taxable Gift – a lifetime gift that uses up part of the donor's applicable exclusion amount (see below) and that is part of the donor's estate tax computation. Annual exclusion gifts (see below) and direct payments of tuition and medical expenses (including health insurance premiums) are not adjusted taxable gifts and do not erode the donor's applicable exclusion amount.

After-tax Dollars – dollars on which income tax has already been paid. Roth IRAs and 529 plans (see below), for example, are funded with after-tax dollars.

Alternative Minimum Tax (AMT) – the AMT is a parallel tax system designed to ensure that taxpayers pay "enough" income tax. Originally targeted against a relative handful of wealthy taxpayers, the AMT now reaches deep into the middle class, and disallows many tax benefits (such as deductions for state and local taxes) in computing the AMT. Taxpayers pay AMT if it exceeds their "regular" tax.

Annual Exclusion Gifts – refers to the inflation-indexed amount that donors can give, gift tax-free, to as many people as they want, every year. In 2015, this amount is $14,000 per donee ($147,000 if the donee is a spouse who's not a U.S. citizen). If one spouse wants to make a gift, and the other spouse agrees to it, the gift can be $28,000 per year (a "split gift"). Annual exclusion gifts do not erode the donor's applicable exclusion amount (see below).

Annuity – a fixed amount that is typically payable for a period of years, the annuitant's lifetime, or a

combination of the two. While an annuity offers the certainty of a steady payment, it is not considered a hedge against inflation.

Applicable Credit Amount – once known as the "unified credit." The credit applies against Federal estate and gift tax, and in 2015, is $2,117,800 (i.e., the estate tax on $5.43 million, the 2015 basic exclusion amount (see below)).

Applicable Exclusion Amount – the amount of property that can be sheltered from gift and estate tax. It consists of the inflation-adjusted $5 million "basic exclusion amount" (see below) and for surviving spouses, if applicable, the "deceased spousal unused exclusion amount" (DSUE – see below). If there is no DSUE, the applicable exclusion and basic exclusion amounts are the same.

Ascertainable Standard – a clearly discernible standard by which a trustee is allowed to pay income or principal to a trust beneficiary. A typical ascertainable standard permits distributions for a beneficiary's "health, education, maintenance and support" (what's known as the "HEMS standard"). When a trustee has a "beneficial interest" in the trust – i.e., is eligible for principal or income distributions – such standards prevent the trust property from being includible in the trustee/beneficiary's taxable estate, *and* from being a taxable gift when the trustee/beneficiary makes discretionary distributions to other beneficiaries.

Basic Exclusion Amount (BEA) – this amount is $5 million, indexed for inflation as of 2012. The BEA has increased as follows: $5.12 million (2012), $5.25 million (2013), $5.34 million (2014), and $5.43 million (2015). The BEA is part of the applicable exclusion amount (see above) and helps protect property from gift and estate tax.

Charitable Deduction – the deduction against income, gift and estate taxes for gifts to charity. The charitable income tax deduction is limited, but the gift or estate tax deduction is unlimited.

Charitable Gift Annuity – an annuity paid by a charity in exchange for a gift to that charity. With cash gifts, the annuity payments are treated as part ordinary income and part return of the investment. With gifts of appreciated property, the transfer is a "bargain sale," and the annuity payments are treated as part ordinary income, part long-term capital gain (if the asset was owned for more than a year) and part return of the investment. If the annuitant outlives her life expectancy (determined at the gift's inception), her continuing payments will be treated as ordinary income; when the gift is made, the present value of charity's remainder interest is eligible for a current income tax deduction. Typically, a charitable gift annuity pays less than a commercial one, and is generally based on recommendations from the American Council on Charitable Gift Annuities. A charitable gift annuity can be a good way to benefit charity *and* retain an income stream. Note that distributions from a charitable gift annuity (other than those that represent a return of capital) are subject to the 3.8% tax on net investment income (see below).

Charitable Lead Trust (CLT) – a "split-interest" trust that is the inverse of a charitable remainder trust (CRT – see below). With a CLT, charity gets the "up-front" income interest, generally for a period of years, and the donor's heirs get the "remainder interest," or what's left over after the income interest ends. The charitable interest usually doesn't generate an income tax deduction, but does generate a gift or an estate tax deduction that helps offset the gift of the remainder interest. As with a CRT, the CLT's income interest must be either an annuity (a fixed amount that never varies) or a unitrust interest (a variable amount that reflects increases (or decreases) in the trust's value). Unlike a CRT, a CLT has no required minimum payout. A CLAT is a charitable lead annuity trust and CLUT is a charitable lead unitrust. CLTs are subject to the 3.8% tax on net investment income (see below).

Charitable Remainder Trust (CRT) – a "split-interest" trust that is the inverse of a charitable

lead trust (see above). With a CRT, an individual gets the "up-front" income interest for a period of years (no more than 20) or life, and charity gets the "remainder interest" (what's left over after the income interest ends). Charity's interest is not subject to estate or gift tax, and is eligible for an income tax deduction (subject to limitations) if the donor creates the CRT during life. Lifetime CRTs are typically used to diversify low-basis assets and defer capital gains tax. The trust's payout is taxable to the up-front beneficiary, but will benefit from favorable capital gains tax rates if the trust is invested for growth (note that distributions of post-2012 income will be treated as "net investment income" (NII) for purposes of the 3.8% tax on NII – see below). With a ***CRAT (charitable remainder annuity trust)***, the payout must equal at least 5% (but no more than 50%) of the trust's *initial* value, and there can't be greater than a 5% probability that the trust's principal will be exhausted before the up-front interest ends. With a ***CRUT (charitable remainder unitrust)***, the payout must equal at least 5% (but no more than 50%) of the trust's *annual* value. For any CRT, charity's remainder interest must equal at least 10% of the trust's initial value. The ***"FLIP-CRUT"*** is a variation on the CRUT, and can effectively serve as an additional retirement vehicle: the trust initially pays the lesser of its income or at least 5% of its annual value, and turns into a regular CRUT on the happening of a specified non-discretionary event (such as the birth of a grandchild) or on a specified date (such as anticipated retirement).

Community Property – the property ownership system that applies in nine states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin. (Alaska has an elective community property system.) Community property applies to married couples, with each spouse deemed to own one-half of the property. When the first spouse dies, the cost basis of all community property, not just one-half, is adjusted to its fair market value. Assuming the property has appreciated, this basis "step-up" wipes out *all* of the property's built-in capital gains. This treatment is more favorable than that of jointly held spousal property in the rest of the United States: in general, when the first spouse dies, only one-half of the jointly held property gets a basis adjustment, so that only one-half of the built-in capital gains disappear.

Credit Shelter Trust – a trust that is typically created under someone's will and is funded with the amount that can be protected from estate tax (see Applicable Exclusion Amount). A credit shelter trust usually provides for the surviving spouse and children, and can pass tax-free to children at the spouse's death; it shelters property from estate tax in both spouses' estates.

Crummey Power – a power designed to ensure that a donor's gift to a trust is a "present interest" and therefore qualifies for the annual exclusion (see above). A Crummey power permits the beneficiary to withdraw the gift for a limited period of time (say, 30 days). If the trust has no Crummey powers, lifetime gifts from the donor typically will be ineligible for the annual exclusion and will erode the donor's applicable exclusion amount (see Adjusted Taxable Gift) unless the trust qualifies as a Minor's Trust (see below). Crummey powers are typically used in irrevocable life insurance trusts (see below). "Crummey" was the name of the taxpayer who litigated this issue.

Decanting – refers to when a trustee "pours over" – or decants – an existing trust into a new trust. Although not every jurisdiction permits decanting (for which the rules vary), decanting can still be permitted by the trust terms. In general, decanting is done to facilitate the trust's administration.

Decoupling – refers to what a number of states (about 18 or so) have done to preserve *state* estate tax dollars: by untying themselves from the federal system, decoupled states can still collect state estate tax dollars. Many decoupled states (such as Massachusetts and Vermont) base their tax on the now-repealed state death tax credit (a former revenue-sharing arrangement between the states and Uncle Sam); other decoupled states (such as New York and Washington) have stand-

alone estate tax systems. Yet regardless of how the decoupled state calculates its estate tax, residents of such states or non-residents who own property there may have *state* estate tax issues even if those individuals are no longer subject to federal estate tax.

Defined Value Clause – a clause designed to mitigate adverse gift tax consequences when the donor gives away hard-to-value property. With such a clause, the gift's value typically equals a fixed dollar amount: if the IRS argues that the property is undervalued, the clause reallocates the donor's "excess" gift to another beneficiary (such as charity); if charity is not involved, the formula can effectively reallocate the excess to the donor – an approach the IRS opposes.

Donor-Advised Fund – a charitable fund that is typically run by a community trust or a financial institution. The donor's contribution goes into a separate account, and is eligible for a current income tax deduction even though the dollars may not be currently paid to charity. Because the fund is treated as a public charity, the donor is entitled to a larger income tax deduction than for gifts to a private foundation (see below).

DSUE (Deceased Spousal Unused Exclusion Amount) – in the case of a surviving spouse, the DSUE represents the amount of unused applicable exclusion amount of the last predeceased spouse (see "Portability"). In other words, for example, if Wife survives Husband, the DSUE represents the lesser of Husband's basic exclusion amount (see above) or his applicable exclusion amount (which could include DSUE from *his* predeceased prior wife) minus his taxable estate. The DSUE can't be any larger than the basic exclusion amount in effect at the predeceased spouse's death.

Dynasty Trust – a trust that is created in a jurisdiction that has abolished the "rule against perpetuities" (see below). A dynasty trust can theoretically last "forever" and need not terminate when the law usually requires trusts to terminate – generally about 100 years after they are created. Such trusts are typically set up in Delaware, South Dakota or Alaska.

