Estate and Gift Tax Updates and Hot Audit Topics.

Orange County Estate Planning Council

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PROPOSED ESTATE AND GIFT LEGISLATION

1. Built in Gains Tax

This proposal was in the Biden administration Greenbook and would tax not only appreciation following enactment, but also past tax appreciation. This is contrary to the 1969 proposed "Taxation of Appreciation of Assets Transferred at Death or by Gift" which would have only been prospective. This retroactive appreciation also contrasts the 1976 enactment of carryover basis. This provided for a "fresh start valuation" on December 31, 1976 and a proration of appreciation for non-marketable assets before that date. Gain would be recognized on transfers by gift or at death, equal to the excess of an asset's fair market value on the date of the gift or death. The proposal recognizes losses if basis exceeds fair market value. The proposal highlights that gain would be reported on the Federal gift or estate tax return or on a separate capital gains return. However, the proposal emphasizes that gain would be taxable income to the decedent and that tax imposed on gains deemed "realized at death" would be deductible on the estate tax return of the decedent's estate. There are some exclusions and deferral for family businesses.

2. Tinkering With The Revenue Reconciliation Act of 2017

The current legislation increased the Applicable Exclusion Amount for gifts and transfers on death and the Generation Skipping Transfer Exemption – currently 11.7 million for all purposes. This amount will sundown in 2025 and return to a $5 million exemption indexed by inflation in 2026. Proposals have included:

a. Revisions to the Amount of and Indexing of the Applicable Exclusion Amount on Death and During Life- a lower gift tax exemption amount than on death..
b. Decreasing the Generation Skipping Transfer Tax.
c. Increasing Rates.

3. Wealth Tax

A 2% annual tax on wealth over $50 million and 3% on wealth over a billion. This is very difficult and expensive to administer.

REMINDERS ON CURRENT LEGISLATION

Partnership Audits. A reminder to think through these new rules and make sure that there are provisions in place when dealing with not only agreements but sales of businesses and other transactions. IRS' position is that revocable trusts cannot push out. Further detail on these complicated rules are attached to the materials.

Revenue Rulings-9100 Relief. The cost of a Revenue Ruling is now $38,000 (previously $30,000) and the time to obtain one, if IRS will rule can be over a year. Always review the most recent Rev Proc –issued annually-currently Rev Proc 2021-1.

Revenue Procedure 2017-34, 2017-26 IRB 1282. Relief Procedure for Extension of time to Elect Portability. This Revenue Procedure provided permanent relief for estate's to elect portability when the election has not been made on a timely filed estate tax return but only if certain requirements are met and is still the only relief for late portability. Section 2010(c)(5)(A) requires that the portability election be made on the estate tax return of the decedent so that his or her unused exclusion amount will be conveyed to his or her surviving spouse. A number of estates failed to meet the filing requirement. Under the Revenue Procedure, a late election is available only if the decedent and the estate meet the following requirements:

1. Was survived by a spouse,
2. Died after 2010,
3. Was a citizen or resident of the United States,
4. The executor was not required to file an estate tax return because it was under the threshold prescribed in IRC Section 6018(a),
5. The executor did not timely file an estate tax return,
6. The election is made on a complete and properly prepared Form 706,
7. A statement on the top of the Form 706 "FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY UNDER SECTION 2010(c)(5)(A), and
8. The 706 must be filed within two years of the decedent's date of death.

If the estate fails to utilize the revenue procedure within two years, it may still use 9100 relief and request a private letter ruling under section 301.9100-3.

<u>Relaxation of Appraisal Rules on Portability Returns.</u> There is not statute of limitations running on a portability return hence IRS has relaxed reporting rules and no appraisals are required. This can be an issue and needs to be thought through for income tax purposes.

<u>Closing Letter</u>. A closing letter can be requested for $67 Further guidance will be issued. These will not be provided with returns filed solely electing portability.

LITIGATION DEVELOPMENTS

I. Federal Tax Cases

Estate of Warne v. Commissioner of Internal Revenue:

Facts: Miriam Warne (Decedent) and her husband opened a family trust in 1981. The trust became the majority interest holder of five LLC's. The five LLC's held interest in multiple properties. In 2012, decedent gave fractional interest to her kids and grandchildren. Then in 2014 the Decedent died. In the 9th amendment to the trust agreement, the decedent left 75% of the interest in one of the properties to a charitable foundation and the remaining 25% of the interest in that property to another charitable foundation. In 2015, the decedent's estate filed a gift tax return form. In 2018, the Commissioner (defendant) mailed the estate a notice of deficiency for a gift tax deficiency in 2012. The plaintiff filed petitions challenging the gift tax deficiency. Plaintiffs claim that the commissioner erred when he increased the values of the estate and the LLC's.

Analysis: The Court first discusses the different issues left to be addressed. These include: the fair market value of the leased fee interests as of the gift date; the fair market values of the leased fee interests at the decedent's death; the appropriate discount for lack of control and marketability for the majority interests the family trust held in LLC's; whether a discount applies to the 25% interest in Royal Gardens that the trust donated to a charitable foundation and whether a 4% discount applies to the 75% interest donated to the foundation; and whether the Section 6651(a)(1) addition to tax applies. The Court first states that a valuation of a gift tax is a factual issue that is based in the specific circumstances. The Court states that Appraisals of leased interests should reflect actual leases and expense structures, not hypothetical ones. Regarding the leased fee values at the time of the gift dates, the court ends up siding with the estate's calculations. The Court then analyzed the value of the properties at the time of the decedent's death. The court again adopts the plaintiffs' (estate) calculations. The court states that normally they would not give a discount for a lack of control, but since the parties agreed to one.

However, since the family trust has the majority control in the LLC's, then the discount should be small. The Court then addresses the Plaintiffs' argument that the lack of marketability for the stocks should be grounds for a tax discount. The court ends up applying a 5% discount for the lack of marketability. The Court then addresses the plaintiff's argument that since 100% of the Royal Gardens interest was transferred, then a discount on the tax is unnecessary and the parties should be able to get a 100% tax deduction. The Court disagrees with this finding, and analyzes that a discount should apply. The court states that a 27.5% discount should apply for the 25% interest transferred, and a 4% discount should apply to the 75% transferred interest. The Court then finally addresses the addition to the tax for failure to timely reply. The decedent transferred interests in the property in 2012 and the defendant claimed that she did not file a timely return. The Plaintiffs argue that the decedent had reasonable cause to not file the return. However, the Plaintiffs do not offer any evidence for this excuse. Accordingly, the tax addition for an untimely filing should be applied.

Note: The Court allowed tax discounts for lack of control and lack of marketability for majority controlling interests in five real estate holding entities, siding with the analyses of the Estate's expert. If a decedent's interest in a property is donated to charitable beneficiaries, valuation discounts may apply causing the estate to pay unexpected estate tax.

Morrissette v. Commissioner of Internal Revenue:

Facts: IRS issued a notice of deficiency determining an estate tax deficiency of approximately $39.4 million with respect to the estate of Clara Morrissette. The IRS increased the fair market value of the decedent's contract rights in six "split-dollar" life insurance policies from around $7.5 million to over $32 million. The Estate claims that the fair market value of the contract rights was around $10.5 million. Along with this increase, the respondent also added a 40% penalty for gross undervaluation

Issue: Whether section 2036 or 2038 applies to recapture inter vivos transfers made as part of the split-dollar agreements? If not, then what is the fair market value of the split dollar rights?

Analysis: The court held that sections 2036 and 2038 do not apply because the transfers of that were made as part of a split-dollar agreement were not both fall under the bona fide sale exception of both sections. The court used the discounted cash flow method to determine the fair market values of the contract rights. The court held that the 40% penalty for gross undervaluation applied.

Badgley v. United States:

Facts: In 1998, decedent made a grantor retained annuity trust (GRAT) funded by a one-half interest in a family partnership and 3 parcels of land. The decedent died three months

before the annuity interest expired. The federal tax return reported a gross estate valued at $36.8 million. This included the properties and interests that were in the GRAT. The executor of the estate claims that the properties/interests in the GRAT should not be counted in determining the decedent's gross estate..

Analysis: The Ninth Circuit Court of Appeals ruled that just because Section 2036(a)(1) mentions income and not annuity, that does not mean that ambiguities are excluded. The Court in the past has consistently held that parties cannot escape federal income taxation by hiding behind legal nuances. The court affirmed the ruling of the Federal District Court, because the interest in a GRAT can be counted in a decedent's estate when the grantor dies during the GRAT term.

Nelson v. Commissioner T.C.

Facts: Husband and wife created Longspar Ltd. One of the purposes of the limited partnership was to ensure that the underlying company of Warren Equipment Company (WEC) would stay in business and under control of the Warren family. WEC directly and indirectly owned 100% interest in eight subsidiaries that operated several businesses. In 2008, the couple created the 2008 Nelson Descendant Trust. Mr. Nelson was the settlor and trustee of the trust. The couple's 4 daughters were beneficiaries to the trust. In December of 2008, Mrs. Nelson gifted interest in Longspar to the Nelson Descendant Trust. Two days later, Mrs. Nelson sold Longspar to the Nelson Descendant Trust for $20 million. The IRS then conducted an audit and determined that there was a $611,708 deficiency on the gift and a $6,123,168 deficiency for the sale.

Issue: Whether Mrs. Nelson had transferred what the court described as "fixed dollar amounts or percentage interests" (in other words, had used a defined value formula, in which case there would be no adverse gift tax consequences) and, if they had not, what the values were of the interests that were transferred.

Analysis: The Tax Court accepted the application of a defined value clause based on an appraisal to be obtained in 90 or 180 days, and Multi-tiered discounts were allowed. This was based on an appraisal within a limited period of time.

Estate of Streightoff v. Commissioner

Facts: Frank Streightoff (Frank) created a revocable living trust in which his daughter was the trustee. On the same day, Streightoff Investments LLP (LP) was created. Frank funded LP almost entirely through cash, marketable equity securities, municipal bonds, and mutual fund investments. Frank also held an 88.99 percent limited partnership interest in LP. He gave his daughters 1.54% shares in LP. His sons and former daughter-in-law held 0.77% interest. Frank was the sole general partner of LP. Elizabeth was the managing member of Streightoff Management. Frank also assigned 88.9% interest in LP in his irrevocable. Frank died on May 6, 2011. The estate listed the 88.99 percent interest in LP as an assignee interest with a value of $4,588,000 as of the alternate valuation date. This valuation reflected discounts for lack of marketability, lack of control, and lack of

liquidity, totaling 37.2 percent. The IRS issued a notice of deficiency of $491,750. The IRS stated that the value of Frank's interest in LP could be discounted only for lack of marketability and not for lack of control and lack of liquidity.

Analysis: The Tax Court determined that the revocable trust held a limited partnership interest in LP at the alternate valuation date because the Assignment assigned the LP interest as a limited partnership interest in both substance and form. Accordingly, the court agreed with the IRS's valuation expert that the only discount allowed was an 18% discount for lack of marketability. The fifth circuit court of appeals upheld this ruling.

Fuller v. United States

Facts: Harry H. Fuller II died and named his son, Harry M. Fuller III ("Harry III"), as executor of his estate. Harry III filed an estate tax return showing no tax due, but thereafter the IRS assessed a deficiency based on an estate tax liability of $170,558. Hary III paid over 120,000 dollars to the IRS. The IRS later determined that he actually owed 243,000 dollars. Harry III paid that amount and sued for a refund, alleging that the IRS should be bound by the $120,588 figure given Harry III by the IRS representative. The IRS moved to dismiss.

Analysis: The U.S. District Court granted the government's motion to dismiss. The court explained that a claim of estoppel requires proof of: (i) an intentional or reckless misrepresentation, (ii) intended to induce some action in reliance, and (iii) which reasonably induces action in detrimental reliance by the other party.

United States v. Kohls

Facts: Douglas Kohls (Doug) was the executor of his deceased father's estate. Doug filed an estate tax return on December 10, 2002, showing an overpayment of $7.52 million. Douglas signed a Form 890, consenting to the immediate assessment of a $199,077 estate tax deficiency. Doug then applied for and received three consecutive one-year extensions of the time to pay the deficiency. The Government then sued Doug both personally and as executor for the unpaid taxes, plus interest and penalties, noting that Doug's distributions to himself rendered the estate unable to pay the taxes. Doug asserted that the 13-year statute of limitations on collection actions (10 years plus the three years of extensions) had expired.

Analysis: The District Court granted summary judgement for the government. The court held that the statute of limitations on the suit for collection begins to run on assessment, and that the assessment did not occur on the date of the Form 890, but rather on the date on which the liability is recorded by the IRS under Section 6203.

Thomas v. Commissioner T.C.

Facts: Petitioners assert that petitioner husband took the petition to the Fernley, Nevada USPS office on March 5, 2018, and placed it in the mailbox before 5 p.m., the last mail pickup time at that office. The USPS postmarked the envelope on March 6, 2018.

Analysis: Accordingly, because the envelope containing the petition bears a legible USPS postmark, we must disregard the mark made by the private postage meter. This is consistent with law providing that a private postage meter yields to the official post office time stamp

United States v. Marin

Facts: Carla Marin (Carla) was the co-executrix of the $7.4 million estate of her mother, Ana Beatriz Marin, which included 29 parcels of real property, cash, notes, and mortgages, and a small amount of personal property. Ana left behind a holographic will. The will was in dispute when the temporary administrator filed a federal estate tax return declaring a liability of $1.8 million and electing to defer part of the tax under Section 6166. The IRS audited and found a deficiency of $245,060. The United States filed suit against both the estate and both executors.

Analysis: The U.S. District Court for the Southern District of New York denied Carla's motion, finding that the Government had alleged sufficient facts to sustain all of its claims: (a) the interim accounting showed that the estate earned over $2 million in income, although it had not filed an income tax return since 2010; (b) soon after Ana's death Carla and her two brothers received more than $670,000 in cash; (c) before and after notice that federal estate taxes were due, the estate paid over $2.2 million of debts to certain creditors who did not have priority over the IRS, for advertising costs, bank fees, property maintenance costs and taxes, and insurance; and (d) Carla also had resided in and personally used certain estate properties. These facts established that Carla made payments to beneficiaries and creditors in contravention of the IRS's priority debt position and after knowing that the estate owed the taxes and was insolvent, satisfying the requirements of 31 U.S.C. §3713. The Court holds that there is fiduciary liability for preferring creditors and beneficiaries over the IRS-those who did not have priority.

