CURRENT ISSUES IN AGRICULTURAL LAW CONFERENCE
UNIVERSITY OF WYOMING COLLEGE OF LAW
LARAMIE, WYOMING
MARCH 29, 2019

FEDERAL TAX, ESTATE AND BUSINESS PLANNNING UPDATE

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PART ONE

I. I.R.C. §199A – Qualified Business Income Deduction

A. Proposed regulations.

1. On August 8, 2018, the Treasury issued proposed regulations under I.R.C. §199A that was created by the Tax Cuts and Jobs Act (TCJA) enacted in late 2017. *REG-107982.* Those proposed regulations are intended to provide taxpayers guidance on planning for and utilizing the new 20 percent pass-through deduction (known as the QBID) available for businesses other than C corporations for tax years beginning after 2017 and ending before 2026.

2. While some aspects of the proposed regulations are favorable to agriculture, other aspects create additional confusion, and some issues are not addressed at all.

3. The proposed regulations provide a favorable aggregation provision that allows a farming operation with multiple businesses (e.g., row-crop; livestock; etc.) to aggregate the businesses for purposes of the QBID. This is, perhaps, the most important feature of the proposed regulations with respect to agricultural businesses because it allows a higher income farming or ranching business to make an election to aggregate their common controlled entities into a single entity for purposes of the QBID.

4. In several areas, the proposed regulations are helpful to farming and ranching operations. These include an aggregation rule that allows a farmer to combine the rental income from one entity with the farm income from another entity and compute the QBID based on the combined net income (and wages and qualified property if the taxpayer is over the applicable income threshold).

5. Similar to the benefit of aggregation, farms with multiple entities can allocate qualified W-2 wages to the appropriate entity that employs the employee under common law principles. This avoids the taxpayer being required to start payroll in each entity.

6. Likewise, carryover losses that were incurred before 2018 and that are now allowed in years 2018-2025 will be ignored in calculating qualified business income (QBI) for purposes of the QBID. This is an important issue for taxpayers that have had passive losses that have been suspended under the passive loss rules.

    a. The passive loss rules of I.R.C. §469 are applied before determining QBI. For example, if a rental activity incurs a $10,000 loss in 2018, but I.R.C. §469 only allows $5,000 of the loss to be netted against another rental with $5,000 of income, net QBI will be zero. The rental loss to be carried forward from 2018 is $5,000 and the QBI loss carryforward will be $5,000.

    b. Attention should be paid to ensure that tax software is treating I.R.C. §469 loss carryovers properly.

7. For farmers that also do consulting, a favorable rule is included that this "specified service trade or business" (SSTB) income is ignored if it is less than 10 percent of overall income from the business if average gross revenues are less than $25 million. In that instance, the income will be treated as "normal" business income for QBID purposes.

8. Under the proposed regulations, if a farmer or rancher only has one business and the business shows a loss, a QBID cannot be claimed in the current year and the loss will carry forward to the following year as a "separate" item of qualified business income (QBI). However, for farming and ranching business multiple entities, if one entity shows a loss, that loss must be netted against the income of the other entities. For taxpayers that are beneath the income threshold, the net amount is multiplied by 20 percent to compute the QBID. For taxpayers over the threshold, the proposed regulations contain a calculation procedure that will be favorable for farmers, ranchers and other taxpayers.

9. The proposed regulations confirm that real estate leasing activities can qualify for the QBID without regard to whether they are active or passive in nature. *See, e.g., Prop. Treas. Reg. §1.199A-1(d)(4), Examples 1 and 2.* That is certainly the case if the rental is between "commonly controlled" entities. For rentals not between commonly controlled entities, the income is QBI if the rental activity constitutes a trade or business under I.R.C. §162.

B. Comparing the proposed regulations with the final regulations issued on January 18, 2019.

Note - The final regulations are effective upon being published in the Federal Register. But, in general, a taxpayer can rely on either the final or proposed regulations for tax years that end in 2018. Some parts of the final regulations apply to tax years ending after December 22, 2017, or to tax years ending after August 16, 2018. However, these situations apply to the anti-abuse rules, including the anti-abuse rules that apply to trusts.

1. Losses

    a. Proposed regulations. Under the proposed regulations, carryover losses that were incurred before 2018 and that are now allowed in years 2018-2025 will be ignored in calculating qualified business income (QBI) for purposes of the QBID. This is an important issue for taxpayers that have had passive losses that have been suspended under the passive loss rules. While this loss allocation rule is generally favorable, clarification was needed on a couple of points. For instance, could a taxpayer also ignore pre-2018 suspended losses for purposes of the Excess Business Loss rule under I.R.C. §461(l)?

b. Final regulations. The final regulations, consistent with the regulations issued under former I.R.C. §199, provide that any losses that are disallowed, suspended, or limited under I.R.C. §465 (passive loss rules) §704 and I.R.C. §1365 (or any other similar provision) are to be used on a first-in, first-out basis.

   i. In addition, the final regulations clarify that an NOL deduction (in accordance with I.R.C. §172) is generally not considered to be in connection with a trade or business. Excess business losses (the amount over $500,000 (mfj)) are not allowed for the tax year.

   ii. However, an Excess Business Loss under I.R.C. §461(l) is treated as an NOL carryover to the next tax year where it reduces QBI in that year. The carry forward becomes part of the taxpayer's NOL carryforward in later years. There is no mention whether this amount gets retested under I.R.C. §461(j) (involving subsidized farming losses). Under prior law, those disallowed losses retained their character in a later tax year. That is no longer the case and it appeared that the NOL generated under I.R.C. §461(l) would not be subject to other loss limitation provisions.

2. Included and Excluded Items

   a. Under the proposed regulations, QBI includes net amounts of income, gain, deduction, and loss with respect to any qualified trade or business. I.R.C. §199A(c).

   b. Business-related items that constitute QBI include ordinary gains and losses from Form 4797; deductions that are attributable to a business that is carried on in an earlier year; the deduction for self-employed health insurance under I.R.C. §162(l); and the deductible portion of self-employment tax under I.R.C. §164(f).

   c. The final regulations are consistent with the proposed regulations on the treatment of the self-employed health insurance deduction and retirement plan contributions. Prop. Treas. Reg. §1.199A-1(b)(4) defines QBI as the net amount of qualified items of income, gain, deduction and loss with respect to a trade or business as determined under the rules of Prop. Treas. Reg. §1.199A-3(b). The above-the-line adjustments for S.E. tax, self-employed heath insurance deduction and the self-employed retirement deduction are examples of such deductions.

      i. QBI is reduced by certain deductions reported on the return that the business doesn’t specifically pay, including the deduction for one-half of the self-employment tax, the self-employed health insurance deduction, and retirement plan contributions.

      ii. The self-employed health insurance deduction may only “apply” to Schedule F farmers because, with respect to partnerships and S corporations, it is actually a component of either shareholder wages for an S corporation shareholder or guaranteed payments to a partner and, thus, may not reduce QBI.

      iii. The self-employed health insurance deduction should not be removed from an S-corporate owner on their individual return because it has already been removed on Form 1120-S. Do not deduct it twice. If QBI were reduced by the amount of the I.R.C. §162(l) deduction on the 1040, QBI would be (incorrectly) reduced twice. In other words, QBI should not be reduced by the self-employed health insurance from the S corporation or the partnership. The deduction for the S corporation

shareholder is allocated to the wage income, and the deduction for the partner is from the guaranteed payment.

iv. The one-half self-employment tax deduction for the partner is allocated between guaranteed payments (if any) and that portion of the K-1 allocated income associated with QBI.

> **Note:** Some tax software programs are not treating this properly. Watch for updates, such as a box to check on the self-employed health insurance screen.

d. The final regulations also clarify that the deduction for contributions to qualified retirement plans under I.R.C. §404 is considered to be attributable to a trade or business to the extent that the taxpayer's gross income from the trade or business is accounted for when calculating the allowable deduction, on a proportionate basis. *See Prop. Treas. Reg. §1.199A-3(b)(vi).*

i. When an S corporation makes an employer contribution to an employer-sponsored retirement plan, that contribution, itself, reduces corporate profits. Thus, there is less profit on which the QBID can potentially apply. Thus, for some S corporation owners, a contribution to an employer-sponsored retirement plant will effectively result in a partial deduction, but still subject the entire contribution, plus all future earnings, to income tax upon distribution.

ii. The final regulations make clear that sole proprietors and partners must also "back out" these amounts from business profits before applying the QBID. This rule will make 401(k)s with a Roth-style option more valuable.

iii. It is noted that business owners of an SSB with income high enough to phase-out the QBID and those who believe their future marginal tax rate will be significantly lower than the present marginal tax rate, as well as those who need to reduce their AGI to qualify for other deductions, credit, etc.

e. The final regulations do not address how deductions for state income tax imposed on the individual's business income or unreimbursed partnership expenses are to be treated.

f. The final regulations also don't mention whether the deduction for interest expense to a partnership interest or an S corporation interest is business related.

g. Some tax software is presently reducing QBI passed through from an S corporation or partnership by the I.R.C. §179 amount which is passed through separately. Other tax software allows the practitioner to either include or exclude the I.R.C. §179 amount. A suggested approach is to always exclude it at the entity level because it is not known if it can be deducted on the taxpayer's personal return. Operating properly, tax software should calculate QBI with a reduction for the I.R.C. §179 deduction at the individual level.

h. Guaranteed payments for the use of capital in a partnership are not attributable to the partnership's business, unless they are properly allocable to the recipient's qualified trade or business (not likely).

i. Also excluded from QBI are amounts that an S corporation shareholder receives as reasonable compensation or amounts a partner receives as payment for services under I.R.C. §§707(a) or (c).

3. Capital Gain/Loss. The QBID is limited to the lesser of 20 percent of taxable income less "net capital gains" as defined in I.R.C. §1(h).

   a. The I.R.C. §1(h) definition includes: long-term capital gains; qualified dividend income; I.R.C. §1231 gain not taxed as ordinary income (they are ordinary to the extent of unrecaptured net I.R.C. §1231 losses from the prior five years); I.R.C. §1250 gains (i.e., gain from real estate sales representing depreciation claimed); long-term rate for collectibles.

   b. The proposed regulations appeared to take the position that gain that is "treated" as capital gain is not QBI. *Prop. Treas. Reg. 1.199A-3(b)(2)(ii)(A).*

      i. This interpretation would exclude I.R.C. §1231 gain (such as is incurred on the sale of breeding livestock) from being QBI-eligible. But, it could also be argued that is an incorrect interpretation of the relevant Code provisions. It also is arguably inconsistent with the purpose of the QBID statute. I.R.C. §1222(3) defines long-term capital gain as the gain from the sale or exchange of a capital asset held for more than one year, if and to the extent the gain is taken into account in computing gross income. I.R.C. §1231(a)(1) treats the I.R.C. §1231 gains as long-term capital gain. I.R.C. §199A(a)(2)(B) neither modifies nor makes any other specification.

      ii. Also, I.R.C. §1222(11) defines "net capital gain" as the excess of the net long-term capital gain for the year over the net short-term capital loss. None of the other provisions on I.R.C. §1222 mention I.R.C. §1231. Simply because, as the proposed regulations state, gain is "treated as" capital gain does not make it capital gain. Rather, "treated as" should be read in a manner that the tax on I.R.C. §1231 gain is computed in the same manner as capital gain.

      iii. I.R.C. §1231 reflects gain on the disposition of a business asset. As such, the argument is, I.R.C. §1231 gain should be QBI because the purpose of I.R.C. §199A is to provide a lower tax rate on business income. Losses from the sale of short-term depreciable assets (Part II of Form 4797) should not reduce QBI if I.R.C. §1231 gains (Part 1 of Form 4797) are present.

   c. The final regulations remove the specific reference to I.R.C. §1231 and provide that *any* item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss, including any item *treated as* one of these under any Code provision, is not taken into account as a qualified item of income, gain, deduction or loss.

      i. Comprehensive definition.

      ii. Includes any item that is reported on Schedule D plus qualified dividends. Qualified dividends are specifically included in the term "capital gain" by reference to I.R.C. §1(h).

      iii. The I.R.C. §1231 gain character is determined at the shareholder level.

iv. If I.R.C. §1231 netting yields a loss, all of the I.R.C. §1231 gains and losses are treated as ordinary. This may require the practitioner to modify the QBI figure that was reported out on the K-1.

4. Commodity trading.

   a. The proposed regulations provided that "brokering" is limited to trading securities for a commission or a fee. *Prop. Treas. Reg. §199A-5(b)(2)(x).*

      i. Clarification was needed to ensure that brokering of commodities did not constitute a specified service trade or business (SSTB). An SSTB is eligible for the QBID, but under a different set of rules that apply to non-SSTB businesses (such as farms and ranches).

      ii. For instance, the concern was that under the proposed regulations a person who acquired a commodity (such as wheat or corn for a hog farm), and transported it to the ultimate buyer might improperly be considered to be dealing in commodities. This would have resulted in the income from the activity treated as being from an SSTB. None of the commodity income would have been eligible for the QBID for a high-income taxpayer.

      iii. This is also an important issue for private grain elevators. A private grain elevator generates income from the storage and warehousing of grain; it also generates income from the buying and selling of grain. Is the private elevator's buying and selling of grain "commodity dealing" for purposes of I.R.C. §199A? If it is, then a significant portion of the elevator's income will not qualify for the QBID.

   b. The final regulations clarify that the brokering of agricultural commodities does not constitute an SSTB and does so by pointing to I.R.C. §954.

5. W-2 wages.

   a. The final regulations specify that the IRS may provide for methods of computing taxable wages.

   b. Simultaneously with the release of the final regulations, the IRS issued Rev. Proc. 2019-11. The Rev. Proc. notes that it applies only for QBID purposes, and recites the W-2 wages definition from the proposed regulations. Thus, statutory employees that a have a Form W-2 with Box 13 marked are not W-2 wages for QBID purposes.

   c. Wages paid in-kind to agricultural labor are not eligible W-2 wages, but wages paid to children under age 18 are. For the background statutory analysis of this issue see: https://lawprofessors.typepad.com/agriculturallaw/2018/08/the-qualified-business-income-deduction-and-w-2-wages.html.

   d. The proposed regulations set forth three methods for computing W-2 wages – unmodified box method; modified box 1 method; and the tracking wages

method. The Rev. Proc. also provided special rules to use for a short tax year which requires the use of the tracking wages method.

e. Contractor payments made on Forms 1099 are not wages for QBID purposes. The regulations create a rebuttable presumption for three years that an individual is an employee.

6. Multiple trades or businesses.

   a. The final regulations follow the approach of the proposed regulations concerning a taxpayer that has multiple trades and businesses.

   b. Items of QBI that are properly allocable to more than a single trade or business must be allocated among the several trades or businesses to which they are attributed using a reasonable method based on the facts. That method is to be consistently applied each year.

   c. The same concept applies for individual items.

   d. Trades or businesses conducted by a disregarded entity will be treated as conducted directly by the owner of the entity for QBID purposes. *Treas. Reg. §1.199A(e)(2).*

7. Income Tax Basis

   a. Under I.R.C. §199A, higher income taxpayers compute their QBID in accordance with a wages/qualified property (QP) limitation. The amount of QP that is used in the limitation is tied to the what is known as the "unadjusted basis in assets" (UBIA). However, the proposed regulations raised some questions about UBIA that needed clarified.

   b. For instance, Prop. Treas. Reg. §1.199A-4(b), Example 3, needed modified. When a tax-free contribution of property to a corporation is involved, the transferor's unadjusted basis should continue to be the UBIA. The placed-in-service date would be the date that the transferor originally placed the property in service. I.R.C. §351 should simply be viewed as a continuation of the taxpayer's holding. The only difference is that the asset is being held via the S corporation. Indeed, the tax attributes of the contributed asset remain unchanged. Likewise, the transferor's depreciation history with respect to the contributed asset carries into the S corporation. Thus, the unadjusted basis should also carry into the corporation.

   c. The final regulations clarify that the UBIA of property received in either an I.R.C. §1031 or 1033 exchange is the UBIA of the relinquished property. In addition, the placed-in-service date of the replacement property is the service date of the relinquished property. Similar concepts apply for transfers that are governed by I.R.C. §§351, 721 and 731.

   d. The final regulations also take the position that property contributed to a partnership or S corporation under the non-recognition rules retains the UBIA of the contributor. In addition, an I.R.C. §743(b) adjustment is QP to the extent of an increase in fair market value over original cost.

i. On February 1, 2019, the Treasury released corrected draft final regulations under I.R.C. §199A.

ii. The corrections include, among other things, corrections to the definition and computation of excess I.R.C. §743(b) basis adjustments for purposes of determining the UBIA immediately after an acquisition of qualified property, as well as corrections to the description of an entity disregarded as separate from its owner for purposes of the QBID.

iii. An I.R.C. §743(b) basis adjustment is to be treated as qualified property to the extent the adjustment reflects an increase in the FMV of the underlying qualified property.

iv. An "excess I.R.C. §743(b) basis adjustment" is an amount that is determined with respect to each item of qualified property and is equal to an amount that would represent the partner's I.R.C. §743(b) basis adjustment with respect to the property as determined under Treas. Reg. §1.743-1(b) and Treas. Reg. §1.755-1, but calculated as if the adjusted basis of all of the partnership's property was equal to the UBIA of such property.

v. The absolute value of the excess I.R.C. §743 basis adjustment cannot exceed the absolute value of the total I.R.C. §743(b) basis adjustment with respect to qualified property.

vi. The excess I.R.C. §743(b) basis adjustment is treated as a separate item of qualified property placed in service when the transfer of the partnership interest occurs.

vii. The rule in vi. above is limited solely to the determination of the depreciable period for QBID purposes. It does not apply to the determination of the placed in service date for depreciation or tax credit purposes.

viii. The recovery period for such property is determined under Treas. Reg. §1.743-1(j)(4)(i)(B) with respect to positive basis adjustments and Treas. Reg. §1.743-1(j)(4)(ii)(B) with respect to negative basis adjustments.

ix. I.R.C. §743(b) is the adjustment. I.R.C. §754 is simply the election to put it on the partnership books. I.R.C. §754 is allowed when an I.R.C. §743(b) adjustment is made, but not I.R.C. §734(b).

e. For entities, the UBIA is measured at the entity level, and the property must be held by the entity as of the end of the entity's tax year.

f. As for a decedent's estate, the fair market value of property that is received from a decedent pegs the UBIA and the new depreciation period (for purposes of the computation of the limitation) is reset as of the date of the decedent's death.

8. Trusts

    a. The final regulations specify that a non-grantor trust that is established for "a primary purpose" of avoiding income tax under I.R.C. §199A will be considered to be aggregated with trust settlor/grantor for QBID purposes.

    b. In addition, distributable net income (DNI) transferred from a non-grantor trust to a beneficiary is treated as having been received by the beneficiary. This could lead to an increase in the creation of non-grantor, irrevocable, complex trusts.

    c. The final regulations also did not place any limitation on the use of irrevocable trusts that are considered to be owned by the beneficiary(ies). *See I.R.C. §678.*

    d. However, this does not necessarily mean that there should be a rush to create irrevocable trusts. The IRS, supported by the courts, often view the substance of a transaction as more controlling than form when it believes that the entity was created primarily for tax avoidance purposes. *See, e.g., Helvering v. Gregory, 293 U.S. 465 (1935).*

9. Miscellaneous

    a. Under the final regulations, a veterinarian is engaged in the provision of health care and, therefore, is an SSTB.

    b. No clarity was given as to the treatment of insurance salesmen – they are often statutory employees

    c. The final regulations contain a three-year lookback period on the reclassification of workers from employee (W-2) status to independent contractor (Form 1099) reporting. Employees do not have QBI, but independent contractors can.

10. Aggregation – multiple businesses

    a. The proposed regulations provide a favorable aggregation provision that allows a farming operation with multiple businesses (e.g., row-crop; livestock; etc.) to aggregate the businesses for purposes of the QBID.

    b. This was, perhaps, the best feature of the proposed regulations with respect to agricultural businesses because it allows a higher income farming or ranching business to make an election to aggregate their common controlled entities into a single entity for purposes of the QBID. This is particularly the case with entities having paid no wages or that have low or no qualified property.

    c. Entities with cash rental income already qualified the income as QBI via common ownership (common ownership is required to aggregate)

    d. Once the applicable threshold for 2018 ($157,500 for a single filer; $315,000 for a married filing joint return) is exceeded, the taxpayer must have qualified W-2 wages or qualified property basis to claim the QBID. Aggregation, in this situation, may allow the QBID to be claimed (assuming the aggregated group has enough W-2 wages or qualified property).

e. Common ownership is required to allow the aggregation of entities to maximize the QBID for taxpayers that are over the applicable income threshold. *Prop. Treas. Reg. §1.199A-4(b).*

f. "Common ownership" requires that each entity has at least 50 percent common ownership.

g. But, the common ownership rule does not require every person involved to have an ownership in every trade or business that is being aggregated, or that you look to the person's lowest percentage ownership. For example, person A could have a 1 percent ownership interest in entity X and a 99 percent ownership interest in entity Y, and an unrelated person could have the opposite ownership (99 percent in X and 1 percent in Y) and the entities would have common ownership of 100 percent (the group of people have 50 percent or more common ownership).

h. The proposed regulations limited family attribution to just the spouse, children, grandchildren and parents. *See Prop. Treas. Reg. §1.199A-4(b)(3).* In other words, the proposed regulations limited common ownership to lineal ancestors and descendants.

    i. Excluded were siblings – which are often involved in farming and ranching businesses.

    ii. One way to plan around the lack of sibling attribution, for example, was to have one child own 100 percent of one business and another child of the same parent own 100 percent of another business. In that situation, the parent is deemed to have 100 percent ownership of both businesses even though there is no sibling attribution. The two businesses could be aggregated, even though there is no sibling attribution, as long as at least one parent is alive.

i. The proposed regulations were also unclear concerning whether (for taxpayers over the applicable income threshold) it mattered if the entities are on a calendar or fiscal year-end.

j. In order to elect to aggregate entities together, the proposed regulations required *all* of the entities in a combined group must have the same year-end, and none can be a C corporation. But, rental income paid by a C corporation in a common group could be QBI if the C corporation was part of that combined group.

    i. If this reading were correct, that meant that the rental income could qualify as QBI.

    ii. That interpretation is beneficial to farming and ranching businesses – many are structured with multiples entities, at least one of which is a C corporation.

k. The final regulations provide that siblings are included as related parties via I.R.C. §§267(b) and 707(b).

    i. Including siblings in the definition of common ownership for QBID purposes will be helpful upon the death of the senior generation of a farming or ranching operation.

ii. In addition, the final regulations retain the 50 percent test and clarify that the test must be satisfied for a majority of the tax year, at the year-end, and that all of the entities of a combined group must have the same year-end.

l. The final regulations also specify that aggregation for 2018 can be made on an amended return. The aggregation election can be made in a later year if it was not made in the first year.

11. Rental Activities

a. The proposed regulations confirmed that real estate leasing activities can qualify for the QBID without regard to whether the lessor participates significantly in the activity. That's particularly the case if the rental is between "commonly controlled" entities.

b. But, the proposed regulations could also have meant that the income a landlord receives from leasing land to an unrelated party (or parties) under a cash lease or non-material participation share lease may *not* qualify for the QBID.

i. If this is correct, it could mean that the landlord must pay self-employment tax on the lease income associated with a lease to an unrelated party (or parties) to qualify the lease income for the QBID.

ii. Clarification was needed on the issue of whether the rental of property, regardless of the lease terms will be treated as a trade or business for aggregation purposes as well as in situations when aggregation is not involved.

iii. Clarification is critical because cash rental income may be treated differently from crop-share income depending on the particular Code section involved. *See, e.g., §1301.*

c. The proposed regulations also contained an example of a rental of bare land not requiring any cost on the landlord's part. *See Prop. Treas. Reg. §1.199A-1(d)(4), Example 1.*

i. This seemed to imply that the rental of bare land to an unrelated third party qualifies as a trade or business.

ii. Another example in the proposed regulations also seemed to support this conclusion. *Prop. Treas. Reg. §199A-1(d)(4), Example 2.* Apparently, this means that a landlord's income from passive triple net leases (a lease where the lessee agrees to pay all real estate taxes, building insurance, and maintenance on the property in addition to any normal fees that are expected under the agreement) should qualify for the QBID. But, existing caselaw is generally not friendly to triple net leases being a business under I.R.C. §162. Clarification on this point was also needed.

d. Unfortunately, the existing caselaw doesn't discuss the issue of ownership when it is through separate entities and, on this point, the Preamble to the proposed regulations created confusion.

i. The Preamble says that it's common for a taxpayer to conduct a trade or business through multiple entities for legal or other non-tax reasons, and also states that if the taxpayer meets the common ownership test that activity will be deemed to be a trade or business in accordance with I.R.C. §162.

ii. But, the Preamble also stated that "in most cases, a trade or business *cannot* be conducted through more than one entity." So, if a taxpayer has several rental activities that the taxpayer manages, the Preamble raised a question as to whether those separate rental activities can't be aggregated unless each rental activity is a trade or business.

iii. The Preamble also raised a question as to whether the Treasury would be making the trade or business determination on an entity-by-entity basis. If so, triple net leases might not generate QBI.

iv. But, another part of the proposed regulations extended the definition of trade or business beyond I.R.C. §162 in one circumstance when it referred to "each business to be aggregated" in paragraph (ii). *Prop. Treas. Reg. §1.199A-4(b)(i).* This would appear to mean that the rental of property would be treated as a trade or business for aggregation purposes. *See Prop. Treas. Reg. §199A-1(b)(13).*

e. The final regulations removed the bare land rent example in the proposed regulations.

i. Unfortunately, no further details were provided on the QBI definition of trade or business. That means that each individual set of facts will be key with the relevant factors including the type of rental property (commercial or residential); the number of properties that are rented; the owner's (or agent's) daily involvement; the type and significance of any ancillary services; the terms of the lease (net lease; lease requiring landlord expenses; short-term; long-term; etc.).

ii. Certainly, the filing of Form 1099 will help to support the conclusion that a particular activity constitutes a trade or business. But, tenants-in-common that don't file an entity return create the implication that they are not engaged in a trade or business activity.

f. The final regulations clarify that rental paid by a C corporation *cannot* create a deemed trade or business.

i. This is a tough outcome as applied to many farm and ranch businesses and will require some thoughtful discussions with tax/legal counsel about restructuring rental agreements and entity set-ups.

ii. Before the issuance of the final regulations, it was believed that land rent paid by a C corporation could still qualify as a trade or business if the landlord could establish responsibility (regularity and continuity) under the lease. Landlord responsibility for mowing drainage strips (or at least being responsible for ensuring that they are mowed) and keeping drainage maintained (i.e., tile lines), paying taxes and insurance and approving

cropping plans, were believed to be enough to qualify the landlord as being engaged in a trade or business. That appears to no longer be the case.

g. Along with the release of the final regulations, the IRS issued Notice 2019-7 (Jan. 18, 2019). The Notice is applicable for tax years ending after December 31, 2017 and can be relied upon until the final Revenue Procedure is published.

   i. The Notice provides tentative guidance and a request for comments on the sole subject of when and if a rental activity (termed as a "rental real estate enterprise) will be considered to be an active trade or business.

   ii. The Notice also provides a safe harbor. While real estate rented or leased under a triple net lease is not eligible under the safe harbor (unless common control allows it), a taxpayer who has an active business of entering into and selling triple net leases may still be considered to be sufficiently active to qualify as a trade or business under existing case law.

   iii. The Notice defines a triple net lease to include an agreement that requires the tenant to pay taxes, fees, and insurance, and to be responsible for maintenance in addition to rent and utilities, and includes leases that require the tenant to pay common area maintenance expenses, which are when a tenant pays for its allocable portion of the landlord's taxes, fees, insurance, and maintenance activities which are allocable to the portion of the property rented. The definition seems to leave open the ability to avoid triple net lease status by having the tenant be responsible for some portion of the maintenance, taxes, fees, insurances, and other expenses that would normally be payable by a landlord.

   iv. Failure to meet the safe harbor does not fully preclude the lease from generating QBI.