Estate Tax – a tax on the transfer of property at death. Generally, if a decedent's taxable estate exceeds her available applicable exclusion amount (see above), her estate will be subject to estate tax. Now that this exclusion is permanently $5 million, indexed for inflation, fewer individuals may be affected by the federal estate tax, for which the top rate is 40%. (The 2015 basic exclusion amount (see above) is $5.43 million.)

Executor – the individual, bank or trust company named in someone's will to administer that person's estate when she dies, and to ensure that the will's terms are carried out (a bank or trust company in that role is called a "corporate" executor). The executor's duties include figuring out what the decedent owned, gathering the decedent's assets, determining her debts and liabilities, and filing any necessary federal or state estate tax returns and final gift and income tax returns. The executor also must make a number of post-mortem tax planning decisions and preserve the estate's assets before they are distributed. This can mean managing those assets, and appropriately insuring them.

Family Limited Partnership (FLP) – a pass-through entity that can garner gift and estate tax valuation discounts, since limited partnership interests are worth less than the underlying partnership property ("pass-through" means that income passes through to the partners, and is not separately taxed to the partnership). Discounts arise because of restrictions on the rights and powers of limited partners: for example, limited partners cannot freely transfer their respective interests, control distributions, participate in the partnership's management, or easily withdraw from the partnership. FLPs (along with limited liability companies – see below) invite scrutiny from the IRS; they are generally looked upon

more favorably if they have "legitimate non-tax purposes," and are funded with some kind of working business, rather than just marketable securities or cash.

Fiduciary – one who stands in a relationship of trust to others, and often holds people's assets. Executors and trustees, for example, are fiduciaries. A bank or trust company is a "corporate" fiduciary. As then-Judge Benjamin Cardozo described the fiduciary's standard of behavior in a 1928 New York Court of Appeals case (*Meinhard v. Salmon*), it requires "[n]ot honesty alone, but the punctilio of an honor the most sensitive."

529 Plan – a tax-preferred account that allows parents, for example, to save for their children's higher education. Like a Roth IRA, a 529 plan is funded with after-tax dollars (see above); as long as withdrawals are used for "qualified higher education expenses," such as college tuition and room and board, the earnings portion of the withdrawal is not subject to income tax. All 50 states offer these plans.

Generation-Skipping Transfer Tax (GST) – a transfer tax that is *in addition* to the estate or gift tax; it typically applies to transfers, whether outright or in trust, to people two or more generations below the donor, such as grandchildren. The GST exemption (or amount that can be protected from GST) equals the basic exclusion amount (see above); in 2015, it is $5.43 million. Unlike the applicable exclusion amount (see above), the GST exemption is not "portable" from the deceased spouse to the surviving spouse. The tax rate is 40%.

Gift Tax – a tax on lifetime transfers of property. The basic exclusion amount (see above), which equals $5.43 million in 2015, protects lifetime transfers from gift tax. The top gift tax rate is 40%.

Grantor – the person who creates a trust is called a grantor. Another term for this is "settlor" or "trustor."

Grantor Retained Annuity Trust (GRAT) – a trust that is used to transfer future appreciation to the grantor's children at little or no gift-tax cost. The grantor funds a GRAT with property that is likely to appreciate significantly or is a "cash cow"; the trust pays the grantor an annuity, typically for two to three years. At the end of that period, whatever is left in the GRAT (the "remainder interest") passes either outright or in further trust to the grantor's children. The GRAT is generally structured so that the present value of the grantor's annuity equals virtually 100% of what the grantor put into the trust, thereby eliminating the gift to heirs (a "zeroed-out GRAT"). Assuming the GRAT outperforms the interest rate used to value the annuity (see 7520 Rate), that "excess" will pass tax-free to children.

Grantor Trust – a trust the grantor creates while she's alive, and that she owns, for income tax purposes (such as a revocable trust – see below). In other words, the trust is not a separate taxpayer, and its income, losses, deductions and credits are reported on the grantor's income tax return. A "defective" grantor trust is deliberately structured to be taxable to the grantor for income tax purposes but will not be includible in her estate. The advantage of such a trust is that the grantor's payment of the trust's income taxes is effectively a tax-free gift to the trust and its beneficiaries, who are relieved of the tax liability; also, transactions between the grantor and the trust (such as a sale of appreciated assets) are not taxable.

Gross Estate – refers to everything a decedent owns at death, including individually owned property, her share of jointly held property, pension plans, insurance benefits, etc. Determining the size of a decedent's gross estate is the first step in determining her potential estate tax liability.

Health Care Proxy – the document in which an individual names someone else to be her "health care agent" or "health care surrogate." The agent will make health care decisions for the individual when she no longer can. The rules regarding

health care proxies vary from state to state. See Living Will, below.

HIPAA – refers to the Health Insurance Portability and Accountability Act, which has rules regarding patient privacy. Health care providers cannot share information regarding an individual's medical treatment or conditions with, say, family members unless the patient consents to such sharing or, if the patient is not able to consent, the provider feels it's in the patient's "best interests."

Incentive Trust – a trust that is typically created under someone's will, and that is designed to reward beneficiaries for certain types of behavior, such as achieving high grades or finding gainful employment. Incentive trusts, for example, may authorize principal distributions equal to a beneficiary's earned income: although well-meaning, such "carrots" could inadvertently penalize a beneficiary who chooses a low-paying profession or stays at home to raise a family or take care of a disabled relative – probably not what the trust's creator had in mind!

Income Beneficiary – the individual or entity currently eligible to receive income from a trust.

Inherited IRA – typically refers to an IRA that a non-spouse beneficiary receives after the IRA owner's death. For example, if deceased Dad names Daughter as his IRA beneficiary, Daughter has an Inherited IRA.

Inheritance Tax – a tax that some states impose at death. Unlike the estate tax, which is imposed on *property* passing at someone's death, an inheritance tax is imposed on the *recipient* of the property, based on the recipient's relationship to the decedent: in general, the closer the degree of kinship, the lower the tax.

***In Terrorem* Clause –** a clause in a will (or revocable trust) that threatens to disinherit anyone challenging the document. Courts are generally reluctant to enforce "no-contest" clauses and construe statutes authorizing them very narrowly. In some jurisdictions, such as Florida, these clauses are unenforceable.

Intestate – when an individual dies without a will to dispose of her probate estate (see below) at death, this property will pass by "intestate succession" under local law, which sets forth who the individual's heirs are and how much they will take (first in line are typically the surviving spouse and children).

Itemized Deductions – these deductions are reported on Schedule A of Form 1040, and reduce the taxpayer's taxable income. They include deductions for state and local income taxes, mortgage interest and charitable contributions; other items, such as medical and miscellaneous expenses, must exceed certain percentages of adjusted gross income (AGI – see above) to be deductible. If the taxpayer's AGI exceeds a threshold amount (e.g., $309,900 for married joint filers in 2015), the taxpayer's itemized deductions may be subject to the Pease limitation (see below). Itemized deductions are in lieu of the standard deduction.

Irrevocable Life Insurance Trust (ILIT) – an irrevocable trust designed to own insurance on an individual's life, and remove the insurance from that person's taxable estate. Typically, the insured's surviving spouse and children are the trust beneficiaries; when both spouses are gone, the trust passes estate tax-free to children. Insurance trusts usually have Crummey powers (see above) so that gifts to the trust (generally used to pay insurance premiums) qualify for the annual exclusion (see above). If an existing policy is transferred to the trust, the insured must live for three years to keep the insurance out of his estate; if the insured's trustee buys the policy, the three-year rule does not apply.

"Kiddie Tax" – an income tax rule that taxes a child's "unearned income" in excess of $2,100 (the 2015 threshold) at the parent's highest rate. The kiddie tax applies to children under 18, and to 18 year-olds and full-time students, age 19 – 23, who don't earn more than half of their own support. (Unearned income refers to investment income such as interest, dividends and capital gains.) Custodial accounts under the Uniform Transfers to Minors Act, for example, are subject

to the kiddie tax (see UTMA/UGMA accounts). Note that if the parent elects to report the child's income on the parent's income tax return (as opposed to filing a separate return for the child), the child's unearned income will be included in the parent's unearned income for purposes of the 3.8% tax on net investment income (see below).

Life Expectancy – the length of time someone is expected to live according to a given mortality table. For example, according to the mortality table used to determine "required minimum distributions" (see below) for an "inherited IRA" (see above), the life expectancy of a 40 year-old is 43.6 years.

Limited Liability Company (LLC) – like the family limited partnership (FLP – see above), LLCs are often used for planning purposes, and typically contain various restrictions on marketability and transferability of LLC interests, which can help garner valuation discounts for the members' interests. The LLC is a pass-through entity, meaning that its income passes through to its members. LLCs (along with FLPs) are under scrutiny from the IRS; they are generally looked upon more favorably if they have "legitimate non-tax purposes," and are funded with some kind of working business, rather than just marketable securities or cash.

Living Will – a document that sets forth someone's health care wishes when she no longer can. Because the law generally presumes that individuals would want everything done to keep them alive, living wills typically (but not always) rebut that presumption and direct that the individual not be kept in a "persistent vegetative state." Most states recognize living wills, which are often coupled with a "health care proxy" (see above).

Marital Deduction – the deduction against gift or estate tax for gifts made by one spouse to the other, either outright or in trust. The deduction effectively postpones tax until the surviving spouse dies, and is unlimited if that spouse is a U.S. citizen (if not, the deduction is subject to restrictions – see Annual Exclusion Gifts, above, and QDOT, below).

