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The 401(k) as a Pivotal Point in the Movement

Towards Defined Contribution Plans

By Michael J. Thomas

The 401(k) has been closely associated with the shift among qualified retirement plans from defined benefit (DB) plans, (i.e. traditional pensions), to defined contribution (DC) plans. See Samuel Estreicher and Laurence Gold, *The Shift from Defined Benefit Plans to Defined Contribution Plans*, 11 LEWIS & CLARK L. REV. 331, 331-333 (2007). This article highlights the growth of DC plans with a 401(k) salary deferral feature, first available in 1980.¹

Shift From Defined Benefit Plans to Defined Contribution Plans

When the Employee Retirement Income Security Act (ERISA), 29 U.S.C. §§1001-1461, became law in 1974, DB plans involving a fairly secure monthly benefit were the predominant type of employer-sponsored, qualified retirement plan by number of participants.² See Barry Kozak, *The Cash Balance Plan: An Integral Component of the Defined Benefit Plan Renaissance*, 37 J. MAR. L. REV. 753, 802 (2004). At the time, DC plans (commonly a profit sharing plan) were primarily viewed as a way to supplement a participant's anticipated pension benefit. Janice Kay McClendon, *The Death Knell of Traditional Defined Benefit Plans: Avoiding a Race to the 401(k) Bottom*, 80 TEMP. L. REV. 809, 814 (2007). The view that DC plans should be viewed primarily as supplementary to DB plans is still asserted in recent times. See, e.g., Chase A. Tweel, *Retirement Savings in the Face of Increasing Longevity: The Advantages of Deferring Retirement*, 14 N.C. BANKING INST. 103, 123 (2010).

Buttressed by the generally favorable investment market, the 401(k) flourished through the 1980s and 1990s, becoming perhaps the most important retail product of the financial services industry. See Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451, 484-85 (2004). By the mid-to-late 1990s, DC plans with a 401(k) feature were the predominant plan type by number of participants,³ with such plans often adopted by growing companies in the technology, financial and similar "new economy" sectors.



See McClendon, *supra*, at 820. While older businesses could offer a DC plan, they could not easily move away from their core DB plan. This shift occurred as many older companies in the mining, manufacturing, and other labor-intensive sectors, associated with DB plans in the post-World War II era, were declining in relative influence. *Id.* The trend towards DC plans was even more pronounced among smaller employers.⁴

Historically, the lack of investment diversification was a major pitfall in many 401(k) plans, often exacerbated by a participant's short time horizon until retirement. In 2004, in large 401(k) plans with five thousand or more participants, the employer's stock accounted for 34% of total assets. See Estreicher and Gold, *supra*, at 337-38, n. 15. Disproportionate investment in the employer's stock, often the employer's contribution, resulted in lack of diversification, which can have substantial, if not catastrophic, financial consequences to participants, as seen in the Enron stock collapse in 2001. Lorraine Schmall, *Defined Contribution Plans After Enron*, 41 BRANDEIS L.J. 891, 891-93 (2003). General market risk is present as well. If the stock market experiences an appreciable drop in the last year before retirement, participants will find themselves with a 401(k) account value that is much less than it was months previously. See Zelinsky, *supra*, at 460

(noting that "investments' variability may strike on the downside at an inopportune time").

In a traditional pension, the investment risk falls upon the employer. Zelinsky, *supra*, at 458-60 (discussing the major aspects of investment strategy in a DB plan trust, including the longer time horizon and inherent economies of scale). For many reasons, it is inherently easier for a pension plan, managing millions or even billions of dollars in assets, to diversify and weather market downturns, compared to typical participants self-managing their investments. *Id.* at 459 (contrasting economies of scale inherent in DB plans and the "dispersed" nature of "self-directed" DC plans). Additionally, the participant's expectations of a monthly payment are at least partially insured by the Pension Benefit Guaranty Corporation, although that adds to the costs of such plans. *Id.* at 503.

Pension Protection Act of 2006

The Pension Protection Act of 2006 ("PPA"), Pub. L. No. 109-280, 120 Stat. 780, codified in various sections of the U.S. Code, was described as the "most sweeping reform of America's pension laws in over 30 years." See Remarks by President George W. Bush at the August 17, 2006 signing ceremony, *reprinted in*

2006 U.S.C.C.A.N. S39. Of relevance here, the PPA encouraged diversification in DC plans by requiring that an employer offer at least three investment options other than employer's stock, "each of which is diversified and has materially different risk and return characteristics." 26 U.S.C. §401(a)(35)(D) (providing for three investment options other than employer's stock); 29 U.S.C. §1054(j) (parallel ERISA provision). Plan sponsors were required to notify participants of their diversification rights, effective for plan years beginning after 2006. 29 U.S.C. §1021(m).