United States v. Estate of Kelley

Facts: Lorraine M. Kelley ("Lorraine") died, and her brother Richard Saloom (Richard S), and Richard J. Lecky were her co-executors. Lorraine's executors filed a timely estate tax return reporting a gross estate of over $1.7 million and a tax liability of $214,412. Richard S. agreed to the assessment of $448,367 of additional tax liability. Richard S. gave $50,000 of the annuity payments to his daughter Rose. After these distributions, the estate had no assets, but it still owed the government $400,000 in estate tax. Richard S. entered into an installment agreement with the IRS and, after his death, Rose continued making installment payments on his behalf. The United States sued Richard's estate, and Rose too, as transferees of Lorraine's estate and as fiduciaries of the two estates, and under the New Jersey Uniform Fraudulent Transfer Act ("UFTA").

Analysis: The court granted summary judgment against Richard S's estate as a transferee of Lorraine's estate under Section 6324(a)(2). The court explained that this section imposes liability on transferees who receive property from a decedent's estate, if the estate fails to pay its taxes. The court also granted summary judgment that Richard S was liable as a fiduciary of Lorraine's estate under 31 U.S.C. §3713(b), because he had distributed estate assets to himself, rendering the estate insolvent, and he knew or should have known of the outstanding estate tax liability. The court also held that Rose had liability under 31 U.S.C. §3713(b) because she distributed $1.1 million of her father's estate to herself, rendering it insolvent, and she knew or should have known of the outstanding estate tax liability. A fiduciary may be personally liable for estate taxes if beneficiaries are paid before paying the IRS.

United States v. Paulson

Facts: John Paulson (John) was the son of the founder of Gulfstream Aerospace Corporation. John was also the executor of his father's estate and co-trustee of his father's revocable trust. Upon the death of his father, the estate filed an estate tax return electing to pay part of the taxes in installments under Section 6166. In the return, John included a letter requesting discharge under Section 2204. The IRS received the letter, but never responded. The IRS and the estate subsequently fought over a $37 million tax deficiency. The IRS sued the estate in 2015.

Analysis: The District Court held that John's request under Section 2204 was effective. The court noted that the plural form of fiduciary in the letter's title, "Request for discharge of fiduciaries from personal liability" could indicate that John requested to be discharged as both trustee and executor, and that requesting the longer nine-month review time was not inappropriate since he was also asking for discharge as an executor. The Trustee was not liable for estate tax because of the release under Section 2204."

United States v. Mengedoht

Facts: Jan Mengeholdt was the executor of the estate of Carl Mengeholdt. Jan did not file a tax return for the estate. The gov. sued Jan for $2.6 million. District Court granted summary judgement for the government.

Analysis: The Court of Appeals affirmed the ruling of the lower court regarding Jan's liability and a foreclosure for unpaid estate taxes was upheld. The Court also held that a non-lawyer could not represent an entity in federal court.

United States v. Widfeldt

Facts: Widfeldt received two parcels of land from his mother. Widfeldt's mother did not file a tax return for receipt of the parcels.

Analysis: The Court held that James was personally liable for over $1 million in unpaid estate and gift taxes and the court ordered the foreclosure on and sale of the two inherited properties to satisfy the estate tax deficiency.

Sage v. Commissioner T.C.

Facts: Jason P. Sage, a real estate developer, owned through IDG, a subchapter S corporation, three parcels of Oregon real estate encumbered by liabilities in excess of the value of the properties. Between 2010 and 2012, the liquidating trusts disposed of the properties. Jason reported losses of $5.3 million. The IRS did not allow the losses and claimed a tax deficiency.

Analysis: The tax court supported the IRS and stated that the liquidating trusts were grantor trusts, hence, the transfer of property from the grantor to the grantor trust could not result in recognition of a loss.

Heiting v. United States

Facts: A taxpayer's revocable trust held stock which the trustee sold. The trust provided that stock was not to be sold. The trustee bought the stock back. The taxpayer was forced to pay tax on the gain from buying back the stock. The taxpayer sought a credit under the next year's tax return under the claim of right doctrine.

Analysis: The Court denied the credit and tax benefit, because the trust was revocable. Therefore, the prohibition on the sale of stocks along with the reacquiring of the stock was not mandatory.

United States v. Harding

Facts: Harding received a real estate parcel and transferred the property to an irrevocable trust. The IRS issued a judgement against Harding for 11 years of unpaid taxes.

Analysis: The Court held "that: (1) Alfred was the true owner of the real estate; (2) Alfred's transfer of the property to the Trust was fraudulent; (3) to the extent that the Trust holds an interest in the real property, it does so as Alfred's nominee or alter ego; (4) the Government has valid federal tax liens against the real property; (5) the federal tax liens against Alfred encumber the real property and should be foreclosed; and (6) the Government may submit an Order of Foreclosure and Judicial Sale of the subject property. The grantor's income tax liability can be recovered from the trustee.

United States vs. Steele

Facts: Steele owed the IRS income tax for four years. The IRS sought to collect these amounts by putting a levy on a property which was owned by a trust created by Steele.

Steele was neither the trustee nor the beneficiary of the trust. However, Steele did reside in the property under a 99-year lease.

Analysis: The Court held that Steele provided no evidence that he did not owe the taxes. The court also ruled that the trust held the property as a mere nominee for Spencer's benefit. "The court then looked to the factors that federal courts have held determine whether a trust is a nominee, including: (1) the source of the funds used to purchase the property; (2) the taxpayer's continued use of the property without the payment of a fair rental value; (3) the taxpayer's continued payment of maintenance charges and real estate taxes; (4) the nominees' acquisition of the property without any consideration, or for inadequate consideration; (5) the taxpayer's acts of holding himself out as the owner of the property; (6) the transfer of the property in anticipation of suit or the incurrence of liabilities by the taxpayer; and (7) the relationship between the taxpayers and the nominee, that is, whether it is a close one, such as by blood or marriage." The court held that Steele had maintained control of the property and the trust was his nominee hence the IRS lien attaches to property held by the nominee trust.

<u>Wilson v. United States:</u>

Facts: Wilson created a foreign trust in 2003 due to him suspecting that his wife would divorce him. Once the divorced was finalized, Wilson terminated the trust and received over $9 million. Wilson was late in filing his Form 3520. When Wilson filed, the IRS issued a 35% penalty against him. This was a penalty for trust beneficiaries. After Wilson's death, the estate sued the government seeking recovery for the penalty. The estate claimed that the 35% penalty did not apply because Wilson was also the owner of the trust under the grantor trust rules and deemed owners are subject only to a 5% late filing penalty under Section 6677(b). Wilson's estate moved for summary judgement

Analysis: The US District Court granted the estate's motion for summary judgement, because the 5% penalty was the appropriate one. The lower penalty on the owner of a trust is in lieu of the beneficiary penalty and not in addition to it. The U.S. owner of foreign trust can be penalized for failing to file Form 3520, but cannot also be penalized as beneficiary.

<u>Mann v. United States</u>

Facts: Mann owned a house which she gave to a charity. But the deed was not recorded. The charity employs disadvantaged people to deconstruct properties to use the parts for sale. The charity itself does not perform the demolition work. Second Chance incurred approximately $13,144 in expenses in deconstructing the house. Mann and her husband deducted $675,000 for their gift of the house, $24,206 for their gift of the personal property, and $11,500 for the cash donations. The IRS denied all deductions. The District court granted summary judgement for the government holding that only the cash donations of could be deducted since Mann did not completely convey all rights of the property to the charity. The parties appealed.

Analysis: The Court of Appeals affirmed the ruling of the lower court, because the Mann's only transferred contractual ownership of the land and did not record the deed.

Dickinson v. Commissioner, T.C.

Facts: A shareholder and chief financial officer of a privately held company desired to donate shares of stock to the Fidelity Investments Charitable Gift Fund. In three years, the shareholder donated appreciated shares to the gift fund. It was clear that that the Gift Fund owned and had exclusive control of the shares prior to the redemption and had full discretion over all conditions of subsequent sale and was not under any obligation to sell the shares.

Analysis: In *Humacid Co. v. Commissioner*, 42 T.C. 894, 913 (1964), the court held that: "the form of this kind of transaction [i.e., as a donation of shares followed by the charity's redemption of the shares rather than as a sale of shares by the taxpayer followed by a donation of the cash proceeds] if the donor (1) gives the property away absolutely and parts with title thereto (2) before the property gives rise to income by way of a sale." The donor met the first prong of this test, because they transferred all of their rights in the donated party. The court refused to: "treat a redemption in this type of situation as an anticipatory assignment of income as long as the charity is not legally bound to sell the donated shares and cannot be compelled to surrender the shares for redemption."

Fakiris v. Commissioner, T.C.

Facts: George Fakiris was a commercial real estate developer in New York City, and 60 percent partner in Grou Development, LLC. In 2001, the LLC paid $700,000 for a 1929 Staten Island movie and vaudeville house. The LLC planned to raze the theater and construct a high-rise building, but those plans were opposed by the community. The LLC wanted to give the theater to the Richmond Dance Ensemble, Inc., a nonprofit corporation that wanted to restore it and use it for public performances. The LLC then agreed to sell the theater to WEMGO, a qualified public charity that agreed to retransfer the property to Richmond Dance after the latter obtained tax-qualified status. The sales contract prohibited WEMGO from transferring the property for five years, unless directed by the LLC to transfer it to Richmond Dance. The actual deed of transfer, however, included no restriction on WEMGO's ability to retransfer the theater and no power in the LLC to direct a transfer. A qualified appraisal in the year of the transfer to WEMGO valued the theater at $4.5 million. A qualified appraisal by the same appraiser the next year valued it at $5 million. The Tax Court denied the income tax deduction because the LLC's retained power to direct when WEMGO could retransfer the property rendered the gift incomplete for income tax purposes.

Analysis: The taxpayer moved for reconsideration. The court needed to determine the actual value of the theater in order to determine the amount of the overvaluation penalty. Section 6662(e)(1)(a) states that the overvaluation penalty is 20 percent if the valued claimed is 150 percent or more of the correct valuation, or 40 percent if the value claimed is 200 percent or more of the correct valuation. The court noted that in Woods the Supreme Court held that a Section 6662(b)(3) accuracy-related penalty applied even

when the transaction was disregarded for lack of economic substance. The Tax Court held that the determination that a donor has not relinquished dominion and control over the gift property is analogous to the determination that a partnership is a sham and does not exist for tax purposes. Here, the Tax Court applied a 40 percent gross overvaluation penalty because the charitable gift was not a completed transfer, without determining the value of the property.

II. Private Letter Rulings

PLR 202020008-010:

Facts: Decedent was the sole trustee and beneficiary of two trusts. No governing law for the trusts were mentioned and the decedent moved from state to state.

Analysis: The IRS held that the decedent did not have a general power of appointment and neither of the state laws in the states where the decedent lived impacted the GST grandfathered status of the trust.

PLR 202019015

Facts: The executor of Decedent's estate hired an Attorney to prepare the estate tax return, and Attorney recommended that the alternate valuation date be elected. The alternate valuation date appraisals were not completed by the extended due date of the return, and the return was timely filed without the election. The IRS extended the time in which the estate could make the alternative valuation date.

Analysis: The IRS allowed a late alternate valuation date election since the return was within one year of being timely filed.

PLRs 202011001-005 & 202013001-005: Modification of Grandfathered Trusts:

Facts: A father and mother made a trust for the benefit of their son which would terminate 21 years after the death of the son. Subsequent to Son's death, the trustees and advisory board members of Trust A and the successor trusts petitioned the local court to modify the trust to provide that if property is distributed upon the termination of Trust A to beneficiaries who had not reached a certain age, the trustee could make payments or distributions of that property to a vested continuing trust for the beneficiary. The trustees requested a ruling that the proposed modification would not cause Trust A or its successor trusts to lose their grandfathered exemption from GST tax.

Analysis: IRS ruled that the amendment of the trust would not un-grandfather the trust for generation-skipping transfer tax purposes.

BITCOIN CRAZE

Bitcoin increased by over 300 percent in 2019; while the S&P 500 rose by just 29 percent. More and more individuals are investing in this and other crypto-currencies. At some point the taxing authorities will issue guidance as massive tax dollars are escaping the system.

IRA'S AND RETIREMENT PLANS

Due to the ability to stretch for only 10 years under the SECURE Act, consideration should be made to remove a trust as primary beneficiary and name children or other beneficiaries directly. The reason being, if there is more than one beneficiary of the Trust, and all are individuals as opposed to charities, etc. (as is the case with more than one child), the beneficiary with the shortest life expectancy (the oldest child) will be considered the Designated Beneficiary for purposes of determining minimum required distributions. If each child were named as a beneficiary directly instead of the trust, this allows each child to stretch distributions to their life expectancy. There are other factors to consider in naming children directly:

-beneficiaries may decide not to take advantage of the stretch, but cash in the inherited IRA. Naming beneficiaries directly removes some of your control over the situation;

-some beneficiaries may need financial structure due to immaturity or irresponsibility, and running the IRA through a trust can help achieve this;

-a beneficiaries creditors and ex-spouses can attach to an inherited IRA, but not a trust IRA. Keep this in mind if there is concern about divorce or debt.

SALT RELIEF

California has adopted a pass-through-entity work-around the federal state and local tax limitation of $10,000, last Friday, when Governor Newsom signed AB 150. AB150, is

confusing and hopefully the FTB will issue regulations. In the meantime, I have tried to identify where I am speculating as to what was intended.

Last Friday, July 16, 2021, Governor Newsom signed AB 150 which provides that certain *qualified* pass-through entities may elect a 9.3% tax and credit system that it intended to bypass the current $10,000 individual itemized deduction limit against paid state and local taxes. This new act is of interest to nearly every client who has a pass-through business entities (i.e., partnerships and S Corporations) or who may wish to consider forming one for purposes of saving federal income taxes.

Effective Date.

AB 150 is effective for tax years beginning on or after January 1, 2021. AB 15 will end for years beginning before January 1, 2026, or sooner, if the limitation on individual state deductions is repealed.