Minor's Trust – a trust that holds property for a minor child, and is sometimes referred to as a "2503(c) trust." Gifts to the trust qualify for the annual gift tax exclusion even though the trust beneficiary does not have a Crummey power (see above). The trust must be solely for the child, and can be used for the child's benefit before he reaches age 21, when the property must be turned over to him. The trust may, however, give the child, say, 30 days to terminate it at age 21; if the child does not, the trust will continue.

Net Investment Income (NII) – as of 2013, a 3.8% tax applies to "net investment income." NII includes interest, dividends, annuities, royalties, rents and capital gains (i.e., passive income), but not distributions from retirement accounts such as IRAs and 401(k)s, self-employment income, excluded gain (as from the sale of a principal residence) and municipal bond income. (See 3.8% Tax on Net Investment Income.)

Pease Limitation – refers to the limitation on most itemized deductions (see above) if a taxpayer's adjusted gross income (AGI – see above) exceeds a threshold amount. In 2015, for married couples filing jointly, that amount is $309,900, and for single taxpayers, it is $258,250. "Pease deductions" include those for state and local taxes, mortgage interest and charitable contributions, but *not* those for medical expenses, investment interest or casualty, theft or wagering losses. Taxpayers affected by Pease will see their Pease deductions reduced by the *lesser of* 3% of their AGI in excess of the relevant threshold amount OR 80% of their Pease deductions. Unless the taxpayer's AGI is exponentially higher than his Pease deductions, however, the 3% "haircut" will likely apply. ("Pease" is the name of the lawmaker who introduced this provision.)

PEP – refers to the "personal exemption phase-out." Taxpayers with adjusted gross income (AGI – see above) over a threshold amount – e.g., in 2015, $309,900 (married couples filing jointly) and

$258,250 (single taxpayers) – are subject to PEP, which can eliminate all personal exemptions (they are phased out by 2% for every $2500 by which the taxpayer's AGI exceeds the relevant threshold amount).

Per Capita – "by the head." Trust documents occasionally provide that when the current beneficiary dies, the remaining trust property will pass to the individual's "surviving issue, *per capita* and not *per stirpes*." This means that all of the beneficiary's surviving descendants take an equal share of what's left of the trust. To illustrate, assume that Parent is the current beneficiary, and has three children, each of whom has two children. At Parent's death, the property passes to her surviving issue, *per capita* and not *per stirpes*. Because Parent has nine surviving descendants (three children and six grandchildren), each one receives 1/9 of the trust remainder. The more usual distribution, however, is *per stirpes* (see below).

Per Stirpes – "by the stocks" or "by the roots." Trust documents often provide that when the current beneficiary dies, the remaining trust property will pass to the individual's "surviving issue, *per stirpes*." This means, for example, that grandchildren split whatever share their deceased parent would have received. To illustrate, assume that Parent is the current beneficiary, and has three children, each of whom has two children. Parent's son predeceases her. At Parent's death, the property passes to her surviving issue, *per stirpes*. Parent's two living children each take 1/3, and her predeceased son's two children split their father's 1/3 share, each taking 1/6. Contrast this disposition with "*per capita*" (see above).

Pre-tax Dollars – dollars on which income tax has not yet been paid. Many retirement accounts (such as 401(k)s) are funded with pre-tax dollars – meaning that future distributions from the account will generally be subject to income tax.

"Portability" – this refers to a surviving spouse's ability to effectively "inherit" her deceased spouse's unused applicable exclusion amount – or DSUE (see above). For this to happen, the executor must file a timely estate tax return for the deceased spouse, even if that spouse's estate is under the filing threshold ($5.43 million in 2015); merely filing the return is deemed to elect portability. The surviving spouse can use the leftover exclusion for gift OR estate tax purposes. Note that the deceased spouse's unused generation-skipping transfer tax exemption (see above) is not portable, nor is that spouse's unused *state* estate tax exemption (except in Delaware and Hawaii).

Power of Appointment – a trust beneficiary's right to direct who takes trust property, either during the beneficiary's life or at death. With a "general power of appointment" (GPA), the beneficiary can give the property to herself, her estate, her creditors or the creditors of her estate – in addition to giving it to other people. GPA property is includible in the beneficiary's estate for estate tax purposes. With a "limited power of appointment" (LPA), the beneficiary cannot give the property to herself, her estate, her creditors or the creditors of her estate – even though, depending on how broadly the power is written, she conceivably could give it to anyone else. LPA property is *not* includible in the beneficiary's estate for estate tax purposes.

Power of Attorney – a document wherein an individual (the "principal") names someone else to act as her "attorney-in-fact" and transact business on her behalf. Note that the attorney-in-fact is not authorized, for example, to make annual exclusion gifts (see above) unless the document so states. A "*durable"* power of attorney is effective when executed and remains so even if the principal becomes incompetent. A "*springing"* power of attorney does not become effective until a stated event occurs, such as the principal's incompetence. Any power of attorney ends at the principal's death.

Present Value – what a future dollar (or revenue stream) is worth in today's dollars. For example, with a GRAT (see above), the present value of the

grantor's annuity is subtracted from the fair market value of the trust property to determine the present value of the grantor's remainder gift to heirs (they get what's left after the annuity ends). So if, for instance, the present value of the grantor's annuity is 100%, the present value of the remainder gift is zero. The 7520 rate (see below) is the interest rate used to make this computation.

Private Foundation – a charitable entity that can be created either as a trust or a corporation, and that can last in perpetuity. It gives the founder maximum control over his charitable giving, and lets him direct how the foundation uses its contributions. Private foundations have a number of rules that must be scrupulously followed, such as minimum amounts that must be paid out annually and prohibitions on self-dealing. Gifts to private foundations are eligible for a limited income tax deduction, and an unlimited gift or estate tax deduction.

Probate Estate – assets that a decedent owns in his own name that are governed by his will, and not by contract or state law. The probate estate includes individually owned real estate, bank and brokerage accounts and tangible personal property, but not, for example, jointly owned property, and life insurance, qualified plan benefits and IRAs that name someone other than the decedent's estate as the beneficiary.

Prohibited Transaction – any of six proscribed direct or indirect transactions between a "disqualified person" and the person's retirement plan, including, for example, a loan between an IRA owner and her IRA. If, say, the IRA owner runs afoul of the prohibited transaction rules, the IRA loses its tax exemption and is treated as fully distributed to the IRA owner and therefore potentially subject to income tax.

QDOT – a "qualified domestic trust." This trust qualifies for the marital deduction (see above) and postpones estate tax when the surviving spouse is not a U.S. citizen. It can be structured as 1) a QTIP trust (see below), where the surviving spouse receives all of the trust's income; 2) a "general power of appointment" trust, where the surviving spouse receives all of the trust's income *and* can direct what happens to the property at death, including appointing it to herself or her estate; 3) a charitable remainder trust (see above), where the surviving spouse is the only income beneficiary; or 4) an "estate trust," where trust income accumulates and the trust pours into the surviving spouse's estate at death. Principal distributions to the surviving spouse, unless "hardship" related, will trigger the estate tax that would have been payable at the first spouse's death if the trust had not been in existence. The QDOT is thus "pay as you go," whereas the QTIP trust is "pay once you're gone"; it reflects the concern that the surviving spouse might not be a U.S. resident at death, a circumstance that could defeat collecting the estate tax that was deferred at the first spouse's death.

QTIP Trust – a "qualified terminable interest property" trust; it qualifies for the marital deduction (see above) and therefore postpones estate tax. The surviving spouse must receive all of the trust's income at least annually, and may receive principal distributions at the trustee's discretion, if the trust permits this. When the surviving spouse dies, the trust is taxable in his estate. After taxes, the property passes according to the trust's terms – as set forth by the predeceased spouse. QTIP trusts are especially useful in second marriages, where the predeceasing spouse wants to provide for her surviving spouse, but ensure that the children from her first marriage receive any remaining trust property when the surviving spouse dies.

Qualified Personal Residence Trust (QPRT) – a trust to which the grantor transfers a "personal residence" (i.e., a principal residence or a vacation home) and retains the right to use the residence for a term of years. At the end of the trust term, the residence passes to the grantor's heirs. Although the grantor's transfer of the residence to the trust is a gift, that gift is reduced by the present value of the grantor's right to use the residence and direct what happens to it if he dies during the trust term. No matter how much

the residence appreciates by the time the heirs receive it, it won't be subject to gift or estate tax. For the QPRT to be successful, the grantor must outlive the trust term.

Qualified Plan – refers to various retirement vehicles, including pension, profit sharing and 401(k) plans; it also loosely refers to IRAs (individual retirement accounts).

Remainderman – the individual or entity (such as a trust) that takes the "remainder" of a trust, or what's left when the current beneficiary's interest ends.

Required Minimum Distribution (RMD) – refers to the annual distribution an account owner must start taking from a qualified plan, such as a 401(k) or a pension or profit sharing plan, at the later of retirement or reaching age 70½. With IRAs, RMDs must start at age 70½, even if the IRA owner is still working. Non-spouse beneficiaries of "inherited IRAs" (see above) must start taking RMDs the year after the owner's death.

Revocable Trust – a trust that the grantor can revoke or amend at any time. Also known as a "living trust," a revocable trust offers no transfer tax savings, but serves as an asset management vehicle during the grantor's life, and can help provide for the grantor upon his disability or incompetence. As long as the grantor is alive, the trust is a grantor trust (see above), with its income reportable on the grantor's return. At the grantor's death, the trust becomes irrevocable and a separate taxpayer; it typically serves as a will substitute, and governs the disposition of assets the grantor transferred to it during life and at death (usually through a "pour-over" will).

Right of Election – refers to the surviving spouse's right to "elect against" the predeceased spouse's will and take a share of that spouse's estate, as determined under state law. The elective share is in lieu of whatever the surviving spouse would have received under the predeceased spouse's will.