As noted, the increased utilization of the 401(k) feature, and DC plans generally, has been particularly evident among small employers, often newer businesses which never set up a traditional pension. The PPA contained at least one provision to encourage the establishment of DB plans among smaller employers, by authorizing, for plan years beginning on or after Jan. 1, 2010, the so-called "DB(k)" plan, essentially a simplified DB plan with a 401(k) feature.⁵

It warrants observing that 401(k) plans also involve the risk of "pre-retirement leakage," the relative ease with which DC plan participants may withdraw funds from their account prior to retirement. That may occur upon an employee's pre-retirement departure or through a loan against the account, often allowed by such plans. See Estreicher and Gold, *supra*, at 334; Department of Labor, Employee Benefits Security Administration, REPORT OF THE WORKING GROUP ON RETIREMENT PLAN LEAKAGE (November 13, 1998).

Pre-retirement leakage has not historically been an issue with DB plans, although the PPA authorized such plans to allow pre-retirement distributions for older employees. That is, PPA §905, codified at 26 U.S.C. §401(a)(36), permits, but does not require, DB plans to allow in-service distributions to employees who have reached age 62. Previously, such plans could not begin paying benefits until the employee had terminated employment, assuming that the employee was vested and met the plan's retirement age. See Zelinsky, *supra*, at 456, n. 6.

Conclusion

The 401(k), a key factor—along with demographic and economic changes—in the trend away from DB plans, is one, albeit popular, feature within the qualified retirement plan system influenced by

ERISA and federal tax law and policy. This is not intended to argue that one plan type is always better for every individual than another plan.

In early 2009, around the beginning of the recent recession, a *Kiplinger* writer posed the following:

Since the stock market's peak in October 2007, investors have lost as much as \$2.5 trillion in their 401(k) and IRA accounts. Layer that anguish on top of existing frustrations with 401(k) plans – that hidden fees nibble away at returns, balances are inadequate, and less than half of U.S. workers even have access to one – and the question arises: Are 401(k)s a failed experiment, or are they just in need of tweaking?⁶

While that rhetorical question may seem stark, participants should be aware of the advantages and drawbacks of any particular plan relative to others, given their investment time horizon and other factors. Although an employer has a continuing fiduciary duty to monitor fund investment options, *Tibble v. Edison International*, 575 U.S. ____ (2015), proactive participants should monitor their 401(k), as with other investments, to ensure diversification, remaining aware of any particular plan's characteristics relevant to their situation. ■

Endnotes

¹ 26 U.S.C. §401(k), titled "Cash or deferred arrangements," was added to the Internal Revenue Code in 1978 but was not effective until 1980. See EMPLOYEE BENEFITS RESEARCH INSTITUTE, "History of 401(k) Plans: An Update" (2005), available at <https://www.ebri.org/pdf/publications/facts/0205fact.a.pdf>. While commonly termed a 401(k) "plan," it refers to a cash or deferral feature allowing the employee to elect to defer income by opting to have some of his or her salary placed into a 401(k) account. It does not technically exist as its own free-standing plan but rather as a component feature of a DC plan, typically a profit-sharing plan. See JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF H.R. 4, THE "Pension Protection Act of 2006," as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006, JCX-38-06 at 231, n. 257 (August 3, 2006), available at <http://www.house.gov/jct/x-38-06.pdf>. It was designed to address constructive receipt issues posed by employees choosing to defer income, despite their ability to receive the income

currently as cash or cash equivalents (e.g. payroll check). See COLLEEN E. MEDILL, INTRODUCTION TO EMPLOYEE BENEFITS LAW: POLICY AND PRACTICE 97 (2d ed. 2007).

² Department of Labor, Employee Benefits Security Administration, *Private Pension Plan Bulletin Historical Tables and Graphs* December 2009 (hereafter "2009 DOL Bulletin") at Table E1, available at <http://www.dol.gov/ebsa/pdf/1975-2007historicaltables.pdf>; Table E5 (slightly over 33 million participants covered by DB plans in 1975 compared to about 11.5 million covered by DC plans that year).

³ See Estreicher and Gold, *supra*, at 332; see also 2009 DOL Bulletin, *supra* note 2, at Table E5 (in 2007, there were about 42 million employees covered by DB plans compared to over 81 million covered by DC plans).

⁴ See, e.g., Zelinsky, *supra*, at 482 (referring to the "death of the small-employer defined benefit plan"); Department of Labor, Employee Benefits Security Administration, REPORT OF THE WORKING GROUP ON THE MERITS OF DEFINED CONTRIBUTION VS. DEFINED BENEFIT PLANS WITH AN EMPHASIS ON SMALL BUSINESS CONCERNS at Part III (November 13, 1997).

⁵ The DB(k) was authorized by PPA §903 ("Treatment of Eligible Combined Defined Benefit Plans and Qualified Cash or Deferred Arrangements"), adding Code subsection 414(x), available to employers with at least two but no more than five hundred employees. See also 26 U.S.C. §414(x)(6)(B) (single plan for 26 U.S.C. §§6058, 6059); 29 U.S.C. §1060(e)(5)(B) (corollary amendments to ERISA). Despite contemporaneous coverage, the DB(k) continues to be relatively unknown. See, e.g., David Pitt, *Hybrid Retirement Plan in the Works; DB(k) Alongside 401(k) Would Provide Security, Guaranteed Pension*, WASH. POST, Nov. 15, 2009 at G3.