   Note: For landowners receiving annual "wind lease" income for aero generators on their farmland, even though the income is received as part of a common controlled group, the actual income is not paid by any member of the controlled group. It is essentially triple net lease income with no services provided by the farmer (or spouse). This income will not be QBI, given the inability of the landowner to provide "services" under the lease agreement.

h. An individual may rely on the safe harbor, as well as a partnership or S-corporation that owns the applicable interest in the real estate that is leased out (such as farmland). As noted above, the final regulations take the position that the lessor entity must be a pass-through entity (or a sole proprietorship) that owns the real estate directly or through another entity that is disregarded for income tax purposes. Rent that is paid by a C corporation doesn't count.

i. Each individual taxpayer, estate or trust can elect to treat each separate property as a separate enterprise, or all similar properties as a single enterprise, for purposes of applying the safe harbor rules, except that commercial and residential real estate cannot be considered as part of the same enterprise for testing purposes.

i. In other words, all commercial rents can be netted as one single enterprise, and all residential rentals can be netted as another enterprise.

ii. But, real estate that is under a triple net lease, and real estate used as a residence by the taxpayer cannot be part of an aggregated enterprise for testing purposes because they cannot qualify to be included in the safe harbor.

j. The Notice specifies that for each separate enterprise, certain requirements must be satisfied each year for the enterprise's income to be eligible for the safe harbor:

i. Maintenance of separate books and records to reflect the income and expenses for each enterprise.

ii. Aggregate records for properties that are grouped as a single enterprise.

iii. Contemporaneous records (similar to auto logs) of time reports, logs, etc., with respect to services performed and the party performing the services with respect to tax years beginning January 1, 2019. The requirement is inapplicable to 2018 returns or fiscal year filers for years ending before 2020.

iv. For tax years 2018 through 2022, 250 or more hours of "rental services" must be performed to qualify the property for the safe harbor in each calendar year. Rental services include time spent by owners, employees, agents, and independent contractors of the owners, which can include management and maintenance companies who have personnel who keep and provide contemporaneous records. Rental services also include advertising to rent or lease properties; negotiating and executing leases; verifying tenant information; collecting rent; daily management and repairs; buying materials and supervising employees and independent contractors. Starting in 2023, such hours are needed three out of five years.

v. Must include a statement on the return (under penalty of perjury) that the rental enterprise satisfies the requirements. Use of the safe harbor is done on an annual basis.

vi. To restate, the safe harbor does not apply to triple-net leases. Thus, a farm landlord that cash rents farmland via a triple-net lease will not qualify the rental income as QBI even if working more than 250 hours in the lease activity.

vii. Implications for crop-share lease income.

- For crop share lease income, the landlord must do more than simply receive a share of the crop without incurring any crop-related expenses in order to qualify the lease income as QBI.

- If the landlord shares in crop expenses, the IRS will likely argue that the landlord must clear the 250-hour hurdle. While putting in less than 250 hours doesn't mean the lease income is not QBI, the landlord bears the burden to prove that it is.

- Structured rental situations involving common ownership avoids the safe harbor restrictions (and under the final regulations "related parties" includes brothers and sisters). Thus, rent paid by an individual or pass-through entity to an individual or pass-through entity under common ownership qualifies as QBI. If rent is paid by a C corporation under common ownership, it will not qualify as QBI, unless safe harbor rules satisfied (and (likely) self-employment tax is paid).

k. The safe harbor requirements will most likely be easier to satisfy by taxpayers having multiple properties, and cannot be used by a taxpayer that rents their personal residence(s) out for part of the year. While most rental house scenarios, cash rents and crop shares won't qualify for the safe harbor, they may qualify under common control without regard to any hour requirement, or they can still generate QBI based on the overall facts and circumstances.

l. The common ownership rules trump the safe harbor rules. Thus, qualifying the income of rental entities as QBI (e.g., land held outside a farming operating entity that is leased to the farming entity) via common ownership will not necessarily make the rental income that passes through to the owners subject to self-employment tax. The only time the safe harbor rules apply is when rent is received from an entity that is not part of a common group.

   i. If a farm entity pays rent to a sole proprietor farmer or pass-through entity with common ownership, no hours are required related to the rental income. The rental income, by default, qualifies as QBI unless it is paid by a C corporation.

   ii. In this situation, the lease could be a passive lease. If the rental amount is set at fair market value, none of the income is subject to self-employment tax. *See, e.g., Martin v. Comr., 149 T.C. No. 12 (2017).*

   iii. Under the proposed regulations, rents could by paid by a C corporation under common ownership and the rental income would qualify as QBI. Under the final regulations, the rent must be paid by an individual or "relevant pass-through entity" (RPE). But, for farmers that farm as a C corporation and pay rent to themselves or an RPE, the rental income is QBI for 2018 via the proposed regulations. None of such rent will count as QBI for 2019 and later years. While the safe harbor can be utilized for post-2018 years, it requires the landlord put in at least 250 hours in the activity (which may trigger self-employment tax).

12. Based on the final regulations, the IRS announced that it would be making changes to various Forms, Schedules and Instructions and re-posting them to the IRS website. Impacted are the Instructions for the Form 1040; Instructions for the Form 1065; Schedule K-1 Instructions for the Form 1120-S; Instructions for the Form 1120-S; Schedule K-1 Instructions for the Form 1041 and Instructions for the Form 1041, Schedule K-1.

C. Agricultural Cooperatives

1. As initially enacted, I.R.C. §199A provided for a 20 percent deduction on gross sales to an agricultural cooperative.

2. As amended, the incentive provided to a farmer to sell to an agricultural cooperative as opposed to a private grain buyer was removed and a transition rule put in place.

    a. The transition rule specifies that a farmer's calculation of their QBID for 2018 does not include grain sold to a cooperative if the cooperative accounted for those sales when calculating its domestic production activities deduction (DPAD) under former I.R.C. §119 on its 2018 return.

    b. The transition rule will have an impact on many patrons

    c. Patrons that receive qualified payments from cooperatives with fiscal years that begin in 2017 and end in 2018 are subject to the transition rule.

        i. For these patrons, a DPAD can be claimed (under the former rules) if the cooperative passed through the DPAD.

        ii. Such payments cannot be considered in the calculation of the patron's 2018 QBID.

        iii. The Joint Committee on taxation confirms this tax treatment in its *Bluebook* of December 2018.

        iv. A cooperative must report to the patron the amount of qualified payments made to the patron in 2018 that were included in the cooperative's DPAD computation from January 1, 2018 to the last day of the cooperative's fiscal year ending in 2018.

    d. As in the non-cooperative setting, a patron of a cooperative cannot be a C corporation and benefit from the QBID.

    e. The transition rule has no application to grain sales to non-cooperatives.

    f. The transition rule only affects 2018 farm income tax returns. The timing of grain sales to a cooperative will not impact the QBID calculation for 2019 and beyond.

    g. A farmer cannot use any of the sales to a cooperative between January 1, 2018 and the cooperative's 2018 year-end in calculating the QBID (e.g., new DPAD). It is immaterial if the farmer is over or under the income threshold. Net income related to such payments will not be QBI and also will not qualify for the DPAD (old). The only deduction that the farmer may qualify for is the old DPAD that the cooperative passes through (if any). But, this DPAD may have already been passed out by the cooperative in late 2017 resulting in no deduction in 2018.

    h. A farmer must reduce their QBID (e.g., new DPAD) by the lesser of: (1) 9 percent of QBI related to cooperative payments; or (2) 50 percent of wages allocated to cooperative net income.

    i. A farmer can deduct the DPAD (old or new) that is passed through from the cooperative (limited to 100 percent of taxable income including capital gains).

    j. For calendar year 2018, a patron may receive two written notices: (1) a notice of the DPAD reported on Form 8903 and which is deducted above-the-line; and (2) a notice of the new DPAD which is part of the new QBID and is reported on the special I.R.C. §199A worksheet. The DPAD shows up on line 23 and flows through to Schedule 1 on line 36

(total adjustments line). The QBID (if any) will show up as part of the QBID (I.R.C. §199A worksheet).

k. Form 1099-PATR that indicates patronage dividends, per-unit retains, DPAD, etc., does not break down the allocation between the old and new DPAD.

l. The preparation of a patron's return requires a copy of each written notice of DPAD allocation to determine the old/new DPAD; a copy of Form 1099-PATR; and a breakdown of the sales and patronage received from the cooperative from January 1, 2018 until the cooperative's year-end.

m. For patrons subject to the transition rule, for the post-fiscal year QBID computation involves a computation 2018 expenses will need to be computed and allocated. In other words, the patron places income into three "buckets" (pre-fiscal yearend 2018 of the cooperative; post-fiscal yearend of the cooperative; and all others). No specific allocation of expense is necessary.

3. A cooperative passing through a portion of their deduction to the patron could raise the patron's QBID above 20 percent.

4. A cooperative could issue non-qualified equity providing a tax benefit to the patron that would be redeemed to the patron at a later date.

5. Cash patronage paid to a patron is part of the QBID calculation.

6. Agricultural and horticultural cooperatives are allowed a deduction equal to 9% of the lesser of the cooperative's QPAI for the year or taxable income (determined without regard to patronage dividends, per-unit retain allocations, and non-patronage distributions).

   a. The deduction, however, cannot exceed 50% of the cooperative's W-2 wages for the year that are subject to payroll taxes and are allocable to domestic production gross receipts.

   b. The cooperative may choose to either claim the deduction or allocate the amount to patrons (including other specified agricultural or horticultural cooperatives or taxpayers other than C corporations).

7. An eligible patron of an agricultural or horticultural cooperative that receives a qualified payment from the cooperative can claim a deduction in the tax year of receipt in an amount equal to the portion of the cooperative's deduction for QPAI that includes the following:

   a. Allowed with respect to the portion of the QPAI to which such payment is attributable.

   b. Identified by the cooperative in a written notice mailed to the patron during the payment period described in IRC §1382(d).

8. A qualified payment to a patron is any amount that meets the following three tests:

   a. The payment must be either a patronage dividend or a per-unit retain allocation.

   b. The payment must be received by an eligible patron from a qualified agricultural or horticultural cooperative.

c. The payment must be attributable to QPAI with respect to which a deduction is allowed to the cooperative.

9. The cooperative's deduction is allocated among its patrons on the basis of the quantity or value of business done with or for the patron by the cooperative.

10. A patron computes the patron's share of net profit based on the percentage of sales to the cooperative.

11. Under IRC §199A(g), a cooperative cannot reduce its income under IRC §1382 for any deduction allowable to its patrons. Thus, the cooperative must reduce its deductions that are allowed for certain payments to its patrons in an amount equal to the §199A(g) deduction allocated to its patrons.

12. A patron is allowed a deduction for amounts allocated without regard to wages expense. The only limitation at the patron level is taxable income.

13. A patron of an agricultural or horticultural cooperative that receives a QBID from the cooperative is not subject to the 20% of tentative taxable income limit. Instead, the patron's QBID is limited to taxable income. In addition, a patron who receives a QBID from a cooperative may offset any character of income, including capital gain.

14. The patron's deduction may not exceed the patron's taxable income for the tax year (determined without regard to the deduction but after accounting for the patron's other deductions under IRC §199A(a)). However, for any qualified trade or business of a patron, the initial QBID is reduced by the lesser of: (1) 9% of the QBI allocable to patronage dividends and per-unit retains received by the patron, or (2) 50% of the W-2 wages (subject to payroll tax) with respect to the business.

15. For a farmer who reports income and expenses on Schedule F, is a patron of an agricultural cooperative, and pays no qualified wages, there are two steps to calculate the tax benefits.

    a. The cooperative's final QBID that is passed through to the patron can be applied to offset the patron's taxable income regardless of source.

    b. The farmer/patron is entitled to an initial QBID equal to 20% of net farm income, subject to the wage limit that applies to taxpayers with income over the threshold amount ($315,000 for MFJ taxpayers and $157,500 for all others).

16. For farmers who pay qualified W-2 wages and sell to agricultural cooperatives that also pay W-2 wages, their initial QBID is reduced by subtracting the lesser of 50% of W-2 wages or 9% of QBI attributable to the income from the cooperative. Thus, for a farmer with farm income beneath the threshold amount ($315,000 for MFJ taxpayers and $157,500 for all others), the QBID will never be less than 11% (i.e., 20% less 9%).

17. If the farmer is above the income threshold amount, the W-2 wages/QP limit is applied before the 9% limitation. The farmer's QBID cannot exceed 20% of taxable income. To this amount is added any pass-through deduction from the cooperative to produce the total deductible amount.

18. For farmers who sell agricultural products to non-cooperatives and pay W-2 wages, a deduction of 20% of net farm income is available. If taxable income is less than net farm income, the

deduction is 20% of taxable income less capital gains. If taxable income before the QBID exceeds the income threshold amount, the deduction may be reduced on a phased-in basis.

19. Whether a taxpayer receives an advantage from selling agricultural products to a cooperative depends on various factors.

    a. In general, a farmer with farm income over the applicable income threshold for their filing status obtains a larger QBID by paying qualified wages if the farmer does not have enough QP to generate the full QBID allowed.

    b. Conversely, a farmer that is below the applicable income threshold derives a larger QBID by not paying qualified wages, or by paying qualified wages in an amount such that half of the wages paid is less than 9% of the farmer's Schedule F income that is attributable to the cooperative.

PART TWO – ESTATE AND BUSINESS PLANNING UPDATE

NOTE: The following are selected blog posts from my *Agricultural Law and Taxation* blog that is part of the *Law Professor Blog Network*. The following are selected posts over the past year that touch on farm/ranch estate and business planning. The blog is accessible via my website: www.washburnlaw.edu/waltr. From the homepage, scroll down the left side until finding the link for the blog. There is also a procedure noted there to receive an email notification when a new blog post is available.

Monday, March 25, 2019

Sale of the Personal Residence After Death

Overview

Upon death, particularly the death of the surviving spouse, the estate executor may need to dispose of the decedent's personal residence. When that happens, numerous tax considerations come into play. There are also some planning aspects to handling the personal residence.

The sale of the personal residence after death – that's the topic of today's post.

Income Tax Basis Issues

Upon death, the executor may face the need to dispose of the decedent's personal residence. The starting point to determining any tax consequences of the disposition involves a determination of income tax basis. If the residence was included in the decedent's gross estate, the tax basis will be determined in accordance with fair market value as of the date of the decedent's death under the willing buyer-willing seller test. *I.R.C. §1014.* That is based largely on sales of comparable properties, and requires more than a simple market analysis by a real estate agent.

If the decedent was the first of the two spouses to die, a determination of how the residence was titled at death will need to be made. For a residence held in joint tenancy or tenancy in common, only the value of the decedent's share of the residence will be included in the decedent's estate and receive a basis step-up to fair market value. *Id.* In common-law property states where the residence is owned in joint tenancy between the spouses, the property is treated at the first death as belonging 50 percent to each spouse for federal estate tax purposes. *I.R.C. § 2040(b).* This is known as the "fractional share" rule. Thus, one-half of the value is taxed at the death of the first spouse to die and one-half receives a new income tax basis. However, in 1992 the Sixth Circuit Court of Appeals applied the "consideration furnished rule" to a husband-wife joint tenancy involving farmland. *Gallenstein v. United States, 975 F.2d 286 (6th Cir. 1992).* The result was that the entire value of the land acquired before 1977 was included in the estate of the first spouse to die. That meant that the full value was subject to federal estate tax, but was covered by the 100 percent federal estate tax marital deduction. The entire property received a new income tax basis which was the objective of the surviving spouse. Other federal courts have reached the same conclusion.

If the residence is community property, the decedent's entire interest will receive a basis step-up to fair market value. If the residence is held in joint tenancy with rights of survivorship, the decedent's interest passed by the survivorship designation to the designated survivor.

Loss Potential

If a surviving spouse sells the marital home shortly after the first spouse's death, the survivor will often realize a loss largely due to the expenses incurred with respect to the sale. If the survivor realizes a gain, then, the survivor is eligible for the $250,000 exclusion of gain. *I.R.C. §121.* That exclusion is a maximum of $500,000 if the sale occurs within two years of the first spouse's death.

Residence Held in Trust

A revocable trust is a common estate planning tool. If the decedent's personal residence was held in a revocable trust and passed to the surviving spouse upon the first spouse's death under the terms of the trust to continue to be held in trust, the house receives a full step-up (or down) in basis to the current fair market value at the death of the surviving spouse. If the house is distributed outright to a beneficiary (or beneficiaries) and then the beneficiary immediately sells the home, a loss generally will be a nondeductible personal loss unless the home is first converted to a rental property before it is sold. This is a key point that may require some planning to allow for rental use for a period of time before sale.

If the residence must be sold by the estate or trust to pay debts or to satisfy cash distributions to beneficiaries, any loss on the sale might be deductible. That loss could potentially offset other income of the trust or estate, or it could flow through to the beneficiaries. However, the IRS position is that an estate or a trust cannot claim such a loss unless the residence is a rental property or is converted to a rental property before it is sold. This position has not been widely supported by the courts which have determined that a trust or estate can claim such a loss if no beneficiaries use the home as a residence after the decedent's death and before it is sold. It is important to get good tax counsel on this issue. It's an issue that comes up not infrequently.

Conclusion

The sale of the personal residence after death presents numerous tax issues. With a modest level of planning, negative tax consequences can be avoided and helpful tax provisions can be taken advantage of.

Friday, March 15, 2019

Can The IRS Collect Unpaid Estate Tax From The Beneficiaries?

Overview

If the federal estate tax isn't paid when due nine months after the date of the decedent's death, is a person that receives property from the decedent's estate personally liable for the unpaid tax? Does it matter *how* the person received the property - either by gift, as a surviving joint tenant or as a beneficiary of the estate? How long does the IRS have to collect the tax? These are all important questions, especially with respect to a farmer's estate where present economic and financial conditions may have dissipated estate property such that the estate no longer has assets and funds with which to pay the tax, or where the assets have already been distributed.

The personal liability of estate beneficiaries for federal estate tax – that's the topic of today's post.

Establishing Liability

With the present level of the exemption from federal estate tax pegged at $11.4 million for deaths in 2019, it's very unlikely that any particular estate will have to worry about federal estate tax. But, this enhanced level of exemption (it was, in essence, doubled by the late 2017 tax legislation) is set to expire at the end of 2025 and go back to the pre-2018 level of $5 million (adjusted for inflation). Also, it is possible that a change in the political winds come 2020, could reduce the exemption below $5 million. That would make it far more relevant again for many farm and ranch families.

When a decedent's estate has a federal estate tax liability, it is due nine-months after the date of death. *I.R.C. §6075(a)*. A six-month extension is available. But, if the tax is not paid when it is due, any transferee, surviving tenant or beneficiary of the estate is personally liable for the unpaid estate tax to the extent the property they received was included in the decedent's gross estate under I.R.C.

§2034 through I.R.C. §2042. *I.R.C. §6324(a)(2).* The IRS also has a special lien for any unpaid gift tax. *I.R.C. §6324(b).* These liens arise automatically – no assessment, notice or demand for payment or filing is required. The lien attaches to the gross estate and lasts for the earlier of ten years from the date of the decedent's death or until the tax is paid. *I.R.C. §6324(a).* The lien attaches to the extent of tax shown to be due by the return and of any deficiency in tax found to be due. *Treas. Reg. §301.6324-1(a)(1).*

The IRS must prove that an unpaid tax exists at the time of death and that a beneficiary received property that was included in the decedent's gross estate at death. I.R.C. §§ 2035-2042 list the various types of property and the rules governing how those types of property are included in the decedent's gross estate for estate tax purposes. Each beneficiary of estate property is personally liable for any unpaid estate tax based on the property they received from the estate and to the extent of the property's value at the time of the decedent's death. *I.R.C. 6324(a)(2). See also Baptiste v. Comr., 29 F.3d 433 (8th Cir. 1994), aff'g. in part and rev'g. in part 100 T.C. 52 (1993); Baptiste v. Comr., 29 F.3d 1533 (11th Cir. 1194), aff'g., 100 T.C. 252 (1993).*

Procedurally, the IRS is not required to follow the normal process for collecting a deficiency when it moves to assert the lien against a transferee of estate property. *See, e.g., United States v. Geniviva, 16 F.3d 522 (3rd Cir. 1994).* The special estate tax lien is also not subject to the filing and notice requirements of the general IRS lien of I.R.C. §6321. *I.R.C. §6323(a).* Thus, buyers, holders of security interests, other lien holders and judgment lien creditors may not be protected unless I.R.C. §6324 provides protection. *Rev. Rul. 69-23, 1969-1 CB 302.*

Some property is exempt from the IRS lien. Included in the exempt list is any part of the decedent's gross estate that is used to pay charges against the estate or pay administrative costs. *I.R.C. §6324(a)(1).* The lien also doesn't apply to any part of the decedent's property that is transferred to a bona fide buyer or holder of a security interest, except that the lien attaches to any consideration received. *I.R.C. §§6324(a)(2)-(3).* Also, any property that is released via certificate is exempt. *I.R.C. §6325; Treas. Reg. §301.6324-1(a)(2)(iv).*

Recent Case

The issue of liability of estate beneficiaries for unpaid estate tax came up in a recent case from South Dakota. In *United States v. Ringling, No. 4:17-cv-04006-KES, 2019 U.S. Dist. LEXIS 28146 (D. S.D. Feb. 21, 2019), the* defendants were the daughters and one grandson of the decedent. The decedent died in late 1999 leaving his estate equally to his daughters and providing a specific bequest of farmland to one of the daughters as part of her co-equal share of the estate. The will named the daughters as co-personal representatives of his estate. The estate included farmland and crops among other assets. In 1999, the federal estate tax exemption equivalent of the unified credit was $650,000 and the top rate was 55 percent.

In 1996, the decedent entered into an agreement with his grandson to buy additional farmland. Under that agreement, the decedent bought the land and the grandson was to pay the decedent $32,000 via an installment contract. Ten days before his death in 1999, the decedent forgave the remaining balance due on the contract of $27,600.96. Also, in 1996 the decedent conveyed a warranty deed to his grandson for the family farm along with irrigation equipment and permits, retaining a life estate and the right to receive the rent income and profits from the farm during his life. After death, the farm was appraised at $345,700. Six days before death, the decedent and his grandson entered into a contract for deed of additional farmland. This contract called for the grandson to pay $90,000 to the decedent, with $10,000 to be paid before or at the time of deed execution and the balance to be paid in 20 equal installments. The grandson would not take possession until March 1, 2000. At the time of the decedent's death in late 1999, the unpaid balance on the contract was $80,093.30.

In early 2008, the estate filed Form 706 reporting a gross estate of $834,336 and a net estate tax due of $28,939. No payment accompanied the filing. On Form 706, the estate reported assets as three pieces of farmland; co-op shares; stocks; bonds; two contracts for deed; cash; bank accounts; certificates of deposit (CDs); two life insurance policies; a corn crop that had been gifted to the

grandson; the decedent's pickup truck; a van; and other miscellaneous property. The Form 706 reported that each of the daughters received $121,988 and that the grandson received $416,116. Later in 2008, the IRS agreed that the estate tax was $28,939, but that a late filing penalty of $6,511.27 and a failure to pay penalty of $7,234.75 should be added on. In addition, the IRS assessed interest of $23,189.78. The total amount the IRS asserted due was $65,874.80. In 2010, the estate requested an abatement of the penalties and interest. The IRS denied the request. In 2013, the IRS sent the defendants Form 10492 Notice of Federal Taxes Due with respect to the estate. Later in 2013, the IRS filed a Notice of Federal Tax Lien on the farmland. The Notice was also sent to the estate. A hearing was not requested. Beginning in 2010, the defendants had made some payments on the estate tax liability, but as of mid-2018 over $63,000 remained due. The IRS then sued seeking payment from the daughters and the grandson personally via I.R.C. §6324(a)(2) and sought summary judgment. Only one daughter filed a response in opposition to summary judgment.

The court noted that each of the daughters and the grandson jointly owned property with the decedent at the time of his death. The jointly owned property also included a checking account on which one of the daughters continued to write checks after the decedent's death. Under I.R.C. §2040, the court noted, the decedent's gross estate included all property that he and any other person held as joint tenants with rights of survivorship. The two life insurance policies were included in the estate by virtue of I.R.C. §2042. Various gifts were also included in the gross estate under I.R.C. §2035. These included the decedent's transfer of the corn crop and CDs to the grandson, as well as the forgiveness of the balance due on the contract for deed. These were all included in the estate because they had been transferred within three years of death. Also included in the decedent's gross estate was the decedent's retained life estate in the family farm that he had transferred to his grandson. The retained life estate caused the farm to be included in the gross estate and made it subject to the special estate tax lien as I.R.C. §6324(a)(2) property.