Rollover IRA – an IRA funded with "rollover" dollars from an employer-sponsored retirement account – as in Worker changes jobs or retires, and moves her 401(k) from former employer into a "rollover" IRA. Also refers to when a surviving spouse is named as the beneficiary of her deceased spouse's IRA and rolls it into an IRA in her name; in so doing, the surviving spouse becomes the new IRA owner, meaning that she can name her own beneficiaries, and is subject to the same "required minimum distribution" rules (see above) as the original IRA owner.

Roth IRA – an individual retirement account that is funded with after-tax dollars (see above). Roth IRAs differ in some important ways from "traditional" IRAs (see below): for example, the account's earning are income-tax free provided the owner doesn't take out more than what was contributed in the first five years of the account's creation, the owner can still contribute to the account even after reaching age 70½, and the owner has no "required minimum distributions" (see above).

Rule against Perpetuities – the general rule that a trust must terminate within "lives in being" plus 21 years. In other words, unless the jurisdiction governing the trust has abolished its rule against perpetuities (see Dynasty Trust), the trust must terminate no later than 21 years after the death of a designated person who was alive when the trust was created (the theory is that property should not be tied up forever). A trust that lasts for the perpetuities period often runs for about 100 years.

Sale to a Defective Grantor Trust – like the GRAT (see above), this technique is a way to transfer appreciation gift-tax efficiently. The grantor sells an asset to a trust in exchange for a note that is usually interest-only (i.e., a balloon note). Because the trust is structured so that the grantor owns it for income tax purposes, neither gain from the sale nor interest on the note is taxable to the grantor. Appreciation in excess of the note's interest rate remains in the trust for the grantor's heirs, gift-tax free. If the grantor dies while the note is outstanding, the income tax

consequences regarding the transaction are uncertain; there could also be gift and generation-skipping transfer tax consequences if, on audit, the IRS increases the value of the asset sold.

Second-to-die/Survivorship Life Insurance – a cost-effective insurance policy on two people's lives that does not pay out until both are dead. Married couples frequently use second-to-die insurance to replenish the wealth lost to estate taxes at the surviving spouse's death, and provide cash for what could be an otherwise illiquid estate. Typically, second-to-die insurance policies on married couples are held in irrevocable life insurance trusts (see above) to ensure that the policies will not be includible in either spouse's estate.

7520 Rate – an interest rate that the IRS publishes monthly. The 7520 rate is an assumed rate of return, and is used to determine the present value of items like annuities, life estates, and income and remainder interests (it is defined in Section 7520 of the Internal Revenue Code). For example, the 7520 rate is used to determine the present value of the annuity in a GRAT, and the present value of the retained interest in a QPRT. The 7520 rate is sometimes referred to as the "hurdle rate": the more the transferred property outperforms it, the better the result (i.e., more property is removed tax-free from the grantor's estate).

Stepped-up Basis – the upward adjustment in basis that occurs when someone dies owning appreciated assets (if the assets have depreciated, there is a "step-down" in basis). That is, at death, an individual's assets are effectively "marked to market," so that any built-in capital gains *and* losses disappear.

"Stretch" IRA – refers to the protracted payout that the beneficiary of an "inherited IRA" (see above) can receive for his "required minimum distributions" (see above). For example, if 55 year-old son inherits deceased Dad's IRA, Son can receive RMDs over his 28.7 year life expectancy (see above).

Taxable Estate – a decedent has a "taxable estate" when property passing at death does not qualify for the marital or charitable deduction (see above) AND exceeds the filing threshold ($5.43 million in 2015) plus adjusted taxable gifts (see above). In other words, if Sarah, who's always been single, dies in 2015 and leaves her $6 million estate to her niece, she will have a taxable estate.

Taxable Income – this refers to all income, minus all deductions and personal exemptions. It is the amount on which a taxpayer's regular income tax is figured. In 2015, if a taxpayer's taxable income exceeds, for example, $464,850 for married couples filing jointly, and $413,200 for single taxpayers, that excess income will be subject to the top rate of 39.6%; in addition, qualified dividends and most long-term capital gains will be subject to a top rate of 20% (note that these taxpayers will also be subject to the 3.8% tax on "net investment income" (see below)).

3.8% Tax on Net Investment Income (NII) – as of 2013, there is a 3.8% tax on "net investment income" (see above). The tax applies to both individuals AND trusts and estates. For individuals, the tax is 3.8% times the *lesser of* the individual's NII OR adjusted gross income (plus foreign earned income) minus a threshold amount that is *not* indexed for inflation ($250,000 (married couples filing jointly), $200,000 (single taxpayers), and $125,000 (married filing separately)). For trusts and estates, the tax is 3.8% times the *lesser of* the entity's undistributed NII OR the entity's adjusted gross income minus the amount at which the entity hits the highest tax bracket (for 2015, this number is $12,300).

"Traditional" IRA – also known as an "ordinary" or a "regular" IRA, this type of individual retirement account is any IRA that is not a Roth IRA or a SIMPLE IRA. Depending on the IRA's owner's "modified adjusted gross income," contributions to the account may or may not be deductible (deductible contributions are "pre-tax" (see above) and non-deductible contributions are "after-tax" (see above)).

Transfer Tax – a tax on the transfer of property. Estate, gift and generation-skipping transfer taxes are all transfer taxes.

Trust – an entity where the trustee holds legal title to the assets, and the beneficiaries (the people who benefit from the trust) hold beneficial title to the assets. A trust can help save people from themselves, potentially insulate assets from creditors and offer tax savings.

Trustee – the individual or bank or trust company named to administer a trust's assets. The trustee's duties include managing the trust's assets, making appropriate distributions to beneficiaries and filing tax returns for the trust. When a bank or trust company fills that role, it is called a "corporate" trustee.

Unrelated Business Taxable Income (UBTI) – refers to taxable income that is unrelated to a tax-exempt entity's purpose and will trigger excise tax. For example, if an IRA generates income through a margin account, that "debt-financed income" is a subset of UBTI, and will generate excise tax.

UTMA/UGMA Accounts – refers to "custodial" accounts under the Uniform Transfer to Minors Act and the Uniform Gifts to Minors Act (UTMA is replacing UGMA in many states). Both Acts provide a simple framework for transferring property to minors: in general, UTMA permits donors to give a broader class of assets than UGMA and holds those assets until the minor reaches age 21 (unless the donor selects age 18 at the account's creation); UGMA usually requires the minor to receive the property at age 18, unless the donor selects age 21. The "kiddie tax" (see above) applies to these accounts.

Will – the document by which an individual disposes of her probate estate (see above) at death.

April 7520 rate

The IRS has issued the April 2015 applicable federal rates: the April 7520 rate is 2.0%, a 0.20% (20 basis points) increase from March's 1.8% 7520 rate. The April mid-term rates are: 1.70% (annual), 1.69% (semiannual and quarterly), and 1.68% (monthly). The March mid-term rates were: 1.47% (annual), 1.46% (semiannual and quarterly), and 1.46% (monthly).

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Tax Topics

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More on the President's tax proposals

Last month, we discussed some of President Obama's latest tax proposals. These were previewed in a Fact Sheet the White House issued several days before Mr. Obama's State of the Union address on January 20th. Since then, Mr. Obama has issued his Fiscal Year (FY) 2016 Budget incorporating these proposals, and the Treasury Department has issued its so-called "Green Book" explaining them. What follows is a look at some of the FY 2016 Budget proposals, along with a continuation of last month's discussion, supplemented by details from the Green Book.

The FY 2016 Budget has many familiar proposals, including limiting the value of certain tax benefits for high-income taxpayers, imposing a "Fair Share Tax" on individuals with over $2 million of adjusted gross income (their total tax would need to equal at least 30%), and taxing "carried interest" (relevant to managers of hedge funds and private equity funds) as ordinary income. One proposal has already been scrubbed – namely, taxing the earnings on future contributions to 529 plans when account owners make "qualified withdrawals" for items such as college tuition and room and board (the proposal debuted in the Fact Sheet mentioned above, and generated immediate bipartisan criticism; by the time the Administration withdrew it as a "distraction" from Mr. Obama's other proposals, it was too late to pull it from the Green Book, which was already at the printer).

The Budget's ***retirement account*** proposals have mostly been seen before, and include the following:

- **Cap the aggregate amount** taxpayers can accumulate in retirement accounts to about $3.4 million, or enough to support a $210,000 joint and survivor annuity for a hypothetical 62 year-old with a 62 year-old spouse.

- **Require a 5-year payout for most non-spouse beneficiaries** of IRAs and other retirement plans. With a few exceptions (such as for disabled beneficiaries or minor children), non-spouse beneficiaries of IRAs and other retirement plans would need to withdraw the balance of the inherited retirement account within

five years of the owner's death (this would mean no more "stretch IRAs" that are payable over a beneficiary's life expectancy).

- **Simplify "minimum required distribution" (MRD) rules.** Under current law, owners of "traditional" IRAs are required to start taking distributions from their IRAs at age 70½, but Roth IRA owners are not. Under the proposal, Roth IRA owners would now be subject to the MRD rules, which would not apply to taxpayers with aggregate retirement accounts under $100,000. In addition, the proposal would "harmonize" the contribution rules to IRAs, so that Roth IRA owners could no longer contribute to their Roth IRAs after they reach age 70½, just like owners of traditional IRAs.