⁶ Anne Kates Smith, *The Future of your 401(k)*, February 2009, available at <http://www.kiplinger.com/article/retirement/T001-C000-S002-the-future-of-your-401-k.html>.

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Use of Trusts in Planning for Distribution of IRA's to a Spouse

By Dean B. Cross

I. Introduction

Articles discussing the complex planning for the distribution of retirement assets held in qualified plans and individual retirement accounts (IRAs) are plentiful. Central to the planning process is determining the appropriate mechanism for distributing an IRA to the surviving spouse (Spouse). This article explains the required minimum distribution (RMD) rules applicable to distributing IRAs, in trust, to a Spouse. For a valid analysis, however, the tremendous tax deferral a Spouse enjoys as the outright beneficiary of the deceased spouse's (Owner's) IRA must be compared to and balanced against the non-tax reasons for designating a marital trust as the distributee of the Owner's IRA.

II. Spouse as IRA Beneficiary

As of 2012, investments in IRA assets totaled more than \$4.7 trillion. The accumulation of assets in qualified plans and IRAs is attributable, in part, to the tax free growth that is allowed until withdrawals must commence, which for the purposes of this article, begins after the death of the Owner, with the Spouse or a trust benefitting the Spouse, as the designated beneficiary.¹

The Spouse, as the designated beneficiary of the Owner's IRA, may continue the tax deferral benefits implicit in the IRA but must elect to roll the Owner's IRA into an IRA owned by the Spouse. IRC §401(c)(4), (9); PLR 9311037. RMDs, from the Owner's IRA rolled into an IRA owned by the Spouse, do not have to begin until the Spouse reaches the age of 70½. Reg. §1.401(a)(9)-5, A-1. As the new owner of the IRA, the Spouse may choose different beneficiaries from those originally chosen by the Owner.

As the new owner of the IRA, the Spouse's RMDs are calculated using the Uniform Life Table, which are calculated using the joint life expectancy of the Spouse and a presumed beneficiary who



is not more than 10 years younger. Reg. § 1.409(a)(9)-9, A-2. Use of the Uniform Life Table delays the beginning date for RMD's to age 70½ and in most cases assures that the IRA will not be exhausted during the Spouse's lifetime.

If the Spouse does not elect to roll over the Owner's IRA, the Owner's IRA becomes an "inherited IRA" and the Spouse is treated as a beneficiary, not an owner. IRC §408(d)(3); Reg. § 54.4981A-T, A-d(10)(b). As a beneficiary, the date upon which RMD's begin depends not on when the Spouse attains the age of 70½ but on whether the Owner had attained 70½ prior to death. If the Owner had attained the age of 70½ prior to the date of death, distributions would begin on or before Dec. 31 of the year after the Owner's death. Reg. § 1.401(a)(9)-2, A-5. If the Owner had not attained age 70½, distributions would begin on the later of the year after the Owner died or the year in which the Owner would have attained 70½ years of age. Reg. § 1.401(a)(9)-3, A-3(b).

One advantage exists that may outweigh the loss of the tax deferral available through the spousal rollover if the Spouse treats the IRA as an inherited IRA. If the Spouse is younger than 59½ and elects the spousal rollover to maximize deferral, any distributions prior to 59½ will be subject to a 10 percent penalty. IRC §72(t)(2)(A)(ii). Electing to hold the IRA as

an inherited IRA will enable the Spouse to take distributions prior to 59½ without penalty. IRC §72(t)(2)(A)(i). In such an instance, the Spouse should treat estimated distributions needed prior to age 59½ as an inherited IRA and treat the remainder of the IRA as a spousal rollover.

As an inherited IRA, the Spouse does not have the option of delaying RMD's until the Spouse attains the age of 70½, which maximizes the deferral period before which RMD's must commence. Instead, RMD's are calculated based on the Spouse's life expectancy using the Single

Life Table. Reg. §1.401(a)(9)-9, A-1. Assuming the Spouse lives as long as expected under the Single Life Table and that only the required minimum distributions are taken annually, the assets of the inherited IRA will probably be completely distributed by the Spouse's death. A second disadvantage, often overlooked, is that after the death of the Spouse, successor beneficiaries must continue to take distributions based on the Spouse's life expectancy and not the life expectancy of the successor beneficiary.

