estate planning briefs®

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Final portability Regs. issued

On June 12, the IRS issued final Regulations for electing portability of a deceased spouse's unused exemption amount (DSUEA). The final rules incorporate some, but not all, of the suggestions from practitioners.

Perhaps the biggest disappointment is the absence of an automatic extension of time to file the election if the deceased spouse's estate was below the filing threshold for an estate tax return. Rev. Proc. 2014-18 made the extension automatic for estates of decedents who died before January 1, 2014, and practitioners asked that the rule be made permanent. The Final Regs. do make these small estates eligible for an extension to make the election, but it is not automatic.

—T.D. 9725; 2015-26 IRB 1122

> COMMENT: Also rejected by the IRS was the suggestion that a short version of Form 706 be created for those estates that are filing an estate tax return solely to make the DSUEA election.

Prohibited transaction

In 2007, Michael and Christina Wu sold their home and each deposited $200,000 in an IRA to shelter the proceeds from further taxation. IRAs are a good deal for taxpayers, but they aren't *that* good. The normal contribution limit for IRAs and Roth IRAs in 2015 is $5,500, plus an extra $1,000 "catch-up" contribution for those 50 and older. One may "roll" money into an IRA from an employer's qualified plan, such as a 401(k) plan, or from another IRA. There is no dollar limit on such rollovers. But there is no provision for rolling the proceeds of a home sale into an IRA. Michael and Christina each had made an excess IRA contribution, which is subject to a 6% excise tax every year until they withdraw the excess from the IRA.

In March 2010, the couple filed tax returns acknowledging the excess contribution, and they withdrew the excess amounts on March 23 of that year. In computing several tax penalties and interest for them, the IRS applied the excess contribution penalty for tax year 2009, even though the couple had withdrawn the excess before tax filing day. The couple paid the full penalty and sued for a refund in 2012. In the above-cited decision, the District Court holds that it has jurisdiction over the couple's case and refuses to dismiss it. The Court held that the rule that one has until tax filing day to make a withdrawal applies regardless of the year of the initial excess contribution.

Despite the fact that the U.S. savings rate is generally thought to be too low, the problem of excess IRA contributions is rather large. The Treasury Inspector General for Tax Administration (TIGTA) reported in March that 57,484 taxpayers without eligible compensation potentially made $125 million in the 2011 tax year. That implies $7.5 million owed in excise taxes.

Some of the overfunding of IRAs appears deliberate. TIGTA reported 2,585 cases of IRAs for children under age 10—IRA contributions are not allowed unless an individual has earned income. So a contribution for a child actor is fine, but a contribution by a parent to give a child a head start on retirement is not.

Other funding errors may be inadvertent. For example, taxpayers must take a required minimum distribution (RMD) every year once they reach age 70½ or pay a penalty tax. Let's say that someone in this position rolls the IRA from one financial institution into another before taking an RMD for the year. That transfer is treated as a distribution, so the amount of the RMD also will be an excess contribution to the new IRA. The penalty applies even if the RMD is taken later in the year.

—Michael H. Wu et ux. v. United States; No. 1:14-cv-03925

COMMENT: One final note. Contributions to traditional IRAs are not allowed for taxpayers who reach age 70½, even if they have earned income. Therefore, any contribution by someone that age and up is an excess contribution.

Extension granted

When Decedent died, Spouse was not a U.S. citizen. In accordance with IRC §2056A, Spouse created a Qualified Domestic Trust (QDOT) and arranged for a corporate co-trustee of the trust. Assets that would have passed outright to Spouse from Decedent passed to the QDOT, and the marital deduction was saved.

Some years later, Spouse became a U.S. citizen. The corporate trustee was not immediately notified of the change of status and so did not file Form 706-QDT to let the IRS know about it, as required. The trustee now asks for an extension of time to file the Form.

The IRS gives the trustee another 120 days to complete the paperwork. Everyone has acted in good faith, Spouse was continuous a resident of the U.S., and there were no taxable distributions from the trust before the citizenship change.

—Private Letter Ruling 201516055

New cash-out limit

In a move that caught some retirement planners by surprise, in July the IRS issued new rules restricting the availability of lump sum distributions from pension plans. In general, when one reaches retirement one has a choice between a stream of payments that will last for life (or for the joint lives of a married couple) or a single payment that is actuarially equivalent to that amount. The calculation of that payment is based upon life expectancy and an interest rate factor.

Beginning in 2012, some employers began offering lump sum distributions to retirees who already had begun to receive their pensions, as well as those who were not yet in pay status. The object was to remove the liability from company balance sheets. It also reduces longevity risk for the employer, the chance that the retiree will live beyond what the actuaries predicted when the pension was funded. Initially, the IRS approved the move.

Not anymore. Subject to some narrow exceptions, from now on once a retiree begins receiving pension payments they may not be replaced by a lump sum distribution.

The question on some people's minds is, could the IRS apply a similar rule to plan participants on the cusp of retirement? Most likely, Congressional action would be needed for so radical a change.