The court held that the defendants were personally liable for the unpaid federal estate tax as transferees of estate property and that they did not receive the property free and clear of estate tax liabilities. The court noted that transferee liability is not limited to those receiving a gift or bequest under a decedent's will or via the administration of a revocable trust. Rather, liability extends to recipients of *all property included in the gross estate* including transferees who received lifetime gifts that are included in the gross estate under I.R.C. §2035 because they were made within three years of death; gift recipients whose gift was a discharge of indebtedness to the decedent; transferees who receive the property as surviving join tenants; property passing to remaindermen when the decedent had a life tenancy in the property; and life insurance proceeds on the life of the decedent.

The one daughter that filed a response to the IRS summary judgment motion asserted that the government was barred by the statute of limitations. After all, she noted, the decedent died in 1999 and the IRS didn't file suit to collect the tax until early 2017. However, under I.R.C. §6324(a)(2), personal liability for unpaid estate tax can be asserted by the IRS ten years from the date the assessment is made against the estate. *I.R.C. §6502(a)(1). See also United States v. Botefuhr, 309 F.3d 1263 (10th Cir. 2002).* The assessment was made in 2008 (remember the estate didn't file Form 706 until 2008) and the IRS sued in 2017, nine years into the 10-year timeframe for doing so and 18 years after the decedent's death. The daughter challenging the government's motion didn't dispute these facts. Now, the court's decision finding the daughters and grandson personally liable for the unpaid estate tax comes just over 19 years after the decedent's death.

Conclusion

The clear lesson of the case is that federal estate tax liability just doesn't go away if the estate doesn't pay it. In addition, the IRS has a lengthy timeframe to collect the tax. Proper pre-death planning can, of course, help to either minimize or eliminate the tax. Also, if the exemption from federal estate tax were to drop in the future, more farms, ranches and small businesses would get caught in its snare. That was certainly the result for the South Dakota farming operation in the recent case.

Monday, February 25, 2019

Estate Planning in Second Marriage Situations

Overview

A married couple's estate planning goals and objectives often dovetail - benefit the surviving spouse for life with the remaining property at the death of the surviving spouse passing to the children. But, estate planning when a second marriage (either as a result of death or divorce) is involved is more complex, especially when each spouse has children from the prior marriage. The estate planning techniques of first marriage situations often don't work when a second marriage is involved. But, the IRS recently blessed a second marriage estate planning technique.

Estate planning for second marriages – that's the topic of today's post.

Second Marriage Estate Plans

Potential problem areas. Blended families are not uncommon. When I first started practicing law, I was tasked with developing an estate plan for an older married couple. Each one of them had outlived their prior spouse and each of them had children from that prior marriage. They each had a separate farming/ranching operation. It was imperative to them that their respective children carry on the farming/ranching business that was associated with each of them. In this situation, the common estate plan for a married couple wouldn't work. It was no longer appropriate to balance ownership of all assets equally between the couple and then via reciprocal (i.e., mirror) wills leave a portion of the assets to the surviving spouse outright with the balance in a "credit-shelter" trust and the remainder at the death of the surviving spouse split between all of the kids (from both prior marriages). This standard approach could have resulted in children of one family eventually owning the other family's farming/ranching operation. That would not have been a good result.

It's also common in first marriages for the spouses to own the home and land as joint tenants with right of survivorship. Upon the death of the first spouse, the jointly held asset automatically passes to the surviving spouse. While that results in the surviving spouse having complete ownership of the asset, that is often not a desirable outcome in a second marriage situation. The survivor could leave the asset at death to their children of the first marriage.

Beneficiary designations can also lead to a similar problem as jointly held property. The spouse is often named as the beneficiary of life insurance, retirement plans/accounts, etc. But, this can become a problem upon death and the subsequent remarriage of the surviving spouse.

Potential solution. One approach that is used in second (and subsequent) situations involves a revocable trust that is funded either during the grantor's life or at death or via beneficiary designations (or some combination). The grantor can amend or revoke the trust at any time before death, and on death the trust becomes irrevocable and continues for the surviving spouse's benefit and the benefit of the children of the first marriage. The trust income can be paid to the surviving spouse during life and the trust assets remaining at the surviving spouse's life pass to the grantor's children of the first marriage. A "spendthrift" provision can be added to the trust to provide additional assurance that the assets ultimately land in the correct hands, and are not dissipated by creditors, etc. In addition, the trust allows the grantor to maintain post-death control over the assets of the family from the first marriage. The assets are not left outright to the surviving spouse of the second marriage, and the surviving spouse cannot change the estate plan to exclusively benefit the survivor's own children, for example.

Handling Retirement Plans

In second marriage situations, can an individual retirement account (IRA) also be placed in a trust so that account income benefits the surviving spouse of the second marriage for life with the account balance passing to the children of the pre-deceased spouse's first marriage? The tax code complicates matters, but a recent IRS private letter ruling shows how it can be accomplished.

In general, annual required minimum distributions must be taken from traditional IRAs at the required beginning date (RBD) – April 1 of the year after the year in which the account owner turns 70 ½. *I.R.C. §401(a)(9)(C)(i)(I)*. Special rules apply when the IRA owner dies after the RBD. In that case, any balance remaining in the account is distributed in accordance with certain rules. For example, if the account owner didn't designate a beneficiary, the post-death payout period is determined by what the deceased owner's life expectancy was at the time of death. *Treas. Reg. §1.401(a)(9)-(5).* If the IRA owner named a non-spouse as the beneficiary, the account balance is paid out over the longer of the remining life expectancy of the designated beneficiary or the remaining life expectancy of the IRA owner. *Id.*

If the IRA owner designated the spouse as the IRA's sole designated beneficiary, the required distribution for each year after death is determined by the longer of the remining life expectancy of the surviving spouse or the remaining life expectancy of the deceased spouse based on their age at the time of death. *Id.* This can allow payouts to be "stretched." But, naming the surviving spouse as the beneficiary of an IRA also gives the surviving spouse the ability to treat the IRA as their own. That means that the surviving spouse can name their own beneficiaries – not necessarily a good result in second marriage situations where each spouse has children of a prior marriage.

Trust as a beneficiary. Can a trust be named the beneficiary of the retirement plan so that the surviving spouse doesn't have complete control over the account funds? In general, the answer is "no." *Treas. Reg. §1.401(a)(9)-4, Q&A 3.* However, a trust beneficiary (with respect to the trust's interests in the IRA owner's benefits) is treated as the designated beneficiary of an IRA if certain conditions are satisfied for the period during which the RMDs are being determined by treating the trust beneficiary as the designated beneficiary of the IRA owner. See *Treas. Reg. §1.401(a)(9)-4, Q&A 5(b).*

Recent IRS ruling. In *Priv. Ltr. Rul. 201902023 (Oct. 15, 2018),* the decedent created a revocable living trust during life. The trust contained a subtrust to hold the benefits and distributions from his retirement plans (and other assets). He died after attaining his RBD and after distributions from his IRA had started. The revocable trust and the subtrust became irrevocable upon his death. His IRA named the trust as the beneficiary. The terms of the trust specified that property held by the subtrust were to be "held, administered, and distributed" for the sole benefit of his (younger) surviving spouse. Upon her death, the trust specified that the retirement plan (along with the remaining assets of the subtrust) were to be divided equally between *his* children or their descendants.

The IRS noted that the trust identified the surviving spouse as the sole beneficiary of the subtrust in accordance with Treas. Reg. §1.401(a)(9)-4, Q&A 5(b)(3). In addition, the trust required the trustee to pay the surviving spouse any and all funds in the subtrust that the trustee withdrew, including RMDs, and there could be no accumulation for any other beneficiary. That satisfied the requirements of Treas. Reg. §1.401(a)(9)-4, Q&A-5 (valid trust under state law; trust is irrevocable or becomes so on death of account owner; the trust identifies the beneficiary; and the plan administrator is given appropriate documentation) and the surviving spouse was treated as the sole designated beneficiary of the IRA. Thus, the IRS concluded that the payment to the two trusts (first to the revocable trust and then to the subtrust) was permitted by Treas. Reg. §1.401(a)(9)-4. Q&A-5(d) which says that if the trust beneficiary is named as the beneficiary of the account owner's interest in another trust, that beneficiary will be treated as having been designated as the beneficiary of the first trust and, be deemed to be the IRA account owner for distribution purposes.

In addition, the IRS determined that because the surviving spouse had a longer life expectancy that did the decedent, the applicable distribution period for the IRA should be based on her life expectancy. This means that via the trust and the subtrust, the surviving spouse received RMDs as if she were the designated sole beneficiary. Upon her death, any remaining assets of the subtrust will be distributed to the pre-deceased spouse's children or their descendants.

Conclusion

Unique estate and business planning issues present themselves in second marriage situations. Along with a well-drafted marital agreement, other steps should be taken to ensure the continued viability of separate farming/ranching operations that are brought into the subsequent marriage while simultaneously benefiting each spouse's children of the prior marriages appropriately at the death of their respective parent. Included in this planning is the treatment of retirement accounts. The recent IRS ruling illustrates one way to leave an IRA to the spouse of a second marriage and avoid negative consequences.

Tuesday, February 5, 2019

Can a State Tax a Trust With No Contact With the State?

Overview

Last summer, the U.S. Supreme Court decided *South Dakota v. Wayfair, 138 S. Ct. 2080 (2018)*, where the court upheld South Dakota's ability to collect taxes from online sales by sellers with no physical presence in the state. That decision was the latest development in the Court's 50 years of precedent on the issue, and I wrote on the issue here: https://lawprofessors.typepad.com/agriculturallaw/2018/06/state-taxation-of-online-sales.html

Does the Supreme Court's opinion mean that a state can tax trust income that a beneficiary receives where the only contact with the state is that the beneficiary lives there? It's an issue that is presently before the U.S. Supreme Court. It's also the topic of today's post – the ability of a state to tax trust income when the trust itself has no contact with the taxing state.

The "Nexus" Requirement

Article I, Section 8 of the U.S. Constitution says that, "The Congress shall have the power...to regulate commerce…among the several states…". That is a rather clear statement – the Commerce Clause grants "exclusive authority [to] Congress to regulate trade between the States." As I pointed out in the blog post on the *Wayfair* decision last summer, a state tax will be upheld when applied to an activity that meets several requirements: the activity must have a substantial nexus with the state; must be fairly apportioned; must not discriminate against interstate commerce, and; must be fairly related to the services that the state provided. Later, the U.S. Supreme Court said that a physical presence was what satisfied the substantial nexus requirement.

The physical presence requirement to establish nexus was at issue in *Wayfair* and the Court determined that a "substantial nexus" could be present without the party subjected to tax having a physical presence in the taxing jurisdiction. But, the key point is that the "substantial nexus" must be present. Likewise, the other three requirements of prior U.S. Supreme Court precedent remain – the tax must be fairly apportioned; it must not discriminate against interstate commerce, and; it must be fairly related to services that the state provides. In other words, taxing a business without a physical presence in the state cannot unduly burden interstate commerce. The *Wayfair* majority determined that the South Dakota law satisfied these tests because of the way it was structured – limited application (based on transactions or dollars of sales); not retroactive; the state was a member of the Streamlined Sales and Use Tax Agreement; the sellers at issue were national businesses with a large online presence; and South Dakota provided tax software to ease the administrative burden.

Taxing an Out-Of-State Trust?

The U.S. Supreme Court has now decided to hear a case from North Carolina involving that state's attempt to tax a trust that has no nexus with the state other than the fact that a trust beneficiary is domiciled there. *Kimberley Rice Kaestner Trust 1992 Family Trust v. North Carolina Department of Revenue, 789 S.E.2d 645 (N.C. Ct. App. 2016)*, *aff'd.*, *814 S.E.2d 43 (N.C. 2018)*, *pet. for cert. granted,*

No. 18-457, 2019 U.S. LEXIS 574 (U.S. Sup. Ct. Jan. 11, 2019). The trust at issue, a revocable living trust, was created in 1992 with a situs of New York. The primary beneficiaries were the settlor's descendants. None of the descendants lived in North Carolina at the time of the trust's creation. The trust was divided into three separate trusts in 2002, one for each of the settlor's children. The beneficiary of one of the sub-trusts was a North Carolina resident at that time. The trustee was replaced in 2005 with a successor trustee who resided in Connecticut. North Carolina tax returns were filed for tax years 2005-2008 for the accumulated trust income, that was distributed to the beneficiaries, including the non-North Carolina beneficiaries. In 2009, the trust filed a claim for a refund of North Carolina taxes in an amount slightly exceeding $1.3 million. The trust claimed that N.C. Gen. Stat. §105-160.2, which assesses tax on the amount of taxable income of the estate or trust that is for the benefit of a North Carolina resident, was unconstitutional on due process and Commerce Clause grounds. The defendant denied the claim, and the hearing officer later dismissed the case for lack of jurisdiction.

The trial court dismissed the request for injunctive relief with respect to the refund claim, but denied the defendant's motion to dismiss the constitutional claims. The trial court then granted summary judgment for the trust on the constitutional claim and ordered the defendant to refund the taxes paid on its accumulated income.

On appeal, the appellate court affirmed. The appellate court determined that the trust failed to have sufficient minimum contacts (as required by the Due Process Clause) with North Carolina to subject the trust to North Carolina income tax. The court cited both *International Shoe Co. v. Washington, 326 U.S. 310 (1945)* and *Quill Corp. v. North Dakota, 504 U.S. 298 (1992)* to support its position on this point. The trust did not have any physical presence in the state during the tax years at issue, contained no North Carolina property or investments, had no trust records that were created or kept in North Carolina, and the place of trust administration was not in North Carolina. Basing the imposition of state tax on a beneficiary's domicile, by itself, did not establish sufficient minimum contacts with the state to satisfy the Due Process Clause and allow North Carolina to tax a non-North Carolina trust. The appellate court held that *Brooke v. Norfolk, 277 U.S. 27 (1928)* was controlling. In that case, a Maryland resident created a testamentary trust with a Maryland situs for a Virginia beneficiary. Virginia assessed tax on the trust corpus, but the Court held the assessment to be unconstitutional.

On further review, the state Supreme Court affirmed, also noting that a key to the case was that the trust beneficiary did not receive trust distributions during the years at issue. As such, the North Carolina statute violated the Due Process Clause of the U.S. Constitution.

The North Carolina Supreme Court's decision was delivered 13 days before the U.S. Supreme *Wayfair* decision, and was based on the controlling U.S. Supreme Court decision at that time – *Quill*. Consequently, the North Carolina Department of Revenue, based on *Wayfair,* sought U.S. Supreme Court review. On January 11, 2019, the U.S. Supreme Court agreed to hear the case.

Conclusion

State taxation of trusts varies greatly from state to state in those states that have a state income tax. A trust's situs in a state certainly permits that state to subject the trust to the state's income tax as a resident. But, a trust may be tied to a state in other ways via a grantor, trustee, assets, or a beneficiary. In addition, whether a trust is a revocable or irrevocable trust can make a difference. For instance, the Illinois definition of "resident" includes "an irrevocable trust the grantor of which was domiciled in this State at the time such trust became irrevocable." *35 ILCS/1501(A)(20)(D); see also, Linn v. Department of Revenue, 2 N.E.3d 1203 (Ill. Ct. App. 2013).* Indeed, a trust may have multiples states asserting tax on the trust's income.

However, due process requires that before a state can tax a trust's income, the trust must have a substantial enough connection (e.g., nexus) with the state. How the U.S. Supreme Court decides the North Carolina case in light of its *Wayfair* decision will be interesting. It's a similar issue but, income tax is involved rather than sales or use tax. In my post last summer (noted above) I discussed why that difference could be a key distinction. In addition, while a trust could be subject to state income

tax based on its residency, the trust has grantors and trustees and beneficiaries and assets that can all be located in different states – and can move from state-to-state (at least to a degree).

The U.S. Supreme Court decision will have implications for trust planning as well as estate and business planning. Siting a trust in a state without an income tax (and no rule against perpetuities) is looking better each day.

Friday, February 1, 2019

Time to Review of Estate Planning Documents?

Overview

The laws surrounding estate planning have changed significantly in recent years and have done so multiple times. That means that it might be a good idea to review wills, trusts and associated estate planning documents to make sure they still will function as intended at the time of death.

But, just exactly what should be looked for that might need to be modified? One item is clause language in a will or trust that is now outdated because of the current federal estate tax exemption that is presently much higher than it has been in prior years.

That's the topic of today's post – the need to review and modifying (when necessary) clause language in a will or trust that no longer will work as anticipated because of the increase in the federal estate tax exemption.

Common Will and Trust Language

Wills and trusts that haven't been examined in the last five to seven years should be reviewed to determine if pecuniary bequests, percentage allocations and formula clauses will operate as desired upon death. For example, if will or trust language refers to the "Code" and/or uses Code definitions for transfer tax purposes, or otherwise refers to the Code to carry out bequests, that language may now produce a result that no longer is consistent with the testator's intent.

Common language used in wills and trust to split out shares to a surviving spouse in "marital deduction" and "credit shelter" amounts often refers to the "Code." In other words, the split of the shares is tied to the amount of the federal estate tax exemption at the time of the testator's death. This results in an automatic adjustment of the marital deduction portion of the first spouse's estate (as well as the credit shelter amount) in accordance with the value of the federal estate tax exemption at the time of the decedent's death.

Why is such language an issue? For starters, it could result in nothing being left outright to a surviving spouse. For example, a clause that leaves a surviving spouse "the minimum amount needed to reduce the federal estate tax to zero" with the balance passing to the spouse in life estate form could result in nothing passing outright to the surviving spouse in marital deduction form. That would be the case, for example, with respect to an estate that is not large enough to incur federal estate tax. Presently, the threshold for estate taxability at the federal level is a taxable estate of $11.4 million which means that very few estates will be large enough to incur federal estate tax. For nontaxable estates, the formula language that was designed to minimize estate tax by splitting the bequests to the surviving spouse between marital property and life estate property no longer works - surviving spouse would receive nothing outright.

On the other hand, a beneficiary of an estate that is not subject to federal estate tax would receive everything under a provision that provides that the beneficiary receives "the maximum amount that can pass free of federal estate tax."

Formula clause language. As can be surmised from above, a common estate planning approach for a married couple facing the possibility of at least some estate tax upon either the death of the first

spouse or the surviving spouse has been for the estate of the first spouse to be split into a marital trust and a credit shelter (bypass) trust. To implement this estate planning technique, the couple's property is typically re-titled, if necessary, to roughly balance the estates (in terms of value) so that the order of death of the spouses becomes immaterial from a federal estate tax standpoint. This necessarily requires the severance of joint tenancy property. Estate "balancing" between the spouses is critical where combined spousal wealth is between one and two times the amount of the federal estate tax exemption. For many years that range was between $600,000 and $1.2 million. Then the ranged ratcheted upward to between $3 million and $6 million. It then moved upward again to a range of $5 million to $10 million. Now it is a range of $11.4 million to $22.8 million.

What formula clause language does is cause the trusts to be split in accordance with a formula that funds the credit shelter trust with the deceased spouse's unused exemption, and funds the marital trust with the balance of the estate. As indicated above, the increase in the exemption can cause, a complete "defunding" of the surviving spouse's marital trust and an "over stuffing" of the credit shelter trust. That may not be what the decedent had planned to occur. For instance, here's a sample of language to be on the lookout for:

"To my Trustee…that fraction of my residuary estate of which the numerator shall be a sum equal to the largest amount, after taking into account all allowable credits and all property passing in a manner resulting in a reduction of the Federal Estate Tax Unified Credit available to my estate, that can pass free of Federal Estate Tax and the denominator of which shall be the total value of my residuary estate

For the purpose of establishing such fraction the values finally fixed in the Federal Estate Tax proceeding in my estate shall control.

The residue of my estate after the satisfaction of the above devise, I devise to my spouse; provided that, any property otherwise passing under this subparagraph which shall be effectively disclaimed or renounced by my spouse under the provisions of the governing state law or the Internal Revenue Code shall pass under the provisions of paragraph…".

To reiterate, while the above language typically worked well with federal estate tax exemption levels much lower than the current $11.4 million amount, the language can now result in an "over-stuffed" credit shelter trust (and related de-funding of the marital trust).

Consider the following example:

John and Mary, a married couple, had a combined spousal wealth of $3 million in 2001 at a time when the exclusion from the estate tax was $1 million. As part of the estate planning process, they re-titled their assets and balanced the value of the assets between them to eliminate problems associated with the order of their deaths. Assuming John dies first with a taxable estate of $1.5 million, the clause would result in $1 million passing to the bypass trust and $500,000 passing outright to Mary in the marital trust created by the residuary language. Upon Mary's subsequent death, her estate would consist of her separate $1.5 million (assuming asset values have not changed) and the $500,000 passing outright to her under the terms of John's will. With a $1 million exclusion, only $1 million would be subject to the federal estate tax.

With the present $11.4 million exclusion, the clause would result in John's entire estate passing to the bypass trust, and nothing passing outright to Mary as part of the marital trust. While the couple's estate value is not large enough to trigger an estate tax problem, it would be better to have some of the property that the clause caused to be included in the bypass trust be included in Mary's estate so that it could receive an income tax basis equal to the date of death value. With the present $11.4 million exclusion, all of John's property could be left outright to Mary and added to her separate property with the result that Mary's estate would still not be subject to federal estate tax. But, all of the property would be included in her estate at death and the heirs would receive an income tax basis equal to the fair market value at the time of Mary's death.

Charitable bequests. The same problem with formula clause language applies to many charitable bequests that are phrased in terms of a percentage of the "adjusted gross estate" or establish a floor or ceiling based on the extent of the "adjusted gross estate."

Conclusion

The standard advice has been to routinely revisit existing estate planning documents every couple of years. Not only does the law change, but family circumstances can change and goals and objectives can change. But, the rules surrounding estate planning have been modified several times in recent years which means that plan should be revisited even more frequently.

One final thought. The current rules sunset at the end of 2025 and then revert back to the rules in play in 2018. That means that the estate tax exemption would go back to $5 million plus inflation adjustments. So, just because federal estate tax might not be a problem for a particular estate, that doesn't mean that estate planning can be ignored. Reviewing wills and trusts for outdated language is important, but overall objectives should be reviewed and related documents such as financial and health care powers of attorney should be executed or modified as necessary.

The bottom line - there remain numerous reasons for seeing an estate planning attorney for a review of estate planning documents. Examining drafting language in older wills and trusts is just one of them.

Major Development from 2018

No "clawback." In a notice of proposed rulemaking, the U.S Treasury Department eliminated concerns about the imposition of an increase in federal estate tax for decedents dying in the future at a time when the unified credit applicable exclusion amount is lower than its present level and some (or all) of the higher exclusion amount had been previously used. The Treasury addressed four primary questions. On the question of whether pre-2018 gifts on which gift tax was paid will absorb some or all of the 2018-2025 increase in the applicable exclusion amount (and thereby decrease the amount of the credit available for offsetting gift taxes on 2018-2025 gifts), the Treasury indicated that it does not. As such, the Treasury indicated that no regulations were necessary to address the issue. Similarly, the Treasury said that pre-2018 gift taxes will not reduce the applicable exclusion amount for estates of decedents dying in years 2018-2025.

The Treasury also stated that federal gift tax on gifts made after 2025 will not be increased by inclusion in the tax computation a tax on gifts made between 2018 and 2015 that were sheltered from tax by the increased applicable exclusion amount under the TCJA. The Treasury concluded that this is the outcome under current law and needed no regulatory "fix." As for gifts that are made between 2018-2025 that are sheltered by the applicable exclusion amount, the Treasury said that those amounts will not be subject to federal estate tax in estates of decedents dying in 2026 and later if the applicable exclusion amount is lower than the level it was at when the gifts were made. To accomplish this result, the Treasury will amend Treas. Reg. §20.2010-1 to allow for a basic exclusion amount at death that can be applied against the hypothetical gift tax portion of the estate tax computation that is equal to the higher of the otherwise applicable basic exclusion amount and the basic exclusion amount applied against prior gifts.

The Treasury stated that it had the authority to draft regulations governing these questions based on I.R.C. §2001(g)(2). The Treasury, in the Notice, did not address the generation-skipping tax exemption and its temporary increase under the TCJA through 2025 and whether there would be any adverse consequences from a possible small exemption post-2025. Written and electronic comments must be received by February 21, 2019. A public hearing on the proposed regulations is scheduled for March 13, 2019. *IRS Notice of Proposed Rulemaking, REG-106706-18, 83 FR 59343 (Nov. 23, 2018).*

Monday, December 3, 2018

What Are The Tax Consequences On Sale Or Exchange of A Partnership Interest?

Overview

Partnerships are a common entity form for farming operations. This is particularly true when the farming operation participates in federal farm programs. A general partnership is the entity form for a farming operation that can result in the maximization of federal farm program payments. But, tax issues can get complex when a partner sells or exchanges a partnership interest. In addition, the 20 percent deduction for non-C corporate businesses may also come into play.

The tax issues surrounding the sale or exchange of a partnership interest – that's the topic of today's post.

General Rule

When a partner sells or exchange a partnership interest to anyone other than the partnership itself, the partner generally recognizes a capital gain or loss on the sale. *I.R.C. §741.* That's a good tax result for capital gain because of the favorable tax rates that apply to capital gain income, but not a good tax result if a loss is involved because of the limited ability to deduct capital losses (e.g., they offset capital gain plus $3,000 of other income for the year). When a partner sells his interest in the partnership to the partnership in liquidation of the partner's interest, the liquidating partner generally does not recognize gain (except to the extent money is received that exceeds the partner's basis in the partnership interest or the partner is relieved of indebtedness). The liquidating partner receives a basis in the distributed property equal to what his basis had been in the partnership interest.

Exception

The general rule that a partner's sale or exchange of his partnership interest triggers capital gain doesn't apply to the extent the gain realized on the transaction is attributable to "hot assets." "Hot assets" (as defined under I.R.C. §751) are unrealized receivables or inventory items of the partnership. In essence, "hot assets" are ordinary income producing assets that have not already been recognized as income, but eventually would have been recognized by the partnership and allocated to the partner in the ordinary course of partnership business and taxed at ordinary income rates. The partner's sale or exchange of their interest merely accelerates the recognition of the income (such as with depreciation recapture). Thus, the income on the transaction is recharacterized from capital to ordinary. *I.R.C. §751(a).* The rationale for the recharacterization is that if the partnership were to sell such "hot assets," ordinary income or loss would be recognized on the sale. Thus, when a partner sells or exchanges a partnership interest, the partner should recognize ordinary income on the portion of the income from the sale of the partnership interest that is attributable to the "hot assets." If this recharacterization rule didn't apply, a partner would be able to transform what would have been ordinary income into capital gain by selling or exchanging their partnership interest.