III. Trust As IRA Beneficiary

Circumstances such as blended families, disability and other non-tax considerations may argue against naming the Spouse as the designated beneficiary². In such situations, the Owner must name the Spouse, individually, as the sole beneficiary of a trust, subject to satisfaction of "see through trust" rules.³ During the Spouse's lifetime, the Spouse must receive all distributions from the IRA and no distributions from the IRA can be accumulated in the trust. Although not defined in the Code, a trust in which the spouse, or any other individual, is the sole lifetime beneficiary is known as a conduit trust.⁴

Distributions to the Spouse must begin on the later of the year after the Owner's death, or the year in which the Owner would have reached 70½ and the Spouse's

life expectancy, for RMD purposes, is recalculated annually. IRC § 401(a)(9)(B)(iv). If the Spouse dies before attaining 70 ½ years of age, the Spouse is treated as the participant for calculating distributions to beneficiaries named to receive IRA benefits after the Spouse's death.

Naming the Spouse as the sole beneficiary of a trust funded with IRA benefits may satisfy non-tax considerations but is not a panacea. The significant tax deferral opportunity enjoyed by the Spouse, individually, as the sole owner of the IRA is lost because the trust is named as the IRA beneficiary and not the Spouse. Reg. § 1.408-8, A-5(a). For example, if the Spouse is named as the beneficiary of the Owner's IRA and makes the election to treat the IRA as the Spouse's IRA, distributions from the IRA are taken over 27.4 years beginning at age 70, thus preserving the tax deferred growth of assets within the IRA. Conversely, a 61 year old Spouse that is the sole beneficiary of a conduit trust at the time of the Owner's death, has a life expectancy, for distribution purposes, of 24.4 years and must begin taking the distributions no later than the year after the Owner's death, thereby losing the tax deferral benefit of treating the Owner's IRA as being owned by the Spouse. Reg. § 1,401(a)(9)-9, A-1.

IV. Credit Shelter Trust and QTIP Trust as IRA Beneficiary

A credit shelter trust is created when the deceased spouse provides, in a Will or the IRA Owner's revocable trust, for funding, at death, of a trust with the available estate tax exclusion amount. QTIP trusts, on the other hand, are created to qualify assets for the marital deduction and also provide for remainder beneficiaries other than the Spouse. IRC § 2056(b)(7); Rev. Rul. 2000-2. If either the credit shelter trust or the QTIP trust are drafted as a conduit trust and funded with the Owner's IRA, distributions over the Spouse's life expectancy will, effectively, liquidate the Owner's IRA. From an estate tax perspective, use of a conduit credit shelter or QTIP trust is not beneficial because distributions to the Spouse from the Owner's IRA would be included in the Spouse's estate on the Spouse's death.

Conversely, a different set of rules applies if the Spouse is named as a lifetime beneficiary of a trust, funded by the Owner's IRA, with children of the Owner or others individuals, named as the identifiable remainder beneficiaries. Credit shelter or QTIP trusts may be drafted as

accumulation trusts. Distributions from the Owner's IRA are accumulated within the trust and delivered to the Spouse, as needed for the Spouse's health, education, support, and maintenance, thus the name "accumulation trust". Reg. § 1.401(a)(9)-5, A-7(c)(3) ex. 1.

For RMD purposes, the measuring life is the oldest of the Spouse and the identifiable remainder beneficiaries, which in most cases would be the life expectancy of the Spouse. Reg. § 1.401(a)(9)-5, A-7(c)(3). Upon the death of the Spouse, the remainder beneficiaries of the trust would continue to receive RMD's based, not on each remainder beneficiary's life expectancy, but on the life expectancy of the Spouse. Any significant age disparity between the Spouse and the remainder beneficiaries reduces the tax deferral available under the Single Life Table.⁵

As an accumulation trust, any income retained in the trust would be subject to income tax at the trust's marginal tax rate, which reaches 39.6 percent on income of \$12,400. Income distributed to the Spouse would be taxed at the Spouse's marginal tax rate.

Funding the credit shelter trust or the QTIP Trust with all or a portion of the Owner's IRA has some distinct disadvantages. With required RMD's and the potential that the Spouse may have a long life, the Owner's IRA, could be entirely distributed due to the Spouse's decreasing life expectancy. IRC § 651; IRC § 661. Unless expended by the Spouse, the distributed IRA benefits held by either trust would be included in the Spouse's estate for estate tax purposes. IRC § 2033.

V. Trust as Beneficiary

Even though an IRA may be left to a trust, a Spouse, under certain circumstances, may still have an opportunity to obtain the maximum tax deferral under IRC §408 available through a spousal rollover. PLR 200549021. To be eligible for the spousal rollover, distributions from the IRA held in trust cannot be subject to a distribution standard, such as health, education, support and maintenance and no other person or entity must be able to exercise discretion with respect to the distribution. *Id.* In such an instance, the Service recognizes and treats a "deemed" transfer of the IRA to the trust followed by the transfer into an IRA set up and maintained in the Spouse's name as spousal rollover. *Id.*

VI. Conclusion

Some experts believe that 40 percent of America's wealth is represented by investments in retirement plans, such as IRAs and qualified plans. See Wilcenski and Pleat, "Dealing with Special Needs Trust and Retirement Benefits", Special Needs, Vol. 36, No. 2, p. 9, (Feb. 2009) Distributing the wealth represented by the investment in retirement benefits requires that estate planning practitioner balance opportunities for tax deferral of IRA and qualified plans against family estate planning issues. ■

Endnotes

¹ IRC § 401(c)(4), (9); McCullough, II, McCullough III, McCullough IV, *How a Trusteed IRA Can Improve Your Retirement Plan*, 29 Utah Bar J. 26 (2016). All references and citations to the Code are to the Internal Revenue Code of 1986 as amended.