- **Allow 60-day rollovers for *all* inherited IRAs and other plans.** Under current law, a surviving spouse beneficiary of an IRA or other retirement plan can make a tax-free rollover of the account in one of two ways: 1) receive a distribution of the account dollars and, within 60 days, deposit them into an IRA for herself (a "60-day rollover"); or 2) use a trustee-to-trustee transfer, so that the dollars never pass through the spouse's hands. A non-spouse beneficiary, however, is only allowed to make a trustee-to-trustee transfer for the inherited account; in other words, if Daughter, for example, attempts a 60-day rollover for the IRA she inherited from Mom, she will be treated as having withdrawn the entire account (if Mom only funded the IRA with pre-tax dollars, it will be fully includible in Daughter gross income). To address this trap for the unwary, the proposal would allow non-spouse beneficiaries to use 60-day rollovers for their inherited IRAs and other retirement accounts.

- **Limit Roth conversions to pre-tax dollars.** This provision is new, and would effectively prevent "back door" contributions to Roth IRAs by taxpayers who otherwise make "too much" to directly contribute to a Roth (married joint filers with more than $193,000 of "modified adjusted gross income" (MAGI) – generally, adjusted gross income with certain items added back – can't contribute to a Roth, nor can a single taxpayer with more than $131,000 of MAGI). Under the proposal, a taxpayer could only convert a traditional IRA to a Roth IRA to the extent the converted amount would be includible in the taxpayer's income. In other words, taxpayers could no longer make an after-tax contribution to a traditional IRA, and then convert that after-tax amount to a Roth IRA.

  Comments. Where the Administration's retirement proposals will go is unknown – provisions that are designed to simplify matters for taxpayers, such as permitting 60-day rollovers for non-spouse beneficiaries of IRAs, fall under the "save people from themselves" category, and seem non-controversial. Other proposals, however, such as capping the amount people can accrue in retirement accounts to approximately $3.4 million, seem unlikely to garner bipartisan support. Still, the provision that would require most non-spouse beneficiaries to withdraw the balance of their inherited retirement account within five years of the owner's death could have legs: it has already been on Congress's radar before, and was also part of the tax reform Discussion Draft that was issued a year ago by now-retired Rep. Dave Camp (R-MI), the former Chairman of the House Ways & Means Committee.

In terms of ***estate and gift tax***, the Budget's proposals are mostly familiar, such as outlawing sales to so-called "defective grantor trusts" and limiting the duration of the generation-skipping transfer tax exemption to 90 years; a few proposals have been refined, however:

- **Restore 2009 transfer tax parameters.** Prior budgets have suggested returning to the transfer tax parameters that were in effect in 2009 (e.g., the $3.5 million estate tax exclusion, $1 million gift tax exclusion and top rate of 45%) – but not until 2018. The FY 2016 Budget would accelerate the effective date to 2016.

- **Limit GRATs.** Grantor retained annuity trusts (GRATs) are a highly effectively way to pass potential appreciation to children for little or no gift tax cost ("zeroed-out" GRATs), typically through GRATs that last no more than 2 or 3 years. Consistent with prior proposals, the current proposal would hobble GRATs by requiring that they last for at least 10 years and no more than the grantor's life expectancy, and by prohibiting the annuity from declining over the trust term. Unlike prior proposals, however, this one is quite specific about how it would eliminate zeroed-out GRATs: at the GRAT's inception, the "remainder interest" (what eventually passes to children) would have to at least equal the greater of 25% of the value of the assets contributed to the GRAT or $500,000 (but not more than the value of what was contributed). Grantors could also no longer swap out assets in the trust – thereby precluding a grantor from taking back low-basis property and substituting high-basis property for it.

- **Simplify the gift tax annual exclusion.** Last year was the first appearance of this proposal to "simplify" the gift tax annual exclusion, which allows a donor to give $14,000 per year to as many people as she wishes – $28,000 if the donor's spouse agrees – without eroding any of the donor's $5.43 million exclusion. The proposal would eliminate the "present interest" requirement for annual exclusion gifts, and create a new category of transfers that would allow a donor to give away up to $50,000 gift-tax free. (The "present interest" requirement means, for example, that when a donor makes a gift in trust, the beneficiary must have a limited opportunity (for, say, 30 days) to withdraw the gift; this withdrawal right is known as a "Crummey power," and is something the IRS would like to eliminate.) It was unclear under the prior proposal whether this new category was in addition to the $14,000 per donee exclusion, or was an additional limitation on such gifts. This year's proposal clarifies that the new category would be a further limit on annual exclusion gifts. In other words, if the donor gave away more than $50,000 in this new category (the number would be indexed for inflation after 2016), the gift would erode the donor's $5.43 million exclusion, even if total gifts to each donee didn't exceed $14,000.

  Comments. It seems unlikely that the current Republican-controlled Congress will revisit gift and estate tax issues anytime soon. (But see the discussion below.)

The Budget's proposals regarding ***"reforming" the taxation of capital income*** were discussed last month, based on information in the Fact Sheet mentioned above. Here is a further discussion of these proposals based on details in the Green Book:

- **Increase the top rate for capital gains and dividends to 28%.** The top rate for most long-term capital gains (i.e., gains on assets that have been owned for more than one year) and "qualified dividends" is currently 20% – to which taxpayers in this bracket must add the 3.8% tax on net investment income that took effect in 2013. In other words, the top rate is really 23.8%. Under the Fact Sheet, it was unclear whether the 3.8% tax was on top of the proposed 28% rate. The Green Book says that the 28% percent rate *includes* the 3.8% tax. Thus, the Budget proposes increasing the top rate by 4.2%, from 20% to 24.2%, which the 3.8% tax would bring to 28%.

- **Transfers of appreciated property –** or as the Fact Sheet referred to the issue, the **"trust fund loophole."** Under current law, when a donor gives appreciated property to a donee, the donee takes the donor's basis in the property, so that if the donee later sells the property, she pays the same capital gains tax the donor would have paid. If the donor dies owning appreciated property, however, the so-called "basis step-up" rules eliminate the property's built-in capital gains, which therefore are never subject to income tax. Under the proposal, gifts of appreciated property, whether made during life or at death, would generally be treated as sales that trigger tax on the built-in gain. Gifts to charity would not trigger tax, and spousal gifts would not be taxable until the spouse disposed of the asset or died.

Individuals could exempt $100,000 of gain from tax ($200,000 per married couple), along with $250,000 of gain on a primary residence ($500,000 per married couple); the $100,000 exclusion would be indexed for inflation after 2016. The gain would be taxable to the donor the year the transfer is made, or to the decedent if the transfer occurs at death. Any tax on the gains realized at death would be deductible on the decedent's estate tax return "(if any)."

Comments. The Green Book's mention of deducting the capital gains tax on gifts made at death on the decedent's estate tax return – "(if any)" – indicates that the estate tax would still be in place, and that property could be subject to BOTH estate tax and income tax at death. What does this mean for individuals who are no longer subject to federal estate tax because of the current $5.43 million exclusion? They could well be caught by this new "death tax": although the proposed gain exemptions mentioned above ($100,000 and $250,000 for a primary residence), may offer some protection, it is easy to imagine circumstances where the exemptions would fall woefully short – such as shielding appreciation in the home deceased Mom and Dad lived in for nearly 40 years. It is difficult to imagine the current Congress approving such a scenario.

So what is the point of this proposal? Is it a pre-emptive strike, and a possible bargaining chip for estate tax repeal, as some have suggested? As much as Republicans would like to see such repeal, it seems improbable that they would trade the old "death tax," which affects fewer and fewer people, for a new one with a far broader reach.

Yet how much longer will the estate tax survive? The exclusion was $5 million in 2011; thanks to inflation-indexing, it has now reached $5.43 million ($10.86 million per married couple), and will continue climbing – barring a change in the law. The estate tax is thus disappearing for most people, something that is reflected in a one-page IRS fact sheet issued in August 2013, entitled "Estate Tax Returns Filed for Wealthy Decedents, 2003-2012."

Interesting statistics from this document include the following:

- In 2012, about 9,400 estate tax returns were filed, versus about 73,100 returns in 2003. This 87% decline was primarily due to the gradual increase in the filing threshold, which was $1 million in 2003, and $5.12 million in 2012.
- In 2012, the total net estate tax reported on all estate tax returns filed for that year was $8.5 billion.
- In 2012, stock and real estate made up about half of the assets reported on decedents' estate tax returns.
- Decedents with assets of $20 million or more held significantly more stock (about 40% of total assets) than real estate and retirement assets, unlike decedents with fewer assets.

Contrast those statistics with the following: in August 2014, the Joint Committee on Taxation (JCT) issued its most recent analysis of "tax expenditures" and their projected cost. (Tax expenditures are tax benefits that reduce income tax revenues, such as the income exclusion for employer-provided health care and the deduction for home mortgage interest.) The JCT estimated that over Fiscal Years 2014-2018, the government will lose some $174.8 billion by NOT taxing capital gains at death. Although this amount is far less than the estimated cost of the preferential rates for dividends and capital gains over the same period (about $632.8 billion), it looks positively robust compared to the anemic estate tax revenues. So between the shrinking estate tax and IRS statistics about the concentrated stock and real estate holdings of wealthy decedents, how to satisfy revenue estimators and estate tax advocates alike? Answer: a capital gains tax at death!

To sum up. Republicans and Democrats both talk of tax reform, yet bridging the gap between their two approaches – revenue-neutrality versus raising taxes on the top 1% to 2% of taxpayers – may not be possible; and the window of opportunity, such as it is, may close fairly soon. So what to make of these FY 2016 Budget proposals, at least as they pertain to increasing taxes on the top 1% to 2% of taxpayers? The term "aspirational" comes to mind. That is, these proposals seem like blueprints for possible tax law changes if the 2016 elections bring a Democratic "trifecta": a Democratic president and Democrats in control of both the House and the Senate. As to the likelihood of these proposals being enacted before the 2016 elections, however? Never say never, but...

Who says there's no humor in taxes?