Similarly, when a partnership distributes property to a partner in exchange for the partner's interest in the "hot assets" of the partnership, the transaction may be treated as sale or exchange of the hot assets between the partner and the partnership that generates ordinary income. It is possible, and perhaps frequent, for a partner involved in farming to recognize ordinary income and a capital loss, even though the partner had an overall gain on the sale. The ordinary income is taxed immediately, but the capital loss is limited as described above.

Types of "Hot Assets"

Unrealized receivables. There are three categories of unrealized receivables: (1) goods; (2) services; and (3) recapture items. I.R.C §751(c) defines the term "unrealized receivables" as including, "to the extent not previously includible in income under the method of accounting used by the partnership,

any rights (contractual or otherwise) to payment for (1) goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or (2) services rendered, or to be rendered." In addition, the term "unrealized receivables" includes not only receivables, but also depreciation recapture. *See, e.g., Treas. Reg. §§1.751-1(c)(4)(iii) and (v).*

In the farming context, the "goods" terminology contained in the definition of "unrealized receivables" would include property used in the trade or business of farming that is subject to depreciation or amortization as defined by I.R.C. §1245. Included in the definition of I.R.C. §1245 property is personal property (I.R.C. §1245(a)(3)(A)) such as farm equipment and machinery. Also included in this definition are horses, cattle, hogs, sheep, goats, and mink and other furbearing animals, irrespective of the use to which they are put or the purpose for which they are held. *Treas. Reg §1.1245-3(a)(4).* The definition also includes certain real property that has an adjusted basis reflective of accelerated depreciation adjustments. *I.R.C. §1245(a)(3)(C).* That would include such assets as farm fences and farm field drainage tile. It also includes grain bins and silos by virtue of a definitional provision including a facility that is used for the bulk storage of fungible commodities. *I.R.C. §1245(a)(3)(B)(iii).* In addition, the definition includes single purpose agricultural or horticultural structures as defined in I.R.C. §168(i)(13). *I.R.C. §1245(a)(3)(D).*

The "goods" terminology also includes real property defined by I.R.C. §1250 that has been depreciated to the extent that accelerated depreciation incurred to the date of sale is in excess of straight-line depreciation. Farm property that falls in the category of I.R.C. §1250 property includes barns, storage sheds and work sheds. If these properties are sold after the end of their recovery period, there is no ordinary income. Also, included in this definition is farmland on which soil and water conservation expenses have been recaptured. *I.R.C. §751(c); IRC §1252(a).*

The "unrealized receivables" definition also includes rights (contractual or otherwise) to payment for goods delivered or to be delivered to the extent that the payment would be treated as received for property other than a capital asset, or services rendered or to be rendered to the extent that the income from such rights to payment was not previously included in income under the partnership's method of accounting. The rights must have arisen under contracts or agreements that were in existence at the time of the sale or distribution, although the partnership may not be able to enforce payment until a later time. *Treas. Reg. §1.751-1(c)(1).* Thus, in the ag realm, the definition includes the present value of ordinary income attributable to deferred payment contracts for grain and livestock, installment notes for assets sold under the installment method, cash rent lease income, and ag commodity production contracts.

Inventory. The other category of "hot assets," inventory items, includes stock in trade or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the tax year, and property the taxpayer holds primarily for sale to customers in the ordinary course of business. *I.R.C. §751(d) referencing I.R.C. §1221(a)(1).* Whether a taxpayer holds property as a capital asset or for use in the ordinary course of business is a dependent on the facts. *See, e.g. United States v. Winthrop, 417 F.2d 905 (9th Cir. 1969).* For many farm partnerships, inventory items that constitute "hot assets" might include harvested crops, livestock that are being fed-out, poultry, tools and supplies, repair parts, as well as crop inputs (e.g., seed, feed and fertilizer) not yet applied to the land. On the other hand, an unharvested crop is not included in the definition of "inventory" if the unharvested crop is on land that the taxpayer uses in the trade or business that has been held for more than a year, if the land and the crop are sold or exchanged (or are the subject of an involuntary conversion) at the same time and to the same person. *I.R.C. §1231(b)(4).*

Inventory also includes any other property that, if sold by the partnership, would *neither* be considered a capital asset *nor* I.R.C. §1231 property. *I.R.C. §751(d)(2).* I.R.C. §1231 property is real or depreciable business property held for over a year (two years for some livestock). Thus, for a farm partnership, included in the definition of "inventory" by virtue of not being I.R.C. §1231 property would be single purpose agricultural or horticultural structures, grain bins, or farm buildings held for one year or less from the date of acquisition (*I.R.C. §1231(b)(1);* personal property (other than livestock) held

for one year or less from the date of acquisition (*Id.);* cows and horses held for less than 24 months from the date of acquisition (*I.R.C. §1231(b)(3)(A));* and other livestock (regardless of age, but not including poultry) held by the taxpayer for less than 12 months from the date of acquisition (*I.R.C. §1231(b)(3)(B)).*

Qualified Business Income Deduction

The Tax Cuts and Jobs Act (TCJA) creates new I.R.C. §199A effective for tax years beginning after 2017 and before 2026. The provision creates an up to 20 percent deduction from taxable income for qualified business income (QBI) of a business other than a C corporation. To be QBI, only ordinary income is eligible. Income taxed as capital gain is not. If gain on the sale or exchange of a partnership interest involves "hot assets," the gain is taxed as ordinary income. Is it, therefore, QBI-eligible?

Under Prop. Treas. Reg. §1.199A-3, any gain that is attributable to a partnership's hot assets is considered attributed to the partnership's trade or business and may constitute QBI in the hands of the partner. Thus, if I.R.C. §751(a) or (b) applies on the sale or exchange of a partnership interest, the gain or loss attributable to the partnership assets that gave rise to ordinary income is QBI. Given the potentially high amount of "hot assets" that a farm partnership might contain (particularly when depreciation recapture is considered), the QBI deduction could play an important role in minimizing the tax bite on sale or exchange of a partnership interest.

Conclusion

When a partnership interest is sold or exchanged, the resulting tax issues have to be sorted out. An understanding of what qualifies as a "hot asset" helps in properly sorting out the tax consequences. In addition, the new QBI deduction can help soften the tax blow.

Thursday, November 15, 2018

Unpaid Tax At Death – How Long Does IRS Have To Collect?

Overview

Upon death, the typical process is for someone to be appointed to handle the administration of the decedent's estate. Once the administrator is appointed, a court-governed process is set in motion that includes providing notice to known and unknown creditors of the estate by means of publishing notice and providing actual notice to known creditors or those that could reasonable be determined to be creditors. Once notice is provided, the creditors have only a few months (usually less than six) to present their claims against the estate for payment.

Does that same timeline on presenting claims apply to the IRS? The ability of the IRS to collect on an unpaid tax claim against a decedent's estate – that's the topic of today 's post.

Claim Procedure

As an example, Kansas law specifies that "[E]very petitioner who files a petition for administration or probate of a will shall give notice thereof to creditors, pursuant to an order of the court, and within 10 days after such filing. K.S.A. 59-709(a). The notice is to be "to all persons concerned" and shall state the filing date of the petition for administration or probate of a will. The notice must be published three consecutive weeks and is to be actually be given to "known or reasonably ascertainable creditors" (those discovered by searching reasonably available public records) before expiration of the four-month period for filing claims. K.S.A. 59-709(b). Mere conjectural claims are not entitled to actual notice. Impracticable and extended searches for creditors are not required. If proper notice is not given, the personal representative and the heirs may be liable.

Timeframe For Filing Claims

As noted above, under Kansas law, the creditors have a four-month period to file their claims. That four-month timeframe runs from the time that notice is first published to creditors. However, with respect to the IRS, it has a 10-year collection period that runs from the date it assesses tax. *I.R.C. §6502(a)(1).* This provision says that the IRS can collect the unpaid tax by either levy or by a court proceeding begun within 10 years after the tax is assessed.

Recent Case

The ability of the IRS to collect unpaid tax from a decedent's estate and the application of the 10-year statute was at issue in a recent case. In *United States v. Estate of Chicorel, No. 17-2321, 2018 U.S. App. LEXIS 30069 (6th Cir. Oct. 25, 2018)*, the IRS was seeking to collect on an income tax assessment that it had made more than 10 years earlier. Under the facts of the case, the IRS assessed tax of $140,903.52 on September 12, 2005 for the 2002 tax year. The tax didn't get paid before the decedent died in the fall of 2006. In early 2007, the decedent's nephew was appointed the estate's personal representative, and he published a notice to creditors (in accordance with Michigan law) of the four-month deadline for presenting claims. However, he did not mail the notice to the IRS even though he knew of the unpaid tax liability. In early 2009, the IRS filed a proof of claim in the ongoing probate proceeding. The nephew didn't respond, and the IRS filed a collections proceeding in early 2016 attempting to reduce the 2005 tax assessment to judgment. The estate claimed that the claim was filed too late, but the trial court held that the filing in 2009 of the proof of claim was a "court proceeding" as required by I.R.C. §6502(a)(1). Thus, because it was filed within 10 years from the date the tax was assessed, the IRS could collect the tax outside the 10-year window.

On appeal, the appellate court affirmed. The appellate court noted that whether a proof of claim is a "proceeding in court" is a question of federal law that turns on the nature, function, and effect of the proof of claim under state law. *See United States v. Silverman, 621 F.2d 961 (9th Cir. 1980); United States v. Saxe, 261 F.2d 316 (1st Cir. 1958).* That meant that the appellate court had to look at how Michigan treated the filing of a proof of claim in a probate proceeding and whether it qualified as a "court proceeding" under I.R.C. §6502(a). The appellate court noted that the nature, function, and effect of a proof of claim in Michigan had significant legal consequences for the creditor, the estate, and for Michigan law generally. Because of this, the appellate court held that the filing of the proof of claim qualified as a proceeding in court under I.R.C. §6502(a). The appellate court noted that the Michigan probate code specifies that "[f]or purposes of a statute of limitations, the proper presentation of a claim . . . is equivalent to commencement of a proceeding on the claim." *Mich. Comp. Laws. §700.3802(3).* Thus, the filing of the proof of claim not only tolled the statute of limitations, it constituted a "proceeding" that required the decedent's estate to take action – either providing notice that the claim is disallowed or allowed. The filing of the proof of claim started a process whereby the claim would eventually be dealt with one way or the other. The appellate court also noted that the executor failed to give actual notice to the IRS to present its claim because it was a known creditor of the estate. That failure excused the IRS from filing the claim within the four-month window after notice was first published and extended that deadline to three years from the date of the decedent's death. Thus, the IRS had timely filed its proof of claim.

The appellate court also determined that the filing of the proof of claim was timely under I.R.C. §6502(a). That statute, the court held, is satisfied once the government started any timely proceeding in court. Because that requirement was satisfied, the IRS has an unlimited amount of time to enforce the assessed tax. The appellate court noted that I.R.C. §6502(a) focuses on the ability of the IRS to collect assessments. While it does not permit the IRS to let an assessed tax lie dormant and then attempt to collect the tax way at some far off future date, once a timely collection action has been filed, the IRS can collect the tax beyond the 10-year timeframe. *See United States v. Weintraub, 613 F.2d 612 (6th Cir. 1979).* The appellate court noted that the IRS filed its proof of claim in 2009 which was well within the 10-year limitations period for the 2005 assessment. That filing constituted a "proceeding in court" under I.R.C. §6502(a) in satisfaction of that provision's 10-year requirement. There was no further time bar on the ability of the IRS to collect. The is not requirement

that a “judgment” be reached in the proceeding within that 10-year time frame, and the ability of the IRS to collect did not expire until the tax liability is satisfied or becomes unenforceable.

Conclusion

While in just about every situation a creditor must present its claim against a decedent’s estate within a short time-frame post-death, the rules governing the ability of the IRS to collect on an unpaid tax liability from a decedent’s estate are different. Once the IRS timely files its claim in the probate proceeding, it remains a creditor until the tax is paid. It also may not be barred by state law statute of limitations if it doesn’t timely file a claim against an estate. See, *Board of Comm'rs of Jackson County v. United States, 308 US 343 (1939); United States v. Summerlin, 310 US 414 (1940)* .

Is the executor personally liable for the tax? Perhaps. But, I.R.C. §6905(a) does provide a procedure for the executor to escape personal liability if doing so would not impact the liability of the decedent’s estate.

Just another one of the quirks about tax law and the IRS. It’s helpful to know. As Benjamin Franklin stated in 1789, “In this world nothing can be said to be certain, except death and taxes.”

Tuesday, October 30, 2018

What Happens When a Partner Dies?

Overview

Many farming and ranching operations are structured in the partnership form, and many of them operate simply on an oral basis. The lack of a written partnership agreement can cause numerous problems. One of those problems can be uncertainty that results when a partner dies. What happens to the deceased partner’s partnership interest? Is it allocated among the surviving partner(s)? Does it pass to the deceased partner’s spouse or other heirs? Does something else happen to it?

The passage of a deceased partner’s partnership interest into the “wrong” hands can create various problems – not the least of which is possible discontinuation of the partnership business and farm business assets, including land, falling into hands of persons that have no interest in continuing the farming or ranching business. Even if a written partnership agreement exists, lack of clear language can also create uncertainty as to what happens when a partner dies.

Partnerships and the death of a partner – That’s the focus of today’s post.

What Is A Partnership?

First things first – when does a partnership exist? A partnership is an association of two or more persons to carry on as co-owners a business for profit. *Uniform Partnership Act, § 6.* As an estate planning device, the partnership is generally conceded to be less complex and less costly to organize and maintain than a corporation. A general partnership is comprised of two or more partners. There is no such thing as a one-person partnership, but there is no maximum number of partners that can be members of any particular general partnership.

If there is a written partnership agreement, that usually settles the question of whether the arrangement is a partnership. A partnership agreement (or articles of partnership) is a contract among the parties in which they agree to certain arrangements about income, rights to decision making, and accounting procedures. These are the practical kinds of problems that are addressed in a partnership agreement.

If there is no written partnership agreement, questions may arise as to whether a landlord/tenant lease arrangement constitutes a partnership. Because a partnership is an agreement between two or more individuals to carry on as co-owners a business for profit, a partnership generally exists when there is a sharing of net income and losses. There are numerous factors for determining partnership

existence, but one of those involves the sharing of net income – an issue that can arise in oral lease arrangements.

Is a lease a partnership? A crop-share lease shares gross income, but not net income because the tenant still has some unique deductions that are handled differently than the landlord's. For example, the landlord typically bears all of the expense for building maintenance and repair, but the tenant bears all the expense for machinery and labor. Thus, there is not a sharing of net income and the typical crop-share lease is, therefore, not a partnership. Likewise, a livestock share lease is usually not a partnership because both the landlord and the tenant will have unique expenses. But, if a livestock share lease or a crop-share lease exists for some time and the landlord and tenant start pulling out an increased amount of expenses and deducting them before dividing the remaining income, then the arrangement will move ever closer to partnership status. When the arrangement arrives at the point where there is a sharing of net income, a partnership exists.

For written farm leases where partnership treatment is not desired, it is often suggested to have written into crop-share and livestock-share leases a provision specifying that the arrangement is not to be construed as a partnership. In addition, it's advisable for the landlord and tenant to not hold themselves out publicly as being in a partnership.

Death of a Partner

As mentioned, if a partnership arrangement exists, the death of a partner can create issues. For example, in *In reEstate of Humphreys, No. E2009-00114-COA-R3-CV, 2009 Tenn. App. LEXIS 716 (Tenn. Ct. App. Oct. 28, 2009),* a farmer died intestate and an implied partnership was deemed to exist with the decedent's surviving spouse which entitled the surviving spouse to one-half of the assets of the farm business with the balance distributed to the decedent's estate. While the couple filed Schedule F only in the decedent's name, the Schedule F included the incomes of both the decedent and the surviving spouse.

Similarly, in a case from Montana in 1985, *In re Estate of Palmer, 218 Mont. 285, 708 P.2d 242 (1985)*, the court determined that a partnership existed even though title to the real estate and the farm bank account were in joint tenancy. As such, the surviving spouse of the deceased "partner" was entitled to one-half of the farm assets instead of the land and bank account passing to the surviving joint tenant.

Recent Case

A recent North Dakota case involving the death of a partner illustrates what can happen in the written partnership agreement doesn't clearly address the matter of a partner's death. In, *Estate of Moore v. Moore, 2018 N.D. 221 (2018), t*wo brothers were co-equal partners in a farming partnership. Under the written partnership agreement, upon the death of a partner, the partnership continued, but the estate of a deceased partner could not make business decisions without the surviving partner's approval. Also, the written partnership agreement stated that, "Land owned as tenants in common by [the partners] is contributed to the partnership without charge.

The partnership was responsible for all of the costs and management associated with the land and treated the land as if it were owned by the partnership. This contribution could not be retracted except on dissolution of the partnership or agreement by both partners. The partnership agreement also specified that, "Any land owned [by] other persons operated by the partnership is leased by the partnership and not by individual partners."

One of the partners died in 2012, and his will devised part of his land to his brother and the rest to his step children and nephew. The land that was devised to the step-children and nephew was burdened with a condition stating that the property should, "be sold in a commercially reasonable manner so as to derive the most value therefrom within six (6) months of my death." In 2012 this land was conveyed to the children and they also requested partition and sale of the land held as co-tenants. The

defendant challenged the conveyance stating the estate should have sold the property rather than conveying it.

In 2014 the trial court agreed and vacated the conveyance and returned the property to the deceased partner's estate. The surviving partner continued to farm, and the deceased partner's estate sued for rent due on the partnership property. The trial court denied the estate rent, stating that partnership was not liable for rent six months after the decedent's death. It also determined that the agreement continued the partnership for six months so that the surviving partners could decide what to do. The trial court also held that the partnership lacked standing during the litigation between 2012 and 2014 over the conveyance because the estate did not own the property. Finally, the trial court held that the estate did not show that they were due relief as they could not show that the defendant was unjustly enriched.

On appeal, the appellate court affirmed in part, reversed in part, and remanded the case. The appellate court, based on the partnership agreement, determined that the partnership was not dissolved upon death, but that the estate became a partner that was owed profits and losses. The appellate court determined that the district court erred when interpreting the statement in the partnership agreement that, "the partners intend… that there be an extended time to deal with a partner leaving or the death of a partner before the necessary wind up of the partnership or its continuation by the remaining partners." The appellate court held that this did not invoke a dissolution and winding up period after one of their deaths. Because the appellate court held that the partnership was not dissolved, and the land was held as co-tenants, there was no rent due. The partnership was still valid, and the land was being used within the guidelines of the agreement. As a result, the use of the land was correct, the surviving partner was not unjustly enriched, bur was merely continuing the business as a partner.

The ultimate holding of the appellate court affirmed that the estate was not due any rent between the decedent's death and sale of the property. However, the estate may be still owed profits from the partnership. Since the estate became a partner, with limited abilities, the court remanded the case for an accounting of profits or losses after the decedent's death.

Conclusion

A partnership is often a preferred form of business organization for a farm or ranch business. It's best to formalize the arrangement with a carefully crafted written agreement. Death of a partner is one of those issues that a written agreement should address. If it doesn't, or the arrangement is an oral one, unexpected consequences can result.

Friday, October 12, 2018

Corporations Post-TCJA and Anti-Corporate Farming Laws

Overview

Interest in the corporate form of farm or ranch organization has varied over the years. That interest has generally peaked when corporate rates are lower compared to rates applicable to individuals and pass-through entities. In the 1970s, many farming operations were incorporated for succession planning reasons. But, with the Tax Cuts and Jobs Act (TCJA) establishing a flat C corporate rate of 21 percent effective for tax years beginning after 2017, some taxpayers may be enticed to structure their business in the C corporate form.

Is the C corporation a good business format for a farming operation? As with many tax planning considerations, numerous factors must be accounted for. Farming C corporations post-TCJA – that's the topic of today's post.

Tax Basics

For tax years beginning before 2018, corporations paid tax on income at progressive marginal rates, with the first $50,000 of taxable income taxed at 15 percent. Dividends paid by a corporation (if any) to its shareholders were (and still are) generally taxed to the shareholder at a 15 percent or 20 percent rate. That combined 30 percent rate (15 percent on corporate income and 15 percent rate on the dividend) was less than the 39.6 rate which was the highest marginal rate for individuals. Thus, if a farm corporation's income could be kept at approximately $50,000 of taxable income a year, tax savings could be achieved in the corporate structure. The tax planning for many farming C corporations was designed to accomplish that objective.

For tax years beginning after 2017, however, the C corporate rate is a flat 21 percent and no domestic production deduction of nine percent (I.R.C. §199) is available. In addition, for tax years beginning after 2017, a C corporation cannot claim the 20 percent deduction for qualified business income. *I.R.C. §199A.* This all means that for many farming corporations, the effective tax rate in 2018 could be at least 40 percent higher than it was in 2017 (at least through 2025).

But, it is also true that many farm C corporations were established as means of providing tax-deductible meals and lodging to the owners on a tax-free (to the owners) basis. That can still be done post-2017, except that the deduction for the cost of meals is only 50 percent rather than being fully deductible.

Other Considerations

In general, firms turn to the corporation because they are seeking a collection of advantages they cannot achieve with a partnership, joint venture, limited partnership or limited liability company. For instance, the corporation provides a means for simplified internal accounting, extension of the planning horizon and a way to keep the business together beyond the present generation. Also, if plans are not made for continuity of the farm or ranch business, there is a tendency for individuals, over time, to focus less on the future. This causes decision making to be less than optimal. The corporation, as an entity of perpetual existence, helps to extend the planning horizon over which decisions are made which may result in a more rational set of economic decisions.

The corporation also tends to smooth the family farm cycle and make it possible for the continuation of the operation into subsequent generations with greater efficiency. Empirical studies in several states reveal that four major factors account for most of the decisions to incorporate in those states. These factors are: (1) ease of transferring interests in property by transferring shares of stock to accomplish specific estate planning objectives; (2) possibilities for planning management and ownership succession to make continuation of the business easier after death of the original owners; (3) avoidance of full owner liability for obligations of the business through shareholder limited liability; and (4) opportunities for income tax saving.

Thus, there still exist significant non-tax reasons to form a farming C corporation. However, it may not be the best entity structure for federal farm program payment limitation purposes. If a C corporation (or any other entity that limits liability) is the farming entity, the Farm Service Agency will limit the eligibility for payment limitations to the entity itself. Then, the owners of that entity will have to split the amount of government payments attributable to the one "person" determination between themselves. If a pass-through entity were utilized that did not limit owner liability at the entity level, then each owner (member) of the entity would be entitled to its own payment limit.

Anti-Corporate Farming Laws

When it comes to agricultural law and agricultural taxation, special rules apply in many situations. One of those special situations involves farming corporations. Historically, the first significant wave of interest in the corporate form for farm and ranch businesses dates back to the 1920s at a time when change was occurring very rapidly in the agricultural industry. The prevailing belief at the time was that the mechanization of agriculture was going to produce a few large "factories in the field." This

widespread belief produced a wave of state legislation, much of it still in existence today, limiting the use of the farm or ranch corporation. Kansas was the first state to legislate anti-corporate farming restrictions. Other states, primarily in the Midwest and the Great Plains, followed suit. Restrictions were enacted (in addition to Kansas) in North Dakota, Oklahoma, Minnesota, South Dakota, Missouri, Wisconsin, Nebraska and Iowa. Other restrictions were enacted in Colorado, Texas, West Virginia and South Carolina. In many of these states, the restrictions remain on the books (albeit modified in some states).

Recent case. The North Dakota anti-corporate farming restriction bars corporations, other than family farming corporations, from owning farm land and engaging in farming or agriculture. The specific statutory language states: "All corporations and limited liability companies, except as otherwise provided in this chapter, are prohibited from owning or leasing land used for farming or ranching and from engaging in the business of farming or ranching. A corporation or a limited liability company may be a partner in a partnership that is in the business of farming or ranching only if that corporation or limited liability company complies with this chapter." However, by virtue of a 1981 amendment, the statute also states: "This chapter does not prohibit a domestic corporation or a domestic limited liability company from owning real estate and engaging in the business of farming or ranching, if the corporation meets all the requirements of chapter 10-19.1 or the limited liability company meets all the requirements of chapter 10-32.1 which are not inconsistent with this chapter." This amended language became known as the "family farm exception" because it requires shareholders to have a close family relation who is actively engaged in the operation. Historically, the state attorney general and secretary of state have interpreted the "family farming" exception as a way to allow out-of-state family farming corporations to own farm land and conduct agricultural operations in North Dakota. However, in *North Dakota Farm Bureau, Inc. v. Stenehjem, No. 1:16-cv-137, 2018 U.S. Dist. LEXIS 161572 (D. N.D. Sep. 21, 2018),* the plaintiff, North Dakota's largest farm group along with other family farming corporations challenged the law as written on the basis that the law violated the "Dormant Commerce Clause" as discriminating against interstate commerce. The court agreed, enjoining the State from enforcing the family farm exception against out-of-state corporations that otherwise meet the statutory requirements (which the State didn't do anyway).

Conclusion

The C corporation remains a viable entity structure for the farm or ranch business. While some of the tax advantage has been reduced, other factors indicate that the C corporation still has its place. In any event, wise tax and legal counsel should be consulted to determine the right approach for any particular situation

Wednesday, October 10, 2018

The TCJA, Charitable Giving and a Donor-Advised Fund

Overview

The changes made by the Tax Cuts and Jobs Act (TCJA) for tax years beginning after 2017 could have a significant impact on charitable giving. Because of changes made by the TCJA, it is now less likely that any particular taxpayer will itemize deductions. Without itemizing, the tax benefit of making charitable deductions will not be realized. This has raised concerns by many charities.

Are there any tax planning strategies that can be utilized to still get the tax benefit from charitable deductions? There might be. One of those strategies is the donor-advised fund.

Using a donor-advised fund for charitable giving post-TCJA – that's the topic of today's post.

