Judson M. Stein, Esq.
Partner
Member of NJ Bar
jstein@genovaburns.com
Direct: 973-230-2080

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Dear Clients and Colleagues:

The following is a summary of some of the more important tax developments that have occurred during the second quarter of 2016 that may affect you, your family, your investments, and your livelihood. Please call us for more information about any of these developments and what steps you should implement to take advantage of favorable developments and to minimize the impact of those that are unfavorable.

New Jersey Adopts "Uniform Trust Code." After years of consideration and debate, New Jersey has finally enacted its own version of the Uniform Trust Code ("UTC"). The UTC is a unified set of trust laws which were first introduced back in 2000. At least 30 states have now enacted some portion of the model framework. New Jersey has ambitiously adopted nine of the eleven model Articles which are now codified under New Jersey Statutes Chapter 31, Title 3B. The UTC is designed to provide guidance on New Jersey specific trust matters pertaining to both establishment and administration. Most of the UTC provisions are default rules which come into play where a trust fails to adequately address an issue.

It is noteworthy that New Jersey already has well-developed trust and estate laws. Many of the local rules are set forth in the governing New Jersey Statutes and the common law. Despite such ample guidance, practitioners have continued to debate the proper interpretation of trust law. For example, there may be disagreement as to how to unwind a trust or alternatively, the appropriate breadth of fiduciary powers when directing investments. Likewise, there can be debate regarding the administration of a trust. Such disagreement has only led to more uncertainty. The UTC brings some much needed consistency to New Jersey. In addition, the new law stems from the public's perception of trust law which can be described as one of uncertainty and mystery. Indeed, trust law is one of the oldest laws in the country and access to these rules is limited. The UTC's consolidation of the trust laws into one accessible place allows for easier access to answers, thereby affording practitioners and the public more confidence when navigating these once perceived unchartered waters.

The UTC is lengthy in scope and applies to express trusts, charitable or noncharitable in nature, and trusts created under a statute which requires the trust to be administered in the manner of an express trust. The new law begins with a definitional guide clarifying such key terms as "qualified beneficiary" and "knowledge." While these terms may appear basic at first glance, they are open to differing legal interpretations. Following general definitions, the code segues into the requirements for trust creation in New Jersey. The new law sets forth the parameters for trust establishment, trust representation such as which representatives may be appointed, and judicial intervention. Moreover, the UTC provides guidance with respect to the responsibilities trustees have to their beneficiaries. The UTC also addresses special needs trust provisions, spendthrift powers, and emphasizes administrative duties such as loyalty, as well as the remedies for breach of fiduciary duty. All of these pertinent topics were in need of consistency.

Perhaps equally paramount, the UTC clarifies the ways in which a seemingly permanent trust may be later modified or even terminated. In our estate planning practice, clients often establish trusts for the benefit of future generations based upon their current succession goals. Nevertheless, and as time goes by, these objectives can change due to their unique circumstances. To illustrate, an irrevocable trust originally designed to provide for the grantor's children and further descendants in separate lifetime trusts may no longer be appropriate. Similarly, there are cases where multiple trusts were created to own portions of several closely held businesses which might now be consolidated for administrative convenience. Finally, family members may become divided and thus unable to participate in decision-making.

Other key provisions include:

- Upon reaching 35, if a beneficiary becomes aware of the trust, the trustee must provide them with the trust agreement and administration information;
- Recognizing and defining Special Needs Trusts for individuals with disabilities;
- Recognizing and defining Pet Trusts; and
- Defining who may represent and legally bind another individual in trust administration.

In conclusion, the UTC provides new consistency, clarity, and predictability to New Jersey's trust law. Clients who create trusts here will feel more comfortable knowing that the interpretation and administration of their trust will be treated similarly in different states. Finally, consolidating all of these rules into one place will hopefully dispel some of the public's misconception regarding the mystery of trust law and provide easier access to answers. Stay tuned.