Earlier in February, the IRS requested public comments on the final QSLOB regulations. *What* could this possibly refer to? The answer is far less fun than the acronym itself: Qualified Separate Lines of Business. Oh well.

March 7520 rate

The IRS has issued the March 2015 applicable federal rates: the March 7520 rate is 1.8%, a 0.20% (20 basis points) drop from February's 2.0% 7520 rate. The March mid-term rates are: 1.47% (annual), 1.46% (semiannual and quarterly), and 1.46% (monthly). The February mid-term rates were: 1.70% (annual), 1.69% (semiannual and quarterly), and 1.68% (monthly).

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Tax Topics

01/26/15

2015-01

And they're off!

The 114th Congress has begun, with Republicans controlling both the Senate and the House of Representatives. Sens. Mitch McConnell (R-KY) and Harry Reid (D-NV) have switched roles, with Mr. McConnell now the Majority Leader, and Mr. Reid the Minority Leader. Rep. John Boehner (R-OH) is still the Speaker of the House, and Rep. Nancy Pelosi (D-CA) the Minority Leader. As to the two tax-writing committees, Rep. Paul Ryan (R-WI) is the new Chairman of the House Ways & Means Committee, and Rep. Sander Levin (D-MI) is the Ranking Member. In the Senate, Sens. Orrin Hatch (R-UT) and Ron Wyden (D-OR) have also switched roles, with Mr. Hatch now the Chairman of the Senate Finance Committee, and Mr. Wyden its Ranking Member.

What might this mean for tax reform? That is an open question. Although tax reform has been widely discussed, it faces many obstacles, including how little time Congress has before being consumed by the upcoming 2016 elections. There is also that small matter of the deep philosophical divide between the two parties: Republicans support a revenue-neutral approach to reform, while Democrats support increasing taxes on the top 1% to 2% of taxpayers.

President Obama's recent State of the Union address reflected this divide, with Mr. Obama proposing a number of lower- and middle-income tax breaks, including a new tax credit for two-earner families, streamlining child-care tax incentives, and simplifying and expanding education tax breaks to improve college affordability. These benefits would be funded by some $320 billion in tax increases on the wealthy, along with a fee on the biggest financial firms. The White House issued a fact sheet on these proposals on January 17th, in advance of Mr. Obama's address.

Here is some of what the fact sheet says about the proposed increases:

- ***Close the "trust fund loophole."*** The stepped-up basis rule eliminates built-in capital gains on appreciated assets at the owner's death. The proposal would change this, so that bequests at death (or lifetime gifts) of appreciated property would be a "realization event" and trigger income tax on the gains.

Gifts to charity would not trigger the tax, nor would spousal gifts until the surviving spouse's death. In addition, individuals could exempt $100,000 worth of capital gains ($200,000 per married couple), as well as $250,000 of gain on a primary residence ($500,000 per married couple). Tangible personal property, other than "expensive art and similar collectibles" would be tax-exempt; no tax would be due on "inherited small, family-owned and operated businesses – unless and until the business was sold"; any closely held business could elect to pay the tax on gains over 15 years. Because of these provisions, "only a tiny minority of small businesses could possibly be affected by the repeal of stepped-up basis."

Comment: the fact sheet refers to stepped-up basis as "perhaps the largest single loophole in the entire individual income tax code," but is silent about the estate tax, which currently applies to taxable estates over $5.43 million ($10.86 million for married couples) at a 40% rate. Stated another way, because of the $5.43 million exclusion (which is indexed for inflation), many people are no longer subject to federal estate tax. This fact, coupled with the basis step-up for appreciated assets, means that many heirs receive an inheritance that is free of both federal estate tax and built-in capital gains (note that there might still be *state* estate tax). Mr. Obama's proposal would change this, however, and again make death a "taxable event"; although the fact sheet states that "capital gains generally represent only a fraction of an asset's value," the maximum $100,000 gain exemption (plus $250,000 on a primary residence) might not go very far for individuals who have owned their assets – especially their homes – for years. Heirs could therefore discover that their inheritance is subject to *both* estate tax *and* capital gains tax.

- ***Increase the top rate for capital gains and dividends to 28%*** for couples with more than $500,000 of income. The fact sheet states that this was the rate under President Reagan.

  Comment: the Tax Reform Act of 1986, enacted under President Reagan, set a top 28% rate for capital gains, and reduced the top income tax rate from 50% to 28%. Transition rules applied, but the aim was for both capital income and ordinary income to be taxed at the same top rates. This uniform approach did not last: capital gains tax rates declined, and ordinary income tax rates increased (currently, the top rate on most long-term capital gains is 23.8% (20% plus the 3.8% tax on net investment income) and the top rate on ordinary income is 39.6%; since 2003, "qualified dividends" have been taxed at capital gains rates). The proposal is silent about how much income single taxpayers could have before hitting the 28% rate, which the 3.8% tax would presumably push to 31.8% (the 3.8% tax can apply to individuals with more than $200,000 of income or married couples filing jointly with more than $250,000 of income).

- ***Impose a fee on large financial institutions.*** The proposal would impose a 0.07% (seven basis points) fee on the liabilities of financial firms with assets over $50 billion (about 100 firms, according to the fact sheet). The fee would lead the firms to make decisions "more consistent with the economy-wide effects of their actions, which would in turn help reduce the probability of major defaults," and is "broadly consistent" with a proposal in the tax reform plan of former (and now retired) House Ways and Means Chairman Dave Camp (R-MI).

  Comment: Rep. Camp released his nearly 1,000-page tax reform draft proposal in February 2014; it stirred much discussion, but had few adherents. The draft included a 0.035% (three-and-a-half basis points) excise tax on what he called "systemically important" financial institutions, and their "excess consolidated assets" (within the meaning of the Dodd-Frank Act) over $500 billion. Whether Mr. Obama's proposal is in fact broadly consistent with Mr. Camp's proposal is unknown; it is no less controversial, however.

- ***Limit "upside-down" education savings incentives and consolidate them into a single benefit.*** Education savings incentives would be consolidated into one vehicle and the savings would be redirected into the "better-targeted" American Opportunity Tax Credit. For new contributions to 529 plans, the proposal would roll back expanded tax cuts that were enacted in 2001; it would also repeal tax incentives for the much smaller Coverdell education savings program.

  Comment: some of the key 2001 changes to 529 plans were: 1) exempting withdrawals for "qualified higher education expenses" from income tax (originally, the earnings portion of the withdrawal would be taxable); 2) expanding permissible room and board expenses to include the charges actually imposed for school-provided room and board; and 3) permitting private colleges and universities to create programs allowing individuals to buy pre-paid tuition credits for undergraduate education. Given the ever-increasing costs of higher education, it seems counter-productive to curtail anything that helps people provide for these costs, even if some of those people are high earners. 529 plans, which are funded with after-tax dollars, effectively act like Roth IRAs: if the account is used for its designated purpose – such as paying for a beneficiary's college tuition and room and board – the account earnings will not be taxable.

  Coverdell Education Savings Accounts (named in honor of the late Sen. Paul Coverdell (R-GA)) are far less widely used: the maximum contribution of $2,000 per year is disallowed if the taxpayer has "too much" income ($110,000 for single taxpayers, and $220,000 for married joint filers); like 529 plans, Coverdells are funded with after-tax dollars, and the earnings are not taxed; unlike 529 plans, Coverdells can be used for qualified K-12 expenses. Eliminating the tax incentives for Coverdells would have a much smaller impact than any cut-back on 529 plans.

- ***"Prevent wealthy individuals from using loopholes to accumulate huge amounts of tax-favored retirement benefits."*** The fact sheet states that tax-preferred retirement plans are intended to help working families save for retirement, yet loopholes have let some wealthy individuals convert such accounts into tax shelters, "including 300 extraordinarily wealthy individuals who have accumulated more than $25 million each in IRAs." The proposal would prohibit "contributions to and accruals of" additional benefits in tax-preferred retirement plans and IRAs once balances are about $3.4 million, enough to provide an annual income of $210,000 in retirement.

  Comment: President Obama had a similar proposal in his Fiscal Year 2015 Budget, except that it simply limited additional contributions to a taxpayer's aggregate retirement accounts once they reached that $3+ million number; if dollars kept accruing in the accounts because of good investment performance, such accruals were permitted. This proposal appears to change that approach, however. Capping retirement accounts at a maximum level would pose significant administrative hurdles, not to mention probably requiring a 100% excise tax on any "excess" accruals to maintain the permitted level.

To sum up. Mr. Obama's proposals, which presumably will be further detailed in his upcoming Fiscal Year 2016 Budget, seem unlikely to engender bipartisan compromise on tax reform. Indeed, it is difficult to imagine these proposals getting any legislative traction in the current Congress. Perhaps the focus, however, is setting the stage for the 2016 elections. Judging by these proposals and recent comments from the Administration and top Republican tax-writers, tax reform for individual taxpayers may be out of reach, although corporate tax reform may be a possibility. Time will tell.

It is now 2015 and…

…several important tax changes take effect – namely, revised rules for 60-day IRA rollovers and the so-called "unbundling" rules, which limit the deductible expenses of trusts and estates. Here are the details:

60-day IRA rollovers. 60-day rollovers refer to a taxpayer's ability to take money out of her IRA tax-free IF she puts it back into an IRA within 60 days. *Bobrow v. Commissioner,* which the Tax Court decided on January 28, 2014 (T.C. Memo. 2014-21), held that taxpayers could only make ONE such rollover per 12-month period, and not one per account. This decision surprised many, as both IRS Publication 590 and the related proposed Treasury Regulation said that the limitation of one-rollover-per-12-month-period applied on a *per account* basis – a generous interpretation of the underlying statute that was contrary to the IRS's successful argument in *Bobrow*. (Yes, the two positions did not match.)