² Designated Beneficiary, under RMD Rules, is defined as a beneficiary having a life expectancy greater than zero and takes by reason of a death beneficiary designation or governing Plan document. See, Reg. § 1.401(a)(9)-4, A-3.

³ The "see through trust" rules require that the trust be valid under state law, that the trust is or will become irrevocable upon the death of the participant, the trust beneficiaries named to receive the retirement benefits must be identifiable, plan documents must be provided to the IRA custodian or IRA trustee, and all trust beneficiaries must be individuals. See, Reg. § 1.401(a)(9)-4, A-5(b); Reg. §1.401(a)(9)-4, A-1.

⁴ PLR 200537044; Suma V. Nair, *The Basics of Estate Planning with Retirement Benefits*, Boston Bar Association-Trusts and Estates Section, Pg. 6, May 3, 2012.

⁵ Life Expectancy for a 60 year old Spouse is 25.2 years while a 30 year old child has a life expectance of 53.3 years. Assuming an IRA with a principal balance of \$100,000, distributions to the child based on the Spouse's life expectancy would be \$3,968 per year. Distributions based on the child's life expectancy would be \$1,876 per year.

Dean Cross practices with the Law Offices of Dean B. Cross in the areas of business and corporations, elder law, estate planning/probate/wills and taxation. He sits on the Taxation Section Board of Directors.

Proposed Internal Revenue Code Section 2704 Regulations—

Will They be Implemented?

By Barbara F. Applegarth

On Aug. 4, 2016, proposed regulations under Internal Revenue Code (IRC) Section 2704 were published in the Federal Register. Following publication of the proposed regulations, there was widespread concern that the proposed regulations would negatively impact intergenerational transfers of closely held family businesses because they eliminated certain valuation discounts on gift and estate transfers to family members (making those transfers cost-prohibitive). There was also concern that the proposed regulations introduced an element of uncertainty into the tax system.

Even with those concerns, a treasury secretary under Hillary Clinton would have undoubtedly supported finalization of the proposed regulations because Clinton had announced increases in the estate tax rate and a reduction in the estate tax credit as part of her tax plan. The 2016 election of Donald Trump as president, however, may result in a delay in finalization or even withdrawal of the proposed regulations. Unless the proposed regulations are withdrawn, however, potential issues with the proposed regulations remain.

Background

Congress enacted IRC Section 2704 in 1990 in response to the Tax Court decision in *Estate of Harrison v. Commissioner*, T.C. Memo. 1987-8 (1987).¹ In *Estate of Harrison*, Daniel Harrison and his two sons organized a limited partnership. Harrison received all limited partnership interests and a one percent general partnership interest. His sons each received a 10.6 percent general partnership interest. Each of the general partners could dissolve the partnership, but this right terminated on death. On dissolution, each general and limited partner would receive a proportionate share of partnership assets.

Harrison's sons, as co-executors of his estate, filed a Federal estate tax return for the estate reflecting the value of Harrison's



limited partnership without consideration of Harrison's general partnership right to dissolve the partnership and receive a proportionate share of partnership assets. The Internal Revenue Service challenged the valuation, arguing that the right to dissolve the partnership should be considered in valuing the limited partnership interests. The valuation difference was \$26,555,020.

The Tax Court determined that the value of Harrison's limited partnership interests which passed "at the instant of death" did not include the right to dissolve the partnership. Assuming the sons received the limited partnership interests, they held the power to receive all of the value in the partnership. However, the value subject to Federal estate tax was less than the value of all of the partnership assets. The result was that the sons could have immediately liquidated the limited partnership and received all of the limited partnership assets, but the assets subject to Federal estate taxes were determined as if they did not have this right.

Following the decision in *Estate of Harrison* there was substantial concern that wealthy taxpayers could control assets to the "instant of death" while reducing the Federal estate tax value of the assets through rights which lapse at death. Decreasing the Federal estate tax value of assets will decrease any Federal estate tax payable as was the case in *Estate of Harrison*. To avoid this result, IRC Section 2704 limited valuation discounts

on certain direct and indirect transfers among family members by treating certain lapses as transfers (IRC Section 2704(a)) and ignoring certain restrictions in valuing entity interests for transfer tax purposes (IRC Section 2704(b)).

Treasury Regulations under IRC Section 2704 were finalized in 1992². Although by 2004 the Treasury Department indicated that revisions might be made to the Regulations³, the Treasury Department did not formally propose revisions until Aug. 4, 2016, with publication of the proposed regulations in the Federal Register.