Summary.

This election allows an electing qualified business entity (with respect to electing qualified owners) the right to elect to self-impose an entity level FTB tax of 9.3% against a portion of reported entity level of income. A credit will then be allowed as a pass-through personal income tax credit against qualified electing owners of the entity.

California and other enacting states believe that this work-around the $10,000 itemized deduction limitation should work, but it is not necessarily blessed by the Treasury. Conceptually, if a state tax deduction is allowed at an entity level, then federal income allocated under a Schedule K-1 should be correspondingly reduced. For California tax purposes, this structure will not result in any state income tax savings, but the reduction may result in a lower federal income tax liability than would otherwise be allowed under current law.

Electing Qualified Entities.

A new concept added by AB150 is “electing qualified entities”. Referencing R&T Code 19002, this AB 150 states that qualifying entities are essentially partnerships and S Corporations, i.e. pass-through business entities. However, Section 19002 states that qualifying entities may only consist of ones having members/partners that are solely corporations or Section 17004 owners (individuals, fiduciaries, estates, or trust subject to any tax, but excluding partnerships). However, elsewhere, AB 150 seems to state that the only “qualified taxpayers” are those under Section 17004. These seeming conflicts need to be resolved as to the effect of a corporate partner or member in an LLC. We don’t know if these two provisions can be reconciled – where corporations are referred to as qualified taxpayers under 19002 as to the entity, but not under 17004, which uses the same exact term.

We also don’t know why a tiered partnership is excluded. We hope that regulations are adopted that find intent to allow partnerships and corporations to be owners in an eligible entity, but not disqualify the entity. At least one writer has already concluded that all owners must be qualified taxpayers – i.e., not partnerships or corporations, to have the entity eligible to make the election.

On the other hand, in one area AB150 is clear, disregarded entities (i.e. single member LLCs and QSSSCs) are NOT qualified to make the election. And, this make sense, because the U.S. Treasury would likely object to this work-around as being abusive.

Election is effective only for owners who elect.

In addition to the election by the entity, there must be an election by at the qualified owners. The law is written so that not all qualified owners need elect. The law reads that if the entity elects, then those who do not elect will not preclude the election for those who do elect.

While state law seems to defy any requisite minimum owner vote for the entity management to make an election, it is unlikely that tax law will be found to supersede an owner’s legal rights by contract. While the risk of a dispute may seem low, it may be prudent to revise partnership and operating agreements to cover requisite votes. On the other hand, those who do not elect should not have their K-1 affected.

What this Election Does.

How AB 150 works is at least facially simple. Again, the law is intended to follow a work-around of the limit to the individual (trust/estate) $10,000 limit on deducting state and local taxes as an itemized deductions. The law is intended to follow federal guidance as to when state taxes paid are not subject to that limit. Federal guidance – at least currently – indicates that because state taxes charged to legal entities need not be separately stated apart from the entity's business income – in reporting allocable shares, a state and local charges are simply netted against reportable income shown on each owner's Schedule K-1.

How the law follows this is to impose an elective corporate level type tax. A qualified partnership or S Corporation making this California state tax election will have imposed a 9.3% tax, which will be charged to the entity with respect to the owner's "share" of entity level income. Assuming this is "kosher" under federal tax law, the tax paid should then be deductible in computing federal net income at an entity level. Thus, the owner's share reflects a smaller amount as his or her allocated federal income on the Schedule K-1. However, state tax reporting purposes, it's not a deduction, but will be treated as a state tax credit on the owner's Schedule K-1. It will hopefully reduce the owner's share of California personal income taxes.

While this loophole would seem to work, it is not without risk from the IRS. The IRS may determine that it did not intend this result in issuing guidance. On the other hand, at this time, California joins a dozen states asserting that the guidance is consistent with the current law. In addition, even if this right to claim a deduction in reporting federal taxable income is allowed, it is not without complications. One is complication is the timing of the right to take a state tax deduction for the California 9.3% elective tax. There may be limitations on deductions, such as the requirement that tax actually be paid, for a cash basis taxpayer. There are also the 461(h) economic performance rules that may affect timing as to taxes.

There are also planning concerns, particularly what to do about the upcoming quarterly state tax estimates. The FTB might not allow state taxes paid in the 2022-year to be credited against the 2021-year personally, if paid with respect to the 2021-year. We just need more guidance on the credit. Indeed, the California estimated tax rules for giving a credit on paid tax do not appear to apply here, at least not yet.

<u>Example</u> (000s omitted)

Mr. A. and Ms. B own AB Partnership on a 50/50 basis.

During each of 2021 and 2022-years, the AB Partnership had net income of $100 before state taxes. An AB 150 election was made during 2021 and 2022. Accordingly, the AB Partnership paid $9.3 during the 2022-year in California income tax for the 2021-year and $4.65 (50%) for the 2022-year.

Federal.

For K-1 reporting purposes, the federal net income will be $100.00 for the 2021-year and $86.05 for the 2022-year. ($100 – both $9.3 and $4.65) – which is to be split between A and B.

California.

For the K-1 for California reporting, the California owners will report a total of $100 of net income - $50 each for both years.

Each will receive a state tax credit. ***Speculating*** *that the credit will only be allowed on an "as paid" basis – then the amount of the credit that will be allowed for the 2021-yar is zero. For the 2022-year the total amount of the personal state tax credit reported on Schedule K-1 will be $13.95 ($9.3 + $4.65), split $6.97 ½ each..*

Election.

More guidance will be needed on making the election. AB 150 specifies that the election must be made on a timely return, and once made, it will be irrevocable.

Payment of Tax.

AB 150 does cover that the election is annually made and once made it is irrevocable, and cannot be changed on an amended return. The election must take place annually with a timely declaration for the election year. For tax years beginning 2021, regardless of any renewals, tax is due on or before the due date of the company's return. For tax years beginning between 2022 and 2025, election tax is due in two installments:

The first, payment must be made by June 15 of the taxable year of the election in an amount equal to the higher of $ 1,000 or 50% of the tax paid in the previous year. Second, the remainder is due before the due date of the original return (excluding any renewals).

The new law has many other provisions. Electing owners can claim 9.3% of the tax paid by the entity on their personal/trust/estate California tax return as a credit, to the extent allocated to them. Excess credits can be carried forward for up to five years. In addition, regulations will need to clarify other provisions such as to the manner of reporting and claiming credits, and the reporting for nonresidents with California source income.

More on the law may be found at the following link: https://leginfo.legislature.ca.gov/faces/billCompareClient.xhtml?bill_id=202120220AB150&showamends=false

ADEQUATE DISCLOSURE

Estate and Gift Tax Returns:

- Gift Tax. According to IRC §6501(c)(9), the statute of limitation for gifts does not toll as to an item reported on a gift tax return unless the item is disclosed in a manner adequate to apprise the IRS of the "nature of the gift and the basis for the value so reported."
- Estate Tax. Although the gift tax "qualified appraisal" rules of Treas Reg §301.6501(c)-1(f)(3) do ***not*** apply to the estate tax return, they can serve as a guide.

QUALIFIED APPRAISAL

These attacks are alive and well-not for the taxpayer..

Donations: For any charitable donation of non cash/non-marketable assets in excess of $5,000 a qualified appraisal must be obtained or the deduction will be denied and penalties can apply. This must be attached to a timely filed return and the Form 8283 must be completed and attached.

A "***qualified appraisal***" means an appraisal which:

- Is made not earlier than 60 days prior to the date of contribution nor later than the due date of the return on which the deduction is claimed;
- Is prepared by a *qualified appraiser;*
- Does not involve a prohibited appraisal fee; and
- Includes:
  - A description of the property and its physical condition;
  - The date (or expected date) of its contribution;
  - The terms of any agreement that relates to the use, sale, or other disposition of the property;

- Treas Reg §1.170A-13(c)(3)

- The name, address and identifying number of the appraiser and the person who employs or engages the appraiser;
- The appraiser's qualifications;
- A statement that the appraisal was prepared for income tax purposes;
- The date (or dates) on which the property was appraised;
- The appraised fair market value of the property on the date (or expected date) of contribution;
- The method of valuation used; and
- The specific basis for the valuation.

– Treas Reg §1.170A-13(c)(3)(ii)

Notice 2006–96. A "*qualified appraisal*" means an appraisal which is:

- treated as a *qualified appraisal* under regulations or other guidance; and
- conducted by a *qualified appraiser* in accordance with generally accepted appraisal standards and any regulations or other guidance.

Appraisal Summary: The term "appraisal summary" means a summary of a *qualified appraisal* that--

- **(A)** — Is made on the form prescribed by the IRS [form 8283];
- **(B)** — Is signed and dated by the donee;
- **(C)** — Is signed and dated by the *qualified appraiser*; and
- **(D)** — Includes the information required by Treas Reg §1.170A-13(c)(4)(ii) (above).

Treas Reg §1.170A-13(c)(4)

Form 8283, signed by the appraiser and the donee, must be attached to the income tax return on which the deduction for the contribution is first claimed

- A "*qualified appraiser*" means an individual (other than an excluded person) who includes on the appraisal summary a declaration that he or she:
  - Either holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis;
  - Is qualified to make appraisals of the type of property being valued because of his or her qualifications;
  - Is ***not*** an *excluded person*; and
  - Understands that an intentionally false or fraudulent overstatement of the value may subject the appraiser to a civil penalty under IRC §6701 for aiding and abetting an understatement of tax liability.

  Treas Reg §1.170A-13(c)(5)

- Exclusions. The following persons cannot be *qualified appraisers*:
  - The donor or the taxpayer who claims a deduction for the contribution;
  - A party to the transaction in which the donor acquired the property being appraised unless the property is donated within 2 months of the acquisition and its appraised value does not exceed its acquisition price;
  - The donee of the property;
  - Any person employed by any of the foregoing persons;
  - Any person related to any of the foregoing persons under IRC §267(b), or married to a person who is in a relationship described in §267(b) with any of the foregoing persons;
  - An appraiser who is regularly used by any person described above who does not perform a majority of his or her appraisals for other persons.

- Fees. In general, the fee arrangement cannot be based on a percentage of the appraised value of the property.

Notice 2006–96. A "*qualified appraiser*" means an individual who:

- (i) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in regulations;
    - An appraiser will be treated as having earned an appraisal designation from a recognized professional appraiser organization if the appraisal designation is awarded on the basis of demonstrated competency in valuing the type of property for which the appraisal is performed.
- (ii) regularly performs appraisals for which the individual receives compensation; and
- (iii) meets such other requirements as may be prescribed in regulations or other guidance.
    - An appraiser will be treated as having demonstrated verifiable education and experience in valuing the type of property subject to the appraisal within the meaning of IRC §170(f)(11)(E)(iii)(1) if the appraiser makes a declaration in the appraisal that, because of the appraiser's background, experience, education, and membership in professional associations, the appraiser is qualified to make appraisals of the type of property being valued.
    - An appraiser will be treated as having met minimum education and experience requirements if:
        - For real property the appraiser is licensed or certified for the type of property being appraised in the state in which the real property is located.

– For returns filed after February 16, 2007, the declaration required under Treas. Reg. §170A-13(c)(5)(i) must include an additional statement that the appraiser understands that a substantial or gross valuation misstatement resulting from an appraisal which the appraiser knows, or should have known, would be used in connection with a return may subject the appraiser to a civil penalty under IRC §6695A.

- An individual will not be treated as a *qualified appraiser* unless that individual:
- demonstrates verifiable education and experience in valuing the type of property subject to the appraisal; and
- has not been prohibited from practicing before the IRS at any time during the 3-year period ending on the date of the appraisal.

Penalties

IRC §6662. Accuracy-Related. A 20% penalty shall apply to any underpayment attributable to:

- *Negligence* or disregard of rules or regulations.
- Any *substantial understatement* of income tax.
- Any *substantial valuation misstatement* under Chapter 1.
    - There is a *substantial valuation misstatement* under Chapter 1 if the value or the adjusted basis of any property claimed on any return of tax imposed by Chapter 1 is 150% or more of the amount determined to be the correct amount.
- Any substantial estate or gift tax valuation understatement.
    - There is a *substantial estate or gift tax valuation understatement* if the value claimed on a return is 65% or less of the "correct" amount.
- **Gross Valuation Misstatements.** To the extent that the underpayment is attributable to one or more gross valuation misstatements, the penalty shall be increased to "40%."
    - The term "*gross valuation misstatements*" means (i) any substantial valuation overstatement determined by substituting *200%* for 150%; or (ii) any substantial estate or gift tax valuation understatement as determined by substituting *40%* for 65%.

IRC §6694. Understatement by Tax Return Preparer.

- Unreasonable Positions. The penalty shall be equal to the greater of $1,000 or 50% of the income derived by the preparer with respect to the return.
- Willful or Reckless Conduct. The penalty shall be equal to the greater of $5,000, or 50% of the income derived by the preparer with respect to the return.
- Abatement Where Liability Not Understated. If there is a final determination that there was no understatement, the penalty shall be abated.

IRC § 6701. Aiding and Abetting Understatement. Any person who aids or assists in the preparation of a return who knows that a position would result in an understatement shall pay a $1,000 penalty (unless the return relates to the tax liability of a corporation, in which case the penalty shall be $10,000).

IRC §6695A. Appraiser Penalty. If the claimed value of property based on an appraisal results in a substantial or gross valuation misstatement under §6662, a penalty is

imposed under §6695A on any person who prepared the appraisal and who knew, or reasonably should have known, the appraisal would be used in connection with a return or claim for refund.

Penalty Avoidance/Defenses

Treas Reg §1.6662-3(b)(3) *Reasonable Basis*.

Treas Reg §1.6662-3(c) *Adequate Disclosure*.

Treas Reg §1.6662-4(d) *Substantial Authority*.

Reliance on Opinion or Advice.

- All facts and circumstances must be taken into account. Reliance may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.

Valuation Misstatements of Charitable Deduction Property.

There may be *reasonable cause and good faith* with respect to an underpayment attributable to a substantial (or gross) valuation misstatement of charitable deduction property only if:

- the claimed value of the property was based on a *qualified appraisal* by a *qualified appraiser*; and
- the taxpayer made a good faith investigation of the value of the contributed property.