Termination of Trust Does Not Trigger Generation Skipping Transfer Tax. In Private Letter Ruling (PLR) 201626016, the IRS ruled that the termination of a trust under a court-approved Nonjudicial Settlement Agreement would not cause the trust to become subject to generation-skipping transfer (GST) tax. The trust in question had 18 living beneficiaries, five of whom were minors. Due to the large number of living beneficiaries and potential beneficiaries, the administration of the trust became unwieldy; consequently, it was difficult for the trustees to determine and weigh the relative needs of the beneficiaries for the purpose of making all distributions. Accordingly, the adult beneficiaries entered into a Nonjudicial Settlement Agreement directing that the trust terminate, and the trustees distribute the trust estate in equal shares to 12 of the current adult beneficiaries, each of whom was either a grandchild or great-grandchild. The parties further agreed that the remaining adult beneficiary, as well as several minor beneficiaries, would not receive a distribution. Thus, the primary issue became whether the termination would trigger a GST tax, as is typically the case.

The IRS held that the termination of the trust in this case did not generate any GST tax. Specifically, the IRS instructed that an existing exempt trust may be modified by nonjudicial reformation that is valid under state law where the change: (1) does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the modification; and (2) does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

IRS Clarifies "Grantor Trust" Definition in Bankruptcy and Insolvency Settings. The IRS has issued final regulations clarifying the definition of grantor trusts within the context of the bankruptcy and insolvency exclusions for cancellation of debt (COD) income. COD income is includable in gross income; however, the Code provides for a number of pertinent exclusions. For example, gross income does not include any amount which would otherwise be includible in gross income by reason of the discharge of indebtedness of the taxpayer if the discharge occurs during bankruptcy or to the extent the taxpayer is insolvent. The terms “indebtedness of the taxpayer,” “Title 11 case,” and “insolvent” are all defined using the term “taxpayer.” The Code broadly defines a “taxpayer” as any person subject to any internal revenue tax.

Notably, a grantor trust is any part of a trust that is treated as being owned by the grantor or another person. All items of income, deductions, and credits attributable to the trust are includable in computing the owner's taxable income and credits. For example, a parent may create a grantor trust for estate and succession planning. Where the parent is the grantor, the parent reports the grantor trust’s income on their own Form 1040. Stated another way, the grantor and their own trust are considered the same economic unit.

Nevertheless, some taxpayers have taken the position that the bankruptcy exception is available if a grantor trust or disregarded entity is under the jurisdiction of a bankruptcy court, even if its owner is not. Similarly, some taxpayers maintain that the insolvency exception is available to the extent a grantor trust or disregarded entity is insolvent, even if its owner is not. The taxpayers argue that because, for Federal income tax purposes, the disregarded entity is disregarded and the “taxpayer” is the owner of the disregarded entity's assets and liabilities, the owner is properly seen as being subject to the bankruptcy court's jurisdiction, or being insolvent, even though, technically, they are not.

The IRS has rejected this position and now clarifies in the final regulations that when applying the bankruptcy or insolvency exceptions to the discharge of indebtedness income of a grantor trust or a disregarded entity, the term “taxpayer” refers to the owner(s) of the grantor trust or disregarded entity. The regulations provide that the insolvency exception is available only to the extent the owner is insolvent, and the bankruptcy exception is available only if the owner of the grantor trust or disregarded entity is subject to the bankruptcy court's jurisdiction. Thus, the regulations provide that grantor trusts and disregarded entities themselves will not be considered owners for this purpose.

With respect to partnerships, the regulations state that the owner rules apply at the partner level to the partners of the partnership to whom the discharge of indebtedness income is allocable. For example, if a partnership holds an interest in a grantor trust or disregarded entity, the applicability of the bankruptcy and insolvency exceptions to COD income of the grantor trust or disregarded entity is tested by looking to the partners to whom the income is allocable.

IRS Can Require Sole Owners of Disregarded Entities to Provide EINs. A Program Manager Technical Advice (PMTA) recently concluded that the IRS now has the power to modify tax return forms and instructions to require the sole owner of a disregarded entity to provide the entity's EIN on the owner's tax return. Taxpayers typically themselves are the source of information necessary to compute tax and are required to report information that the IRS considers relevant. Specifically, the requirements for making and filing tax returns are found in Sec. 6011(a) which provides that any person liable for any tax imposed by the Code must file a return and that includes the information required by the forms and IRS regulations. Sec. 6011(b) authorizes the IRS to require taxpayers to include on their returns the information necessary to properly identify the taxpayer.