TCJA Changes

A taxpayer gets the tax benefit of charitable deductions by claiming them on Schedule A and itemizing deductions. However, the TCJA eliminates (through 2025) the combined personal exemption and standard deduction and replaces them with a higher standard deduction ($12,000 for a single filer; $24,000 for a couple filing as married filing jointly). The TCJA also either limits (e.g., $10,000 limit on state and local taxes) or eliminates other itemized deductions. As a result, it is now less likely that a taxpayer will have Schedule A deductions that exceed the $12,000 or $24,000 amount. Without itemizing, the tax benefit of charitable deductions is lost. This is likely to be particularly the case for lower and middle-income taxpayers.

Bundling Gifts

One strategy to restore the tax benefit of charitable giving is to bundle two years (or more) of gifts into a single tax year. Doing so can cause the total amount of itemized deductions to exceed the standard deduction threshold. Of course, this strategy results in the donor's charities receiving a nothing in one year (or multiple years) until the donation year occurs.

Donor-Advised Fund

A better approach than simple bundling (or bunching) of gifts might be to contribute assets to a donor-advised fund. It's a concept similar to that of bundling, but by means of a vehicle that provides structure to the bundling concept, with greater tax advantages. A donor-advised fund is viewed as a rather simple charitable giving tool that is versatile and affordable. What it involves is the contribution of property to a separate fund that a public charity maintains. That public charity is called the "sponsoring organization." The donor retains advisory input with respect to the distribution or investment of the amounts held in the fund. The sponsoring organization, however, owns and controls the property contributed to the fund, and is free to accept or reject the donor's advice.

While the concept of a donor-advised fund has been around for over 80 years, donor-advised funds really weren't that visible until the 1980s. Today, they account for approximately 4-5 percent of charitable giving in the United States. Estimates are that over $150 billion has been accumulated in donor advised funds over the years. Because of their flexibility, ease in creating, and the ability of donors to select from pre-approved investments, donor advised funds outnumber other type of charitable giving vehicles, including the combined value included in charitable remainder trusts, charitable remainder annuity trusts, charitable lead trusts, pooled income funds and private foundations.

Mechanics. The structure of the transaction involves the taxpayer making an irrevocable contribution of personal assets to a donor-advised fund account. The contribution is tax deductible. Thus, the donor gets a tax deduction in the year of the contribution to the fund, and the funds can be distributed to charities over multiple years.

The donor also selects the fund advisors (and any successors) as well as the charitable beneficiaries (such as a public charity or community foundation). The amount in the fund account is invested and any fund earnings grow tax-free. The donor also retains the ability to recommend gifts from the account to qualified charities along with the fund advisors. The donor cannot, however, have the power to select distributes or decide the timing or amounts of distributions from the fund. The donor serves in a mere advisory role as to selecting distributees, and the timing and amount of distributions. If the donor retains control over the assets or the income the transaction could end up in the crosshairs of the IRS, with the fund's tax-exempt status denied. *See, I.R. News Release 2006-25, Feb. 7, 2006; New Dynamics Foundation v. United States, 70 Fed. Cl. 782 (2006).*

No time limitations apply concerning when the fund assets must be distributed, but the timing of distributions is discretionary with the donor and the fund advisors.

Benefits

When highly appreciated assets are donated to a donor advised fund, the donor's overall tax liability can be reduced, capital gain tax eliminated, and a charity can benefit from a relatively larger donation. For taxpayer's that are retiring, or have a high-income year, a donor advised fund might be a particularly good tax strategy. In addition, a donor advised fund can be of greater benefit because the TCJA increases the income-based percentage limit on charitable donations from 50 percent of adjusted gross income (AGI) to 60 percent of AGI for cash charitable contributions to qualified charities made in any tax year beginning after 2017 and before 2026. The percentage is 30 percent of AGI for gifts of appreciated securities, mutual funds, real estate and other assets. Any excess contributed amount of cash may be carried forward for five years. *I.R.C. §170(b)(1)(G)(ii)*.

Drawbacks

Donor-advised funds are not cost-free. It is common for a fund to charge an administrative fee in the range of 1 percent annually. That's in addition to any fees that might apply to assets (such as mutual funds) that are contributed to the donor advised fund. Also, the fund might charge a fee for every charitable donation made from the fund. That's likely to be the case for foreign charities.

In addition, as noted above, the donor can only recommend the charities to be benefited by gifts from the fund. For example, in 2011 the Nevada Supreme Court addressed the issue of what rights a donor to a donor advised fund has in recommending gifts from the fund. In *Styles v. Friends of Fiji, No. 51642, 2011 Nev. Unpub. LEXIS 1128(Nev. Sup. Ct. Feb. 8, 2011),* the sponsoring charity of the donor-advised fund used the funds in a manner other than what the donor recommended by completely ignoring the donor's wishes. The court found that to be a breach of the duty of good faith and fair dealing by the fund advisors. But, the court determined that the donor didn't have a remedy because he had lost control over his contributed assets and funds based on the agreement he had signed at the time of the contribution to the donor-advised fund. As a result, the directors of the organization that sponsored the donor-advised fund could use the funds in any manner that they wished. That included paying themselves substantial compensation, paying legal fees to battle the donor in court, and sponsoring celebrity golf tournaments.

Also, an excise tax on the sponsoring organization applies if the sponsoring organization makes certain distributions from the fund that don't satisfy a defined charitable purpose. *I.R.C. §4966*. Likewise, an excise tax applies on certain distributions from a fund that provide more than an incidental benefit to a donor, a donor-advisor, or related persons. *I.R.C. §4967*.

Conclusion

The TCJA changes the landscape (at least temporarily) for charitable giving for many taxpayers. To get the maximum tax benefit from charitable gifts, many taxpayers may need to utilize other strategies. One of those might include the use of the donor-advised fund. If structured properly, the donor-advised fund can be a good tool. However, there are potential downsides. In any event, competent tax counsel should be sought to assist in the proper structuring of the transaction.

Monday, October 8, 2018

Farm and Ranch Estate Planning In 2018 and Forward

Overview

The Tax Cuts and Jobs Act (TCJA) has made estate planning much easier for most farm and ranch families. Much easier, that is, with respect to avoiding the federal estate tax. Indeed, under the TCJA, the exemption equivalent of the unified credit is set at $11.18 million per decedent for deaths in 2018, and an unlimited marital deduction and the ability to "port" over the unused exclusion (if any) at the death of the first spouse to the surviving spouse, very few estates will incur federal estate tax. Indeed,

according to the IRS, there were fewer than 6,000 estates that incurred federal estate tax in 2017 (out of 2.7 million decedent's estates). In 2017, the exemption was only $5.49 million. For 2018, the IRS projects that there will be slightly over 300 taxable estates.

The TCJA also retains the basis "step-up" rule. That means that property that is included in the decedent's estate at death for tax purposes gets an income tax basis in the hands of the recipient equal to the property's fair market value as of the date of death. *I.R.C. §1014*.

But, with the slim chance that federal estate tax will apply, should estate planning be ignored? What are the basic estate planning strategies for 2018 and for the life of the TCJA (presently, through 2025)?

Married Couples (and Singles) With Wealth Less Than $11.18 Million.

Most people will be in this "zone." For these individuals, the possibility and fear of estate tax is largely irrelevant. But, there is a continual need for the guidance of estate planners. The estate planning focus for these individuals should be on basic estate planning matters. Those basic matters include income tax basis planning – utilizing strategies to cause inclusion of property in the taxable estate so as to get a basis "step-up" at death.

Existing plans should also focus on avoiding common errors and look to modify outdated language in existing wills and trusts. For example, many estate plans utilize "formula clause" language. That language divides assets upon the death of the first spouse (regardless of whether it is the husband or the wife) between a "credit shelter trust," which utilizes the remaining federal estate tax exemption amount, and a "marital trust," which qualifies for the (unlimited) federal estate tax marital deduction. The intended result of the language is to cause that trust's value to be taxed in the first spouse's estate where it will be covered by the exemption, and create a life estate in the credit shelter trust property for the surviving spouse that will "bypass" the surviving spouse's estate upon death. As for the martial trust assets, tax on those assets is postponed (if it is taxed at all) until the surviving spouse dies.

But, here's the rub. As noted above, the TCJA's increase in the exemption could cause an existing formula clause to "overfund" the credit shelter trust with up to the full federal exemption amount of $11.18 million. This formula could potentially result in a smaller bequest for the benefit of the surviving spouse to the marital trust than was intended, or even no bequest for the surviving spouse at all. It all depends on the value of assets that the couple holds. The point is that couples should review any existing formula clauses in their current estate plans to ensure they are still appropriate given the increase in the federal exemption amount. It may be necessary to have an existing will or trust redrafted to account for the change in the law and utilize language that allows for flexibility in planning.

In addition, for some people, divorce planning/protection is necessary. Also, a determination will need to be made as to whether asset control is necessary as well as creditor protection. Likewise, a consideration may need to be made of the income tax benefits of family entities to shift income (subject to family partnership rules of I.R.C. §704(e)) and qualifying deductions to the entity. The entity may have been created for estate and gift tax discount purposes, but now could provide income tax benefits. In any event, family entities (such as family limited partnerships (FLPs) and limited liability companies (LLCs)) will continue to be valuable estate planning tools for many clients in this wealth range.

Most persons in this zone will likely fare better by not making gifts, and retaining the ability to achieve a basis step-up at death for the heirs. That means income tax basis planning is far more important for most people. Also, consideration should be made to determine whether insurance is still necessary to fund any potential estate tax liability It also may be possible to recast insurance to fund state death taxes (presently, 12 states retain an estate tax and six states have an inheritance tax (one state (Maryland) has both)) and serve investment and retirement needs, minimize current income taxes, and otherwise provide liquidity at death.

Other estate planning points for moderate wealth individuals include:

- For life insurance, it's probably not a good idea to cancel the polity before having that move professionally evaluated. That's particularly the case for trust-owned life insurance. For pension-owned life insurance, for those persons that are safely below the exemption, adverse tax consequences can likely be avoided.

- Evaluate irrevocable trusts and consider the possibility of "decanting." I did a blog post on decanting earlier this summer.

- For durable powers of attorney, examine the document to see whether there are caps on gifted amounts (the annual exclusion is now $15,000) and make sure to not have inflation adjusting references to the annual exclusion.

- For qualified personal residence trusts (QPRTs) that were created when the estate tax exemption was $2 million, the conventional advice was to deed the house from the QPRT to the children or a remainder trust (which might have been a grantor trust), with a written lease agreement in favor of the parent/donor who would continue to live in the house. Now, it may be desired to have the home included in the estate for basis step-up purposes and the elimination of gain on sale.

- While FLPs and LLCs may have been created to deal with an estate tax value-inclusion issue, it may not be wise to simply dismantle them because estate tax is no longer a problem for the client. Indeed, it may be a good idea to actually cause inclusion of the FLP interest in the estate. This can be accomplished by revising the partnership or operating agreement and having a parent document control over the FLP. Then, an I.R.C. §754election can be made which can allow the heirs to get a basis step-up.

Other Planning Issues

While income tax basis planning (using techniques to cause inclusion of asset value in the estate at death) is now of primary importance for most people, asset protection may also be a major concern. Pre-nuptial agreements have become more common in recent decades, and marital trusts are also used to ultimately pass assets to the heirs of the first spouse to die (who may not be the surviving spouse's heirs) at the death of the surviving spouse. A "beneficiary-controlled" trust has also become a popular estate planning tool. This allows assets to pass to the beneficiary in trust rather than outright. The beneficiary can have a limited withdrawal right over principal and direct the disposition of the assets at death while simultaneously achieving creditor protection. In some states, such as Nebraska, the beneficiary can be the sole trustee without impairing creditor protection.

Powers of attorney for both financial and health care remain a crucial part of any estate plan. For a farm family, the financial power should be in addition to the FSA Form 211, and give the designated agent the authority to deal with any financial-related matter that the principal otherwise could.

Conclusion

While estate planning has been made easier by the TCJA, that doesn't mean that it is no longer necessary. Reviewing existing plans with an estate planning professional is important. Also, the TCJA is only temporary. The estate and gift tax provisions expire at the end of 2025. When that happens, the exemption reverts to what it was under prior law and then is adjusted for inflation. For deaths in 2026, the federal estate and gift tax exemption is estimated to be somewhere between $6.5 and $7.5

million dollars. While those numbers are still high enough to cover the vast majority of people, they are a far cry from the present $11.18 million amount. One thing is for sure – a great deal of wealth is going to transfer in the coming decades. One estimate I have seen is that approximately $30 trillion in asset value will transfer over the next 30-40 years. That's about a trillion per year over that time-frame. A chunk of that will involve farm and ranch real estate, livestock, equipment and other personal property.

Tuesday, October 2, 2018

Social Security Planning For Farmers

Overview

Many farmers and ranchers are reaching retirement age for Social Security benefit purposes. That raises numerous questions involving such things as benefits, earnings, what counts as "wages" and the cash renting of farmland. These are all important questions for farmers and ranchers to have answers to so that appropriate planning can be engaged in and expectations realized.

Social Security benefit planning – that's the topic of today's post.

Retirement Age

For 2009-2020, the full retirement age for persons born in 1943-1954 is 66. Under present rules, in 2027, the full retirement age will be 67.

During the calendar year in which an individual reaches age 66, an earnings limit applies for the months before the individual reaches full retirement age. For example, for an individual that turns age 66 during 2018, there is a monthly earnings limit of $3,780 ($45,360 ¸ 12 months) for the months before full retirement age is reached. Excess earnings for this period result in a $1 reduction in benefits for each $3 of excess earnings received before attaining the age of 66 years. But, for a person that hasn't reached full retirement age, benefits are reduced by $1 for every $2 of earnings over the annual limit of $17,040 for 2018. For those drawing benefits after reaching full retirement age, there is no limit on earnings – benefits are not reduced.

Drawing Benefits

An individual can receive full Social Security benefits if they aren't drawn until full retirement age is achieved. Another way to state it is that if an individual delays taking social security benefits until reaching full retirement age, the individual receives additional benefits for each year of postponement until reaching age 70. The rate of increase is a fraction of one percent per month. In essence, the impact of drawing Social Security benefits before reaching full retirement age is that such a person must live longer to equalize the amount of benefits received over their lifetime compared to waiting until full retirement age to begin drawing benefits.

Taxability of Benefits

About 20 million people each year, some that are undoubtedly farmers and ranchers, pay tax on their Social Security benefits. These people are commonly in the 62-70 age range. Taxing Social Security benefits seems harsh, inasmuch as the person has already paid income tax and Social Security payroll taxes on the earnings that generated the benefits. But, not every dollar of benefits is taxed. What matters is a person's total income from non-Social Security sources such as wages and salaries, investment income (and capital gains on those investments) and pension income. To that amount is added one-half of the person's Social Security income. The total amount then is measured against a limit. For example, a person that files as married-filing-jointly (MFJ) will subject 50 percent of their Social Security benefits to tax if the total amount exceeds $32,000 for 2018 (it's $25,000 for a single filer). The 50 percent changes to 85 percent once the total amount exceeds $44,000 (MFJ) or $34,000 (single) for 2018. Those are the maximum percentages in theory. In reality, however, there is a

complex formula that often results in less Social Security benefits being taxed than that maximum percentage. To boil it down, the formula often results in about 20 percent of Social Security benefits being taxed once the total amount threshold is exceeded.

Special Considerations

Some farmers receive wages in-kind rather that in cash. In-kind wages such as crops or livestock, count toward the earnings limitations test. The earnings limit test includes all earnings, not just those that are subject to Social Security (FICA/Medicare) tax. But, employer-provided health insurance benefits are not considered to be "earnings" for purposes of the earnings limitation test. They are not taxed as wages. *I.R.C. §3121; SSA Program Operations Manual System, §§RS 01402.040; 01402,048.*

Federal farm program payments that a farmer receives are not deemed to be "earnings" when calculating each calendar year's earnings limitation. *SSA Program Operations Manual System §RS 02505.115.* That is the case except for the initial year of Social Security benefit application. In that initial year, all FSA program payments are counted along with other earned income and earnings for purposes of the annual earnings limitation test.

For farmers that cash rent farm ground to their employer, the cash rental income that the farmer receives will likely be treated as "earnings" even though the farmer is getting a wage from the employer. This is particularly the case if the farmer is farming the ground on the employer's behalf. The result would be a "doubling-up" of the wage income and the cash rent income for purposes of the age 62-66 earnings test.

For a farmer that is drawing Social Security benefits, whether retired or not, Conservation Reserve Program Payments received are not subject to Social Security tax. *I.R.C. §1402(a)(1).*

Conclusion

Social Security benefit planning is an item that is often overlooked by farmers and ranchers. However, it is useful to know how such planning may fit into the overall retirement plan of a farmer or rancher. It is just one piece of the retirement, succession, estate plan that should be considered in terms of how it fits in with other strategies. While a farmer or rancher may never actually "retire," there is a benefit to properly timing the drawing of Social Security benefits. In addition, as noted above, there are some special situations that a farmer or rancher should be aware of.

The Social Security Administration website (ssa.gov) has some useful online calculators that can aid in estimating retirement benefits. It may be worth checking out.

Wednesday, September 26, 2018

Spousal Joint Tenancies and Income Tax Basis

Overview

As a result of the Tax Cuts and Jobs Act (TCJA), the exemption equivalent of the unified credit for federal estate and gift tax purposes is presently $11.18 million. That's the amount for decedent's dying in 2018 and gifts made in 2018. There is also a present interest annual exclusion that covers the first $15,000 of gifts made to a donee in 2018. In other words, the first $15,000 is not subject to gift tax and then additional amounts gifted to that donee by the donor start using the donor's unified credit applicable exclusion amount. In addition, the TCJA retained the unlimited marital deduction and income tax basis "step-up."

The amount of the exemption means that very few people will encounter issues with federal estate or gift tax. Indeed, for the vast majority of people, estate planning involves income tax basis planning rather than planning to avoid estate or gift tax. Some states tax estates at death and one state retains

a gift tax, and in these states the exemption is often much lower than the federal exemption. So, for individuals in these states estate and gift tax planning can remain important for state tax purposes.

What is much more important for most people, however, is income tax basis planning. That's because property that is included in a decedent's estate at death receives an income tax basis equal to the property's fair market value as of the date of death. *I.R.C. §1014*. As a result of this rule, much of estate planning involves techniques to cause inclusion of property in a decedent's estate at death. Even though the property will be subjected to federal estate tax, the value will be excluded from tax by virtue of the credit.

A great deal of property (such as farmland and personal residences) is owned in joint tenancy at death. How much of jointly held property is included in a joint tenant's estate at death? That is a very important issue in the present estate planning environment. Specifically, what is the rule involving spousal joint tenancies?

The income tax basis rules at death for spousal joint tenancies – that's the topic of today's post.

Joint Tenancy

A distinguishing characteristic of joint tenancy is the right of survivorship. That means that the surviving joint tenant or tenants become the full owners of the jointly held property upon the death of a fellow joint tenant regardless of the terms of the deceased joint tenant's will. It's important to note that upon a conveyance of real property, transfer to two or more persons generally creates a tenancy in common unless it is clear in the deed or other conveyancing document that a joint tenancy is intended. For example, if Blackacre is conveyed to "Michael and Kelsey, husband and wife," Michael and Kelsey own Blackacre as tenants in common. To own Blackacre as joint tenants, Blackacre needed to be conveyed to them as required by state law. The typical language for creating a joint tenancy is to "Michael and Kelsey, husband and wife, as joint tenants with right of survivorship and not as tenants in common."

Estate Tax Treatment. For joint tenancies involving persons other than husbands and wives, property is taxed in the estate of the first to die except to the extent the surviving owner(s) prove contribution for its acquisition. *I.R.C. § 2040(a)*. This is the "consideration furnished" rule. While property held jointly may not be included in the "probate estate" for probate purposes, the value of that property is potentially subjected to federal estate tax and state inheritance or state estate tax to the extent the decedent provided the consideration for its acquisition. As a result, property could be taxed fully at the death of the first joint tenant to die (if that person provided funds for acquisition) and again at the death of the survivor. Whatever portion is taxed in the estate of the first to die also receives a new income tax basis based on the fair market value of that portion at the date of death.

Consider the following example (from my text, *Principles of Agricultural Law*):

Bob and Bessie Black, brother and sister, purchased a 1,000-acre Montana ranch in 1970 for $1,000,000. Bob provided $750,000 of the purchase price and Bessie the remaining $250,000. At all times since 1960, they have owned the ranch in joint tenancy with right of survivorship. Bob died in 2011 when the ranch had a fair market value of $2,500,000. Seventy-five percent of the date of death value, $1,875,000 will be included in Bob's estate.

Bessie, as the surviving joint tenant will now own the entire ranch. Her income tax basis in the ranch upon Bob's death is computed as follows:

$1,875,000 (Value included in Bob's estate)

+ 250,000 (Bessie's contribution toward purchase price)

$2,125,000

Thus, if Bessie were to sell the ranch soon after Bob's death for $2,500,000, she would incur a federal capital gain tax of $75,000, computed as follows:

$2,500,000 (Sale price)

- 2,125,000 (Bessie's income tax basis)

$375,000 Taxable gain

x.20 (Capital gain tax rate)

$75,000

For joint tenancies involving only a husband and wife, the property is treated at the first death as belonging 50 percent to each spouse for federal estate tax purposes. *I.R.C. § 2040(b).* This is known as the "fractional share" rule. Thus, only one-half of the value is taxed at the death of the first spouse to die and only one-half receives a new income tax basis.

Special rule. In 1992, the Sixth Circuit Court of Appeals applied the consideration furnished rule to a husband-wife joint tenancy in farmland with the result that the entire value of the jointly-held property was included in the gross estate of the husband, the first spouse to die. *Gallenstein v. United States, 975 F.2d 286 (6th Cir. 1992).* The full value was subject to federal estate tax but was covered by the 100 percent federal estate tax marital deduction, eliminating federal estate tax. In addition, the entire property received a new income tax basis which was the objective of the surviving spouse. The court reached this result because of statutory changes to the applicable Internal Revenue Code sections that were made in the late 1970s. To take advantage of those changes, the court determined, it was critical that the jointly held property at issue was acquired before 1977. Under the facts of the case, the farmland was purchased in 1955 for $38,500 exclusively with the husband's funds. The surviving wife sold the farmland in 1988 for $3,663,650 after her husband's death in late 1987. The entire gain on sale was eliminated because of the full basis step-up.

In 1996 and 1997, the federal district court for Maryland reached a similar conclusion. *Anderson v. United States, 96-2 U.S. Tax Cas. (CCH) ¶60,235 (D. Md. 1996); Wilburn v. United States, 97-2 U.S. Tax Cas. (CCH) ¶50,881 (D. Md. 1997).* Also, in 1997, the Fourth Circuit Court of Appeals followed the Sixth Circuit's 1992 decision as did a federal district court in Florida. *Patten v. United States, 116 F.3d 1029 (4th Cir. 1997), aff'g, 96-1 U.S. Tax Cas. (CCH) ¶ 60,231 (W.D. Va. 1996); Baszto v. United States, 98-1 U.S.Tax Cas. (CCH) ¶60,305 (M.D. Fla. 1997).*

In 1998, the Tax Court agreed with the prior federal court opinions. Under the Tax Court's reasoning, the fractional share rule *cannot* be applied to joint interests created before 1977. *Hahn v. Comm'r, 110 T.C. No. 14 (1998).* This is a key point. If the jointly held assets had declined in value, such that death of the first spouse would result in a lower basis, the fractional share rule would result in a more advantageous result for the survivor in the event of sale if the survivor could not prove contribution at the death of the first to die. In late 2001, the IRS acquiesced in the Tax Court's opinion.

Conclusion

So what does all of this mean? It means that for pre-1977 marital joint tenancies where one spouse provided all of the funds to acquire the property and that spouse dies, the full value of the property will be included in the decedent's gross estate. The value of the property will be subject to estate tax, but with an exemption of $11.18 million and the marital deduction, it's not likely that federal estate tax would be due. In addition, and perhaps more importantly, the surviving spouse receives an income tax basis equal to the date of death value. That could be dramatically higher than the original cost basis. If the surviving spouse sells the property, capital gain could be potentially eliminated.

In agriculture, many situations still remain involved pre-1977 marital joint tenancies. Be on the look-out for this planning opportunity. It's a "biggie" in the present era of a large federal estate tax unified credit exemption for federal estate (and gift) tax purposes.

Monday, September 24, 2018

Farm Wealth Transfer and Business Succession – The GRAT

Overview

The Tax Cuts and Jobs Act (TCJA) significantly increased the federal estate and gift tax exemption to $11.18 million for deaths in or gifts made in 2018. That effectively makes federal estate and gift tax a non-issue for practically all farming and ranching operations, with or without planning. However, business succession planning remains as important as ever. Last month, I wrote about one possible strategy, the intentionally defective grantor trust. Today, I discuss another possible succession planning concept – the grantor-retained annuity trust (GRAT). It's another technique that can allow the grantor to "freeze" the value of the transferred assets while simultaneously providing the grantor with a cash flow stream for a specified time-period.

Transferring interests in a farming business (and other investment wealth) to successive generations by virtue of a GRAT – that's the topic of today's post.

GRAT - Defined

A GRAT is an irrevocable trust to which assets (those that are likely to appreciate in value (such as real estate) at a rate exceeding the rate applied to the annual annuity payment the GRAT will make) are transferred and the grantor receives the right to a fixed annuity payment for a term of years, with the remainder beneficiaries receiving any remaining assets at the end of the GRAT term. The fixed payment is typically a percentage of the asset's initial fair market value computed so as to not trigger gift tax. The term of the annuity is fixed in the instrument and is either tied to the annuitant's life, a specified term of years or a term that is the shorter of the two. The annuity payment can be structured to remain the same each year or it can increase up to 120 percent annually. However, once the annuity is established, additional property cannot be added to the GRAT.

A GRAT can accomplish two important estate planning objectives. The GRAT technique "freezes" the value of the senior family member's highly appreciated assets at today's value, and it provides the senior family member with an annuity payment for a term of years. Thus, the GRAT can deliver benefits without potential transfer tax disadvantages. Clearly, the lower the interest rate, the more attractive a GRAT is.

Technical Requirements

A GRAT must make at least one annuity payment every 12-month period that is paid to an annuitant from either the GRAT's income or principal. There is a 105-day window within which the GRAT can satisfy the annual annuity payment requirement. The window runs from the GRAT creation date, which is based on state law. Notes cannot be used to fund annuity payments, and the trustee cannot prepay the annuity amount or make payments to any person other than the annuitant during the qualified interest term.