Proposed Changes to Current IRC Section 2704 Regulations

The proposed regulations under IRC Section 2704 apply both to lapses under IRC Section 2704(a) and to transfers subject to restrictions under IRC Section 2704(b). As with the statute and the current regulations, the proposed regulations are intended only to apply to transfers or deemed transfers of family owned and controlled entities.

Changes from the current regulations include the following:

1. Expanding the definition of entities subject to IRC Section 2704 and what constitutes control.
2. Eliminating discounts where a family member receives an assignee interest.
3. Including of the value of an extinguished liquidation or voting right in the decedent's Federal gross estate if death occurs within three years of the loss of the right.
4. Limiting Federal and state law restrictions excluded from the definition of applicable restrictions.
5. Creating a wholly new class of restrictions called "disregarded restrictions."

The proposed regulations assumed that most intrafamily transfers of closely held business interests were gifts and that the

transferor and other family members owning interests in the business would permit the transferee to enjoy the benefit of the transferred interest without restriction. Consequently, restrictions which had real economic effect were ignored, and the Federal gift or estate tax cost of transferring a business within the family could exceed the value of what the transferee received. This clearly could have a chilling effect on the transfer of closely held business interests within family groups.

The proposed regulations also did not fully address how the new provisions would be applied. For example, the proposed regulations included the value of the loss of a liquidation or voting right occurring within three years of the transferor's death in the transferor's Federal gross estate. There was no indication as to how this adjustment would affect the transferee. Would the transferee increase the basis of the asset received or would the basis remain unchanged? This and other questions caused concern among tax practitioners that the proposed regulations, if finalized, would introduce an element of unnecessary uncertainty into the Federal tax provisions.

Tax Effect

Estate and Gift Taxes—Federal estate and gift taxes are only imposed on individuals making total transfers in excess of \$5 million. Consequently, most taxpayers will not pay any additional Federal estate or gift taxes as a result of finalization of the proposed regulations under IRC Section 2704. Since many states have repealed their gift and estate tax provisions, including New Mexico, state gift and estate taxes are not an issue.

Income Taxes—Although the Federal income tax statutes are not always consistent with Federal gift and estate tax statutes, there are specific income tax provisions which are dependent upon Federal gift and estate tax statutes. These include the Federal income tax basis provisions under IRC Sections 1014 and 1015. Federal gift and estate valuations are used as the starting point in calculating Federal income tax basis in IRC Section 1014 and as a maximum basis in IRC Section 1015. Basis in turn is a measure for gain or loss on disposition of property, depreciation deductions and other Federal income tax calculations.

IRC Section 1014(a)(1) provides generally that the basis of property acquired from a

decendent is its fair market value at date of death. For Federal income tax purposes the question is whether the fair market value of property subject to IRC Section 2704 is the value before or after application of IRC Section 2704. This is an unanswered question. If there is complete parity between IRC Section 2704 and IRC Section 1014, it is likely that the proposed regulations will provide a greater opportunity for basis increase on transfers at death of interests in many family controlled businesses even if no Federal estate tax is imposed on the transfer.

IRC Section 1015 generally provides that where property is transferred by gift, the transferee's basis is the lesser of the transferor's basis or fair market value. In situations where the transferor's basis is greater than fair market value, it is unclear whether the IRC Section 2704 adjustment will increase value. Further if a lapse right is included in the transferor's Federal gross estate, it is unclear whether the transferee's basis will be increased by the lapse value.

Other Federal income tax provisions may be directly or indirectly affected by the proposed regulations. Without additional guidance from the Treasury Department, the effect of the proposed regulations, if finalized, on Federal income taxes will be determined by later administrative and judicial determinations.

If Finalized, Can the Regulations Withstand Judicial Scrutiny?

The Administrative Procedure Act (5 USC Sections 551-559) governs rule making by Federal agencies, including the Treasury Department, and rules promulgated by agencies are subject to judicial review as provided in 5 USC Section 706. Judicial review of agency regulations is very limited under the terms of 5 USC Section 706.

Despite the limitation on judicial review of agency regulations, the Tax Court recently held that Treasury Regulations at issue in the case were invalid. *Altera v. Commissioner*, 145 T.C. 91 (2015). The Tax Court concluded that the Treasury Regulations that the Treasury Department's actions did not reflect "reasoned decision making" because:

1. The regulation lacked a basis in fact;
2. There was no rationale connection between the regulation and the facts found;
3. The Treasury Department failed to respond to significant comments relating to the regulation when proposed; and

4. The Treasury Department's conclusions were contrary to the evidence before it.

It is unclear whether the proposed regulations under IRC Section 2704, if finalized, will survive judicial scrutiny. The comment period for the proposed regulations ended on Nov. 2, 2016, and hearings were held on Dec. 1, 2016. A total of 28,886 comments were received through Dec. 16, 2016, including criticisms that the proposed regulations are overbroad, confusing, exceed agency authority and will have unintended consequences for closely held family businesses.