Under the “check-the-box” rules, an eligible entity that has a single owner and is not treated as a corporation is “disregarded” as an entity separate from its owner. As such, the income earned by a disregarded entity “flows-through” and is therefore reported on the owner's income tax return under the owner's Taxpayer Identification Number (TIN). Disregarded entities can use an EIN for other purposes, such as for reporting employment taxes and other business taxes. The IRS found that allowing a taxpayer to use two types of identification numbers (TINs and EINs) may cause problems internally in associating different types of returns with a single taxpayer. To illustrate, if a disregarded entity has an EIN, it typically does not appear on the owner's tax return. Nevertheless, certain information returns such as Forms 1099 that reflect income earned by a disregarded entity may reflect the entity's EIN and not the owner's TIN. This makes matching the income reported on such an information return to what is reported on an income tax return difficult.

In light of this, the PTMA concluded that tax return forms and instructions can be modified to require the sole owner of a disregarded entity to provide the disregarded entity's EIN on the owner's tax return. In support of its decision, the PTMA cited the IRS's broad authority under the Code to require taxpayers to report certain information. Moreover, the PTMA emphasized that the requirement of having identification numbers on returns is necessary and helpful in securing proper identification of the filer.

Perhaps most interestingly, the PMTA found that while the IRS had the authority to require the sole owner of a disregarded entity to provide the disregarded entity's EIN on the owner's tax return, the failure to do so would neither invalidate the return for statute of limitation purposes, nor make the filer subject to failure to file penalties. Indeed, the relevant caselaw provides that to be deemed a “return,” a document filed with the IRS must: (1) contain sufficient data to calculate the taxpayer's tax liability; (2) purport to be a return; (3) be a reasonable attempt to satisfy the requirements of the tax law; and (4) be signed under penalty of perjury. The omission of a taxpayer's identification number generally does not render a return invalid.

IRS Releases Stricter Collection Financial Standards. A taxpayer seeking to settle a tax debt must present to the IRS an offer which clearly presents their disposable income. In performing this calculation, the taxpayer must follow the established procedures set forth by the IRS for determining how much of their income is available to pay taxes. The IRS analyzes income and expenses to determine the taxpayer's disposable income (gross income less allowable living expenses (ALEs)) available to apply to the tax liability. Allowable expenses include those expenses that meet the necessary expense test. The necessary expense test is defined as expenses that are necessary to provide for a taxpayer's health and welfare and/or production of income. Standards for food, clothing, and other items apply nationwide (“National Standards”). Taxpayers are also allowed the total National Standards amount monthly for their family size without questioning the amount actually spent.

The IRS has revised the National Standards and in doing so, lowered the amounts by which a taxpayer can deduct against income, thereby resulting in a taxpayer having greater disposable income subject to collection.

The new IRS monthly dollar amounts, which are markedly lower than the previous numbers, include the following:

- The food cost amount, for one person, decreased from $315.00 to $307.00; for two persons, it went down from $588.00 to $583.00;
- The housekeeping supplies amount, for one person, decreased from $32.00 to $30.00; for two persons, it went from $66.00 to $60.00;
- The out-of-pocket healthcare amount, for someone 65 or older, decreased from $144.00 to $130.00; and
- The housing/utilities cost amount, a local standard, for Miami-Dade County Florida, for one person, decreased from $1,807.00 to $1,660.00.

No Innocent Spouse Relief Where Applicant Wife Remained Silent. The Tax Court held that where a couple filed jointly, the husband had always been the primary financial provider, and their lifestyle had not changed from earlier years when the couple reported significant business income on their returns, the wife did not qualify for innocent spouse relief with respect to their returns that did not report activity from the husband's business. See Arobo v. Commissioner, T.C. Memo. 2016-66.

In general, married taxpayers who file a joint Federal income tax return are jointly and severally liable for the tax reported or reportable on the tax return. Yet, a spouse who has made a joint return may elect to seek relief from joint and several liability. Specifically, a spouse will be relieved of liability for an understatement of tax if: (a) a joint return was made for the tax year in question; (b) there is an understatement of tax attributable to erroneous items of the nonrequesting spouse; (c) the requesting spouse "establishes that in signing the return he or she did not know, and had no reason to know, that there was such understatement"; (d) taking into account all the facts and circumstances, it would be inequitable to hold the requesting spouse liable for the deficiency attributable to the understatement; and (e) the requesting spouse elects to invoke such relief within two years after the date IRS has begun collection actions with respect to the requesting spouse.