A GRAT is subject to a fixed amount requirement that takes the form of either a fixed dollar amount or a fixed percentage of the initial fair market value of the property transferred to the trust. There is also a formula adjustment requirement that is tied to the fixed value of the trust assets as finally determined for gift tax purposes. The provision must require adjustment of the annuity amount.

From a financial accounting standpoint, the GRAT is a separate legal entity. The GRAT's bank account is established using the grantor's social security number as the I.D. number. Annual accounting is required, including a balance sheet and an income statement.

Tax Consequences of Creating, Funding, Administering and Terminating a GRAT

For income tax purposes, the GRAT is treated as a grantor trust because, by definition, the retained interest exceeds five percent of the value of the trust at the time the trust is created. *I.R.C.*

§673. Thus, there is no gain or loss to the grantor on the transfer of property to the GRAT in exchange for the annuity. There can be issues, however, if there is debt on the property transferred to the GRAT that exceeds the property's basis. Also, when a partnership interest is contributed there can be an issue with partnership "negative basis" (i.e., the partner's share of partnership liabilities exceeds the partner's share of the tax basis in the partnership assets).

Because the trust is a grantor trust, the grantor is taxed on trust income, including interest, dividends, rents and royalties, as well as pass-through income from business entity ownership. The grantor also can claim the GRAT's deductions. However, the grantor is not taxed on annuity payments, and transactions between the GRAT and the grantor are ignored for income tax purposes. A significant tax benefit of a GRAT is that the sale of the asset between the grantor and the GRAT does not trigger any taxable gain or loss. The transaction is treated as a tax-free installment sale of the asset. Also, the GRAT is permitted to hold "S" corporation stock as the trust is a permitted S corporation shareholder, and the GRAT assets grow without the burden of income taxes.

For gift tax purposes, the value of the gift equals the value of the property transferred to the GRAT less the value of the grantor's retained annuity interest. In essence, the transferred assets are treated as a gift of the present value of the remainder interest in the property. That allows asset appreciation to be shifted (net of the assumed interest rate that is used to compute present value) from the grantor's generation to the next generation.

If the GRAT underperforms (i.e., the GRAT assets fail to appreciate at a higher rate than the interest rate of the annuity payment), the GRAT can sell its assets back to the grantor with no income tax consequences (assuming the GRAT is a wholly-owned grantor trust. *Rev. Rul. 85-13, 1985-1 C.B. 184.* Then, the repurchased property can be placed in a new GRAT with a lower annuity payment. The original GRAT would then pay out its remaining cash and collapse.

It is possible to "zero-out" the gift value so there is no taxable gift. An interest rate formula determined by I.R.C. §7520 is used to calculate the value of the remainder interest. If the income and appreciation of the trust assets exceed the I.R.C. §7520 rate, assets remain at the end of the GRAT term that will pass to the GRAT beneficiaries. The basic idea is to transfer wealth to the subsequent generation with little or no gift tax consequences.

The grantor's payment of taxes is not treated as a gift to the trust remainder beneficiaries. *Rev. Rul. 2004-64, 2004-27 I.R.B. 7.* Also, if the trustee reimburses (or has the power to reimburse) the grantor for the grantor's payment of income tax, the reimbursement (or the discretion to reimburse) does not cause inclusion of the trust assets in the grantor's estate. But, it's important that the trustee is an independent trustee.

Death of Grantor During GRAT Term

If the grantor dies before the end of the GRAT term, a portion (or all) of the GRAT is included in the grantor's gross estate. The amount included in the grantor's estate is the lesser of the fair market value of the GRAT's assets as of the grantor's date of death or the amount of principal needed to pay the GRAT annuity into perpetuity (which is determined by dividing the GRAT annuity by the I.R.C. §7520 rate in effect during the month of the grantor's death). *Rev. Rul. 82-105, 1982-1 C.B. 133.*

Example: Bubba died in June 2018 with $700,000 of assets held in a 10-year GRAT. At the time the GRAT was created in June of 2010 with a contribution of $1.5 million, the annuity was calculated to be $183,098.70 per year (based on an interest rate of 3.8 percent and a zeroed-out gift). The amount included in Bubba's gross estate would be the lesser of $700,000 (the FMV of the GRAT assets at the time of death) or $5,385,255.88 (the value of the GRAT annuity paid into perpetuity ($183,098.70/.034)). Thus, the amount included in Bubba's estate would be $700,000.

To minimize the risk of assets being included in the grantor's estate, shorter GRAT terms are generally selected for older individuals. There is no restriction in the law as to how long a GRAT term must be. For example, *Kerr v. Comr., 113 T.C. 449 (1999), aff'd., 292 F.3d 490 (5th Cir. 2002)* involved a

GRAT with a term of 366 days, and there is no indication in the court's opinion that the term was challenged. In *Priv. Ltr. Rul. 9239015 (Jun. 25, 1992),* the IRS blessed a GRAT with a two-year term. See also *Walton v. Comr., 115 T.C. 589 (2000).*

GRAT Advantages and Disadvantages

To summarize the above discussion the following is a brief listing of advantages and disadvantages of a GRAT.

Advantages: 1) there is a reduced gift tax cost as compared to a direct gift; 2) the GRAT receives grantor trust status; 3) the grantor can borrow funds from the GRAT and the GRAT can borrow money from third parties (however, the grantor must report as income the amount borrowed - *Tech. Adv. Memo. 200010010 (Nov. 23, 1999));* and 4) the GRAT term can safely be as short as two years.

Disadvantages: 1) upon formation, some of the grantor's applicable exclusion might be utilized; 2) the grantor must survive the GRAT term to avoid having any part of the GRAT assets being included in the grantor's gross estate; 3) notes or other forms of indebtedness cannot be used to satisfy the required annuity payments; and 4) grantor continues to pay income taxes on all of the GRAT's income that is earned during the GRAT term.

Conclusion

The GRAT is another way to pass interests in the farming or ranching operation to the next generation. While it's not a technique for everyone, it can be helpful for those with substantial estates. Also, keep in mind that the present level of the federal estate and gift tax exclusion amount of $11.18 million is scheduled to "sunset" after 2025. After that, under present law, the exclusion will drop to $5 million with an inflation adjustment. Also, if the political landscape changes to a significant enough degree the exemption could fall sooner and to a greater degree.

Thursday, September 6, 2018

When Can A Corporate Shareholder Be Held Liable For Corporate Debts and Liabilities?

Overview

One of the reasons for the formation of a corporation is to achieve liability protection. Liability of corporate shareholders is limited to the extent of their individual investment in the corporation. In a farm and ranch setting, while a corporation may not actually be utilized as the operating entity, it is commonly used to hold operating assets as a means of shielding the shareholders from personal liability against creditor claims arising from operations.

But, creditor protection is not absolute. In certain circumstances the corporate "veil" can be "pierced" with the result that a shareholder can be held personally liable for corporate liabilities.

Corporate veil-piercing – that's the topic of today's post.

Factors for "Piercing"

Corporate "veil piercing" is generally a matter of state law. A state's corporate code sets forth the rules for properly forming a corporation and the ongoing conduct of the corporate business. It is critical for a corporation and its shareholders to follow those rules. For instance, shareholder limited liability can be lost if the corporation is not validly organized in accordance with state law. In addition, to maintain limited liability the corporation must comply with certain corporate formalities such as conducting an annual meeting, filing an annual report with a designated state office, and electing directors and officers. If these corporate formalities are not complied with, limited liability for shareholders is sacrificed.

Also, a reasonable amount of equity or risk capital must be committed to the corporation. Shareholder limited liability is lost if the corporation is inadequately capitalized. Courts will "pierce the corporate veil" unless a reasonable amount of equity capital is committed to the business to serve as a cushion to absorb the liability shocks of the business. *See, e.g.,* *Dewitt Truck Brokers v. W. Ray Flemming Fruit Co., 540 F.2d 681 (4th Cir. 1976)*.

Illustrative Cases on Veil Piercing

The following cases are a small sample that show the various ways in which corporate veil piercing can arise:

- In *Juniper Investment Co v. United States, 338 F2d 356 (Cl. Ct. 1964)*, a personal holding company's separate existence was disregarded because it acted as the alter ego of the shareholders.
- Listing corporate assets as those of the shareholder on the shareholder's personal loan application resulted in the court finding that the corporation was merely created for the taxpayer to avoid tax and was not a separate entity from the shareholder in *Wenz v. Comr., T.C. Memo. 1995-277.*

- In *Foxworthy, Inc. v. Comr., T.C. Memo. 2009-203*, the court held that the corporation at issue was the taxpayer's alter ego that couldn't be disregarded for tax purposes. The court pointed out that the taxpayer was neither an owner, director or corporate employee. Even so, the taxpayer had complete control over the corporation and used the corporation to buy the taxpayer's personal resident and maintain it. The court noted that the corporation had no real business purposes and was used in an attempt to convert personal living expenses into deductible business expenses.
- Veil piercing was the result where a corporation's funds and a shareholder's funds were comingled and the shareholder controlled and managed the corporation's accounts as his own. *Pollack v. Comr., T.C. Memo. 1982-638.*
- In *Pappas v. Comr., T.C. Memo. 2002-127*, the corporate veil was pierced because there was no real distinction between the taxpayer and the corporation. The taxpayer used corporate funds for personal expenses, the corporation didn't file federal or state tax returns. In addition, corporate formalities were ignored, and the corporation did not have a separate office apart from the taxpayer's home address. Also, the taxpayer was the only corporate employee and corporate records were not maintained.

Recent Case

In *Woodruff Construction, L.L.C. v. Clark, No. 17-1422, 2018 Iowa App. LEXIS 765 (Iowa Ct. App. Aug. 15, 2018),* the defendant formed a corporation and filed articles of incorporation in 1997. The corporation was reincorporated in 2001 after an administrative dissolution. The corporation was engaged in the business of biosolids management. The defendant was the sole owner and director of the corporation along with being the corporation's secretary and treasurer. The plaintiff contracted with a small town to be the general contractor during the construction of a wastewater treatment facility for the town. In early 2010, the plaintiff contracted with the defendant for lagoon sludge removal. The defendant began work, but then ceased work after determining that project would cost more to complete that what the contract was bid for.

In 2012, the plaintiff sued for breach of contract and obtained a judgment of $410,066.83 plus interest in 2014. The corporation failed to pay the judgment and the plaintiff sued in 2015 to pierce the corporate veil and recover the judgment personally from the defendant. The trial court refused to pierce

the corporate veil and also denied a request to impose a constructive trust and equitable lien on the corporate assets. The plaintiff appealed the denial of piercing the corporate veil.

The appellate court determined that the plaintiff had failed to establish that the corporation was undercapitalized – it had assets and was profitable. The plaintiff also did not show that the corporation was undercapitalized at the time it entered into the contract with the plaintiff. There also was no evidence showing that the corporation changed the nature of its work or engaged in an inadequately-capitalized expansion of the business. It was also unclear, the appellate court noted, that the capital transfers from the corporation to the defendant rendered the initial adequate capitalization irrelevant. Thus, the plaintiff failed to establish that the corporation was undercapitalized to an extent that merited piercing the corporate veil.

However, the appellate court noted that the evidence illustrated that the defendant commingled personal funds with corporate funds. The defendant used corporate funds for personal purposes, and also failed to maintain separate books and records that sufficiently distinguished them from the defendant personally. In addition, the appellate court noted that the corporation did not follow corporate formalities. The corporation had been dissolved administratively by the Secretary of State in 1998 due to the failure to file a biennial report, but the corporation continued operations during the time it was dissolved as if the corporation were active. When the new corporation began in 2001, no bylaws, corporate minute book or shareholder ledger were produced. In addition, the new corporation (operating under the same name as the old corporation) was administratively dissolved three times for failure to submit the biennial report (the corporation used the statutory procedure to apply for reinstatement each time). The appellate court determined that the corporation was not considered by the defendant to be a separate entity from himself. Accordingly, the appellate court reversed the trial court and allowed the corporate veil to be pierced and the defendant to be held personally responsible for the judgment.

Conclusion

To obtain creditor protection that the limited liability feature of a corporation can provide, it's critical to follow corporate formalities and respect the corporation as an entity distinct from the shareholder. Failure to do so can result in personal liability for corporate debts and obligations. With machinery, equipment, livestock and unique features on farm and ranch land, achieving liability protection for farmers and ranchers is a big deal. Respecting the corporate entity is key to achieving that protection. Good legal counsel can make sure these requirements are satisfied.

Friday, August 17, 2018

Intentionally Defective Grantor Trust – What Is It and How Does It Work?

Overview

An important concern for many farm and ranch families is how to keep the business in the family and operating as a viable economic enterprise into subsequent generations. Of course, economics and family relationships are very important to accomplishing this objective. So are various types of planning vehicles.

One of those vehicles that can work for some families is an intentionally defective grantor trust (IDGT). It allows the creator of the trust (grantor) to "freeze" the value of the transferred assets while simultaneously providing the grantor with a cash flow stream for a specified time-period. The "freeze" is achieved by capitalizing on the mismatch between interest rates used to value transfers and the actual anticipated performance of the transferred asset.

The use of an IDGT as part of a plan to transfer business assets from one generation to the next – that's the topic of today's post.

IDGT - Defined

An IDGT is a specially type of irrevocable grantor trust that is designed to avoid any retained interests or powers in the grantor that would result in the inclusion of the trust's assets in the grantor's gross estate upon the grantor's death. For federal income tax purposes, the trust is designed as a grantor trust (as far as the grantor is concerned) under I.R.C. §671 for income tax purposes because of the powers the grantor retains. However, those retained powers do not cause the trust assets to be included in the grantor's estate. The trust's income, losses, deductions and credits are reported by the grantor on the grantor's individual income tax return.

The trust is "defective" because the seller (grantor) and the trust are treated as the same taxpayer for income tax purposes. However, an IDGT is defective for income tax purposes only - the trust and transfers to the trust are respected (e.g., they are effective) for federal estate and gift tax purposes. The "defective" nature of the trust meant that the grantor does not have gain on the sale of the assets to the trust, is not taxed on the interest payments received from the trust, has no capital gain if the note payments (discussed below) are paid to the grantor in-kind and makes the trust an eligible S corporation shareholder. *Rev. Rul. 85-13, 1985-1 C.B. 184; I.R.C. §1361(c)(2)(A)(i).*

The IDGT Transaction

The IDGT technique involves the grantor selling highly-appreciating or high income-producing assets to the IDGT for fair market value in exchange for an installment note. The grantor makes an initial "seed" gift of at least 10 percent of the total transfer value to the trust so that the trust has sufficient capital to make its payments to the grantor. Typically, the IDGT transaction is structured so that a completed gift occurs for gift tax purposes, with no resulting income tax consequences. That also means, however, that the transfer is a completed gift and the trust will receive a carryover basis in the gifted assets.

The trust language is carefully drafted to provide the grantor with sufficient retained control over the trust to trigger the grantor trust rules for income tax purposes, but insufficient control to cause inclusion in the grantor's estate. This is what makes the IDGT a popular estate planning technique for shifting large amounts of wealth to heirs and creating estate tax benefits because the value of the assets that the grantor transfers to the trust exceeds the value of the assets that are included in the grantor's estate at death.

Interest on the installment note is set at the Applicable Federal Rate for the month of the transfer that represents the length of the note's term. The installment note can call for interest-only payments for a period of time and a balloon payment at the end, or it may require interest and principal payments. Given the current low interest rates (but they have been rising), it is reasonable for the grantor to expect to receive a total return on the IDGT assets that exceeds the rate of interest. Indeed, if the income/growth rate on the assets sold to the IDGT is greater than the interest rate on the installment note taken back by the grantor, the "excess" growth/income is passed on to the trust beneficiaries free of any gift, estate and/or Generation Skipping Transfer Tax (GSTT).

The IDGT technique became popular after the IRS issued a favorable letter ruling in 1995 *(Priv. Ltr. Rul. 9535026 (May 31, 29915))* that took the position that I.R.C. §2701 would not apply because a debt instrument is not an "applicable retained interest." I.R.C. §2701 applies to transfers of interests in a corporation or a partnership to a family member if the transferor or family member holds and "applicable retained interest" in the entity immediately after the transfer. However, an "applicable retained interest" is not a creditor interest in bona fide debt. The IRS, in the same letter ruling also stated that a debt instrument is not a term interest, which meant that I.R.C. §2702 would not apply.

If the seller transfers a remainder interest in assets to a trust and retains a term equity interest in the income, I.R.C. §2702 applies which results in a taxable gift of the full value of the property sold. For

instance, a sale in return for an interest only note with a balloon payment at the end of the term would result in a payment stream that would not be a qualified annuity interest because the last payment would represent an increase of more than 120 percent over the amount of the previous payments.

How It Works

If for example, a multi-dimensional farming operation is valued at $15 million and is transferred to a family limited partnership (FLP), a valuation discount for lack of marketability and/or minority interest might approximate 30 percent.

Note: A few months ago, the Treasury announced that it was not finalizing regulations that would tighten the ability to valuation discounts in such situations. So, a discount of 30-40 percent would be reasonable for such a transfer.

A 30 percent discount on a $15 million transfer would be $4.5 million. So, the transfer to the FLP would be valued at $11.5 million. Then an IDGT could be created and the $11.5 million FLP interest would be sold to the IDGT in exchange for a note with the installment payments to the grantor under the note being established based on the $11.5 million value rather than the $15 million value. This means that, in effect, $4.5 million has been transferred tax-free the transferors' heirs.

The installment note can be structured in various ways, with the approach chosen generally tied to the cash flow that the assets generate that have been transferred to the IDGT. In addition, the income from the property contained in the IDGT is the grantor's tax responsibility (with those taxes paid annually from a portion of the installment sale payments from the note), but it's not a gift for estate and gift tax purposes. That means, then, that additional assets can be shifted to the IDGT which will further reduce the grantor's taxable estate at death. The heirs benefit and the grantor gets a reduced taxable estate value. That could be a big issue if the current level of the federal estate tax exemption goes back down starting in 2026 (or sooner on account of a political change in philosophy).

When the grantor of the IDGT dies, the only item included in the grantor's gross estate is the installment note. It is included at its fair market value. That means that the IDGT "froze" the value of the assets as of the sale date with any future appreciation in asset value occurring outside of the decedent's estate.

Pros and Cons of IDGTs

As noted above, an IDGT has the effect of freezing the value of the appreciation on assets that are sold to it in the grantor's estate at the interest rate on the installment note payable. Additionally, as previously noted, there are no capital gain taxes due on the installment note, and the income on the installment note is not taxable to the grantor. Because the grantor pays the income tax on the trust income, that has the effect of leaving more assets in the IDGT for the remainder beneficiaries. Likewise, valuation adjustments (discounts) increase the effectiveness of the sale for estate tax purposes.

On the downside, if the grantor dies during the term of the installment note, the note is included in the grantor's estate. Also, there is no stepped-up basis in trust-owned assets upon the grantor's death. Because trust income is taxable to the grantor during the grantor's life, the grantor could experience a cash flow problem if the grantor does not earn sufficient income. In addition, there is possible gift and estate tax exposure if insufficient assets are used to fund the trust.

Proper Structuring of the Sale to the IDGT

Thee installment note must constitute bona fide debt. That is the key to the IDGT transaction from an income tax and estate planning or business succession standpoint. If the debt amounts to an equity interest, then I.R.C. §§2701-2702 apply and a large gift taxable gift could be created or the transferred assets will end up being included in the grantor's estate. I.R.C. §2036 causes inclusion in the grantor's estate of property the grantor transfers during life for less than adequate and full consideration if the grantor retained for life the possession or enjoyment of the transferred property or the right to the

income from the property, or retained the right to designate the persons who shall possess or enjoy the property or the income from it. In the context of an IDGT, if the installment note represents bona fide debt, the grantor does not retain any interest in the property transferred to the IDGT and the transferred property is not included in the grantor's estate at its date-of-death value.

All of the tax benefits of an IDGT turn on whether the installment note is bona fide debt. Thus, it is critical to structure the transaction properly to minimize the risk of the IRS taking the position that the note constitutes equity for gift or estate tax purposes. That can be accomplished by observing all formalities of a sale to an unrelated party, providing sufficient seed money, having the beneficiaries personally guarantee a small portion of the amount to be paid under the note, not tying the note payments to the return on the IDGT assets, actually following the scheduled note payments in terms of timing and amount, making the note payable from the trust corpus, not allowing the grantor control over the property sold to the IDGT, and keeping the term of the note relatively short. These are all indicia that the note represents bona fide debt.

Administrative Issues with IDGT's

An IDGT is treated as a separate legal entity. Thus, a separate bank account is opened for the IDGT in order to receive the "seed" gift and annual cash inflows and outflows. An amortization schedule will need to be maintained between the IDGT and the grantor, as well as annual books and records of the trust.

Conclusion

Farmers and ranchers that intend to keep the farming or ranching business in the family for subsequent generations are searching for ways to accomplish that goal. The IDGT is one tool in the planner's arsenal to accomplish that goal.

Friday, August 3, 2018

Expense Method Depreciation and Trusts

Overview

The Tax Cuts and Jobs Act (TCJA) increased the maximum amount a taxpayer may expense under IRC §179 to $1 million. The TCJA also increased the phase-out threshold amount to $2.5 million for tax years beginning after 2017. The $1 million and $2.5 million amounts are indexed for inflation for tax years beginning after 2018.

Is property held in trust eligible to be expensed under I.R.C. §179? That's a big issue for farm and ranch families (and others). Trusts are a popular part of many estate and business plans, and if property contained in them is not eligible for I.R.C. §179 their use could be costly from an income tax standpoint.

Trusts and eligibility for I.R.C. §179 - that's the topic of today's post.

Does the Type of Trust Matter?

I.R.C. §179(d)(4) states that an estate or trust is not eligible for I.R.C. §179. That broad language seems to be all inclusive – all types of trusts and in addition to estates are included. If that is true, that has serious implications for estate planning for farmers and ranchers (and others). Revocable living trusts are a popular estate planning tool in many estate planning situations, regardless of whether there is potential for federal estate tax. If property contained in a revocable trust (e.g., a "grantor" trust) is not eligible for I.R.C. §179, that can be a significant enough income tax difference that would mean that the estate plan should be changed to not utilize a revocable trust.

Grantor trusts. A grantor trust is a trust in which the grantor, the creator of the trust, retains one or more powers over the trust. Because of this retained power, the trust's income is taxable to the grantor. From a tax standpoint, the grantor is treated as the owner of the trust with the result that all items of income, loss, deduction and credit flowing through to the grantor during the period for which the grantor is treated as the owner of the trust. *I.R.C. §671; Treas. Reg. § 1.671-3(a)(1); Rev. Rul. 57-390, 1957-2 C.B. 326.* Another way of stating the matter is that a grantor trust is a disregarded entity for federal income tax purposes. *C.C.A. 201343021 (Jun. 17, 2013).* Effectively, the grantor simply treats the trust property as their own.

This is the longstanding position of the IRS. In *Rev. Rul 85-13, 1985-1 C.B. 184*, the IRS ruled that a grantor of a trust where the grantor retains dominion and control resulted in the grantor being treated as the trust owner. In other words, a grantor is treated as the owner of trust assets for federal income tax purposes to the extent the grantor is treated as the owner of any portion of the trust under I.R.C. §§671-677. In the ruling, the IRS determined that a transfer of trust assets to the grantor in exchange for the grantor's unsecured promissory note did not constitute a sale for federal income tax purposes. The facts of the ruling are essentially the same as those at issue in *Rothstein v. United States,* 735 F.2d 704 (2d Cir. 1984). In *Rothstein*, while the court found the trust at issue to be a grantor trust, the court concluded that the trust was separate from the taxpayer. But, in the 1985 ruling based on the same facts, the IRS stated that it would not follow *Rothstein* and reasserted its position that a taxpayer is deemed to own the assets contained in a grantor trust for federal tax purposes.

Thus, there is substantial authority for the position that property contained in a grantor trust, such as a revocable living trust, is eligible for expense method depreciation under I.R.C. §179. The grantor is the same thing for tax purposes as the grantor trust.

Irrevocable trusts. An irrevocable trust can't be modified or terminated without the beneficiary's permission. The grantor, having transferred assets into the trust, effectively removes all rights of ownership to the assets and control over the trust assets. This is the opposite of a revocable trust, which allows the grantor to modify the trust. That means that an irrevocable trust is a different entity from the taxpayer and the property contained in the trust is not eligible for expense method depreciation under I.R.C. §179 pursuant to I.R.C. §179(d)(4), unless the grantor retains some degree of power over trust income or assets. For instance, a common situation when an irrevocable trust will be treated by the IRS as a grantor trust is when the grantor retains a five percent or larger reversionary interest in the trust property. The same result occurs when the grantor retains any significant level of administrative control over the trust such as discretionary authority to distribute trust property to the grantor or the power to borrow money from the trust without paying a market rate of interest.

Pass-Through Entities and Irrevocable Trusts

The 20 percent deduction for qualified business income under I.R.C. §199A in effect for tax years beginning after 2017 and before 2026 for taxpayers with business income that are not C corporations, may spark increased interest in pass-through entities. With respect to a pass-through entity, though, questions concerning the use of I.R.C. §179 arise when an irrevocable trust has an ownership interest in the entity. Under Treas. Reg. § 1.179-1(f)(3), a trust that is a partner or S corporation shareholder is barred from deducting its allocable share of the I.R.C. §179 depreciation that is elected at the entity level. The pass-through entity's basis in the I.R.C. §179 property is not reduced to reflect any portion of the I.R.C. §179 expense that is allocable to the trust or estate. Consequently, the entity claims a regular depreciation deduction under I.R.C. §168 with respect to any depreciable basis that results from the inability of a non-grantor irrevocable trust or the estate to claim its allocable portion of the I.R.C. §179 depreciation. *Id.* The irrevocable trust or estate does not benefit from the entity's I.R.C. §179 election.

Conclusion

A revocable living trust, as a grantor trust, can claim I.R.C. §179 depreciation. Thus, that common estate planning vehicle won't present an income tax planning disadvantage by taking I.R.C. §179 depreciation off of the table. However, when an irrevocable trust is involved, the result is different,

unless the trust contains language that gives the grantor sufficient control over trust income or assets. Business property that is contained in an irrevocable trust is generally not eligible for I.R.C. §179 depreciation. But, trust language may change that general result. In addition, if a pass-through entity claims I.R.C. §179 depreciation, none of that depreciation flows to the irrevocable trust (or estate). That means that the entity will need to make special basis adjustments so that the deduction (or a portion thereof) is not wasted. Likewise, the depreciation should be "separately stated items" on the K-1 whenever an irrevocable trust or an estate owns an interest in the entity. Likewise, existing partnership agreements may need to be modified so that I.R.C. §179 deductions are allocated to non-trust partners and other expenses to owners of interests that are irrevocable trusts and estates.