But NOTE:

- These requirements ((i) & (ii), above) apply regardless of whether Treas. Reg. §1.170A-13 permits a taxpayer to claim a charitable contribution deduction for the property without obtaining a *qualified appraisal*. and
- The rules requiring a *qualified appraisal* by a *qualified appraiser* to show reasonable cause and good faith with respect to an underpayment attributable to a substantial (or gross) valuation misstatement of charitable deduction property apply in addition to the generally applicable rules concerning *reasonable cause* and *good faith*.

Loube v. Commissioner T.C.

Facts: The Loubes bought property with the hopes of destroying the structures and constructing a new residence on the lot. The Loubes agreed to have the Second-Hand

Charity deconstruct the property before demolition. An appraiser concluded that the Loube's gift to the charity was over $200,000. The IRS denied the deduction. In the appraisal summary attached to the Loubes' return, they provided no information on their cost or adjusted basis.

Holding: The Tax Court granted the IRS summary judgment denying the entire income tax deduction because an appraisal summary that omits basis data is insufficient to support a deduction.

Campbell v. Commissioner T.C.

Facts: Taxpayer bought eyeglass frames and donated the eyeglass frames. An appraisal concluded that the donation was worth around $24 million. With this amount, the taxpayer's return showed a deduction of $225,000. The taxpayer carried the donation over another year. The IRS disallowed the carry-over of the donation because the contribution lacked donative intent.

Holding: The court held that the taxpayer had not complied with the necessary requirements and did not address the argument of donative intent. The Court also held that the letter furnished by the charity was not a contemporaneous written acknowledgement, because the letter did not state if the charity made any goods or services in consideration of the donation. There was also no qualified appraisal

Brannan Sand & Gravel Co., LLC v. Commissioner, T.C.

Facts: Brannan Sand & Gravel Co., LLC is an asphalt company that contributed a water storage easement to a political subdivision of Colorado and claimed a $200,000 charitable deduction under the rules for conservation easements." The LLC filed its income tax return together with a Form 8283 appraisal summary based on an appraisal prepared by its litigation attorney. The Form 8283 was missing the first page and contained two copies of the second page.

Analysis: Judge Cohen denied the deduction for lack of a qualified appraisal and for failure to substantially comply with the appraisal requirements. The attorney's letter did not include the method of valuation or the specific basis for determining the value, the physical condition of the property, or a statement that the appraisal was prepared for federal income tax purposes. A litigation attorney cannot (and did not) prepare a qualified appraisal.

INTRA FAMILY NOTES

Bona Fide Loans. There are many issues currently in audit and appeals regarding notes. Some of the general guidelines determining whether there is a bona fide loan or gift are provided below.

b. The Service may treat the transfer of assets and property between family members as a gift, although a promissory note was given in return for the transfer. If the loan is not bona fide or there appears to be an intention that the loan would never be repaid, the Service will regard the transfer as a gift.
c. Transfers between family members are presumed to be gifts unless the transferor can prove the receipt of "adequate and full consideration in money or money's worth." (Treasury Regulations Sections 25.2512-8; 25.2511-1(g)(1)).
d. However, a taxpayer may rebut that presumption by showing that, at the time of the transfer, the transferor had:
    a. A real expectation of repayment and
    b. An intention to enforce the loan. (*Estate of Lockett v. Commissioner*, T.C. Memo 2012-123 (April 25, 2012),
e. The U.S. Tax Court considered the following factors to determine a real expectation of repayment and an intention to enforce the loan:
    a. Whether there was a promissory note or other evidence of indebtedness,
    b. Whether interest was charged,
    c. Whether there was any security or collateral,
    d. Whether there was a fixed maturity date,
    e. Whether a demand for repayment was made,
    f. Whether any actual repayment was made,
    g. Whether the transferee had the ability to repay,
    h. Whether any records maintained by the transferor and/or the transferee reflected the transaction as a loan, and
    i. Whether the manner in which the transaction was reported for federal tax purposes is consistent with a loan.

Valuation and discounting. Gift and Estate Tax Regulations for valuing notes generally provide that notes can be valued at less than face value plus accrued interest if the donor or estate demonstrates by "satisfactory evidence" that the value is lower. The IRS has conceded in Technical Advice Memoranda that notes need not necessarily be valued at their face amounts.

Treas. Regs. §20.2031-4. For estate tax purposes, the fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus accrued interest, unless the executor establishes that the value is lower (because

of the interest rate, date of maturity, or other cause) or that the notes are uncollectible in whole or in part or worthless. If not returned at face value, plus accrued interest, satisfactory evidence must be submitted that the note is either worth less than the unpaid amount or that the note is uncollectible, either in whole or in part, and any property pledged as security is insufficient to satisfy the obligation.

Treas. Reg. Section 25.2512-4. For gift tax purposes, ehe regulations provide, "the fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus accrued interest to the date of the gift, unless the donor establishes a lower value. Unless returned at face value, plus accrued interest, it must be shown by satisfactory evidence that the note is worth less than the unpaid amount (because of the interest rate, or date of maturity, or other cause), or that the note is uncollectible in part (by reason of the insolvency of the party or parties liable, or for other cause), and that the property, if any, pledged or mortgaged as security is insufficient to satisfy it."

Considerations. Below are eight specific consideration for valuing mortgage and promissory notes as found in *Technical Advice Memoranda 8229001*. Estate, gift, and income tax cases that illustrate these factors follow.

Presence or lack of protective covenants. The more onerous the restrictions on the borrower, the lower the risk for the lender and the lower the required discount);

Nature of the default provisions and the default risk. The default risk is lower and the discount is lower if the borrower has better coverage for making payments, evidenced by factors such as interest coverage ratios, fixed-charge coverage ratios, and debt-equity ratios. The more stringent the default provisions under the note, the lower the risk to the lender then the lower the discount;

Financial strength of the issuer. The key financial ratios mentioned above and current economic conditions, including financial strength of any parties giving guarantees are important, strong financials indicate lower risk and lower discounts;

Value of the security. The higher the value of the security, the lower the risk for the lender and the lower the discount;

Interest rate and term of the note. This analysis goes beyond just determining if the interest rate on the note equals the current market rate. An increase in market interest rates during the term of the note will decrease the value of the note. The longer the term of the note, the more exposed

the holder is to interest rate increases and the greater the discount on the note or the higher the required interest rate to offset this risk;

Comparable market yields. The yields from various types of financial instruments may be considered. The most comparable debt instrument is used and adjustments are made for specific risk differences from the comparable instrument. There may be fewer comparables for private transaction notes;

Payment history. If payments are current and are made timely, especially if there is a lengthy history of timely payments, the risk for the lender is lower and the discount is lower; and

Size of the note. There are conflicting impacts here. The borrower may have more ability to repay smaller notes, on the other hand small notes are not as likely to be from larger companies with exceptional financials. Plus, the market for potential buyers of small notes is very limited. Hence, smaller notes may call for varying discounts.

IRC Section 7872. This section provides rules for determining the amount of gifts incurred when making below-market loans. The gift amount is the amount of the forgone interest. I.R.C. §7872(e)(2). The statue does not address other factors that may impact the value of the notes –it just addresses how much gift results as a result of using an interest rate that is lower than the appropriate AFR. For example, the statute does not address the gift tax implication of a note that has an interest rate that is equal to or greater than the AFR.

Even following the adoption of IRC Section 7872, the value of notes are also often discounted using the same factors stated in the general estate tax regulations other than the interest rate used in the notes. There are no proposed regulations issued in conjunction with IRC Section 7872 that override the general gift tax valuation principles for notes under Treas. Reg. Section 25.2512-4. Prop. Reg. Section 25.7872-1, addresses the gift tax implications of below market loans under IRC Section 7872, makes no reference to discounting the value of loans for reasons other than comparison of the interest rate on the note to the AFR. The proposed regulations under IRC Section 2512, issued simultaneously with the proposed regulations under IRC Section 7872, simply reference IRC Section 7872.

Case Law and Other Authority for Gift and Estate Tax Issues. Below are cases and other authority discussing both gift and estate tax issues.

Estate of Bolles v. Commissioner T.C. Here the issue was whether advances in amounts over $1 million should be treated as loans or as gifts and whether there was an expectation of repayment and intent to enforce the debt. The Decedent, Mary Bolles, provided payments to her children. She kept a person record of her advances and ttreated

the advances as loans, and forgave the debt account of each child every year on the basis of the gift tax exemption amount. At the time of decedent's death, Mary and her five children were all beneficiaries to the Bolles Trust. Peter, one of the Decedent's children, was experiencing financial difficulties, and entered into an agreement with the Bolles Trust to use trust property as security for $600,000 in bank loans. The agreement also shows that Peter owed the Bolles Trust $159,828 in back rent, and Peter failed to meet the loan agreements. Decedent transferred over $1 million from the years 1985-2007 to Peter. Peter did not repay the decedent. In 1994 decedent began working with an attorney who assisted her in organizing financial affairs. Decedent signed estate planning documents that did not exclude Peter from distribution but added a formula to account for the "loans" that decedent made to him. The formula adds that the amount of distribution received by the beneficiaries would be reduced by the amount of outstanding loans owed to the trust. The Court first addressed an alternative argument on whether or not interest on the advances may be included in the adjustments. The court states that since the notice of deficiency does not state the interest on the loans, then it should not be included in the adjustments. The Court then addresses the second issue regarding burden of proof on the petitioner regarding the gift issue. The Court finds the issue moot as the case permits a resolution on the record of the trial. The Court finally addresses whether or not the advances were loans or gifts. The Court states that for family loans to be characterized as loans, then there must be an expectation of repayment and intent to enforce the debt. The decedent made no loan agreements or attempt to enforce payments of the loans. It is also clear that the Decedent realized that Peter would not repay the loans by 1989. Accordingly, the amounts of money payed through 1989 were loans due to an expectation of repayment, but the payments after that were gifts. She also never enforced repayment after this time.

> _Estate of Duncan v. Commissioner, T.C. Memo_. 2011-255. The Tax Court observed that under fiduciary principles, an irrevocable trust would be questioned for loaning money to another trust (even having the same trustee and beneficiaries) if the interest rate was not greater than the AFR, because the AFR is based on the yield on U.S. government obligations.The court was asked to determine whether interest paid on a "Graegin loan" could be deducted as an administrative expense for estate tax purposes. Here, an irrevocable trust created by the decedent's father loaned $6.5 million to the decedent's revocable trust in order to pay estate taxes. The $10.7 million of interest that was due on the loan at the end of 15 years was deducted. Among other things, the IRS argued that the 6.7% interest rate under the note exceeded the long-term AFR of 5.02% and was unreasonable. The court disagreed, stating that a note from the revocable trust is obviously a riskier investment than a government obligation and therefore a higher interest rate than the AFR is justified. The court emphatically said that using the AFR "would have been unfair to the Walter Trust."
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> _Estate of Reynolds v. Commissioner_, 55 T.C. 172 (1970). Here, units in a voting trust sold to two of decedent's children for three separate $50,000 secured notes with terms of 10-15 years and no interest except that 4% interest rate applied to

late payments. $30,000 of payments were made on each of two the notes and $27,000 of payments were made on the third note. The court agreed with the IRS that the value of each of the notes was only $30,000 and the excess values of the voting trust units over $30,000 constituted gifts. The factors included interest free nature of the note unless a payment was made due to default, large note amounts, ability of children to repay, no interest was ever paid, prevailing interest rates in the years of the transfers, and no showing that any additional payments were ever made on the notes.

Estate of Berkman v. Commissioner, T.C. Memo. 1979-46). This case dealt with unsecured 6% notes from family members with twenty year terms and balloon principal payments. At the end of the twenty year term, the borrowers made timely interest payments and were good credit risks. The IRS disallowed any discount from face. The court allowed discount-to-face for estate tax purposes of 50-60% of various notes focusing on low rate of interest because prime rate was 9.75% at death and long term of notes. The discount for gift tax purposes was lower (15%-25%) because the prime rate was only 7% at the date of the gift.

Estate of Smith v. Commissioner, 923 F. Supp. 896 (S.D. Miss. 1996)). In valuing a promissory note that a publicly-held Fortune 500 company owed to the decedent, bearing 6% interest and annual principal payments of about 10% of the face value of the amount of the note at date of death, the court accepted the estate appraiser's methodology. This methodology determined the value of payments based on a discounted cash flow basis, starting with a discount rate of 10.09% then adjusted to 16% rate to account for differences between the note and publicly-traded debt. A 20% lack of marketability discount factor was also applied.

Scher v. United States, 39 AFTR 2d 77-1580 (D.N.J. 1976)). Here, corporate notes were valued at face value at death although the corporation may have been insolvent at that time. Pursuant to 26 C.F.R. Section 20.2031-1(b), the fair market value is the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. According to the court, the requirement that the hypothetical willing but uncompelled buyer and seller used in the market value test have knowledge of relevant facts, does not contemplate knowledge of insider information. It encompasses only punitive knowledge of that data available in the marketplace. Thus, the notes were not worthless merely by the corporation's insolvency because the corporation at that time had a good credit reputation, was paying notes when presented, and potential lenders would not have a need to check the corporation's actual financial status.

Estate of Hoffman v. Commissioner, T.C. Memo. 2001-109. There was a dispute as to the value of two unsecured promissory notes issued from a family partnership

held by decedent with a twenty year term. The IRS and estate appraiser both used a discounted cash flow approach to value the notes. The difference in value between the two was the fair market value discount rate used. The court adopted the IRS appraiser's approach of using a 12.5% discount rate after considering interest rates associated with various debt instruments. At the time, the prime rate was 6% and Treasury yields ranged from 3 to 6%. The court found that the borrower had enough assets to pay off notes at maturity, and that the 12.5% discount rate incorporated the nonmarketable nature of the notes.

Estate of Luton v. Commissioner, T.C. Memo. 1994-539. The court valued the decedent's 41.9% interest in a liquidating trust, the primary asset of which was an unsecured 10% promissory note payable over about 11 years from a company in good financial condition. The court rejected the estate's argument for discounts due to its comparison of bond yields of similar grade and for lack of control. Here, the decedent could sue to compel trustee to sell the note it is retention was impudent under state law. The court allowed a 10% discount in valuing 41.9% interest in liquidating trust for lack of marketability.