In Arobo, the couple filed joint returns for 2004 through 2007, the years at issue. Mr. Arobo was the family's primary financial provider. Mrs. Arobo had a college degree and earned roughly $20,000.00 per year. Mr. Arobo was the sole owner of a mortgage origination company during the years involved. Mrs. Arobo, while not involved in the operation of the company, paid the household bills. Mr. Arobo regularly gave Mrs. Arobo checks drawn on his individual account or on one of the company's accounts to pay household expenses.

The taxpayers' 2004 through 2007 income tax returns were filed late. The taxpayers' income tax return for 2004 was filed on January 19, 2010. The IRS commenced an audit of that return in October 2010. The taxpayers filed their 2005 and 2006 income tax returns in 2011, while the 2004 return was under audit, through the IRS examining agent. Mr. Arobo was responsible for the preparation and filing of the taxpayers' income tax returns. Mrs. Arobo did not review the returns; rather, she "entrusted her husband and just signed them." She testified that she learned that Mr. Arobo had failed to file their 2004 through 2007 tax returns only when they were contacted by the IRS.

The 2004 and 2005 income tax returns each reported a business loss and negative adjusted gross income. The 2006 and 2007 income tax returns reported adjusted gross income of $52,163.00 and $32,049.00, respectively. No business income or loss was reported on, and no Schedule C, Profit or Loss from Business, was attached to either tax return. The Arobos ultimately came to a settlement with IRS with respect to their unpaid tax liabilities.

However, the court did not grant Mrs. Arobo innocent spouse relief. The court noted that an applicant must demonstrate that they did not know, and had no reason to know, there was an understatement in income tax. The court clarified that an individual has reason to know of an understatement if a reasonably prudent taxpayer in their position at the time they signed the return could be expected to know that the return contained the understatement. It follows that the requesting spouse has a "duty of inquiry" with respect to the income tax return filed. The court instructed that the factors to be considered in making this determination are: (1) the requesting spouse's level of education; (2) the requesting spouse's involvement in the family's business and financial affairs; (3) the presence of expenditures that appear lavish or unusual when compared to the family's past levels of income, standard of living, and spending patterns; and (4) the culpable spouse's evasiveness and deceit concerning the couple's finances.

The court noted that the returns for 2005 through 2007 were filed only after the 2004 return was under IRS examination. As such, a reasonably prudent person in the position of Mrs. Arobo should have been diligent, vigilant, circumspect, and therefore she should have carefully reviewed the 2005, 2006, and 2007 tax returns for accuracy. Even a cursory review of each year's tax return would have revealed that Mr. Arobo's mortgage origination business had reported substantial losses for 2004 and 2005 and that no business income or loss was reported for 2006 and 2007.

Moreover, the court highlighted that Mrs. Arobo was responsible for paying the family's bills. Had she reviewed the tax returns, she would have seen that the returns reported no net business income for four years and yet the family's standard of living had not diminished. Lastly, there was no indication that Mr. Arobo was deceitful or evasive with respect to the family's finances. Based upon all of these factors, the court denied Mrs. Arobo relief.

Estranged Husband Who Did Not Receive IRS Notice Could Challenge Underlying Liability. The Tax Court was recently called upon to decide whether a husband who remained married to, but lived apart from, his wife was entitled to challenge the amount of the underlying tax liability set out in a levy notice that he did not receive until it was too late to request a hearing. See Yasgur v. Commissioner, T.C. Memo. 2016-77.

At the outset, the IRS is required to give a taxpayer written notice when a Federal tax lien is filed upon the taxpayer's property or the IRS intends to levy. The notices must inform the taxpayer of the right to request an administrative hearing in the Appeals Office. A taxpayer is precluded from contesting the tax liability at such a hearing unless the taxpayer did not receive a deficiency notice or otherwise have an opportunity to dispute the liability.