This potential difference in tax treatment between revocable grantor trusts and irrevocable trusts should be considered as part of the overall tax planning and estate/business planning process.

Tuesday, July 24, 2018

Beneficiary Designations, Changed Circumstances and the Contracts Clause

Overview

For many people, the most important estate planning document is the will (or trust) that disposes of property at the time of death. Assets that pass by will are subject to probate and are known as "probate assets." But, a decedent's estate may also have "non-probate assets." Those are assets that are not subject to the probate court's jurisdiction and pass by a contractual beneficiary designation. These contractual arrangements include life insurance, pensions, IRAs and annuities.

For married couples, one spouse typically names the other spouse as the beneficiary of these non-probate assets. But, what if one spouse names the other as the beneficiary of a non-probate contractual arrangement and divorce occurs and the beneficiary designation is not changed? Does the beneficiary-spouse remain the beneficiary, or is that designation automatically revoked? Can the law automatically remove the former spouse as beneficiary? How does the Constitution's Contracts Clause factor into this?

That's the topic of today's post – beneficiary changes upon divorce.

The Contracts Clause

Article I, Section 10, Clause 1 of the U.S. Constitution specifies that a state cannot enact legislation that disrupts contractual arrangements. That provision says that, "[n]o state shall…pass any…Law impairing the Obligation of Contracts." Thus, while citizens have the right to enter into contracts that don't violate "public policy," the government cannot impair otherwise permissible contracts. But, what does that mean? Does it mean that a state can enact a law that changes the contractual beneficiary designation on a life insurance policy, for example? The issue recently came up in a case that made it all of the to the U.S. Supreme Court.

Recent Case

In *Sveen v. Melin, 138 S. Ct. 1815 (2018),* a couple married in 1997. In 1998, the husband bought a life insurance policy that named his wife as the primary beneficiary and his two children from a prior marriage as the contingent beneficiaries. In 2002, a new Minnesota law took effect providing that "the dissolution or annulment of a marriage revokes any revocable…beneficiary designation…made by an individual to the individual's former spouse." Minn. Stat. §524.2-804, subd.1. Thus, divorce automatically revokes the designation of a spouse as the beneficiary. That would cause the insurance proceeds to go to the contingent beneficiary or the policyholder's estate upon death of the policyholder. If the policyholder does not want this result, the former spouse can be named as beneficiary (again). In 2007, the couple divorced and the former husband died in 2011 without

changing the beneficiary designation. The deceased ex-husband's children claimed that they were the beneficiaries of the life insurance proceeds. But, the surviving ex-spouse claimed that she was the beneficiary because the law did not exist at the time the policy was purchased and she was named the primary beneficiary. Her core argument was that the retroactive application of the law violated the Contracts Clause.

The U.S. Court of Appeals for the Eighth Circuit agreed with the surviving ex-spouse *(Metro Life Insurance Co. v. Melin, 853 F.3d 410 (8th Cir. 2017)*, but the U.S. Supreme Court reversed. The Supreme Court noted that the Contracts Clause did not establish a complete prohibition against states from enacting laws that impacted pre-existing contracts. The Court noted that a two-step test existed form determining the constitutionality of such a law. Step one involves the question of whether the law "operated as a substantial impairment of a contractual relationship" based on the extent to which the law undermined the parties' bargain, interfered with the parties' reasonable expectations, and barred the parties from safeguarding their rights. If a contractual impairment is determined under step one, then the second step examines the means and ends of the legislation to determine whether the state law advances a significant and legitimate public purpose.

In *Sveen*, the Court held that the law did not substantially impair pre-existing contractual arrangements. The Court reasoned that the law was designed to reflect a policyholder's intent based on an assumption that an ex-spouse would *not* be the desired primary beneficiary. In addition, the Court stated that an insured cannot reasonably rely on a beneficiary designation staying in place after a divorce – noting that divorce courts have wide discretion to divide property, including the revocation of spousal beneficiary designations in life insurance policies (or mandating that they remain). Accordingly, the Court concluded that a policyholder had no reliance interest in the policy in the event of divorce, and could undo the impact of the law by again naming the (now) ex-spouse as the primary beneficiary. The decedent's children were held to be the primary beneficiaries of the policy.

Kansas Approach

Kansas, like other states, has an automatic revocation provision for wills upon divorce. *Kan. Stat. Ann. §59-610.* For non-probate assets with a beneficiary designation, in divorce actions judges are to include changes in beneficiary status as part of the property division between the spouses and note any change in the divorce decree. *Kan. Stat. Ann. §2-2602(d).* The policyholder remains responsible for actually changing the beneficiary designation*. Id.*

Conclusion

The Court's conclusion expands the reach of the government into private contractual arrangements. It also assumes that all divorces are acrimonious and that a divorced policyholder would never want to benefit a former spouse. That's simply not true. What's more is that the Court upheld the Minnesota law even though it retroactively applied in the case at bar. If a statute that changes (rewrites) the primary beneficiary designation of a contract on a retroactive basis doesn't substantially impair that contract, I don't know what does. Judge Gorsuch seems to agree with that last point in his dissent.

How does your state law treat the issue?

Monday, July 16, 2018

Management Activities and the Passive Loss Rules

Overview

In recent years, the IRS has shown an increased focus on business activities that it believes are being engaged in without an intent to make a profit. If that is the case, the "hobby loss" rules apply and limit deductions to the amount of income from the activity. But, engaging in an activity with a profit intent

may not be enough to fully deduct losses from the activity. That's particularly the case if the taxpayer hires a paid manager to run the operation. In that situation, the IRS may claim that the taxpayer is not materially participating in the activity under the passive loss rules. If the IRS prevails on that argument, loss deductions are severely limited, if not eliminated.

A recent Tax Court case involved both the hobby loss rules and the passive loss rules. While the ranching activity was deemed not to be a hobby, the court believed that the taxpayer was not materially participating in the activity.

Paid managers and the passive loss rules – that's the focus of today's post.

Passive Loss Rules

The passive loss rules, enacted in 1986, reduce the possibility of offsetting passive losses against active income. *I.R.C. §469(a)(1)*. The rules apply to activities that involve the conduct of a trade or business (generally, any activity that is a trade or business for purposes of I.R.C. §162) where the taxpayer does not materially participate (under at least one of seven tests) in the activity on a basis which is regular, continuous and substantial. *I.R.C. § 469(h)(1).*Property held for rental usually is a passive activity, however, regardless of the extent of the owner's involvement in the management or operation of the property.

If the passive loss rules apply, deductions (losses) from passive trade or business activities, to the extent the deductions exceed income from all passive activities, may not be deducted against other income (non-passive activity gains). Losses (and credits) that a taxpayer cannot use because of the passive loss limitation rules are suspended and carry over indefinitely to be offset against future passive activity income from any source. *I.R.C. §469(b)*. For farmers, the passive loss rules are likely to come into play in situations where the farmer is a passive investor in a separate business venture apart from the farming operation. In that case, as noted, the losses from the venture cannot be used to offset the income from the farming operation.

Recent Case

Facts. In *Robison v. Comr., T.C. Memo. 2018-88,* the petitioners were a married couple who lived in the San Francisco Bay area. The husband worked in the technology sector, and during the years in issue (2010-2014) the husband's salary ranged from $1.4 million to $10.5 million. In 1999, the petitioners bought a 410-acre tract in a remote area of southeastern Utah for $2,000,000. They later acquired additional land, bringing their total land holdings to over 500 acres. The wife sold her physical therapy practice to focus her time on the administrative side of their new ranching activity.

The property was in shambles and the petitioners spent large sums on infrastructure to refurbish it. The began a horse activity on the property which they continued until 2010. The activity never made money, with a large part of the losses (roughly $500,000 each year) attributable to depreciation, repairs due to vandalism, and infrastructure expense such as the building of a woodshop and cement factory as the property's remote location made repair work and build-out necessary to conduct on-site. The petitioners did not live on the ranch. Instead, they traveled to the ranch anywhere from four to ten times annually, staying approximately 10 days each time. The petitioners drafted all employee contracts, and managed all aspects of the horse activity.

They deducted their losses from the activity annually, and presumably because of the continued claimed losses, they were audited by the IRS in 2004 and 2008. Each of those audits concluded with an IRS determination that the petitioners were conducting a trade or business with profit intent (e.g., the activity was not a hobby). The IRS also determined that the petitioners were materially participating for purposes of the passive loss rules. The petitioners did not maintain contemporaneous records of their time spent on ranch activities. However, for each of those audits, the petitioners prepared time logs based on their calendars and their historical knowledge of how long it took them to complete various tasks. The IRS deemed the petitioners' approach to documenting and substantiating their time spent on various ranch activities as acceptable. That documentation showed that the

petitioners were putting over 2,000 hours (combined) into the ranch activity annually. In one year alone, they devoted more than 200 hours dealing with the IRS audit.

In 2010, the petitioners shifted the ranch business activity from horses to cattle. The husband retired in 2012 and, upon retirement, the couple moved to Park City, Utah, with the husband devoting full-time to the ranching activity along with his wife. The cattle operation was strictly grass-fed, with the cattle grazing upper-elevation Bureau of Land Management (BLM) land during the summer months. The petitioners negotiated the lease contracts with the BLM. They also hired a full-time ranch manager to manage the cattle. However, the petitioners managed the overall business of the ranch. From 2013-2015, the losses from the ranch declined each year.

The IRS initiated a third audit (all three audits involved different auditors) of the petitioners' ranching activity, this time examining tax years 2010-2014. The IRS examined whether the activity constituted a hobby, but raised no questions during the audit concerning the petitioners' material participation. The IRS hired an expert who spent three days at the ranch looking at all aspects of the ranching activity and examining each head of cattle. The expert produced a report simply concluding that the petitioners had too many expenses for the activity to be profitable. This time the IRS issued a statutory notice of deficiency (SNOD) denying deductions for losses associated with the ranching activity. The IRS claimed that the ranching activity was a "hobby," and also raised the alternative argument that the petitioners failed to satisfy the material participation test of the passive loss rules.

The petitioners disagreed with the IRS' assessment and filed a petition with the U.S. Tax Court. The IRS did not disclose to the petitioners whether the petitioners' alleged lack of material participation was an issue until two days before trial. At the seven-hour trial, the court expressed no concern about any lack of profit motive on the petitioners' part. The IRS' trial brief focused solely on the hobby loss issue and did not address the material participation issue. In addition, the IRS did not raise the material participation issue at trial, and it was made clear to the court that the paid ranch manager was hired to manage the cattle, but that the overall business of the ranch was conducted by the petitioners. At the conclusion of the trial, the court requested that the parties file additional briefs on the material participation issue.

Tax Court's opinion – hobby loss rules. Judge Cohen determined that the ranching activity was not a hobby based on the nine factors set forth in Treas. Reg. §1.183-2. One of the key factors in the petitioners' favor was that they had hired a ranch manager and ranch hand to work the ranch and a veterinarian to assist with managing the effects of high altitude on cattle. This indicated that the activity was being conducted as a business with a profit intent. They had many consecutive years of losses, didn't have a written business plan and didn't maintain records in a manner that aided in making business decisions. However, the court noted that they had made a significant effort to reduce expenses and make informed decisions to enhance the ranch's profitability. Indeed, after ten years of horse activity, the petitioners changed the ranching activity to cattle grazing in an attempt to improve profitability. While the petitioners' high income from non-ranching sources weighed against them, overall the court determined that the ranching activity was conducted with the requisite profit intent to not be a hobby.

Note: While the court's opinion stated that the horse activity was changed to cattle in 2000, the record before the court indicated that the petitioners didn't make that switch until 2010.

Tax Court's opinion – passive loss rules. However, Judge Cohen determined that the petitioners had failed to satisfy the material participation test of the passive loss rule. The losses were, therefore, passive and only deductible in accordance with those rules. The court determined that only two of the seven tests for material participation were relevant – the 500-hour test (Treas. Reg. § 1.469-5T(a)(1)) and the facts and circumstances test (Treas. Reg. §1.469-5T(a)(7)). As for the 500-hour test, the court took issue with the manner in which the petitioners documented their time spent on the ranching activity. The court opined that the logs were merely estimates of time spent on ranch activities and were created in preparation for trial. The court made no mention of the fact that the IRS, on two prior audits, raised no issue with the manner in which the petitioners tracked their time spent on ranch

activities and had not questioned the accuracy of the logs that were prepared based on the petitioners' calendars during the third audit which led to the SNOD and eventual trial.

As for the facts and circumstances test, the court determined that the petitioners could not satisfy the test because of the presence of the paid ranch manager. The court made no distinction between the cattle grazing activity which the ranch manager was responsible for and the overall business operations for which the petitioners were responsible. Indeed, on the material participation issue, due to the presence of the ranch manager, all of the personal actions and involvement of the petitioners on which the court based its determination of their profit motive were dismissed as "investor" hours.

The regulations do not list the facts and circumstances considered relevant in the application of the test, but the legislative history behind the provision does provide some guidance. Essentially, the question is whether and how regularly the taxpayer participates in the activity. *Staff of Joint Comm. on Taxation, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986, at 238 (Comm. Print 1987) [hereinafter 1986 Act Bluebook].* A taxpayer that doesn't live at the site of the activity can still satisfy the test. *Id.* While management activities can qualify as material participation, they are likely to be viewed skeptically because of the difficulty in verifying them. *See, e.g., HR Rep. No. 841, 99th Cong., 2d Sess. II-148 (Conf. Rep. 1986); S. Rep. No. 313, 99th Cong., 2d Sess. 734 n.20 (1986); 1986 Act Bluebook, supra note 35, at 240.* Merely "formal and nominal participation in management, in the absence of a genuine exercise of independent discretion and judgment is not material participation." *HR Rep. No. 841, 99th Cong., 2d Sess. II-148 (Conf. Rep. 1986); S. Rep. No. 313, 99th Cong., 2d Sess. 734 n.20 (1986).* Thus, the decisions the taxpayer makes must be important to the business (and they must be continuous and substantial).

It is true that a taxpayer's management activities are ignored if any person receives compensation for management services performed for the activity during the taxable year. *Treas. Reg. §1.469-5T(b)(2)(ii)(A).* Clearly, this exclusion applies where the "taxpayer has little or no knowledge or experience" in the business and "merely approves management decisions recommended by a paid advisor." *See Treas. Reg. §1.469-5T(k), Ex. 8.* However, the regulation applies well beyond those situations. In addition, a taxpayer's management work is ignored if some other unpaid manager spends more time than the taxpayer on managing the activity. *Treas. Reg. § 1.469-5T(b)(ii)(B).* Thus, there is no attributions of the activities of employees and agents to the taxpayer for purposes of the passive loss rules, but hiring a paid manager does not destroy the taxpayer's own record of involvement for the material participation purposes except for the facts and circumstances test. *See, e.g., S. Rep. No. 313, 99th Cong., 2d Sess. 735 (1986)("if the taxpayer's own activities are sufficient, the fact that employees or contract services are utilized to perform daily functions in running the business does not prevent the taxpayer from qualifying as materially participating").*

Conclusion

Clearly, the petitioners' type of involvement in the ranching activity was not that of an investor. However, equally clearly was that the petitioners' method of recordkeeping was a big issue to the court (even though IRS was not concerned). The preparation of non-contemporaneous logs and those prepared from calendar entries has been a problem in other cases. *See, e.g., Lee v. Comr., T.C. Memo. 2006-193; Fowler v. Comr., T.C. Memo. 2002-223; Shaw v. Comr., T.C. Memo. 2002-35.* Without those logs being available to substantiate the petitioners' hours, the petitioners were left with satisfying the material participation requirement under the facts and circumstances test. That's where the presence of the paid manager proved fatal. Thus, the ranching activity was not a hobby, but it was passive.

Combining the passive loss rules with a hobby loss argument is not a new tactic for the IRS (it was recently utilized with respect to a Kansas ranch), but the *Robison* decision certainly indicates that it can be expected to be used more frequently. But, remember, the IRS, at no point in the audit or litigation in *Robison* pressed the material participation issue – it was simply stated as an alternative issue in the SNOD. It was Judge Cohen that sought additional briefing on the issue.

The result in *Robison* is that the losses will only be deductible to the extent of passive income from the activity. Otherwise, the losses remain suspended until the petitioners dispose of their entire interest in the activity in a fully taxable transaction to an unrelated party. *I.R.C. §469(g)*. That's exactly what is going to happen. The petitioners are tired of the constant battle with the IRS and will not appeal the Tax Court's decision. The ranch is for sale.

Tuesday, June 12, 2018

Impact of Post-Death Events on Valuation

Overview

Normally, property is valued in a decedent's estate at its fair market value as of the date of the decedent's death. The Code and Treasury Regulations bear this our. S*ee I.R.C. §1014*). But, neither the Code nor the regulations rule out the possibility that post-death events can have a bearing on the value for assets in a decedent's estate. The real question is *what* post-death events are relevant for determining the actual date-of-death value of property for estate tax purposes.

Post-death events and their impact on valuation, that's the topic of today's post.

Cases on the Valuation Issue

The cases reveal that consideration may be given to subsequent events that are reasonably foreseeable at the date of death. Those events have a bearing on date-of-death value.

Relevant Cases

Numerous cases illustrate that it is simply not true that, except for the alternate valuation election under I.R.C. §2032, changes in valuation after death are immaterial. The following cases are illustrative:

- In *Gettysburg National Bank v. United States, 1:CV-90-1607, 1992 U.S. Dist. LEXIS 12152 (D. M.D. Pa. Jul. 17, 1992),* property was sold to a third party in an arm's length transaction 16 months after the decedent's death (13 months after its appraisal for estate tax purposes) for less than 75 percent of the value at which it was included in the gross estate. The court allowed the estate to reduce its value, stating that the subsequent sale may be relevant evidence that the appraised fair market value was incorrect.

- In *Estate of Scull v. Comr., C. Memo. 1994-211*, sales of artwork at auction 10 months after the valuation date were the best indicators of fair market value for federal estate tax purposes notwithstanding that the market had changed in the interim, and the court applied a 15 percent discount to reflect appreciation in the market between the date of the decedent's death and the auction.

- *In Rubenstein v. United States, 826 F. Supp. 448 (S.D. Fla. 1993)*, the court determined that the best evidence of a claim's value is the amount for which the claim was settled *after* the decedent's death.

- In *Estate of Andrews v. United States, 850 F. Supp. 1279 (E.D. Va. 1994)*, the court reasoned that reasonably foreseeable *post-death* facts relating to a publication contract under negotiation when the decedent died were germane to the determination of what a willing buyer would pay for the right to use the decedent's name.

- In *Estate of Necastro v. Comr.*, *C. Memo. 1994-352*, environmental contamination was discovered *five years after the decedent's death* and the court allowed the estate to file a claim for refund, reducing the value from the value as reported, which was based on facts known at the

date of death; the revaluation resulted in a reduction of over 33 percent from the value of the property determined before the contamination was discovered. The court's opinion did not, however, address the substantive issue whether facts discovered after death may influence valuation if willing buyers and sellers would not have known the relevant facts as of the valuation date.

- In *Estate of Jephson v. Comr.*, *81 T.C. 999 (1983)*, the court concluded that "[e]vents subsequent to the valuation date may, in certain circumstances, be considered in determining the value as of the valuation date."

- In *Estate of Keller v. Comr.*, *C. Memo. 1980-450*, the court stated that a "sale of property to an unrelated party shortly after date of death tends to establish such value at date of death. The property sold involved a farm and growing crop where both the sale of the farm and the harvesting of the crop occurred post-death.

- In *Estate of Stanton, C. Memo. 1989-341*, the court stated that the *sale of the property shortly after death* is the best evidence of fair market value. Under the facts of the case, the selling price of comparable property sold six months after the decedent's death was also considered with a downward adjustment to reflect the greater development potential of the comparable property and the 10 months of appreciation that occurred after the decedent's death in the actual estate property owned and sold.

- In *Estate of Trompeter v. Comr., 279 F.3d 767 (9th Cir. 2002)*, the Tax Court was reversed for failing to sufficiently articulate the basis for its decision regarding omitted assets and the rationale for the valuation discount selected, but the court nevertheless considered the value of assets using *post-death* developments, including redemption for $1,000 per share of stock valued at $10 per share 16 months earlier, and a coin collection returned at roughly half the value subsequently assigned to it by the taxpayer's estate in an effort to enjoin auction of that asset.

- In *Morris v. Comr., 761 F.2d 1195 (6th Cir. 1985)*, the court considered speculative *post-death* commercial development events for purposes of valuing farmland in the decedent's estate as of the date of the decedent's death. The decedent's farmland was approximately 15 miles north of downtown Kansas City and approximately five miles west of the Kansas City International Airport. At the time of death, plans were in place for a sewer line to service the larger of the two tracts the decedent owned. Also, residential development was planned within two miles of the same tract. In addition, significant roadways and the site for the planned construction of a major interstate were located close to the property. While none of these events had occurred as of the date of death, the court found them probative for determining the value of the farmland as of the date the decedent died. The decedent's son, the owner of the farmland as surviving joint tenant, tried to introduce evidence of the failed closing of some post-death sales to support his claim that the post-death events were speculative. But, the court disagreed, establishing the value of the farmland at $990,000 rather than the estate's valuation of $332,151.

The court's opinion makes it look like that evidence to confirm an appraiser's date-of-death prediction of future events is more likely to be received than evidence adduced to prove wrong an appraiser's prediction concerning future events. In any event, however, the case stands for the proposition that post-death events are relevant for establishing death-time value – even if they are somewhat speculative.

- In *Okerlund v. United States, 365 F.3d 1044 (Fed. Cir. 2004)*, the court dealt with the issue of stock valuation in a closely held company for stock that was gifted shortly before the company founder died and the company (a milk processing operation) suffered a salmonella outbreak. The taxpayers argued that these events should result in a lower gift tax value of the stock, with the

issue being the relevance of post-death events on the value of the gifts. The court stated that "[i]t would be absurd to rule an arms-length stock sale made moments after a gift of that same stock inadmissible as post-valuation date data. The key to use of any data in a valuation remains that all evidence must be proffered in support of finding the value of the stock on the donative date." The court ultimately affirmed the trial court's denial of a lower gift tax valuation based on the reality that the risk factors (the founder's death and matters that could materially affect the business) had already been accounted for in the valuation of the stock.

Conclusion

Clearly, post-death events and other facts that are reasonably predictable as of the date of death or otherwise relevant to the date of death value can serve as helpful evidence of value and allow either an increase (to obtain a higher income tax basis) or decrease (to reduce federal estate tax) in value as a matter or record. For farmland (and other real estate) the market is not static as of the date of death. Thus, appraisers can reasonably look to the arc of sales extending from pre-death dates to post-death dates in arriving at the date-of-death value.

Wednesday, May 23, 2018

The Impact of the TCJA on Estates and Trusts

Overview

The Tax Cuts and Jobs Act (TCJA) that was signed into law on December 22, 2017, represents a major change to many provisions of the tax Code that impact individuals and business entities. I have discussed of the major changes impacting farm and ranch taxpayers and businesses in prior posts. But, the TCJA also makes substantial changes with respect to the income taxation of trusts and estates. Those changes could have an impact on the use of trusts as an estate planning/wealth transfer device. Likewise, the TCJA changes that impact decedent's estate must also be noted.

The TCJA's changes that impact trusts and estates – that's the focus of today's post.

In General

While the media has largely focused on the TCJA's rate reductions for individuals and C corporations, the rates and bracket amounts were also modified for trusts and estates. The new rate structure for trusts and estates are located in I.R.C. §1(j)(2)(E) and are as follows: 10%: $0: $2,550; 24%: $2,551-$9,150; 35%: $9,151-$12,500; 37% - over $12,500. As can be noted, the bracket structure for trusts and estates remains very compressed. Thus, the pre-TCJA planning approach of not trapping income or gains inside a trust or an estate remains the standard advice. That's because the TCJA did not change the tax rates for qualified dividends and long-term capital gains, although the bracket cut-offs are modified slightly as follows: 0%: $0-$2,600; 15%: $2,601-$12,700; 20%: Over $12,700. Those rates and brackets remain advantageous compared to having the income or gain taxed at the trust or estate level.

Other Aspects of Trust/Estate Taxation

Post-TCJA, it remains true that an estate or trust's taxable income is computed in the same manner as is income for an individual. I.R.C. §641(b). However, the TCJA amends I.R.C. §164(b) to limit the aggregate deduction for state and local real property taxes and income taxes to a $10,000 maximum annually. But, this limit does not apply to any real estate taxes or personal property taxes that a trust or an estate incurs in the conduct of a trade or business (or an activity that is defined under I.R.C. §212). Thus, an active farm business conducted by a trust or an estate will not be subject to the limitation.

The TCJA also suspends miscellaneous itemized deductions for a trust or an estate. That means, for example, that investment fees and expenses as well as unreimbursed business expenses are not deductible. This will generally cause an increased tax liability at the trust or estate level as compared to prior law. Why? With fewer deductions, the adjusted taxable income (ATI) of a trust or an estate will be higher. For simple trusts, this is also a function of distributable net income (DNI) which, in turn, is a function of the income distribution deduction (IDD). I.R.C. §651(b) allows a simple trust to claim an IDD limited to the lesser of fiduciary accounting income (FAI) or DNI. Under prior law, all trust expenses could be claimed when determining DNI, but only some of those expenses were allocated to principal for purposes of calculating FAI. Now, post-TCJA, ATI for a trust or an estate will be higher due to the loss of various miscellaneous itemized deductions (such as investment management fees). As ATI rises, DNI will decline but FAI won't change (the allocation of expenses is determined by the trust language or state law). The more common result is likely to be that FAI will be the actual limitation on the IDD, and more income will be trapped inside the estate or the trust. That's what will cause the trust or the estate to pay more tax post-TCJA compared to prior years.

But, guidance is needed concerning the deductibility of administrative expenses such as trustee fees. It's not clear whether the TCJA impacts I.R.C. §67. That Code section does not apply the two percent limitation to administrative expenses that are incurred solely because the property is held inside a trust or an estate. There is some support for continuing to deduct these amounts. I.R.C. §67(g) applies to miscellaneous itemized deductions, but trustee fees and similar expenses are above-the-line deductions for a trust or an estate that impact the trust or estate's AGI. Thus, I.R.C. §67 may not apply. I am told that guidance will be forthcoming on that issue during the summer of 2018. We shall see.