To clarify the rules, then, the IRS and Treasury Department took the following actions post-*Bobrow*:

- March 20, 2014: the IRS issued ***Announcement 2014-15***, which said that the IRS would follow the "*Bobrow* interpretation" of the law for IRA distributions occurring *on or after January 1, 2015*. The IRS also said that it would revise Publication 590 to reflect this change, and that the offending proposed regulation would be withdrawn.

- July 11, 2014: the proposed regulation is withdrawn ***(REG-209459-78)***.

- November 24, 2014: the IRS issued ***Announcement 2014-32***, which expands on Announcement 2014-15, and provides a transition rule for 2015 distributions. Announcement 2014-32 says that taxpayers won't run afoul of *Bobrow* if their 2014 IRA rollover spills into 2015, *provided that* the 2015 IRA distribution "is from a different IRA that neither made nor received the 2014 distribution." The Announcement includes some other details, and emphasizes that the new rule does *not* apply to ***trustee-to-trustee transfers***, where the IRA is moved directly from one trustee to another OR – and this is welcome – if the soon-to-be-ex trustee provides the IRA owner with a check "made payable to the receiving IRA trustee."

Here are some illustrations of how the revised rule may come into play:

- **Moving an IRA.** Sally is 55. Her only IRA is funded entirely with pre-tax dollars – meaning that any distributions from the account will be subject to income tax. In January of 2015, Sally decides to move her IRA from one institution to another. She gets a direct distribution (as in, the IRA dollars are payable to her), and redeposits the money in an IRA at the new institution within 60 days of the distribution. Sally's rollover is successful. Later in the year, Sally wants to change institutions again because the one down the street pays slightly more interest on the short-term CDs she favors. Unless Sally makes a trustee-to-trustee transfer, this rollover will flunk because it is within the 12-month period of the first distribution (flunking means that the entire distribution will be taxable *and* subject to the 10% early withdrawal penalty because Sally is under 59½). If Sally doesn't want the perceived hassle and possible expense of a direct transfer from one trustee to another, she can direct the old institution to make the IRA check payable to the new institution as her IRA trustee, and take the check there herself. Similarly, if Sally has multiple IRAs and wants to move them all at once, she must also use a trustee-to-trustee transfer, otherwise the "excess" rollovers will flunk.

- **60-day interest-free loan.** Sam, age 50, has two IRAs, both of which are funded with pre-tax dollars. April 15th is nearly here, and Sam needs a short-term loan to pay the balance of his 2014 income tax liability. He therefore takes a distribution from IRA1 on April 13th, anticipating that he will be able to repay his account within 60 days. As the deadline approaches, however, Sam is still short on cash. What to do? Prior to *Bobrow*, Sam could have taken a distribution from IRA2 to repay IRA1. Although he would have a new 60-day repayment deadline for IRA2, he would at least have bought himself some time. Post-*Bobrow,* however, Sam can no longer do this: he only gets ONE 60-day rollover per 12-

month period, starting with the date he received the distribution. If Sam doesn't repay IRA1 within 60 days, he'll have the same adverse tax consequences described above.

Deductible expenses for trusts and estates. On May 9, 2014, the IRS issued long-awaited final regulations regarding which expenses a trust or an estate can deduct when calculating "adjusted gross income" (AGI) and which expenses can only be deducted to the extent they exceed 2% of the entity's AGI (the so-called "2% floor") (T.D. 9664). Initially, the regulations were effective for tax years beginning on or after May 9, 2014 – meaning that they took effect immediately for trusts created after May 8, 2014, or decedents dying after that date. On July 17, 2014, in response to industry concerns, the IRS deferred the effective date to tax years beginning after December 31, 2014 (FR Doc. 2014-16834).

It is now 2015. To recap some of the discussion from the 05/30/14 *Tax Topics*, an expense is subject to the 2% floor if a hypothetical individual owning the same property would "commonly" or "customarily" incur that expense (as in, it's a "miscellaneous itemized deduction" for that individual). "Common" expenses include certain ownership costs (such as condominium fees) or the preparation fees for gift tax returns; "uncommon" expenses include the preparation fees for fiduciary income tax returns for trusts and estates, estate tax returns or returns relating to the generation-skipping transfer tax. The biggest "common" expense, however, and the source of litigation surrounding deductible expenses, is investment advisory fees. The IRS's position consistently has been the following: individuals routinely incur these fees, which are only deductible to the extent they exceed 2% of the individual's AGI – why should it be any different for trusts or estates?

This position is reflected in the final regulations. They provide that if a trust or an estate pays a single, "bundled" fee (such as a fiduciary's commission, attorney's fee or accountant's fee) that is *not* calculated on an hourly basis, that fee is exempt from the 2% floor *except for* the investment advisory portion of it, which must be broken out. (Bundled fees that *are* calculated on an hourly basis and that cover 2% floor- and non-2% floor-expenses must be allocated between the two.) The fiduciary (namely, the trustee or executor) may use any "reasonable method" to unbundle the bundled fee.

The earliest that fiduciaries will be reporting under this new regime is April 15, 2016, when a trustee files, say, a Form 1041 reporting a trust's 2015 income. Fiduciaries therefore still have time to figure out the investment advisory portion of their bundled fee using a "reasonable method" that makes sense for their respective institutions; beneficiaries, however, may need to reflect this change sooner: namely, with their estimated tax payments for 2015 (because less of the fiduciary commission may be deductible, more of the beneficiary's trust income may be taxable). Similarly, fiduciaries may need to adjust the 2015 estimated tax payments of a trust or an estate: because the investment advisory portion of the bundled fee is now subject to the 2% floor and therefore does not factor into the entity's AGI, the entity could be more susceptible to the 3.8% tax on net investment income.

To sum up. IRA owners (and trustees) should be mindful of the revised rule regarding 60-day rollovers – it is now only one per taxpayer, and not one per account, in a 12-month period. And fiduciaries and beneficiaries should keep in mind that because less of the fiduciary's fee may be deductible, more of the entity's income may be taxable.

Tax season opens!

The IRS has announced that the filing season for 2014 returns officially opened on January 20th – meaning that those who are due a refund will be filing promptly (those who anticipate owing money come April 15th will likely file a return or an extension close to that date). Should taxpayers and preparers have questions this filing season, they would do well to seek most of their answers online at the IRS website (irs.gov). The

Service has forewarned that it may only be able to answer fewer than half of the calls it receives, and that once a call is answered, there could be a 30-minute wait to speak with a representative.

Why this decline in service? National Taxpayer Advocate Nina Olson, in her recent Annual Report to Congress, cites sobering statistics about IRS budget cuts and the related impact on training, staffing and service. As Ms. Olson notes, there are fewer people to do more work, such as implementing the Affordable Care Act (yes, 2014 returns, for example, will require taxpayers to report whether they have health insurance) and the Foreign Account Tax Compliance Act (known by its catchy acronym, FATCA). IRS Commissioner John Koskinen put it this way in a recent memo to IRS staff, "[W]e have no choice but to do less with less."

Good luck to all of us!

February 7520 rate

The IRS has issued the February 2015 applicable federal rates: the February 7520 rate is 2.0%, a 0.20% (20 basis points) drop from January's 2.2% 7520 rate. The February mid-term rates are: 1.70% (annual), 1.69% (semiannual and quarterly), and 1.68% (monthly). The January mid-term rates were: 1.75% (annual), 1.74% (semiannual and quarterly), and 1.73% (monthly).

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Tax Topics

06/30/14

2014-06

"Inherited" IRAs not protected in bankruptcy

On June 12, 2014, the Supreme Court issued its decision in *Clark v. Rameker* (No. 13-299), and held that an "inherited" IRA is not a "retirement fund" that can be protected in a bankruptcy proceeding. Here were the facts:

In 2000, Ruth Heffron (Mom) established a traditional IRA and named Heidi Heffron-Clark (Daughter) as the sole beneficiary of the account. When Mom died in 2001, her IRA was worth just over $450,000 and passed to Daughter as an "inherited IRA." Daughter could therefore stretch out distributions from the IRA over her life expectancy, and began taking required minimum distributions in January 2002, on a monthly basis. In October 2010, Daughter and her husband filed a Chapter 7 bankruptcy petition: their assets (except for those treated as exempt under the bankruptcy law) would be liquidated to pay creditors. Daughter and Husband argued that her inherited IRA, which was now worth about $300,000, was exempt from her "bankruptcy estate" because it fell within the exception for "retirement funds."

The bankruptcy trustee and one of the judgment creditors disagreed, and went to bankruptcy court. The bankruptcy judge sided with the trustee, and held that Daughter's inherited IRA was not an exempt "retirement fund" (*In re Clark*, 450 B.R. 858 (Bankr. W.D. Wis. 2011)). Daughter appealed, and won in the District Court: her inherited IRA *was* exempt (466 B.R. 135 (W.D. Wis. 2012)). The bankruptcy trustee appealed, and won in the 7th Circuit Court of Appeals: Daughter's inherited IRA was NOT exempt (714 F. 3d 559, 2013). Daughter appealed to the Supreme Court, which agreed to hear the case because of a split in judicial authority: in 2012, the 5th Circuit Court of Appeals had held in *Chilton v. Moser* (674 F. 3d 486) that an inherited IRA *was* exempt.

A unanimous Supreme Court agreed that Daughter's inherited IRA was *not* exempt in bankruptcy. The Court focused on three key points in holding that inherited IRAs are not "retirement funds" within the meaning of the bankruptcy law:

1. The beneficiary of the account can never make additional contributions to it.

2. After the account owner's death, the beneficiary must either withdraw the entire account within five years of the owner's death, or commence mandatory annual distributions the year after the owner's death – no matter how far away from retirement the beneficiary is.