Estate of Friedberg, T.C. Memo. 1992-310. A corporation redeemed shares of Rule 144 restricted stock from estate for a down payment and five year note bearing interest at the short-term rate under IRC Section 6621(b). The IRS was willing to allow only 1% discount on note. The court allowed a 32% discount from face considering: the rate of interest, payment schedule, financial covenants, reporting requirements, restriction that payments could not exceed 15% of the corporation's cash flow in any year, noteholder's possible remedies, corporation's financial condition, yields on comparable securities, and nature of the secondary market for private notes.

Sam Broadhead Trust v. Commissioner, T.C. Memo. 1972-196. The court did not allow any discount from face value plus accrued interest because the estate failed to offer any evidence of a lower value.

Estate of Duncan v. Commissioner, T.C. 2011-255. The Tax Court reasoned that under fiduciary principals, a trustee of an irrevocable trust would be questioned for loaning money to another trust if the interest rate was not greater than the AFR. This was due to the fact that the AFR is based on the yield on U.S. government obligations. This was true even if the other trust had identical trustees and beneficiaries

Technical Advice Memorandum 9240003. Here, a note was valued for estate tax purposes. The note from the decedent's nephew had a face amount of $215,000 and was cancelled in the decedent's will. It was concluded that the note was worth

significantly less than face value because of its uncollectability. Also, and very important, it was determined that the cancellation did not result in taxable income to the nephew because the cancellation was in the nature of a gift.

Frazee v. Commissioner, 98 T.C. 554 (1992). Under IRC Section 7872, a note that bears interest that is equal to or greater than the AFR will not be treated as a gift, merely because of the interest rate that is used on the note. The IRS applied this reasoning here and has continued to consistently applied that position in subsequent private letter rulings.

Helvering v. American Dental, 318 U.S. 322 (1943) held that where a creditor gratuitously forgives a debt, the forgiveness is a gift and not income.

Commissioner v. Jacobson, 336 U.S. 28 (1949) holding that where a creditor cancels a debt involuntarily in an arm's length setting, the cancellation is income and not a gift.

True v. Commissioner, T.C. Memo. 2001-167 The court held that IRC Section 7872 applied to determine the gift tax consequences of a purchase under a buy-sell agreement providing for a note to defer payment, aff'd on other grounds, 390 F.3d 1210 (10th Cir. 2004)

More on Income Tax. Taxpayers want their cake and to eat it too-reducing gift/estate tax but avoiding cancellation of indebtedness income under IRC Section 108 when and if note payments are receieved that exceed the reported value of the note. The general rule under 108 as to related party debt is as follows:

If a debtor acquires its own debt for less than the amount owed, unless some exception applies, the debtor has COD income. Treas. Reg. §1.61- 12(c)(2)(ii) (when debtor acquires its own debt for less than the adjusted issue price debtor realizes COD income in the amount of the excess of the adjusted issue price over the acquisition price).

IRC Section 108(e)(4) and the Treasury Regulations issued under IRC Section 108(e)(4) expand this rule by treating the debtor as acquiring debt acquired by certain persons related to the debtor. Whether or not the person is "related" to the debtor is determined under IRC Sections 267(b) and 707(b)(1) with a modified definition of "family" and a special rule for entities treated as a single employer under IRC Sections 414, 108(e)(4)(A), (B), and (C).

The debt must be acquired from someone who is not "related" to the debtor to avoid CODI IRC Section 108(e)(4)(A).)

The debt may be acquired directly by a related person or "indirectly" in a transaction in which a holder of the debt becomes related to the debtor after having acquired the debt in anticipation of becoming related to the debtor. Treas. Reg. §1.108-2(c).

Although whether debt was acquired by a holder in anticipation of becoming related to the debtor is generally a question to be determined based on the facts and circumstances, debt is deemed to be acquired in anticipation of becoming related to the debtor if the holder of the debt acquired the debt less than six months before becoming related to the debtor. Treas. Reg. §1.108- 2(c)(2) and (3).

The regulations require disclosure by the debtor in certain other circumstances thought by the Treasury to indicate an indirect acquisition of indebtedness by a related person. Treas. Reg. §1.108-2(c)(4).

Exceptions to the related-party COD income rules exist for (i) debt with a stated maturity date that is within one year of the date the debt is acquired by the related person (or, in indirect acquisitions, the date the unrelated holder of the debt becomes a related person) and that is retired by the maturity date and (ii) debt acquired by securities dealers in the ordinary course of business. Treas. Reg. §1.108-2(e)(1),(2).

In direct acquisitions by a related person, the amount of the debtor's COD income is generally measured by reference to the basis of the related person in the debt on the date the related person acquired the debt. Treas. Reg. §1.108-2(f). More complicated rules apply to determine the debtor's COD income when the acquisition is an "indirect" acquisition or the debt is substituted basis property in the hands of the holder under section 7701(a) (42).

As such – with respect to the acquisition of debt by the debtor or by an affiliate from a related party, e.g., mom – for less that the full amount of the debt – this could result in cancellation of debt income. However, pursuant to IRC Section 102 – an exception to the recognition of CODI – is a gratuitous transfer of the debt – if gratuitous there is no income for purposes of IRC Section 108, however there is a gift for other purposes. If the notes are valued and determined to be valued at less than face value – then the excess value of the note over the current fair market

value – is not a gift at all. It is not being gratuitously transferred – and therefor the presumption is that it is CODI.

But, it is not that simple. If a discount in valuation of a note is allowed for estate tax purposes, the note will take a new basis equal to the discounted estate tax value. Therefore, the holder of the note will recognize ordinary income when payments are made, to the extent that the payments exceed the discounted value of the note used for estate tax purposes. For example, Mom lends Child $2,000,000 at the then AFR of 6 percent. When she dies, the value of the note is $700,000, due to valuation issues, even though $1,000,000 is still outstanding. If the note's value for estate tax purposes is $700,000, then when the $1,000,000 is paid, the recipient will have ordinary income of $300,000. If the note is distributed to Child, Child will have cancellation of indebtedness income of $300,000 on the distribution.

The result should be different if an individual receives the note by gift. Under the dual basis rules of IRC Section 1015, the donee's basis in the note would be the donor's basis for purposes of determining the amount of any gain. Therefore, the reduction in value of the note at the time of the gift would not result in a decreased basis for purposes of determining later gain on the note. Note, under IRC Section 1015, the basis for a donor on a gift is the basis in the hands of the donor. So, the donee receives the donor's basis. There are only adjustments downward to basis in a gift situation to FMV if there is a loss reported. Under, the note scenario, no loss would be reported-income is arguably being avoided and IRC Section 1015 does not cover that. So, for income tax purposes, there is in fact a difference in the treatment if the note is gifted versus received as of the date of death.

So, in our prior example, Mom lends Child $2,000,000 at the then AFR of 6 percent. She then gifts the note at a value of $700,000, due to valuation issues, even though $1,000,000 is still outstanding. If the note's value for gift tax purposes is $700,000, then when the $1,000,000 is paid, the recipient will not have ordinary income of $300,000. If the note is distributed to Child, Child will not have cancellation of indebtedness income of $300,000 on the distribution. This is because on a gift Child has the carry over basis of his mom

Olster v. Commissioner, 79 T.C. 456 (1982), aff'd 751 F.2d 1168. In this case, husband promised to execute promissory note secured by mortgage to wife as a lump sum settlement of past and future alimony payments. IRS attempted to value the notes at face value, but the court determined that the notes were worthless. The note bore an interest rate of 6%, it was payable within one year, it was secured by a mortgage on a parcel of land that was unsuitable for development, at the time of transfer husband was in dire financial straits, and hsband failed to make payments when due.

Kronenberg v. Commissioner, 64 T.C. 428 (1967)). This case was an income tax case valuing debt issued by a company in a liquidation. The note was interest-free, nonnegotiable, with no set date for repayment, and the debtor had limited financial resources. The court allowed 37.5% discount from face.

Clayton v. Commissioner, T.C. Memo. 1981-433). An 80% discount on notes was issued as low-interest second mortgages with terms of up to 30 years to facilitate the purchase of homes by high-risk individuals who could not pay down payments and who had a history of being delinquent on payments, small balances on the note meant that foreclosure proceedings were not economically feasible.

Scott v. Commissioner, T.C. Memo. 1979-29).The taxpayer valued a note at a 70% discount based on the sale of a similar note in arm's length transaction. The court concluded that the taxpayer did not show sufficient similarity to the prior transaction and allowed a 30% discount based on the nonrecourse nature of the note, subordinated status of lien, limited nature of security, subsequent default of maker, and timely receipt of interest payments.

CONSERVATION EASEMENT

What is it?

- "…any limitation in a deed, will, or other instrument in the form of an easement, restriction, covenant, or condition, …executed by …the owner of the land subject to such easement and … binding upon successive owners of such land, … the purpose of which is to retain land predominantly in its natural, scenic, historical, agricultural, forested, or open-space condition."

  (Cal Civ Code §815.1)

- An interest in land (as opposed to an estate).

Who creates it?

- The owner/all owners of the land to be subjected to the easement.
  - One co-tenant cannot unilaterally create an easement. (Land owned by concurrent owners is held in undivided interests, which cannot be unilaterally partitioned.)

Who can acquire/hold?

- A tax-exempt nonprofit organization …qualified to do business in the state which has as its primary purpose the preservation, protection, or enhancement of land in its natural, scenic, historical, agricultural, forested, or open-space condition or use.
- The state or any city, county, … district, or other state or local governmental entity, if otherwise authorized to acquire and hold title to real property …
- Certain Native American tribes

(Civ Code §815.3)

Who is bound?

- All successive owners of the land.

What is the purpose?

- To keep the land in the condition it was in when the easement was created

How is it created?

- "…by any lawful method for the transfer of interests in real property."

- “A conservation easement shall be perpetual in duration.”(Cal. Civ. Code § 815.2)

- In a writing signed by the owner(s) of the property to be subject to/burdened by the easement. (In a deed, an easement agreement or a declaration of conditions, covenants and restrictions.)

  - Because it involves an interest in real property, creation is subject to the statute of frauds (Civ Code §1624; CCP § 1971)

- “Instruments creating …conservation easements shall be recorded in the office of the county recorder of the county where the land is situated, …and …shall be subject in all respects to the recording laws” (Civ Code § 815.5)

BASIC TERMS

Basic terms of a conservation easement include:

- Restrictions on future use of the property;
- Future permissible uses of the property (including uses permitted with prior consent);
- Inspection and enforcement rights;
- Rights of access;
  - Public access may be required if the grantor desires tax deductibility
- Retained rights and responsibilities (re real property taxes, insurance, and property maintenance);
- Warranties (re title and hazardous materials);
- Indemnification rights;
- Procedures for seeking and granting consent for particular uses, and for modification, assignment and extinguishment of the easement;
- Valuation in the event of extinguishment or exercise of eminent domain, and distribution of the proceeds;
- Administrative costs;
- Transfer fees;
- Subordination, recordation, and other lender-related issues.

FUNDING COSTS FOR MONITORING AND ENFORCEMENT:

Plan for costs associated with enforcement, including:

- Monitoring compliance; and
- Litigation (or the like) to enforce the terms.

Sources of Funding:

- Grantor
- Third party donor
- Grantee
- Public agency

Tax Planning Opportunities

Income Tax

I.R.C. § 170(h) allows an income tax deduction for a *qualified conservation contribution*

- The amount is determined by the grantor's *(qualified) appraisal;*
- A donor can deduct up to 50% of his or her "contribution base" over other charitable contributions for donating a *qualified conservation easement;*
    - "contribution base" = AGI - any NOL carryover
- A donor can carry-forward any "excess" deduction for up to 15 years Qualifying farmers and ranchers can deduct up to 100% of their income
    - Farmer or rancher: someone who receives more than 50% of his or her gross income from the trade or business of farming
        - IRC §2032A(e)(5) defines a "farming activity"

NOTE: To be deductible, a conservation easements fair market value must be substantiated through a "*qualified appraisal*." See discussion above.

Estate Tax

IRC §2031(c) allows an executor to exclude 40% of the value of land subject to a *qualified conservation easement* from estate tax.

- The amount of the exclusion is limited to $500,000, calculated on the value of the property after the easement is in place.
- The value of the land that is *excluded* from the decedent's estate retains a carryover basis (IRC §1014(a)(4)).
  - Even though the property may be acquired from a decedent, the basis of the excluded portion is not stepped up to its fair market value at the decedent's death.

To Qualifying for the IRC §2031(c) Exclusion, the land subject to a *qualified conservation easement* must:

- Be located in the United States;
- Be owned by the decedent or a member of the decedent's family at all times during the 3-year period ending on the date of the decedent's death; and
- Be a *qualified conservation contribution* (within the meaning of IRC §170(h)) granted by the decedent, a member of his or her family, the executor of the decedent's estate, or the trustee of a trust whose corpus includes the subject land as of the date the election is made

Maximum Benefit Allowed:

- To determine the amount of the exclusion, it is necessary to value the land with and without the *qualified conservation easement*, as of the date of the contribution. If the value of the easement is less than 30% of the value of the land without the easement (reduced by the value of any retained development rights), the exclusion percentage is reduced by 2 percentage points for each percentage point that the ratio falls below 30%.
  - Example: If the value of the easement is 25% of the value before the easement (less the value of the retained development rights), the applicable percentage is 30% (i.e., the starting applicable percentage of 40% - 10% {10% = 2(30% - 25%)}.
  - NOTE: If the value of the easement is 10% or less of the value before the easement, the applicable percentage is zero (i.e., no exclusion is available)

Property Tax

- If the value of the property is lowered because of the easement, the property tax should decrease as well

State Income Tax Credit

- California Natural Heritage Preservation Tax Program provides a tax credit for individuals who donate a conservation easement that protects wildlife habitat, parks and open space, archeological resources, agricultural land and water.
- **NOTE**: This credit is currently unfunded (and can only be claimed if a donor will fund) Public Resources Code §37022

Federal Tax Treatment

Background:

Pre-1969 Act:

- A taxpayer could deduct for income tax purposes the FMV of a scenic easement in perpetuity given to the United States.