Effect of the 2016 Elections

The secretary of treasury heads the Department of Treasury and is a member of the incumbent president's cabinet. The role of the secretary of treasury includes advising the president and implementing the president's tax planning as well as overseeing the operations of the Department of Treasury. With each new administration the Treasury Department's objectives often change.

Changes to the Regulations under IRC Section 2704 were identified as a priority by the Obama Administration which stated its intent to make changes to IRC Section 2704 as early as 2009.⁴ Changes were incorporated into the proposed regulations published on Aug. 4, 2016.

With the election of Donald Trump as president, it is the Trump Administration which will support or disavow the proposed regulations. It is unlikely that a treasury secretary serving under the Trump Administration will support finalization of the proposed regulations, as two of President Trump's stated policy goals are to eliminate the Federal estate tax (and presumably also the Federal gift tax) and to reduce the number of Federal regulations.⁵ Finalizing regulations which potentially increase Federal estate and gift taxes and increase the number of regulations is inconsistent with these goals.

While the proposed regulations under IRC Section 2704 are unlikely to be finalized during the Trump Administration, the issues raised regarding the proposed regulations are still relevant unless the proposed regulations are withdrawn. Staff at the Treasury Department may defer further action on the proposed regulations until a change of administration.

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Basis Reporting Requirements

for Property Received From a Decedent

By Vanessa C. Kaczmarek

In 2015, Congress added two new provisions to the Internal Revenue Code that relate to the basis of property received from a decedent, which the IRS began implementing in the middle of 2016. If estates are required to file estate tax returns, then Section 6035 of the Internal Revenue Code¹ requires executors to provide the IRS and beneficiaries of the estate with information about the value of the property as reported on the estate tax return.²

This is done on the new Form 8971 and Schedule A, Information Regarding Beneficiaries Acquiring Property From a Decedent. Section 1014(f) requires beneficiaries to use the value reported on the estate tax return as their basis in certain instances. The intent is to prevent the IRS from being whipsawed by executors reporting a low value on the estate tax return to minimize estate tax, and a beneficiary claiming a higher value as the basis of the same property to minimize income tax. However, the proposed regulations and reporting requirements are confusing and unduly increase the administrative burden on executors.³

The first thing to note is that the requirements of both Sections 1014(f) and 6035 only apply if an executor is required to file an estate tax return. If a gross estate plus adjusted taxable gifts is under the estate tax exclusion amount—currently \$5.49 million, then Form 8971 does not need to be filed. The proposed regulations under Section 6035 make it clear that Form 8971 is not required if the executor chooses to file an estate tax return for purposes such as making a portability election to allow the surviving spouse to use a deceased spouse's unused estate tax exclusion.

Where it gets confusing is that Section 1014(f) only applies to property included



in a decedent's estate that actually increases estate tax liability. This means that if all of a decedent's property is passed to the decedent's spouse so that the marital deduction eliminates the entire estate tax liability, Section 1014(f) does not apply. If you were to read Section 1014(f) without looking at Section 6035, you could get the impression that Form 8971 is not required for property that does not increase estate tax liability. However, Section 6035 is broader than Section 1014(f) and requires Form 8971 to be filed if the gross estate exceeds the applicable exclusion amount even though no estate tax is owed.

The timing of when Form 8971 must be filed and furnished under the proposed regulations creates potential issues. If a Form 8971 is required, it must be filed no later than the earlier of: (i) 30 days after the due date of the estate tax return, including extensions, or (ii) 30 days after the estate tax return is actually filed. The executor must provide each beneficiary receiving property with a Schedule A. Most estates will not be ready to distribute the estate assets by the time Form 8971 is due. If this is the case, then any asset that may be used to satisfy the bequest to a beneficiary has to be listed on Schedule A. This means that the same property may be included on more than one Schedule A, and Schedule A may include more assets that each particular

beneficiary will receive. In these situations, which will be common, the executor may, but is not required to, file a supplemental Form 8971 and Schedule A's once the actual distributions for each beneficiary are known. This will be a confusing system for beneficiaries, especially if the executor chooses not to provide supplemental Schedule A's. A beneficiary will receive a Schedule A listing certain assets, and then when the property is actually distributed the beneficiary may not receive all of the listed assets. This has the potential for increased litigation. A system that required basis information to be furnished to beneficiaries at the same time as the assets are actually distributed to the beneficiaries would likely avoid these issues and would be easier for executors to administer.

Once the Form 8971 has been filed, that is not the end of the executor's obligation. The executor may have to file a supplemental Form 8971 and Schedule A's. The value reported on the initial Form 8971 and Schedule A's is the fair market value of the property as reported on the estate tax return. However, the final value of the property may change in instances when the IRS redetermines the value, when a court redetermines a value, or when the estate enters into a settlement agreement with the IRS regarding the value of the property. If the final value of the property changes from what is initially reported, the executor is required to supplement Form 8971 and the affected Schedule A's. The supplements must be furnished 30 days after the adjustment to the initial value to the IRS and affected beneficiaries.