3. The beneficiary may withdraw the entire balance of the account – at any time and for any purpose – penalty-free.

In other words, even though the account originally was for someone's retirement – here, for Daughter's mother – it no longer was, and should not be entitled to protection under the bankruptcy laws, which,

> As a general matter…effectuate a careful balance between the interests of creditors and debtors….Allowing debtors to protect funds held in traditional and Roth IRAs comports with this purpose by helping to ensure that debtors will be able to meet their basic needs during their retirement years. At the same time, the legal limitations on traditional and Roth IRAs ensure that debtors who hold such accounts (but who have not yet reached retirement age) do not enjoy a cash windfall by virtue of the exemption – such debtors are instead required to wait until age 59 ½ before they may withdraw the funds penalty-free.
>
> The same cannot be said of an inherited IRA. For if an individual is allowed to exempt an inherited IRA from her bankruptcy estate, nothing about the inherited IRA's legal characteristics would prevent (or even discourage) the individual from using the entire balance of the account on a vacation home or sports car immediately after her bankruptcy proceedings are complete. Allowing that kind of exemption would convert the Bankruptcy Code's purposes of preserving debtors' ability to meet their basic needs and ensuring that they have a 'fresh start'…into a 'free pass'….We decline to read the retirement funds provision in that manner.

The Court thus affirmed the judgment of the 7th Circuit.

Comments. The Supreme Court's decision is unsurprising – and striking in that it was unanimous. The Court did not care that the IRA was *once* a retirement account; what mattered was that it was *no longer* a retirement account, and was completely accessible to the beneficiary. Implicit in this finding is that these were not funds the debtor had accumulated for her OWN retirement, but were an inheritance like any other: fully reachable by creditors unless Mom, for example, had left the property in trust.

Does this mean that owners of large IRAs should routinely be leaving them to, say, a "conduit trust" that simply passes through the required minimum distribution (RMD) to the named beneficiary? After all, such a trust can offer creditor protection, since the beneficiary doesn't "own" the inherited IRA directly. Yet trusts as IRA beneficiaries can be difficult to draft, and present traps for the unwary with respect to the minimum distribution rules, including whether it is possible to determine the oldest trust beneficiary's identity, or whether the surviving spouse is the "sole" trust beneficiary and therefore entitled to special distribution rules that apply to surviving spouse beneficiaries of inherited IRAs (see below). Still, if advisors can successfully navigate these rules, why not make a trust the IRA beneficiary? Several thoughts come to mind.

First, there is the issue of flexibility. Suppose that Dad, age 60, dies on August 1, 2014. His three sons, ages 20, 25 and 35, are his IRA beneficiaries. As long as Dad's sons divide the IRA into three separate inherited IRAs by December 31, 2015, each child can "stretch" RMDs over his own life expectancy (62.1 years, 57.2 years and 47.5 years, respectively). If Dad had named a trust for his sons as IRA beneficiary, the oldest son's life expectancy would be used to determine RMDs – thereby forcing money out more quickly, and losing some of the IRA's inherent tax deferral.

Suppose that instead of his sons, Dad names Mom, age 55, as IRA beneficiary. Dad dies on August 1, 2014. Mom can roll over some of Dad's IRA (thereby deferring RMDs until she is 70 ½), and treat the rest of

it as inherited, thereby gaining immediate access to the account without triggering the 10% early withdrawal penalty that generally applies to pre-59 ½ distributions; she can also defer distributions on that inherited IRA until Dad would have been 70 ½ (*and* take smaller RMDs based on her "recalculated" life expectancy, rather than one based on a fixed number of years). If Dad had named a trust for Mom as beneficiary, Mom's deferral options would be limited: the IRA could not be rolled over, and the special rules just mentioned (deferral until Dad would have been 70 ½ and recalculation) would only be available if Mom were the "sole" trust beneficiary – meaning that the trust requires that she receive the greater of income or the RMD, so that the RMD can't possibly accumulate for the next takers (namely, Mom's sons). While these issues may not sound insurmountable, they still compromise the flexibility of an outright IRA distribution.

Then there are the tax characteristics of IRAs. "Traditional" IRAs are typically funded with "pre-tax" dollars – meaning that every dollar that eventually comes out is typically subject to income tax, because it hasn't yet been paid. By contrast, Roth IRAs, which can only be funded with "after-tax" dollars, typically offer income-tax free distributions, both to owners and to those who inherit the account. Yet once Dad dies, *all* of his IRAs are included in his estate, and potentially subject to estate tax. (Despite the generous $5.34 million federal exclusion in 2014, the federal estate tax could still be an issue, as could *state* estate tax if Dad lives someplace like New York).

Although Dad can defer estate tax on the IRA if it passes to Mom, the IRA will be taxable at her death, when it passes to her sons. If the IRA is used to pay estate tax, that distribution will be taxable income to the sons. Furthermore, if the sons pay that income tax liability with funds from the IRA, they will be taxable on those distributions as well, thereby depleting their inheritance even more. If, however, this is a Roth IRA, the estate tax payment won't trigger income tax, but will deplete an account with very special tax attributes. Simply stated, once Mom and Dad are gone, IRAs – particularly traditional ones – have some significant tax burdens that may make them less attractive than a cash bequest that can be redeployed as the heir wishes. In other words, if widowed Mom is charitably inclined, she might consider leaving her rollover traditional IRA from Dad to charity, and giving her sons other property: the built-in income tax liability won't matter to the charity, and Mom's estate will get a 100% estate tax deduction for the gift. So if Mom took the charitable route for this IRA, there would be no need for a conduit trust.

Finally, there is that great unknown, the future. "Stretch IRAs" – or inherited IRAs that benefit heirs such as children and grandchildren – have started to appear on Congress's radar. The thinking goes like this: why should these accounts, which are really designed for the *owner's* retirement, be used as estate planning vehicles? In early 2012, then-Sen. Max Baucus (D-MT), Chairman of the Senate Finance Committee (and now the ambassador to China), proposed having most inherited IRAs paid out within five years of the owner's death (there were exceptions if the beneficiary were the surviving spouse, a minor child or someone who was disabled). Rep. Dave Camp (R-MI), Chairman of the House Ways and Means Committee, proposed something similar in his Discussion Draft for tax reform that he introduced on February 26th of this year. And most recently, Sen. Ron Wyden (D-OR), Chairman of the Senate Finance Committee, has also followed suit in his bill for replenishing the Highway Trust Fund. The bottom line is that a 5-year distribution rule for most inherited IRAs is viewed by some as "low-hanging fruit," and an easy way to generate much-needed revenue. Where might these proposals go? It's hard to know…but if they become a reality, the IRA trust discussion, of course, would be moot.

So – IRAs payable to a trust? Yes, this approach offers creditor protection. But as with any planning option, it is important to make sure that practical considerations don't outweigh potential benefits, and inadvertently undermine planning goals.

60-day IRA rollovers

Bobrow v. Commissioner was an interesting Tax Court case issued on January 28, 2014 (T.C. Memo. 2014-21). It was interesting because the Tax Court said that taxpayers could only make *one* 60-day IRA rollover per 12-month period, and not one *per account* per 12-month period, as commonly thought.

There was good reason for this common perception, as both Publication 590, issued by the IRS, and the proposed Treasury Regulation on which the publication is based, say that the limitation applies on an account-by-account basis, and not to all of a taxpayer's accounts. Nevertheless, as the Tax Court pointed out, the underlying statute says that the rule applies to *all* of a taxpayer's accounts. Accordingly, the IRS issued Announcement 2014-15 on March 20, 2014, and said that the "*Bobrow* interpretation" of the law would not apply to any IRA rollover distribution before January 1, 2015; in addition, Publication 590 would be corrected, and the related proposed regulation amended. (Yes, the taxpayer in *Bobrow* has now favorably settled with the IRS.)

So what does this mean? Effective January 1, 2015, taxpayers will only be allowed to make ONE 60-day rollover per 12-month period, and not one *per account* per 12-month period (note that the 12-month period starts when the distribution is made, and is not on a calendar-year basis).

What *is* a 60-day rollover? Ostensibly it refers to when an IRA owner moves an IRA from one institution to another, and receives the account monies directly; as long as the owner redeposits the money in another IRA within 60 days of the distribution, there will be no adverse tax consequences, such as having the distribution treated as taxable income or being potentially subject to the 10% early withdrawal penalty if the owner is under 59 ½.

A more typical 60-day rollover, however, is what amounts to a 60-day interest-free loan. That is, if the IRA owner has a short-term need for cash, she can effectively "borrow" the money from her IRA, provided that she returns it within 60 days. (If not, she suffers the potential income tax and penalty consequences just described.) Prior to *Bobrow*, the IRA owner could do this more than once in a 12-month period, provided she did it with different IRAs, and not the same one. As of January 1, 2015, that will no longer be the case, something for IRA custodians to keep in mind should a client request a 60-day rollover.

Does this change affect ***trustee-to-trustee transfers***? No. In other words, if the client wants to move her three IRAs from one institution to another, she can do so as often as she likes, with no tax consequences, as long as the IRAs are being transferred *directly* from institution to institution. But if she receives the three distributions directly, she's already gotten two too many – at least under the new rules. It's *one* 60-day rollover per 12-month period – and if she misses that 60-day deadline, her rollover will flunk.

Yes, IRAs can be tricky…and have *lots* of rules!

July 7520 rate

The IRS has released the July 2014 applicable federal rates. The July 7520 rate remains at 2.2%, where it was in June. The July mid-term rates, however, are slightly down: 1.82% (annual), 1.81% (semiannual and quarterly), and 1.80% (monthly). The June mid-term rates were: 1.91% (annual), 1.90% (semiannual and quarterly), and 1.89% (monthly).

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