The Tax Reform Act of 1969:

- Questioned the deduction for income, estate and gift tax purposes, by adding §170(f)(3), §2055(e), and §2522(c), which specifically deny deductions for most partial interests.
  - However, the Conference Report stated: "The conferees … intend that a gift of an open space easement in gross is to be considered a gift of an undivided interest in property where the easement is in perpetuity." (Emphasis added.) This concept is incorporated in Treas Reg §1.170A-7(b)(1)(ii).

Pre-1976 Act:

- The I.R.S. ruled that easements for the protection of the exterior appearance of a historic building, a hiking and skiing right of way, and a public bathing beach were all deductible for income tax purposes. (Rev. Rul. 75-358, Rev. Rul. 74-583, Rev. Rul. 75-373 & Rev. Rul. 76-331.)

The Tax Reform Act of 1976 and the Tax Reduction and Simplification Act of 1977:

- Substantially amended §170(f)(3)(B) and §170(f)(3)(C). For estate tax purposes, the changes were incorporated into §2055(e)(2).

The Tax Reform Act of 1976:

— Added §2055(f), effective with respect to transfers made after 1986, and specifically authorized the estate deduction for transfers of easements in real property, defined in §170(h).

— In order to qualify for the §2055 estate and §2522 gift tax deductions for transfers occurring after 1986, the transfers do ***not*** have to be exclusively for conservation purposes.

—

IRC §170(f)(3)

Denial Of Deduction [for] Contributions Of Partial Interests In Property

In General — In the case of a contribution … of an interest in property which [is] less than the taxpayer's entire interest…, a deduction shall be allowed … only to the extent that the value of the interest contributed would be allowable as a deduction …if such interest had been transferred in trust.

- **Exceptions** — (IRC § 170(f)(3)(B)):
  - a contribution of a remainder interest in a personal residence or farm,
  - a contribution of an undivided portion of the taxpayer's entire interest in property, and
  - a *qualified conservation contribution*.
- **Qualified Conservation Contribution**

For purposes of IRC § 170(f)(3)(B)(iii), the term "***qualified conservation contribution***" means a contribution:

- Of a **"*qualified real property interest*"** (IRC §170(h)(2))
- To a **"*qualified organization*"** (committed to protect the conservation purposes and having the resources to enforce the restrictions) (IRC §170(h)(3); Treas Reg §1.170A-14(c)(1))
- **Exclusively for conservation purposes** (IRC § 170(h)(4))

QUALIFIED REAL PROPERTY INTEREST

For purposes of IRC §170(h)(2), the term ***"qualified real property interest"*** means … the following interests in real property:

- The donor's entire interest …, other than a "qualified mineral interest",
- A remainder interest, or
- A restriction (granted in **perpetuity**) on the use that may be made of the property

Qualified Organization

A *qualified conservation contribution* must made be to a **"*qualified organization*",** which means the organization must: (i) be committed to protect the conservation purposes; and (ii) have the resources to enforce the restrictions). Examples:

- A governmental unit described in IRC §170(b)(1)(A)(v) or (vi) (e.g., a school board),
- A publicly supported charity (IRC §170(b)(1)(A)(vi), §501(c)(3)), and
- An organization controlled by, and operated for the exclusive benefit of a governmental unit or a publicly supported charity (IRC §509(a)(2) or (3))

(IRC §170(h)(3); Treas Reg 1.170A-14(c)(1))

Private foundations are not permitted to receive *qualified conservation contributions* (IRC §509(a)(2))

Exclusively For Conservation Purposes

For purposes of IRC §170(h), the term "***conservation purpose***" includes (IRC §170(h)(4)(A):

1. Preserving land areas for outdoor recreation by, or for the education of, the general public. IRC §170(h)(4)(A)(i).

   This necessarily entails public access.

   – Examples: preservation of a lake for public boating or fishing; preservation of a public nature or hiking trail. Treas Reg §1.170A-14(d)(2).

2. Protecting a relatively natural habitat of fish, wildlife, or plants, or a similar ecosystem. (IRC § 170(h)(4)(A)(ii))

- Preserving open space, including farmland and forest land:

- For the scenic enjoyment of the general public (§170(h)(4)(A)(iii)(I); Treas Reg §1.170A-14(d)(4)(i)(B), (ii)); or
- Pursuant to a clearly delineated federal, state, or local government conservation policy (§170(h)(4)(A)(iii)(II); Treas Reg §1.170-14(d)(4)(i)(A), (iii)).
- It must yield a significant public benefit (§170(h)(4)(A)(iii); Treas Reg §1.170A-14(d)(4)(i), (iv).)
- Preserving a historically important land area or a certified historic structure (§170(h)(4)(A)(iv), (h)(4)(B)-(C)).
- If restrictions allow future development, the contribution is deductible only if the restrictions require that any such future development conforms with appropriate government construction or rehabilitation standards within the district.
-

Historic Preservation **Land areas that qualify as historically important** include:

- An independently significant land area (and related historic resources) that satisfy certain National Register criteria;
- Any land area (and buildings) within a registered historic district that contribute to the significance of the district; and
- Any land not within a registered historic district which is adjacent to a property listed in the National Register of Historic Places, where the features of the land contribute to the historic or cultural integrity of the property.
  Treas Reg §1.170A-14(d)(5)(ii)

Certified Historic Structures

Two categories:

•Any building, structure, or land area that is listed in the National Register; or

•Any building located in a registered historic district and certified by the Secretary of the Interior as being of historic significance.

Treas Reg §1.170A-14(d)(5)(iii)

Special requirements for restrictions with respect to the exteriors of buildings in a registered historic district (*façade easements*). To qualify for the deduction:

- The *façade easement* must include restrictions that: (i) preserve the entire exterior of the building; and (ii) prohibit any change inconsistent with the historical character of the exterior. ***And***

- The donee must enter into a written agreement with the donor and certify that the ***donee:***

  - is a *qualified organization* with a purpose of environmental protection, land conservation, open space preservation, or historic preservation; ***and***

  - has the resources to manage and enforce the restrictions and a commitment to do so.

IRC § 170(h)(4)(B)(i)

- The donor must include with their return for the year of the contribution (IRC 170(h)(4)(B)(iii)):

– a *qualified appraisal* of the real property interest;

– photographs of the entire exterior of the building; and

– a description of all restrictions on the development of the building.

- For structures described in IRC §170(h)(4)(C)(ii), a fee* is imposed under IRC § 170(f)(13):

  - For a restriction with respect to the exterior of a building, a $500 filing fee is required if the deduction exceeds $10,000; and

  - The deduction is ***not*** allowed unless the donor pays the filing fee with the return for the year of the contribution

*The filing fees are expressly designated for the enforcement of the provisions regarding *qualified conservation contributions*. IRC § 170(f)(13)(C)

Historic Preservation: Public Access

In the case of a gift for the preservation of a historically important property, it is *not* necessary for the entire property to be visible to qualify for a deduction. However, the public benefit may be insufficient to justify a deduction if only a small portion of the property is visible.

If the historic property is not visible from a public way, the easement must permit regular viewing by the general public to the extent such viewing is consistent with the nature and condition of the property.

Treas Reg §1.170A-14(d)(5)(iv)(A)

Factors to consider in determining the required amount of public access:

- The property's historical significance;
- The features that are the subject of the easement;
- The accessibility of the site;
- Potential physical hazards to visitors;
- The privacy of individuals living on the property;
- The degree to which public access would impair the conservation purpose of the contribution; and
- The availability of opportunities for public viewing by means other than visits to the site

Treas Reg §1.170A-14(d)(5)(iv)(A)

EXCLUSIVITY

Incidental benefit:

- If the requirements of a *qualified conservation contribution* are otherwise satisfied, a charitable contribution deduction will not be denied because an incidental benefit inures to the donor as a result of conservation restrictions limiting the property's uses. Treas Reg §1.170A-14(e)(1)

Inconsistent Use:

- No deduction is allowed if the property may be used inconsistently with the conservation purpose.
    - Any donor retained interests must be subject to enforceable restrictions that prevent the retained interests from being used inconsistently with the conservation purpose
- No deduction is allowed if the conservation purpose would destroy other significant conservation interests. Treas Reg §1.170A-14(e)(2).
    - However, a use that is destructive of other conservation interests will be permitted if the use is necessary to protect the conservation interests that gave rise to the contribution. Treas Reg §1.170A-14(e)(3).

(Perpetual) Term:

A conservation easement is ***not*** treated as being *exclusively for conservation purposes* unless the conservation purpose is *protected in* ***perpetuity***.

- A gift of a conservation easement for a period of years, with a reversion to the donor at the end of the term, is ***not*** a *qualified conservation contribution.* (IRC §170(h)(5)(A))

- For contributions of property subject to a deed of trust (or similar lien), no deduction is allowed unless the beneficiary/lienholder agrees to subordinate its rights to the right of the donee to enforce the conservation purposes.

If the interest may be defeated by an act or an event, a deduction is ***not*** disallowed if, as of the date of the contribution, the possibility that the act or event will occur is negligible.

- The burden of proof is on the donor to establish the remoteness of the possibility that the act or event will occur.

Example: A donor contributes a conservation easement in a state that requires use restrictions to be (re)recorded periodically to remain enforceable. Notwithstanding the (re)recording requirement, the easement may be treated as protected in perpetuity.

DUE DILIGENCE

Documents to be Reviewed:

Title Reports

- Review the title on the donor's parcel of land and all other property the donor owns in the area.
- Are there any liens or other encumbrances which can "usurp" the easement? (divesting the Donee/the public of the benefit)

Baseline Documentation

- Documentation may include survey maps, maps identifying certain distinct features of the property, aerial photographs, and on-site photographs. The documentation should establish that the property has environmental or ecological significance that is supported by the conservation purposes stated in the easement to support any tax benefits to be claimed
- To facilitate monitoring and enforcement, the baseline documentation must depict the condition of the property subject to the easement at the time the easement is created

Conservation Easement Deed

- Inspect the deed for compliance with IRC §170(h) to ensure the contribution will be eligible for a charitable contribution deduction.
- To be deductible, a conservation easements fair market value must be substantiated through a "*qualified appraisal*."

The Donee

- To ensure that the done is a *qualified organization* and that the easement "conforms" with the donee's purpose and that the done has the capacity and wherewithal to monitor and enforce the terms of the easement in accordance with the conservation purpose it was created to preserve.

SUBSTANTIATION

- **Income Tax Returns**: According to IRC §170(f) and Treas Reg §1.170A-13, taxpayers must maintain the following records to claim deductions for charitable contributions:
  - A receipt showing:
    - The name of the donee;
    - The date and location of the contribution; and
    - A description of the property.
  - *A contemporaneous written acknowledgement* including:
    - The amount of cash contributed and a description of any property other than cash contributed;
    - Whether the donee organization provided any goods or services in consideration for the contribution; and
    - If the donee organization provided any goods or services (other than intangible religious benefits), a description of the goods or services and a good-faith estimate of the value thereof.

- IRC §170(f)(8)
  - Written records must show:
    - the manner and approximate date of the Donor's acquisition of the property; and

- The Donor's adjusted basis in the property.

VALUATION

(Perpetual) Conservation Restriction:

In general, the value of an easement in the nature of a perpetual restriction on use can be calculated as the net change in the FMV caused by the easement.

- If there is a substantial record of sales of comparable easements, the FMV must be based on the sales prices of the comparable easements. However, because sales of easement s involving perpetual restrictions on use are extremely rare, such easements are usually valued using the "before and after" method.

Treas Reg §1.170A-14(h)(3)(i).

In determining the value of property "before and after" the grant of an easement, the 3 traditional valuation methods (comparable sales, capitalization of income, and replacement cost) are utilized.

"Before and after" valuation method:

In applying the "before and after" method, the "before" value is based on the highest and best use of the property unrestricted by the easement.

The following factors may be relevant:

- The current use of the property;
- The property's realistic and potential uses (regardless of the owner's use);
- The likelihood that the property would be developed if not restricted;
- The cost of developing and subdividing the property; and
- The effect of zoning, conservation, or historic preservation laws that already restrict the use of the property

Factors relevant in determining the value of property after the easement has been granted:

- The effect of any development permissible in light of the easement;

- The amount of access to the property permitted by the easement; and

- The effect of restrictions that may permit uses of the property that will increase its FMV above the FMV at its current use.

Reduction of Adjusted Basis in Property Retained (Treas Reg §1.170A-14(h)(3)(iii)):

- A donor who makes a *qualified conservation contribution* must reduce the adjusted basis in the property retained by the amount of the adjusted basis of the property allocable to the *qualified real property interest* gifted.

    - The adjusted basis allocable to the *qualified real property interest* gifted is determined by the ratio of the value of the *qualified real property interest* gifted to the value of the property before the granting of the restriction.

    - The adjusted basis allocable to the *qualified real property interest* gifted is

      = (value of the *qualified real property interest* gifted)/(”before” value of the property)

Case Law

Oconee Landing Property LLC v. Commissioner, T.C.

Facts: Carey Station, LLC acquired a 99 percent interest in Oconee Landing Property, LLC, by contributing a 356-acre tract of land in Greene County, Georgia. Within a couple of days, Oconee Landing Investments, LLC (the taxpayer), acquired a 97 percent interest in Oconee Landing Property from Carey Station for $2,440,000 and contributed $1.3 million in cash to Oconee Landing Property. Eight days later, the taxpayer gave a conservation easement to the Georgia Alabama Land Trust. Oconee claimed a $20.7 million donation. The deed provided that, if the easement were eliminated by judicial termination, the donee’s share of the proceeds would be adjusted for any improvements made by the donor. The IRS denied the charitable contributions.

Analysis: The Tax Court denied cross motions for summary judgment, pointing out possible defenses to charging the donee with the value of improvements and requiring the payment of outstanding claims on judicial termination. “Regarding the deed provision that charges the donee with the cost of any improvements made by the donor after the gift, in determining the division of the proceeds of a judicial termination of the easement, the court noted that there appeared to have been no pre-existing improvements, and the taxpayer should have the chance to show that it had reserved no right to make any future improvements, or that any such improvements would be of negligible value. Regarding the deed provision that the proceeds of a judicial termination of the easement should be

divided after the satisfaction of prior claims, the court noted that the deed appeared to require that such claims be paid from the donor's share of the proceeds, which would not violate the regulations."