Not only does the executor have an obligation to file supplemental Form 8971 and Schedule A's, beneficiaries may also have to file additional Schedule A's as well. This obligation arises if the

beneficiary transfers property subject to Form 8971 reporting to a related transferee where the transferee takes a carryover basis. For these purposes, a related transferee is a family member, a controlled entity, and any trust that the transferor is deemed the owner of for tax purposes. The beneficiary has to file a supplemental Schedule A with the IRS and provide it to the transferee within 30 days of the date of the transfer. If the subsequent transfer happens before the executor has filed a Form 8971, then the transferor must file a Schedule A indicating the change of ownership, but not the value of the property, and provide the executor with a copy. Then when the Form 8971 is filed, the executor must provide the transferee the Schedule A for the transferred property. If the transfer happens after Form 8971 has been filed but before a final value is determined, the transferor must provide a copy of the supplemental Schedule A to the executor so that the executor can provide any required supplemental Schedule A to the transferee.

One of the harshest provisions under the proposed regulations under Section 1014(f) is the zero basis rule. If estate property is discovered after a Form 8971 has been filed or if the property was omitted and the statute of limitations to assess estate tax has run, the final value of the property is zero. The beneficiary

gets no basis in the property so that when the property is sold, all of the proceeds are taxable, potentially increasing the beneficiary's income tax liability. This penalizes beneficiaries. Accordingly, it may behoove executors to provide beneficiaries, whether they request it or not, with the inventory of estate assets to help ensure all assets are reported on the timely filed estate tax return by prompting beneficiaries to alert executors if assets are missing from the inventory.

It makes sense to provide beneficiaries information about the value of the property they receive from an estate so that they know what their basis in the property is. However, there are many logistical concerns with the proposed regulations that make it difficult and time consuming for practitioners to administer. As Steve Akers has noted, most estate planners are not aware of situations where the beneficiaries have used bases that differ from what was reported on estate tax returns.⁴ It seems unlikely that it is such a prevalent issue that it warrants the administrative burden created by the proposed regulations. Hopefully, a number of the administrative challenges will be addressed in the final regulations. However, until that is done, these are the rules that apply for decedents' estates for whom estate tax returns must be filed after July 31, 2015. ■

Endnotes

¹ All section references herein shall be to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

² The Internal Revenue Code uses the term "executor," and although in New Mexico the term "personal representative" is used instead, this article follows the language of the Internal Revenue Code.

³ For a detailed summary of each provision in the proposed regulations, see the Journal of Taxation's July 2016 article: "IRS Issues Proposed Regulations Regarding 'Consistent Basis Reporting Rules'" by Jennifer Wioncek, Lyubomir Georgiev, Rodney Read, and Ceci Hassan.

⁴ See e.g., Steve Akers, "Estate Planning: Current Developments and Hot Topics," December 2016, available at http://www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Presentation/Print%20PDFs/Hot%20Topics%20Current%20Developments_website.pdf, (last accessed on December 14, 2016).

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Proposed Internal Revenue Code Section 2704 Regulations—Will They be Implemented?

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Conclusion

It is unlikely that the proposed regulations under IRC Section 2704 will be finalized during the Trump Administration. Even if later finalized in their present form, challenges to their implementation are likely. There are few proposed regulations which have generated as much controversy as those under IRC Section 2704, and the tax practitioners who have raised concerns about the proposed regulations will likely lead the challenge to any final regulations. For tax practitioners and their clients the question is whether any action should be taken in anticipation of finalization of the proposed regulations in their current form. If the proposed regulations are finalized at a later date, will transactions taking place prior to the effective date but incomplete at that date be affected? Unfortunately, there is no clear guidance.

To further create uncertainty with the proposed rule, the House will begin consideration of H.R. 5, the Regulatory Accountability Act of 2017. Among other things, this bill will modify the APA to require agencies to choose the lowest-cost alternative for meeting a statutory requirement, will expand public input and vetting of information, will repeal the judicially created doctrines of deference to agency interpretation, and will demand that agencies account for the impact on small businesses. ■

Endnotes

¹ See discussion in letter from Ways and Means Committee members to Jacob Lew, Secretary of Treasury dated November 3, 2016 at https://waysandmeans.house.gov/wp-content/uploads/2016/11/110316_WM_Treasury_ValuationReg.pdf; H. Conf.

Rept. 101-964, at 1137 (1990), 1991-2 C.B. 560, 606.

² T.D. 8395, 57 FR 4277, Feb. 4, 1992; T.D. 8395, 57 FR 11265, Apr. 2, 1992.

³ See Department of Treasury Third Quarterly Update of the 2003-2004 Priority Guidance Plan issued April 23, 2004 which added IRC Section 2704 as an area under consideration and succeeding Priority Guidance Plans.

⁴ General Explanation of the Administration's Fiscal Year 2010 Revenue Proposals (May 2009).

⁵ <https://www.donaldjtrump.com/policies>

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