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The next tax reform

Another tax reform bill is taking shape in the House Ways and Means Committee. The next bill will be "family friendly," according to Committee Chair Kevin Brady (R-Texas). One element will be simplifying the 14 different tax provisions affecting education savings. Another may address retirement savings, though what that means remains vague. More concrete, there may be an attempt to make permanent the individual tax cuts of the Tax Cuts and Jobs Act of 2017. Brady is pushing for a vote before the midterm elections.

Bonanza

The federal government had its best month in history in April, fiscally speaking, according to the Congressional Budget Office. The government took in $515 billion of revenue, and spent $297 billion, leaving a surplus of $218 billion. The previous record surplus was $190 billion, set in 2001.

Typically April is a good month for the U.S. Treasury, but collections came in $40 billion above projections, 13% higher than April last year. The CBO said the underlying dynamics were not yet clear. "The reasons for the added revenues will be better understood as more detailed information becomes available later this year."

— *https://www.cbo.gov/publication/53821*

Alimony trust guidance

IRS has announced that guidance is on the way for alimony trusts, and it is seeking comments on the issue.

Beginning next year, as a result of the Tax Cuts and Jobs Act of 2017, alimony payments will no longer be deductible by the payor and taxable income to the payee, a rule intended to allow rough income splitting for divorced couples. Apparently the Congress believed that the payors were claiming their deductions but some significant fraction of payees were not reporting the income. To avoid the possibility of using a trust as a workaround of the new rule, IRC §682 governing alimony trusts was repealed.

The new guidance will grandfather alimony trusts created for the rest of this year. The Treasury Department and IRS are looking for comments

on whether guidance is also needed regarding the grantor trust rules of §§ 672(e)(1)(A), 674(d), and 677 following a divorce or separation in light of the repeal of former §682.

— Notice 2018-37; 2018-18 IRB 521

Prohibited transaction to the rescue?

In 2005 Stacey arranged a $40,000 loan from her IRA to her father. Another IRA loan was made in 2012, this time $60,000 to Stacey's friend. In 2013, Stacey arranged for a rollover of her IRA to a new custodian. For some reason, the promissory notes for the loans were not rolled into the new account.

The IRS spotted the transaction, and charged that the failure to roll the notes into the new account created a taxable distribution to Stacey of $98,000. (Why the distribution was less than $100,000 was not explained; perhaps $2,000 of principal had been repaid?) Taxes on the distribution, coupled with the penalty for failing to report it plus a 10% penalty because Stacey was not yet 59½, brought the total assessment to some $42,000.

At trial, Stacey initially argued that the notes were rolled into the new account. The Court then ordered both sides to prepare additional memoranda on whether the loan to Stacey's father was a prohibited transaction under IRC §408(e)(2)(A), and what the tax consequence of that would be.

Both parties concluded that the loan was a prohibited transaction, with the result that the IRA ceased being an IRA the year that the loan was made. Accordingly, the distribution of the notes, even if it occurred, would not result in additional taxable income to Stacey in 2013.

Because the IRA terminated so long ago, the statute of limitations for collecting additional taxes that should have been paid in 2005 has expired.

—Marks v. Comm'r, TC Memo 2018-49

COMMENT: Stacey may not be entirely off the hook. Presumably she needs to refile her returns for all open years to report the investment income from the account that became an ordinary investment account in 2005. What's more, the attempted rollover in 2013 was not proper, and the entire amount may be an excess IRA contribution, subject to a 6% excise tax until it is withdrawn.

Special use extension

Parent's estate at death included farmland. We don't have the date of death, or the value of the estate, but it was sufficiently large to be taxable. Son and Daughter, as executors of the estate, employed Accountant to handle the estate tax return. Accountant failed to elect special use valuation for the farmland under IRC §2032A, or to advise the executors about it.

At a later date (again, time frames are not provided), Son met with an attorney to do his own estate planning. The attorney noticed the failure to elect special use valuation, and so the estate requested an extension of time to make the election.

The IRS holds that in relying upon the services of Accountant, Son and Daughter acted reasonably and in good faith. They will not lose the valuation discount provided by IRC §2032A. They will have to abide by the use restrictions included in that code section.

—Private Letter Ruling 201814004

Roth IRA can't invest in an FSC

In 1977 Mazzei obtained a patent for an injector that mixes chemicals with water, and he started a business selling injectors in 1978. The business prospered. In 1984 he began selling injectors overseas through foreign distributors.

Mazzei was a member of the Western Growers Association (WGA). Sometime in the 1990s, WGA began a program that combined interests in a foreign sales corporation (FSC) with an IRA. In 1998 the Mazzei family signed up. Mazzei, his wife, and his daughter each funded a Roth IRA with $2,000. An FSC was formed to handle Mazzei's foreign sales, and each Roth IRA purchased a one-third interest in the FSC. The family accountant looked over the arrangement and declared it to be legitimate.

Each year the FSC collected payments for foreign sales, paid appropriate U.S. taxes, and distributed the balance as dividends to the Roth IRAs. Over a five-year period, more than $500,000 was sent to the three Roth IRAs.

The IRS came after the Mazzeis for excess contributions to their Roth IRAs. The Tax Court concurs, using a substance over form analysis. The Roth IRAs were exposed to no risk, and they had no upside potential. The company controlled by the Mazzeis had complete discretion in directing payments to the FSC. Accordingly, the payments to the Roth IRAs were not dividends but contributions by the owners. The only solace for the taxpayers was that penalties were abated because they relied upon professional advice in implementing their plan.

— Celia Mazzei et. al. v. Comm'r, 150 T.C. No. 7

COMMENT: A vigorous dissent points out that the Tax Court recently was reversed by the Sixth Circuit Court of Appeals in a nearly identical case [Summa II, 848 F.3d 779, reversing T.C. Memo 2015-119). The dissent suggests that the majority is acting like Caligula, who posted tax laws in fine print and so high that the Romans could not read them, because the majority is substituting judge-made law for the clear language of the tax code.

The majority answered that Summa involved a Domestic International Sales Corporation, not an FSC, and Mazzei is appealable to the Ninth Circuit, not the Sixth.

Trust amendment for adult adoptees

Parent, who is still living, created an irrevocable trust before 1985 for his lineal descendants. The creation date is before the effective date of the current generation-skipping transfer tax (GSTT), and so the trust is protected from that tax by the "grandfather" rule for pre-existing trusts. The trust will divide into three portions upon Parent's death, one for each of three children. When the trusts terminate, the remainder will pass to the issue of the children, if any.

Child 1 has three children, and Child 3 has none. Child 2 has a child and grandchild, both of whom were adopted as adults.

Evidently, Parent does not approve of Child 2's actions or lifestyle. Parent petitioned in state court to have the phrase "lineal descendant" exclude adoptees. At the time the trust was created, the state law presumption was that adoptees were not lineal descendants, a presumption that since has been reversed. Parent argues that when the trust was created, he understood lineal descendant to be limited to blood relations.

The state court granted the petition. The tax question is: does this new interpretation have any effect on the status of the trust for generation-skipping tax purposes?

It does not, the IRS holds. The interpretation of the ambiguous term in a manner consistent with what the state's highest court would rule does not change the trust so as to cost it the "grandfather" status under the GSTT. What is more, although the hopes of Child 2's adoptees for trust beneficiary status have been terminated, the interpretation of the trust clause does not trigger a taxable termination, distribution, or gift to any other person.

—Private Letter Ruling 201814002

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