Johnson v. Commissioner T.C.

Facts: Taxpayer was president of a manufacturing company. The President worked from home and did not have an office at the facility. The President bought vacant land around 25 miles from the manufacturing facility. The President built a residence along with some other buildings. In 2007 the taxpayer gave a conservation easement to Colorado Open Lands, a qualified donee, encumbering 116.14 acres of the ranch land (all but five acres), including the area on which the residence stands. The easement restricted the encumbered area from subdivision. The President claimed a $610,000 charitable contribution deduction based on a qualified appraisal. The IRS did not contest the merits of the deduction but claimed that the taxpayer had already deducted more than the value of the easement by the time he got to the years at issue in the case.

Analysis: Tax Court rejects both appraisals and values a conservation easement with its own analysis, valuing the easement at $372,919, the difference between the ranch's fair market value before and after the easement was granted. The Court found, despite the appraiser's being experienced, none of the appraisers' comparable sales to be really comparable. The court concluded that the ranch's before value was $1,021,695 and its after value was $648,775, so it valued the easement at $372,919.

Kissling v. Commissioner, T.C.

Facts: Kissling Interests, LLC gave the National Architectural Trust façade easements on three certified historic commercial buildings in the Allentown Historic District of Buffalo, New York. Local law restricted what building owners could do with properties within the district. The LLC deducted $855,900 for the value of the easement. The IRS disallowed the deductions in full, finding that the easements had no effect on the value of the properties because the state restrictions on development were as severe as the easement. The IRS also imposed a gross valuation misstatement penalty under Section 6662(h).

Analysis: The Tax Court allowed a $674,000 deduction which largely sustained the deduction for the façade easement because local government limitations on development of property within an historic district are more weakly enforced. All of the expert appraisers agreed that the highest and best use of the properties, both before and after the easement gifts, was as residential apartment buildings, and all of them determined value by capitalizing net operating income. The court compared the maintenance and preservation requirements imposed by the local agency on structures within the historic district with those imposed by the easement and concluded that the easement restrictions

were more severe than the local restrictions, particularly in light of relatively lax enforcement by the local agencies.

Rajagopalan v. Commissioner, T.C.

Facts: Warren Sapp and his business partner, Dr. Kumar Rajagopalan, transferred nearly 120 acres of land in western North Carolina to SS Mountain LLC. They bought the parcels for around $3 million. The LLC contributed a conservation easement over 89.378 acres to the North American Land Trust (NALT), a qualified charitable organization. The easement required that the land be used exclusively for a conservation purpose. The real estate market then crashed, causing some of the contracts not to close. The LLC filed an partnership income tax return reporting a charitable gift of $4.9 million and attached a qualified appraisal. The IRS audited the transactions, denied the deduction, and asserted overvaluation penalties.

Analysis: The Tax Court ruled in favor of the taxpayers. The court noted that this was an unusual conservation easement case, because it could value the property based on a number of truly comparable sales. The court acknowledged that the easement was given at the peak of a real estate "bubble," and that values had since fallen significantly, but stated that the value on the date of the gift was all that was relevant but the easement value was proved by recent sales.

Pine Mountain Preserve, LLP v. Commissioner

Facts: Pine Mountain Preserve donated a perpetual easement in gross to the North American Land Trust (NALT). Each easement indicated that the land would be free of any commercial or residential development. However, in the 2005 and 2006 easements there was an exception that allowed for the building of single-family residencies. The easements did not specify the building areas but merely stated that they had to be approved by NALT. The 2007 easement did not provide for rights to build residential dwellings, but rather it allowed Pine Mountain to build a water tower subject to NALT's approval**.** The tax court disallowed any deduction with respect to the 2005 easement. With respect to the 2006 easement, the Tax Court held that the lack of specificity regarding the location of the building areas at the outset did not allow for a deduction under Section 170(h). Both the IRS and Pine Mountain Appealed.

Analysis: On appeal, the court first addressed whether or not the 2005 and 2006 easements were grants of qualified real property interests. The Court of appeals reversed the tax court holding that "a broad limitation on the use of the property that applies to the parcel as a whole satisfies the statutory test, even if within that parcel there exists certain narrow exceptions to that limitation. For the 2007 easement, the court of appeals upheld the tax court ruling that a deduction was proper.

Champions Retreat Golf Founders, LLC v. Commissioner

Facts: Champions retreat golf owned an interest in a golf club. Champions contributed to the North American Land Trust (NALT). The easement restricted the ways that Champions could use the easement area. The easement allowed Champions to build structures with an aggregate of up to 10,000 square feet. Champions claimed $10,427,435 charitable contribution deduction. The IRS denied the deduction both for lack of a proper conservation purpose because it viewed the value of the easement at zero. The tax court judge denied the deduction because the easement did not serve a proper conservation purpose. The tax court held that there was not a sufficient presence of rare, endangered, or threatened species. The case was appealed to the eleventh circuit.

Analysis: The Circuit Court was split but ended up vacating the ruling of the Tax Court. The court held that a land could be a wildlife preserve even if there is a golf course on the land. The Court was willing to overlook unnatural features of the land, because there was evidence that endangered species used the land.

Hoffman Properties II LP v. Commissioner

Facts: Hoffman Properties owned a historic building in Ohio. Hoffman Properties gave a façade easement and airspace rights to the Association of Historic Preservation. Hoffman reserved the right to change the façade with the donee's consent. The reservation clause provided that the donee was deemed to have consented to any written request to which it failed to respond within 45 days. Hoffman filed a tax deduction of $15 million for the gift. The IRS denied the deduction in its entirety.

Analysis: The Tax Court granted partial summary judgement to the IRS finding that the easement did not protect the conservation purposes of perpetuity because the donee lost enforcement power unless it responded to a change request within 45 days. The court stated that the donor can reserve conditional rights that may affect the conservation purposes only if those rights give the done.

Oakbrook Land Holdings, LLC v. Commissioner 154 T.C. 180

Facts: Oakbrook gave a land conservation easement to a land conservancy. Oakbrook had bought the land earlier for $1.7 million. Oakbrook claimed a $9,545,000 charitable contribution. The IRS did not allow the claim, because the deed of easement stated that, if the easement were ever extinguished, the proceeds of the disposition of the property would be divided between the donor and the donee by giving the donee an amount equal to the difference between the fair market value of the conservation area as if not burdened by the easement and the fair market value of the conservation area burdened by the easement. The IRS concluded that: "Reg. §1.170A-14(g)(6) requires that a division in such "judicial extinguishment" cases be based on the relative values of the two shares on the date of the gift, with no other adjustments."

Holding: The Tax Court rejected the taxpayer's notion that Treas.Reg.Section 1.170 is not valid, because the regulation was a product of full notice and comment procedures under the Administrative Procedure Act (APA). The Tax Court upholds the validity of a perpetuity regulation, holding that it was properly promulgated under the APA and that its

interpretation of the statute is entitled to "Chevron deference," and applies the regulation to deny a charitable deduction." Note, there are many many cases citing Oakbrook Land Holdings that have denied charitable contribution deductions with regard to conservation easements.

Carpenter v. Commissioner: TC Memo 2012-1 (January 3, 2012)

- The parties in this case allowed for extinguishment of the conservation easements through mutual consent of the parties, which meant the easement did not continue in perpetuity. The Court reasoned that "although the deed conveying the property indicated an intent 'to preserve and protect in perpetuity the conservation values of the property,' the taxpayers retained various rights that caused the conveyance to fail the perpetuity requirement."

***Mitchell v. Commissioner*:** 138 TC No. 16 (April 3, 2012)

- The IRS argued that the failure to have the mortgage subordinated to the conservation easement at the time the easement was granted prevented the easement's conservation purpose from being protected in perpetuity. The Court stated that subordination of the mortgage was required at the time the easement was contributed because, absent such subordination, in the event of a taxpayer default on the loan the lender could institute a foreclosure proceeding and eliminate the easement.

Minnick v. Commissioner: 611 Fed Appx 477 (9th Cir. 2015)

- In disallowing the deduction, the Ninth Circuit affirmed a 2012 memorandum decision by the Tax Court. The issue before the court was whether Reg. § 1.170A-14(g)(2) requires that the mortgage be subordinated at the time the easement is granted. In this case, it was only after the government raised the issue in its amended answer to the petition for redetermination that the taxpayers secured a subordination agreement from the lender. The Ninth Circuit concluded that the regulation unambiguously required the mortgage to be subordinated at the time of the gift.

I.R.S. INFO 2013-0014:

- Under the Regulations, a conservation purpose may be treated as protected in perpetuity if, upon a subsequent change in conditions that makes impossible or impractical the continued use of the subject property for conservation purposes, the easement is extinguished by judicial proceeding and all of the donee's proceeds from a subsequent sale, exchange, or involuntary conversion of the property are used by the donee in a manner consistent with

the conservation purposes of the original contribution. Treas Reg § 1.170A-14(g)(6)(i).

Belk v. Commissioner: 140 T.C. No. 14 (2012)

- The taxpayer granted a conservation easement over his property, a golf course. The terms of the easement permitted the taxpayer to substitute an area of land contiguous to the property covered by the easement for an equal or lesser area covered by the easement. The right to substitute property subject to the easement was limited by numerous rights given to the land trust. **<u>Held:</u>** the easement was ***<u>not</u>*** a perpetual conservation restriction because the donor was allowed to change what property was subject to the easement.

Irby v. Commissioner: 139 T.C. No. 14 (Oct. 25, 2012)

- The donee was required to reimburse governmental entities out of potential proceeds if the property was condemned. The Tax Court found that the reimbursement provision was consistent with the conservation purpose and satisfied Treas Reg 1.170A-14(g)(6) because "condemnation of the underlying parcels would result in the proceeds going to the donee charity, and in turn to the governmental entities, which are all qualifying organizations under IRC § 170(c)(1), which would use those funds in a manner consistent with the original conservation purposes.

<u>TAX BENEFITS EXAMPLE:</u>

- Towns undeveloped land located in the US. The FMV of the land is $2,000,000. T contributes a *qualified conservation easement* on the land to a *qualified organization* during her 2018 tax year. The FMV of the land after the grant is $1,250,000. If properly documented/substantiated, T is entitled to a $750,000 charitable contribution deduction on her 2018 income tax return.

- T dies in 2020, still owning the land subject to the easement. On the date of her death, the FMV of the land without the easement is $2,500,000, but is valued at $1,500,000 in T's estate because of the easement. As the date-of-contribution value of the easement ($750,000) exceeded 30% of the date-of-contribution value of the land without the easement ($2,000,000), T's estate is entitled to exclude $500,000, which is 40% of the value of the land in the estate, limited to the $500,000 cap.

    - T has also excluded from her estate the $1,000,000 "excess" of the FMV of the property excluding the easement over the date-of-death value of

the property subject to the easement. Thus the “total” exclusion is $1,500,000.

“New” Partnership Audit Rules

DOUG YOUMANS

1. Overview

The Bipartisan Budget Act of 2015 (the “BBA ‘15”) repealed TEFRA and replaced it with new partnership audit rules that apply to partnership taxable years beginning after 2017. The new rules will facilitate more partnership audits because they only require an audit at the partnership level (TEFRA essentially pushed everything down to the partner level, BBA ’15 keeps everything at the partnership level, at least insofar as the IRS is concerned).

The new rules are meant to assist the IRS in auditing partnerships. They are not designed to increase fairness.

2. Terminology

AAR	Administrative Adjustment Request
NAP	Notice of Administrative Proceedings
NOPPA	Notice of Proposed Partnership Adjustment
FPA	Final Partnership Adjustment
Reviewed Year	IRC §6225(d)(1) – the partnership taxable year to which the item being adjusted relates
Adjustment Year	IRC §6225(d)(2) – the taxable year in which: (a) the notice of the FPA is mailed. (b) the decision of a court becomes final; (c) an AAR is made by the partnership.
Partnership Representative	A person (who need not be a partner), with *substantial presence in the United States*, who has the sole authority to bind the partnership.

Substantial presence in the US	(a) must be available to meet in person with the IRS; (b) must have a street address in the US and a telephone number with a US area code where the person can be reached at normal business hours; (c) must have a US taxpayer ID number
Entity Partner Representative	Provided the entity has substantial presence in the US, an Entity Partner Representative can appoint a *Designated Individual* who has substantial presence in the US and who has *capacity to act*. Capacity to Act – not dead, incarcerated, enjoined from acting on behalf of the partnership.
Designated Individual	An individual (who need not be a partner), with *substantial presence* in the United States
Election Out	An "***eligible partnership***" can "elect out" of the new partnership audit regime so that audits and tax liability will be conducted at the partner level (and the pre-TEFRA audit rules will apply).
Push-Out Election	A partnership can elect to cause the reviewed-year partners to pay tax on their shares of the understatement in the current year by: (a) Electing within 45 days after the date of the FPA to use the alternative method; and (b) furnishing, at the time and in the manner that the IRS may provide, each reviewed-year partner and the IRS with a statement of the partner's share of any adjustment to items or income, gain, loss, deduction, or credit, as determined in the FPA (an adjusted Schedule K-1).

3. <u>Partnership Level Determinations and Payments</u>

Subject to several exceptions, the general approach is that:

- the audit will occur and any/all adjustment will apply at the partnership level; and
- Taxes will be paid by the partnership, not the partners, thereby avoiding the necessity of a multitude of individual tax audits of the individual partners.

The rate that is applied at the partnership level generally is the highest rate of tax for individuals or corporations in effect for the reviewed year under IRC §1 (37%) or IRC §11 (21%). The partnership level income tax liability resulting from an audit (the "***imputed underpayment***"), including penalties and interest, will be assessed and collected from the partnership for the "***adjustment year***" (the year in which the adjustments become final, not the "***reviewed year***" that was audited). This can create problems where the reviewed year partners are not the same as the adjustment year partners.

The imputed underpayment amount is reduced to the extent the reviewed year partners file amended returns and pay the tax.

It is surprisingly difficult to change the PR and the DI: *See supplement* regarding Resignation and Revocation of the PR or DI.