In Yasgur, the taxpayers were married but stopped residing together in 1998. They lived approximately 100 miles away from each other and maintained a cordial but distant relationship. The Yasgur’s continued to file joint returns after establishing separate residences and used Mrs. Yasgur's address on their joint returns. Mrs. Yasgur would generally forward Mr. Yasgur's mail to him. In October of 2004, they filed a joint Federal income tax return for 2003 reporting a tax liability of $88,801.00 and tax due of $60,801.00. The $88,801.00 liability was attributable primarily to passive income from Mr. Yasgur's interest in a law partnership which had issued a

Schedule K-1 to Mr. Yasgur shortly before the extended due date of the 2003 return. Mr. Yasgur believed the reported amount was significantly overstated, but he could not obtain any documentation to support that belief before the return's due date. Upon the advice of their accountant, the Yasgurs reported his share of partnership income on their 2003 return consistently with the Schedule K-1, with the intention of subsequently filing an amended return when they had documentation to support Mr. Yasgur's claim of a lesser share.

Thereafter, the IRS issued separate levy notices to Mr. and Mrs. Yasgur on April 30, 2005 via certified mail, both of which were signed for by Mrs. Yasgur on May 4, 2005. Mrs. Yasgur did not forward Mr. Yasgur the levy notice addressed to him and neither of them requested a hearing within 30 days of the notices' mailing. Their attorney later requested a hearing on August 18, 2005 with respect to the levy notice and thereafter requested a hearing with respect to a notice of lien filing. The Yasgurs filed an amended 2003 return in September of 2005 reporting their total tax for 2003 as $24,087.00, not $88,801.00, and claimed a refund due of $3,913.00. An earlier Tax Court decision held that Mrs. Yasgur could not challenge the existence or amount of her underlying 2003 tax liability, because she had a prior opportunity to do so—i.e., that she had received the levy notice and did not avail herself of her right to request a hearing. Therefore, the key issue centered on whether Mr. Yasgur was similarly precluded from challenging the assessment.

On balance, the Tax Court held that Mr. Yasgur could challenge the 2003 underlying tax liability as he neither received nor deliberately refused receipt of the levy notice mailed to him. In rendering its decision, the court found that the IRS had established that the levy notice issued to Mr. Yasgur was delivered to his wife's address. Nevertheless, the court found significant evidence rebutting any presumption that he actually received it; namely, the fact that he did not reside at that address and communicated only infrequently with Mrs. Yasgur. In addition, the court rejected the IRS's assertion that she "undoubtedly would have told him" about something so serious. The levy notices were received in early May 2005, and Mr. Yasgur had informed her that he had been in regular discussions concerning the liability since January of that year. So she easily could have thought the notices concerned matters that they were discussing and misjudged their importance. Furthermore, the court found it telling that Mr. Yasgur was "punctilious and transparent" in his dealings with the IRS. Such pattern of conduct, the court reasoned, was inconsistent with the contention that he received and simply ignored a levy notice.

Finally, the court rejected the government's claim that Mr. Yasgur deliberately refused delivery. The address shown on their joint returns was in fact where Mrs. Yasgur lived, and Mr. Yasgur had no reason to think that a notice of levy would be mailed to him when it was. In the end, Mrs. Yasgur's failure to forward the notice or tell Mr. Yasgur about it was insufficient grounds to conclude that he should be deemed to have received it.

Post-Divorce Settlement Sale of Businesses Between Ex-Spouses-Nontaxable. The Tax Court recently held that where a couple provided in their divorce agreement that they would each own 50 percent of their businesses, but decided over a year later that this arrangement was not working, the ex-husband's sale of his 50 percent interest to the ex-wife was nontaxable as it was incident to the divorce. See Belot v. Commissioner, T.C. Memo. 2016-113.

According to Sec. 1041, no gain or loss is recognized on a transfer of property from an individual to a spouse, or to a former spouse, if made incident to a divorce. A transfer of property is "incident to the divorce" if the transfer occurs not more than one year after the date on which the marriage ceases or the transfer is related to the cessation of marriage. The regulations provide additional guidance:

> (1) A transfer of property is treated as related to the cessation of the marriage if the transfer is pursuant to a divorce or separation instrument, and the transfer occurs not more than six years after the date on which the marriage ceases.
>
> (2) A divorce or separation instrument includes a modification or amendment to such decree or instrument.
>
> (3) Any transfer not pursuant to a divorce or separation instrument and any transfer occurring more than six years after the cessation of the marriage is presumed to be not related to the cessation of the marriage.