A trust as well as an estate can still claim a $600 personal exemption (with the amount unchanged) under I.R.C. §642. Don't confuse that with the TCJA's suspension of the personal exemption for individuals. Also, don't confuse the removal of the alternative minimum tax (AMT) for corporations or the increased exemption and phaseout range for individuals with the application of the AMT to trusts and estates. No change was made concerning how the AMT applies to a trust or an estate. See I.R.C. §55.(d)(3). The exemption stays at $24,600 with a phaseout threshold of $82,050. Those amounts apply for 2018 and they will be subsequently adjusted for inflation (in accordance with the "chained" CPI).

Other TCJA Impacts on Trusts and Estates

The new 20 percent deduction for pass-through entities under I.R.C. §199A can be claimed by an estate or a trust with non-C corporate business income. The deduction is claimed at the trust or the estate level, with the $157,500 threshold that applies to a taxpayer filing as a single person applying to a trust or an estate. The rules under the now-repealed I.R.C. §199 apply for apportioning between fiduciaries and beneficiaries any W-2 wages and unadjusted basis of qualified property under the limitation based on W-2 wages and capital. There is no separate computation required for alternative minimum tax purposes.

The eligibility of a trust or an estate for the I.R.C. §199A deduction may provide some planning opportunities to route pass-through income from a business that is otherwise limited or barred from claiming the deduction through a non-grantor trust so that the deduction can be claimed or claimed to a greater extent. For example, assume that a sole proprietorship farming operation nets $1,000,000 annually, but pays no qualified wages and has no qualifying property (both factors that result in an elimination of the deduction for the business). If business income is routed through a trust (or multiple truss) with the amount of trust income not exceeding the $157,500 threshold, then an I.R.C. §199A deduction can be generated. However, before this strategy is utilized, there are numerous factors to consider including overall family estate planning/succession planning goals and the economics of the business activity at issue.

Clarification is needed with respect to a charitable remainder trust (CRT) that has unrelated business taxable income (UBIT). UBIT is income of the CRT that comes from an unrelated trade or business less deductions "allowed by Chapter 1 of the Code" that are "directly connected" with the conduct of a

trade or business. Treas. Reg. §1.512(a)-1(a). Is the new I.R.C. §199A deduction a directly connected deduction? It would seem to me that it is because it is tied to business activity conducted by the trust. If that construction is correct, I.R.C. §199A would reduce the impact of the UBIT on a CRT. Certainly, guidance is needed from the Treasury on this point.

Related to the CRT issue, the TCJA would appear to allow an electing small business trust (ESBT) to claim the I.R.C. §199A deduction on S corporate income. But, again, guidance is needed. An ESBT calculates the tax on S corporate income separately from all other trust income via a separate schedule. The result is then added to the total tax calculated for the trust's non-S corporate income. Thus, the ESBT pays tax on all S corporate income. It makes no difference whether the income has been distributed to the ESBT beneficiaries. Also, in computing its tax, the deductions that an ESBT can claim are set forth in I.R.C. §641(c)(2). However, the TCJA does not include the I.R.C. §199A deduction in that list. Was that intentional? Was that an oversight? Your guess is as good as mine.

Another limiting factor for an ESBT is that an ESBT can no longer (post-2017 and on a permanent basis) deduct 100 percent of charitable contributions made from the S corporation's gross income. Instead, the same limitations that apply to individuals apply to an ESBT – at least as to the "S portion" of the ESBT. But, the charitable contribution need not be made from the gross income of the ESBT. In addition, the charitable contribution must be made by the S corporation for the ESBT to claim the deduction. If the ESBT makes the contribution, it is reported on the non-ESBT portion of the return. It is not allocated to the ESBT portion.

Under the TCJA, an ESBT can have a nonresident alien as a potential current beneficiary.

If a trust or an estate incurs a business-related loss, the TCJA caps the loss at $250,000 for 2018 (inflation-adjust for future years). The $250,000 amount is in the aggregate – it applies at the trust or estate level rather than the entity level (if the trust or estate is a partner of a partnership or an S corporation shareholder). I.R.C. §461(l)(2). Amounts over the threshold can be carried over and used in a future year.

Conclusion

The TCJA impacts a broad array of taxpayers. Its impacts are not limited to individuals and corporate taxpayers. Trusts and estates are also affected. For those with trusts or involved with an estate, make sure to consult tax counsel to make sure the changes are being dealt with appropriately.

Monday, May 21, 2018

Valuation Discounting - Part Two

Overview

In Part One last Thursday, I examined the basics of valuation discounting in the context of a family limited partnership (FLP). In Part Two today, I dig deeper on the I.R.C. §2036 issue, recent cases that have involved IRS challenges to valuation discounts under that Code section, and possible techniques for avoiding IRS challenges.

I.R.C. §2036 – The Basics

Historically, the most litigated issues involving valuation discounts surround I.R.C. §2036. Section 2036(a) specifies as follows:

(a) General rule. The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

(1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

(b) Voting rights

(1) In general. For purposes of subsection (a)(1), the retention of the right to vote (directly or indirectly) shares of stock of a controlled shall be considered to be a retention of the enjoyment of transferred property.

Retained interest. As you can imagine, a big issue under I.R.C. §2036 is whether assets that are contributed to an FLP (or an LLC) are pulled back into the transferor's estate at death without any discount without the application of any discount on account of the restrictions that apply to the decedent's FLP interest. The basic argument of the IRS is that the assets should be included in the decedent's estate due to an implied agreement of retained enjoyment, even where the decedent had transferred the assets before death. *See, e.g., Estate of Harper v. Comr., T.C. Memo. 2002-121; Estate of Korby v. Comr., 471 F.3d 848 (8th Cir. 2006).*

In the statutory language laid out above, the parenthetical language of subsection (a) is important. That's the language that estate planners use to circumvent the application of I.R.C. §2036. The drafting of the FLP agreement and the associated planning and implementation of the entity should ensure that there are legitimate and significant non-tax reasons for the use of the FLP/LLC. That doesn't mean that a tax reason creating the entity cannot be present, but there must be a major non-tax reason present also.

If the IRS denies a valuation discount in the context of an FLP/LLC and the taxpayer cannot rely on the parenthetical language, the focus then becomes whether there existed an implied agreement of retained enjoyment in the transferred assets. There aren't many cases that taxpayer's win where the taxpayer's argument is outside of the parenthetical exception and is based on the lack of retained enjoyment in the transferred assets, but there are some. *See, e.g., Estate of Mirowski v. Comr., T.C. Memo. 2008-74; Estate of Kelley v. Comr., T.C. Memo. 2005-235.*

Designating possession or enjoyment. What about the retained right to designate the persons who will possess or enjoy the transferred property or its income? In other words, what about the potential problem of subsection (a)(2)? A basic issue with the application of this subsection is whether the taxpayer can be a general partner of the FLP (or manager of an LLC). There is some caselaw on this question, but those cases involve unique facts. In both cases, the court determined that I.R.C. §2036(a)(2) applied to cause inclusion of the transferred property in the decedent's gross estate. *See, e.g., Estate of Strangi v. Comr., T.C. Memo. 2003-145, aff'd., 417 F.3d 468 (5th Cir. 2005); Estate of Turner v. Comr., T.C. Memo. 2011-209.* In an earlier case in 1982, the Tax Court determined that co-trustee status does not trigger inclusion under (a)(2) if there are clearly identifiable limits on distributions. *Estate of Cohen v. Comr., 79 T.C. 1015 (1982).* That Tax Court opinion has generally led to the conclusion that (a)(2) also does not apply to investment powers.

While the *Strangi* litigation indicates that (a)(2) can apply if the decedent is a co-general partner or co-manager, the IRS appears to focus almost solely on situations where the decedent was a sole general partner or manager. The presence of a co-partner or co-manager is similar to a co-trustee situation and also can help build the argument that the entity was created with a significant non-tax reason.

Succession planning. From a succession planning perspective, it may be best for one parent to be the transferor of the limited partnership interests and the other to be the general partner. For example, both parents could make contributions to the partnership in the necessary amounts so that one parent receives a 1 percent general partnership interest and the other parent receives the 99 percent limited partnership interest. The parent holding the limited partnership interest then could make gifts of the limited partnership interests to the children (or their trusts). The other parent is able to retain control of the "family assets" while the parent holding the limited partnership interest is the transferor of the

interests. Unlike IRC §672(e), which treats the grantor as holding the powers of the grantor's spouse, IRC §2036 does not have a similar provision. Thus, if one spouse is able to retain control of the partnership and the other spouse is the transferor of the limited partnership interests, then IRC §2036 should not be applicable.

I.R.C. §2703 and Indirect Gifts

The IRS may also take an audit position against an FLP/LLC that certain built-in restrictions in partnership agreements should be ignored for tax purposes. This argument invokes I.R.C. §2703. That Code section reads as follows:

(a) General rule. For purposes of this subtitle, the value of any property shall be determined without regard to—

(1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or

(2) any restriction on the right to sell or use such property.

(b) Exceptions. Subsection (a) shall not apply to any option, agreement, right, or restriction which meets each of the following requirements:

(1) It is a bona fide business arrangement.

(2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.

(3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

In both *Holman v. Comr., 601 F.3d 763 (8th Cir. 2010)* and *Fisher v. United States, 1:08-cv-0908-LJM-TAB, 2010 U.S. Dist. LEXIS 91423 (S.D. Ind. Sept. 1, 2010)*, the IRS claimed that restrictions in a partnership agreement should be ignored in accordance with I.R.C. §2703. In *Holman*, the restrictions were not a bona fide business arrangement and were disregarded in valuing the gifts at issue. In *Fisher*, transfer restrictions were likewise ignored.

Recent Cases

Several valuation discounting cases have been decided recently that provide further instruction on the pitfalls to avoid in creating an FLP/LLC to derive valuation discounts. Conversely, the cases also provide further detail on the proper roadmap to follow when trying to create valuation discounts via entities.

- *Estate of Purdue v. Comr., T.C. Memo. 2015-249.* In this case, the decedent and her husband transferred marketable securities, an interest in a building and other assets to an LLC. The decedent also made gifts annually to a Crummey-type trust from 2002 until death in 2007. Post-death, the beneficiaries made a loan to the decedent's estate to pay the estate taxes. The estate deducted the interest payments as an administration expense. The court concluded that I.R.C. §2036 did not apply because the transfers to the LLC were bona fide and for full consideration. There was also a significant, non-tax reason present for forming the LLC and there was no commingling of the decedent's personal assets with those of the LLC. In addition, both the decedent and her husband were in good health at that time the LLC was formed and the assets were transferred to it.

- *Estate of Holliday v. Comr., T.C. Memo. 2016-51.* The decedent's predeceased husband established trusts and a family limited partnership (FLP). The FLP agreement stated that, "To the extent that the General Partner determines that the Partnership has sufficient funds in excess of its current operating needs to make distributions to the Partners, periodic distributions of Distributable Cash shall be made to the partners on a regular basis according to their respective Partnership Interests." The decedent, who was living in a nursing home at the time the FLP was formed, contributed

approximately $6 million of marketable securities to the FLP and held a 99.9 percent limited partner interest. Before death, the decedent received one check from the FLP (a pro-rata distribution of $35,000). At trial, the General Partner testified that he believed that the FLP language was merely boilerplate and that distributions weren't made because "no one needed a distribution." The court viewed the FLP language and the General Partner's testimony as indicating that the decedent retained an implied right to the possession or enjoyment of the right to income from the property she had transferred to the FLP. The decedent also retained a large amount of valuable assets personally, thus defeating the General Partners' arguments that distributions were not made to prevent theft and caregiver abuse. The court also noted that the FLP was not necessary for the stated purposes to protect the surviving spouse from others and for centralized management because trusts would have accomplished the same result. The decedent was also not involved in the decision whether to form an FLP or some other structure, indicating that she didn't really express any desire to insure family assets remained in the family. The court also noted that there was no meaningful bargaining involved in establishing the FLP, with the family simply acquiescing to what the attorney suggested. The FLP also ignored the FLP agreement – no books and records were maintained, and no formal meetings were maintained.

Accordingly, the court determined that there was no non-tax purpose for the formation of the FLP, there was no bona fide sale of assets to the FLP and the decedent had retained an implied right to income from the FLP assets for life under I.R.C. §2036(c) causing inclusion of the FLP assets in the decedent's estate.

• *Estate of Beyer v. Comr., T.C. Memo. 2016-183.* In this case, the decedent was in his upper 90s at the time of his death. He had never married and had no children, but he did have four sisters. The decedent had been the CFA of Abbott Lab and had acquired stock options from the company, starting exercising them in 1962 and had accumulated a great deal of Abbott stock. He formed a trust in 1999 and put 800,000 shares of Abbott stock into the trust. He amended the trust in 2001 and again in 2002. Ultimately, the decedent created another trust, and irrevocable trust, and it eventually ended up owning a limited partnership. Within three years of his death, the decedent made substantial gifts to family members from his living trust. Significant gifts were also made to the partnership.

The IRS claimed that the value of the assets that the decedent transferred via the trust were includable in the value of his gross estate under I.R.C. §2036(a). The estate claimed that the transfers to the partnership were designed to keep the Abbott stock in a block and keep his investment portfolio intact, and wanted to transition a family member into managing his assets. The IRS claimed that the sole purpose of the transfers to the partnership were to generate transfer tax savings. The partnership agreement contained a list of the purposes the decedent wanted to accomplish by forming the partnership. None of the decedent's stated reasons for the transfers were in the list.

The court determined that the facts did not support the decedent's claims and the transfers were properly included in his estate. The decedent also continued to use assets that he transferred to the partnership and did not retain sufficient assets outside of the partnership to pay his anticipated financial obligations. On the valuation issue, the court disallowed valuation discounts because the partnership held assets in a restricted management account where distributions of principal were prohibited.

Conclusion

As the cases point out, valuation discounts can be achieved even if asset management is consolidated. Also, it is important that the decedent/transferor is not financially dependent on distributions from the FLP/LLC, retains substantial assets outside of the entity to pay living expenses, does not commingle personal and entity funds, is in good health at the time of the transfers, and the entity follows all formalities of the entity structure. For gifted interests, it is important that the donees receive income from the interests. Their rights cannot be overly restricted. *See, e.g., Estate of Wimmer v. Comr., T.C. Memo. 2012-157.*

Appropriate drafting and planning are critical to preserve valuation discounts. Now that the onerous valuation regulations have been removed, they are planning opportunities. But, care must be taken.

Tuesday, April 17, 2018

Modifying an Irrevocable Trust – Decanting

Overview

Trusts are a popular part of an estate plan for many people. Trusts also come in different forms. Some take effect during life and can be changed whenever the trust grantor (creator or settlor) desires. These are revocable trusts. Other trusts, known as irrevocable trusts, also take effect during life but can't be changed when desired. Or, at least not as easily. That's an issue that comes up often. People often change their minds and circumstances also can change. In addition, the tax laws surrounding estates and trust are frequently modified by the Congress as well as the courts. Also, sometimes drafting errors occur and aren't caught until after the irrevocable trust has been executed.

So how can a grantor of an irrevocable accomplish a "do over" when circumstances change? It involves the concept of "decanting" and it's the topic of today's post.

Decanting 101

Trying to change the terms of an irrevocable trust is not a new concept. "Decanting" involves pouring one trust into another trust with more favorable terms. To state it a different way, decanting involves distributing the assets of one trust to another trust that has the terms that the grantor desires with the terms that the grantor no longer wants remaining in the old trust.

The ability to "decant" comes from either an express provision in the trust, or a state statute or judicial opinions (common law). Presently, approximately 20 states have adopted "decanting" statutes, and a handful of others (such as Iowa and Kansas) allow trust modification under common law. In some of the common law jurisdictions, courts have determined that decanting is allowed based upon the notion that the trustee's authority to distribute trust corpus means that the trustee has a special power of appointment which allows the trustee to transfer all (or part) of the trust assets to another irrevocable trust for the same beneficiaries.

In terms of a step-by-step approach to decanting, the first step is to determine whether an applicable state statute applies. If there is a statute, a key question is whether it allows for decanting. Some statutes don't so provide. If it does, the statutory process must be followed. Does the statute allow the trustee to make the changes that the grantor desires? That is a necessary requirement to being able to decant the trust. If there is no governing statute, or there is a statute but it doesn't allow the changes that the grantor desires, a determination must be made as to what the state courts have said on the matter, if anything. But, that could mean that litigation involving the changes is a more likely possibility with a less than certain outcome.

If conditions are not favorable for decanting in a particular jurisdiction, it may be possible under the trust's terms (or something known as a "trust protector") to shift the trust to a different jurisdiction where the desired changes will be allowed. Absent favorable trust terms, it might be possible to petition a local court for authority to modify the trust to allow the governing jurisdiction of the trust to be changed.

If decanting can be done, the process of changing the trust terms means that documents are prepared that will result in the pouring of the assets of the trust into another trust with different terms. Throughout the process, it is important to follow all applicable statutory rules. Care must be taken when preparing deeds, beneficiary forms, establishing new accounts and conducting any other related business to complete the change.

IRS Private Ruling

In the fall of 2015, the IRS released a Private Letter Ruling that dealt with the need to change an error in the drafting of an irrevocable trust in order to repair tax issues with the trust. *Priv. Ltr. Rul. 201544005 (Jun. 19, 2015).* The private ruling involved an irrevocable trust that had a couple of flaws. The settlors (a married couple) created the trust for their children, naming themselves as

trustees. One problem was that the trust terms gave the settlors a retained power to change the beneficial interests of the trust. That resulted in an incomplete gift of the transfer of the property to the trust. In addition, the retained power meant that I.R.C. §2036 came into play and would cause inclusion of the property subject to the power in the settlors' estates. The couple intended that their transfers to the trust be completed gifts that would not be included in their gross estates, so they filed a state court petition for reformation of the trust to correct the drafting errors. The drafting attorney submitted an affidavit that the couple's intent was that their transfers of property to the trust be treated as completed gifts and that the trust was intended to optimize their applicable exclusion amount. The couple also sought to resign as trustees. The court allowed reformation of the trust. That fixed the tax problems. The IRS determined that the court reformation would be respected because the reformation carried out the settlors' intent.

When to Decant

So, it is possible that an irrevocable trust can be changed to fix a drafting error and for other reasons if the law and facts allow.

What are common reasons decant an irrevocable trust? Some of the most common ones include the following:

- To achieve greater creditor protection by changing, for example, a support trust to a discretionary trust (this can be a big issue, for example, with respect to long-term health care planning);
- To change the situs (jurisdiction where the trust is administered) to a location with greater pro-trust laws;
- To adjust the terms of the trust to take into account the relatively larger federal estate exemption applicable exclusion and include power of appointment language that causes inclusion of the trust property in the settlor's estate to achieve an income tax basis "step-up" at death (this has become a bigger issue as the federal estate tax exemption has risen substantially in recent years);
- To provide for a successor trustee and modify the trustee powers;
- To either combine multiple trusts or separate one trust into a trust for each beneficiary;
- To create a special needs trust for a beneficiary with a disability;
- To permit the trust to be qualified to hold stock in an S corporation and, of course;
- To correct drafting errors that create tax problems and, perhaps, in the process of doing so create a fundamentally different trust.

Conclusion

The ability to modify an irrevocable trust is critical. This is particularly true with the dramatic change in the federal estate and gift tax systems in recent years. Modification may also be necessary when desires and goals change or to correct an error in drafting. Fortunately, in many instances, it is possible to make changes even though the trust is "irrevocable." If you need to "decant" a trust, see an estate planning professional for help.

Thursday, February 22, 2018

Some Thoughts on The Importance of Leasing Farmland

Overview

Leasing is of primary importance to agriculture. Leasing permits farmers and ranchers to operate larger farm businesses with the same amount of capital, and it can assist beginning farmers and ranchers in establishing a farming or ranching business.

Today's post takes a brief look at some of the issues surrounding farmland leases – economic; estate planning; and federal farm program payment limitation planning.

Common Types of Leases

Different types of agricultural land leasing arrangements exist. The differences are generally best understood from a risk/return standpoint. Cash leases involve the periodic payment of a rental amount that is either a fixed number of dollars per acre, or a fixed amount for the entire farm. Typically, such amounts are payable in installments or in a lump sum. A flexible cash lease specifies that the amount of cash rent fluctuates with production conditions and/or crop or livestock prices. A hybrid cash lease contains elements similar to those found in crop-share leases. For example, a hybrid cash lease usually specifies that the rental amount is to be determined by multiplying a set number of bushels by a price determined according to terms of the lease, but at a later date. The tenant will market the entire crop. The landlord benefits from price increases, while requiring no management or selling decisions or capital outlay. However, the rental amount is adversely affected by a decline in price. The tenant, conversely, will not bear the entire risk of low commodity prices, as would be the case if a straight-cash lease were used, but does bear all of the production risk and must pay all of the production costs.

Under a hybrid-cash lease, known as the guaranteed bushel lease, the tenant delivers a set amount of a certain type of grain to a buyer by a specified date. The landlord determines when to sell the grain, and is given an opportunity to take advantage of price rises and to make his or her own marketing decisions. However, the landlord must make marketing decisions, and also is subject to price decreases and the risk of crop failure. For tenants, the required capital outlay will likely be less, and the tenant should have greater flexibility as to cropping patterns. While the rental amount may be less than under a straight-cash lease, the tenant will continue to bear the risk of crop failure.

Another form of the hybrid-cash lease, referred to as the minimum cash or crop share lease, involves a guaranteed cash minimum. However, the landlord has the opportunity to share in crop production from a good year (high price or high yield) without incurring out-of-pocket costs. For a tenant, the minimum cash payment likely will be less than under a straight-cash lease because the landlord will receive a share of production in good years. The tenant, however, still retains much of the production risk. In addition, the tenant typically does not know until harvest whether the tenant will receive all or only part of the crop. This may make forward cash contracting more difficult.

Under a crop-share leasing arrangement, the rent is paid on the basis of a specified proportion of the crops. The landlord may or may not agree to pay part of certain expenses. There are several variations to the traditional crop-share arrangement. For example, with a crop share/cash lease, rent is paid with a certain proportion of the crops, but a fixed sum is charged for selected acreage such as pasture or buildings, or both. Under a livestock-share leasing arrangement, specified shares of livestock, livestock products and crops are paid as rent, with the landlord normally sharing in the expenses. For irrigation crop-share leases, rent is a certain proportion of the crops produced, but the landlord shares part of the irrigation expenses. Under labor-share leases, family members are typically involved and the family member owning the assets has most of the managerial responsibility and bears most of the expenses and receives most of the crops. The other family members receive a share of yield proportionate to their respective labor and management inputs.

Estate Planning Implications

Leasing is also important in terms of its relation to a particular farm or ranch family's estate plan. For example, with respect to Social Security benefits for retired farm-landlords, pre-death material participation under a lease can cause problems. A retired farm-landlord who has not reached full retirement age (66 in 2018) may be unable to receive full Social Security benefits if the landlord and tenant have an agreement that the landlord shall have "material participation" in the production of, or the managing of, agricultural products.

While material participation can cause problems with respect to Social Security benefits, material participation is required for five of the last eight years before the earlier of retirement, disability or death if a special use valuation election is going to be made for the agricultural real estate included in the decedent-to-be's estate. *I.R.C. §2032A.* A special use valuation election permits the agricultural real estate contained in a decedent's estate to be valued for federal estate tax purposes at its value for agricultural purposes rather than at fair market value. The solution, if a family member is present, may be to have a nonretired landlord not materially participate, but rent the elected land to a materially participating family member or to hire a family member as a farm manager. Cash leasing of elected land to family members is permitted before death, but generally not after death. The solution, if a family member is not present, is to have the landlord retire at age 65 or older, materially participate during five of the eight years immediately preceding retirement, and then during retirement rent out the farm on a nonmaterial participation crop-share or livestock-share lease.

Farm Program Payments

Leases can also have an impact on a producer's eligibility for farm program payments. In general, to qualify for farm program payments, an individual must be "actively engaged in farming." For example, each "person" who is actively engaged in farming is eligible for up to $125,000 in federal farm program payments each crop year. A tenant qualifies as actively engaged in farming through the contribution of capital, equipment, active personal labor, or active personal management. Likewise, a landlord qualifies as actively engaged in farming by the contribution of the owned land if the rent or income for the operation's use of the land is based on the land's production or the operation's operating results (not cash rent or rent based on a guaranteed share of the crop). In addition, the landlord's contribution must be "significant," must be "at risk," and must be commensurate with the landlord's share of the profits and losses from the farming operation.

A landowner who cash leases land is considered a landlord under the payment limitation rules and may not be considered actively engaged in farming. In this situation, only the tenant is considered eligible. Under the payment limitation rules, there are technical requirements that restrict the cash-rent tenant's eligibility to receive payments to situations in which the tenant makes a "significant contribution" of (1) active personal labor and capital, land or equipment; or (2) active personal management and equipment. Leases in which the rental amount fluctuates with price and/or production (so-called "flex" leases) can raise a question as to whether or not the lease is really a crop-share lease which thereby entitles the landlord to a proportionate share of the government payments attributable to the leased land.

Under Farm Service Agency (FSA) regulations (7 C.F.R. §1412.504(a)(2)), a lease is a "cash lease" if it provides for only a guaranteed sum certain cash payment, or a fixed quantity of the crop (for example, cash, pounds, or bushels per acre)." All other types of leases are share leases. In April 2007, FSA issued a Notice stating that if any portion of the rental payment is based on gross revenue, the lease is a share lease. Notice DCP-172 (April 2, 2007). However, according to FSA, if a flex or variable lease pegs rental payments to a set amount of production based on future market value that is *not* associated with the farm's specific production, it's a cash lease. *Id.* That was the FSA's position through the 2008 crop year. Beginning, with the 2009 crop year, FSA has taken the position that a tenant and landlord may reach any agreement they wish concerning "flexing" the cash rent payment and the agreement will not convert the cash lease into a share-rent arrangement.

Conclusion

There are many issues that surround farmland leasing. Today's post just scratches the surface with a few. Of course, many detailed tax rules also come into play when farmland is leased. The bottom line is that the type of lease matters, for many reasons. Give your leasing arrangement careful consideration and get it in writing.