4. **<u>Exceptions to Partnership Level Determinations and Payments</u>:**

a. An "***eligible partnership***" can "<u>elect out</u>" of the new partnership audit regime so that audits and tax liability will be conducted at the partner level (and the pre-TEFRA audit rules will apply); and

b. The ***partnership representative*** may make a "***<u>push-out</u> election***," which requires each partner to report its share of any audit adjustments on the partner's return and to pay any resulting income tax liability.

c. ***<u>"Pull-in" Election</u>***: If the Reviewed-year partners:

(1) Pay the tax that would be due with amended returns within 270 days after the date the NOPPA is mailed;

(2) Make binding changes to their tax attributes for later years; and

(3) Provide the IRS with the information necessary to substantiate that the tax was correctly computed and paid (as well as how its tax attributes would be affected in subsequent years).

There are no requirements for partners to file an amended return. See Supplement Regarding Consolidated Appropriations Act Technical Corrections to Partnership Audit Rules.

5. **Partnership Representative ("PR")**

Prior to 2018, partnerships have been required to designate a "tax matters partner," which had to be a partner. Under the BBA '15, partnerships must now designate a "***partnership representative***" on their return each tax year beginning after 2017. If a partnership representative is not so designated, the IRS will designate a partnership representative.

The PR must be a person having a "***substantial presence***" in the U.S., but does not have to be a partner.

The PR has **sole** authority to make elections and represent and bind the partnership (and the partners) in all administrative and court proceedings involving adjustments to the partnership's federal tax return. All notices and communications will be sent only to the PR. The individual partners have **no** right to participate in the audit.

The PR's authority extends to all direct and indirect partners and may not be limited by state law, the partnership agreement or any other document.

The partnership agreement may (and should) address obligations of the PR to the partners, but such contractual commitments do not impact the ability of the IRS to rely solely on elections made by the PR.

6. **Eligibility for *Election Out***

a. **Eligible Partnerships**. Only "***eligible partnerships"*** may make the **annual** election out of the new audit rule regime. Requirements include:

(1) Not more than 100 partners;

(a) count K-1s (including K-1s of any/all s-corporation partners);

(b) husband and wife = 2; and

(2) The partnership can only consist of ***eligible partners***, including individuals, C corporations, foreign entities that would be treated as C corporations if they were domestic entities, S corporations, and estates of deceased partners (excluding partnerships, trusts (including revocable trusts), and disregarded entities).

NOTE: (Family) Partnerships with trusts or disregarded entities as partners do not have the option to elect to "push-out".

Planning Point: **Irrevocable Trust Using S Corporation Exception**. If a partnership includes an irrevocable trust, and if electing out of the new partnership audit rules is important, the trust might contribute its partnership interest to an S corporation, as partnerships with S corporation partners are treated as eligible partnerships.

7. **Election Out:**

a. Must be on a timely filed 1065 for each year;

b. Must include the name, TIN and federal tax classification of each partner (each partner must have a TIN); and

c. Notice must be given to each partner with 30 days of making the election.

Pre-TEFRA Rules Apply. If the election out is made, the pre-TEFRA audit rules will apply.

8. **Administrative Adjustment Requests ("AARs")/Amended Returns**

Under the new rules, partnerships cannot file amended returns. Rather, they must file an "***administrative adjustment request***." An AAR is not a "request" for authority to file an amended return. Rather, it initiates a formal process for requiring each of the partners to report their respective shares of the adjustments requested in the AAR.

9. Overview of Audit Process

a. **Notice of Proposed Partnership Adjustment ("NOPPA")**. The IRS begins the audit process by sending a notice of administrative proceedings ("NAP"), followed by a NOPPA which includes a proposed ***imputed underpayment***, netting all adjustments at the partnership level, and applying the highest tax rate in the reviewed year under IRC §1 (37%) or IRC §11 (21%).

b. **270-Day Period for Modification of Imputed Underpayment**. The filing of the NOPPA starts the running of a 270-day period in which the partners (the PR) may decide how to respond to the proposed adjustment/imputed underpayment.

c. **Some Partners May Amend Their Returns**. Some partners may choose to amend their separate income tax returns to report their respective portions of the adjustments. (This could be advantageous, for example, if the partner is not in the highest rate bracket, or qualifies for the IRC §199A deduction for partnership income that is qualified business income.) If the amended returns take into account all adjustment properly allocable to the amending partners, and if they pay any additional tax due, then the underpayment amount for the partnership is determined without regard to the portion of the adjustments that were reported by the partners on their amended returns.

If some partners choose not to amend their returns, the partnership will pay the additional tax attributable to their proportionate share of the proposed adjustment. The tax payment by the partnership "should" be charged against the capital accounts of the remaining partners who did not amend their returns (this would seemingly require authority to do so under the partnership agreement).

d. **Reporting Partner Attributes Impact the Proposed Adjustment**. The PR will report to the IRS any portion of the adjustment that is not reported on amended returns of the partners, and can report individual partner attributes that would reduce the imputed underpayment. For example, an adjustment in the amount of the imputed underpayment may be appropriate if a partner is tax-exempt entity, or is a C corporation (with a lower tax rate than the highest individual rate), or for capital gains or qualified dividends allocable to an individual partner. However, no adjustment is allowed because individual partners would be allowed deductions under IRC §199A for adjusted income that is qualified business income under IRC §199A. (Regulations might be revised to address this.)

These adjustments must be reported to the IRS within the 270-day window after issuance of the NOPPA. Partners who are in the highest rate bracket may prefer simply to have the tax paid at the partnership level, and charged against their capital accounts, rather than going to the expense of filing amended returns and incurring the risk of possible audits of the amended returns that might increase the likelihood of IRS review of other unrelated items. Another advantage of paying tax at the partnership level is that a 2% reduction of tax applies as a motivation to use the simplified approach (of merely paying tax at the partnership level).

e. **Issuance of Notice of Final Partnership Adjustment ("FPA")**. Following the end of the 270-day period, after the IRS makes adjustments in light of the amounts reported on individual returns and after considering individual partners' attributes affecting the tax attributable to the balance of the adjustment, the IRS will issue an FPA.

f. **"<u>Push-Out</u>" Election**. Within 45 days of the date of the FPA, the <u>PR</u> may make an election to "push-out" the proposed adjustment to the partners by furnishing a statement to the IRS and each partner showing each partner's share of any adjustment to income, gain, loss, deduction, or credit as reported in the FPA for the reviewed year. The election made by the PR is binding on the partnership and the partners. (The partnership agreement may contain provisions about whether the push-out election

should be made or the process for making the decision whether to make the election, but that does not affect the IRS's ability to rely on any election made by the PR.)

(1) Effects:

(a) The push-out election prevents adjustment year partners from bearing the tax liability for the reviewed year(s), unless they were also reviewed year partners.

(b) The reviewed-year partners will calculate any additional tax due for the year under examination and the years from the year under examination to the year of the adjustment by reference to their individual tax attributes.

(c) The underpayment interest rate for the tax deficiency is increased by two percentage points.

(2) Push-Out Election must include:

(a) The name, TIN and federal tax classification of the partnership;

(b) The name, TIN and federal tax classification of each partner;

(c) The year to which the election relates;

(d) A copy of the FPA; and

(f) An identification of the specific imputed underpayment(s) to which it applies.

g. **Filing of Tax Court Petition**. Within 90 days of the date of the FPA, the partnership may file a petition for readjustment with the Tax Court, federal district court having venue, or the Court of Federal Claims.

h. **Payment by Partnership**. Unless the adjustments are reflected on individual partners' amended returns, or are "pushed out" to the partners under the "push-out" election, after appeals are finalized any remaining imputed underpayment is payable by the partnership. While the adjustment year partners are not legally responsible for the additional tax, because the partnership is, the adjustment year partners will bear the tax (unless the partnership agreement provides rights of reimbursement from the review year partners).

10. **<u>Drafting Issues</u>:**

A variety of issues should be addressed when drafting partnership and LLC agreements, and when amending partnership and LLC agreements already in existence, including:

a. **Partnership representative**:

- Process in which a PR is chosen.
- Actions the PR is required to take:
- Actions the PR is prohibited from taking.
- Actions that require the consent of the partners (unanimous or majority?)
- Actions that the PR can take without consent of the partners.
- Who controls/pays for the partnership audit?
- What obligation does PR have to provide notice to partners relating to tax matters?
- What obligations do partners have to provide info and/or otherwise cooperate with the PR?
- What obligations do partners have to indemnify the PR?
- Procedures for removing the PR.
- Procedures for designating a successor PR.

b. **Partner Rights/Obligations**

- Obligations of departing partners for liabilities from "reviewed years."
- Prohibitions on transfers of partnership interests to ineligible partners, if the partnership is electing out of the new audit regime.
- Requirements that an ineligible partner hold its interest through an S corporation.
- Requirements that partners provide partnership with information sufficient to make an election-out election or push-out election.

- Consider requiring:
  - the default rule to be applied for imputed underpayments under a specified dollar amount; and
  - the push-out elections to be made for imputed underpayments at or over that amount.
- Address the level of diligence the PR must exercise to identify partner tax attributes that can reduce an imputed underpayment.

c. **Electing out**:

- Should approval by partners be required? If so, unanimous or majority?
- Should there be transfer restrictions to make sure that the partnership will maintain eligibility to elect out?
- Should there be other provisions in the partnership agreement to ensure eligibility to elect out? (E.g., remain under 100 direct/indirect partners; require partners to provide information required for election out.)

d. **Modification of imputed underpayment**:

- Obligation by PR to seek modification?
- Agreement among partners to cooperate, e.g.:
  - To file amended returns;
  - To provide information.
- Allocation of benefit/burden of tax among (review year) partners?
- Indemnification and clawback from prior (review year) partners?

e. **Push-out**:

- Should the election be mandatory or optional?
- Should partner approval be required if election is optional? If so, unanimous or majority?

- Should partnership be required to contest the adjustments when election is made?
- If partnership is not required to contest, should partner approval be required? If so, unanimous or majority?

11. **Interest and penalties**:

a. **Interest**. Interest on an underpayment is measured from the day after the return due date for the reviewed year and ends on the return due date for the adjustment year (or, if earlier, the date the imputed underpayment is paid).

b. **Penalties**. Penalties are imposed on the partnership as though it was an individual and the imputed underpayment is a tax imposed in the reviewed year.

12. **State issues**:

a. States do **not** automatically follow BBA.

b. Will California follow? If so, when?

13. **Agreements affected**:

a. All Partnership/LLC Operating Agreements – new and old!

b. Purchase/Sale Agreements?

c. Contribution Agreements?

d. Redemption/Dissolution Agreements?

e. Merger Agreements?

f. Disclosure Documents?

g. Loan Agreements

Supplemental Materials

Resignation and Revocation of the PR or DI

1. **Resignation**.

- Permitted only after receipt of a NAP (maybe after?) or if otherwise filing an AAR making other changes.

- Effective 30 days after IRS receives notice.

- Resigning PR may appoint new PR and resigning DI may appoint new DI.

2. **Revocation of the PR**.

- Permitted only upon receipt of a NAP (maybe after?) or if otherwise filing an AAR making other changes.
- Effective 30 days after IRS receive notice.
- Governed by a surprisingly complex set of rules that seem outdated even though they are new.

3. **Revocation of the DI**:

- Not specifically contemplated.
- Can presumably terminate DI appointment by terminating the PR appointment since termination of PR appointment automatically terminates DI appointment.

4. **Can anything be done if PR or DI**:

- Goes to work for a competitor?
- Was an employee who was fired for cause?
- Was arrested (but not yet incarcerated)?
- Take actions that clearly violate the terms of the partnership agreement?
- Does nothing?

Supplemental Materials

Consolidated Appropriations Act

Technical Corrections to the Partnership Audit Rules

1. Imputed Underpayment Determination

a. **Previously**: The imputed underpayment in the adjusted year was determined by netting all adjustments of items of income, gain, loss, or deduction and multiplying the net amount by the highest rate of Federal income tax applicable in effect for the reviewed year. The product is then increased or decreased by any adjustments to items of credit.

b. **Currently**: Any adjustment that reallocates the distributive share of any item from one partner to another is taken into account by disregarding any part of the adjustment that results in a decrease in the amount of the imputed underpayment.

(1) If an adjustment would decrease the imputed underpayment and could be subject to a limitation or not be allowed against ordinary income if the adjustment were taken into account by any person, then the adjustment is not taken into account in determining the imputed underpayment of the partnership.

(2) If an adjustment that flows through to a partner could be subject to a limitation at the partner level, then the adjustment will not be taken into account in determining the partnership's deemed underpayment.

2. Amended Return

a. **Previously**: If one or more partners files amended returns for the tax year of the partners that includes the end of the reviewed year of the partnership, the returns take into account all adjustments made by the IRS that are properly allocable to such partners and payment of any tax due is included with the amended returns. If any adjustment that reallocates the distributive share of any item from one partner to another, a modification will apply only if amended returns are filed by all partners affected by such adjustment.

b. **Currently**: Requirements for reviewed-year partners:

(1) The partner must file for the tax year of the partner that includes the end of the partnership's reviewed year, as well as for any tax year with respect to which

any tax attribute of the partner is affected by reason of any adjustment to a reviewed-year partnership-related item;

(2) The amended returns must take into account all such adjustments that are properly allocable to the partner, as well as the effect of the adjustments on any tax attributes; and

(3) Payment of any tax due must be included with the amended returns.

3. **"*Pull-In*" Election**

a. **Currently**: Alternative procedure to filing amended returns. The IRS determines the partnership's imputed underpayment is reduced by the portion of the adjustments to partnership-related items that reviewed-year partners take into account and with respect to which those partners pay the tax due, provided the requirements of the pull-in procedure are met.

Reviewed-year partners must:

(1) Pay the tax that would be due with amended returns within 270 days after the date the NOPPA is mailed;

(2) Make binding changes to their tax attributes for later years; and

(3) Provide the IRS with the information necessary to substantiate that the tax was correctly computed and paid (as well as how its tax attributes would be affected in subsequent years).

There are no requirements for partners to file an amended return. Generally only applicable to reviewed-year partners. Does not require the participation of all reviewed-year partners.

4. ***Push-Out* Election**

a. **Currently**: The Act allows an adjustment to be pushed out through multiple tiers of entities.