—IRS Notice 2015-49

The "no-rule" list is expanded.

Decedent created an intentionally defective irrevocable grantor trust, the defect being that although the transfer was complete for transfer tax purposes, Decedent continued to pay taxes on the trust income. What happens at Decedent's death? Do the assets get a basis step-up under IRC §1014, even though they were not included in Decedent's estate? The IRS has announced that it will no longer provide private rulings in this area, amplifying Rev. Proc. 2015-3, 2015-1 I.R.B. 129.

—Rev. Proc. 2015-37; 2015-26 IRB 1196

Late basis allocations

2010 was the year without a federal estate tax. The tax basis of property received from a decedent who died during 2010 was, in general, the same as the decedent's tax basis. There was no step-up to fair market value under IRC §1014. However, smaller estates were shielded from this result because the executors for 2010 decedents could allocate a basis step-up among estate assets. Such elections were due by January 17, 2012 [*Notice 2011-76*, 2011-40 I.R.B. 479]. One might think that this issue has been entirely wrapped up by now.

Not so. In a recent ruling, an attorney hired by the estate for tax filings failed to file the Form 8939. The oversight was discovered some years later, and a request for an extension to file the Form was made. The Service found that the estate had relied in good faith upon a qualified professional, and so it granted an additional 120 days to file the Form.

—*Private Letter Ruling 201523009*

COMMENT: See also *Private Letter Ruling 201527010* to the same effect, which involved an accountant.

Stranded property valued "as is"

Pulling owned three parcels of orange groves in Florida. He also owned a minority interest in the Temple Citrus Land Trust (TCLT). TCLT owned two parcels that were contiguous with Pulling's holdings, but they blocked access from his property to the local roads.

How should Pulling's real estate be valued at his death? If it could be combined with the TCLT holdings, the entire tract could be developed as residential real estate, which would be its highest and best use. That is what the IRS argued for. However, because of the geography, it was impossible for Pulling's land to be developed if it were not combined with TCLT. The estate maintained that there was no evidence that an assemblage of the property was imminent or even likely, despite Pulling's minority interest in TCLT.

The Tax Court agreed. Under these circumstances, the potential for residential development is not the highest and best use of the property. The estate's expert valuation of the parcels as orange groves was accepted.

—*Estate of John A. Pulling Sr. et al. v. Commissioner; T.C. Memo. 2015-134*

Don't settle until you are certain

The terms of Warren Billhartz's 1978 divorce decree required him to leave half of his estate to the four children from his first marriage (one son, three daughters), divided equally. He remarried a year later. Most of Billhartz's assets were owned jointly with Marcia, his second wife, or were held in a living trust. Marcia and Ward, the son from the first marriage, were co-trustees of the trust.

Warren died in 2006, leaving a substantial estate. In accordance with the divorce decree, the trust obtained a lifetime annuity for the first wife. Ward received 16% of the balance of the trust, and each of the daughters 6%—in other words, the divorce decree requirement that the children be treated equally was ignored, and they received only 34% of the net trust assets instead of 50% of the estate.

The distribution to the children totaled $14 million. The executor characterized that payment as a claim against the estate, and took a deduction for the full amount under IRC §2053(a)(3). IRS disallowed the entire deduction, creating a tax deficiency of $6.6 million. The estate took the case to the Tax Court. However, after a series of negotiations, the estate and the IRS reached a settlement in which the Service agreed to allow 52.5% of the deduction. No rationale for that partial deduction is provided in the court opinion.

Next, it appears that the daughters were not aware that, under the terms of the divorce decree, they were entitled to the same share of their father's estate as their brother, and that the siblings should have had 50% of the estate. They first learned of the terms of the decree when the Tax Court litigation was filed. The sisters filed a state lawsuit alleging fraud. Curiously, the brother resigned his trusteeship and joined their lawsuit, alleging that Marcia had concealed key documents from them.

With the possibility that additional payouts would be due to the children, the estate moved to void its settlement agreement with the IRS. Litigation with the children was settled with an additional distribution to each of the girls of $1.45 million. Perhaps the estate hoped to apply the 52.5%

deduction to the additional payouts.

The Tax Court refused to set aside the settlement and entered a decision for the IRS. On appeal, the Seventh Circuit Court of Appeals agrees. The estate contended that the settlement was based upon a mistake of fact, that the distributions to the children had already been finalized. The Circuit Court notes that "mistake of fact" does not extend to a failure to anticipate future developments. The estate also alleged that counsel for the IRS had learned from one of the daughters that a lawsuit was being contemplated and should have relayed that information to the estate. The Court stated that the estate itself was in a better position to judge the future actions of the beneficiaries than was the IRS.

—Marcia Billhartz v. Commissioner; No. 14-1216

COMMENT: In a footnote, the Court notes that no opinion has been expressed on the appropriateness of the IRC §2053 deduction for the bequests to the children.