(4) This presumption may be rebutted only by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage.

(5) For example, the presumption may be rebutted by showing that (a) the transfer was not made within the one- and six-year periods described above because of factors which hampered an earlier transfer of the property, such as legal or business impediments to transfer or disputes concerning the value of the property owned at the time of the cessation of the marriage; and (b) the transfer is effected promptly after the impediment to transfer is removed.

In the present matter, the Belot's owned three businesses together, yet their ownership was not equal. Their divorce was finalized on January 8, 2007. The judgment of divorce incorporated a March of 2006 settlement agreement in which the couple transferred stock between them, so that each owned 50 percent of each of the three businesses. Thereafter, in September of 2007, Ms. Belot brought a suit in the New Jersey Superior Court, Civil Part, in which she contended that Mr. Belot had mismanaged the businesses and sought to compel him to sell his shares of the businesses to Ms. Belot. The ex-spouses entered into a settlement agreement in 2008 (second settlement agreement) under which Mr. Belot sold his shares to Ms. Belot.

The court held that Mr. Belot's sale to Ms. Belot of his interests in the marital businesses pursuant to the second settlement agreement qualified for nonrecognition treatment. In rendering its decision, the court emphasized the underlying rationale of Sec. 1041 which is to treat a husband and wife, and a former husband and wife acting incident to divorce, as one economic unit.

Interestingly, the court rejected the government's claim that the transfer made under the second settlement agreement was taxable as the transfer did not relate to the divorce instrument. In so doing, the court noted that the IRS overlooked the fourth sentence of the regulations which provides that the taxable presumption may be rebutted by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage. The court acknowledged that the taxpayers had made such a showing. In addition, the

IRS had maintained that Mr. Belot did not rebut the presumption as provided in the fourth sentence of the regulations, as his transfer of his interests in the businesses to Ms. Belot under the second settlement agreement was not due to "legal or business impediments that prevented a transfer called for by the divorce decree." The court disagreed with this argument, because the fifth sentence merely provides examples and does not create a requirement that Mr. Belot must satisfy to rebut the presumption. Furthermore, the IRS asserted that the judgment of divorce resolved all of the property issues between the taxpayers. However, the court once again disagreed and stated that neither the Code nor the regulations bar application of nonrecognition to divisions of marital property accomplished through sales.

Lastly, the court remarked that this matter was parallel to Young. See Young v. Commissioner, 240 F.3d 369, 374 (4th Cir. 2001). In Young, as in here, a former spouse alleged shortcomings with implementation of the first settlement agreement by the other spouse, and as a result, in both cases, the parties negotiated a second settlement agreement employing different terms for disposition of their marital assets than were contained in their first settlement agreement. The transfers made pursuant to the second settlement agreements in Young and here were made as required by the fourth sentence of the regulations to "effect the division of property owned by the former spouses at the time of the cessation of the marriage" and as required by Sec. 1041, were "related to the cessation of the marriage." In light of this, the court concluded that the post-divorce settlement sale of businesses between the former spouses was nontaxable.

No Rollover Relief for Taxpayer Who Used IRA Distribution as a Short-Term Loan. In PLR 201625022, the IRS refused to waive the 60-day rollover requirement for a taxpayer who used her IRA distribution as a short-term source of funds pending the sale of her vacation home. As a general rule, there is no immediate tax where the distributions from an IRA are rolled over to an IRA or other eligible retirement plan. For the rollover to be tax-free, the amount distributed from the IRA generally must be recontributed to the IRA or other eligible retirement plan no later than 60 days after the date that the taxpayer received the withdrawal from the IRA. A distribution rolled over after the 60-day period will be taxed (and also may be subject to a 10 percent premature withdrawal penalty tax). The IRS may waive the 60-day rule if an individual suffers a casualty, disaster, or other event beyond their reasonable control and not waiving the 60-day rule would be against equity or good conscience. The IRS will consider several factors in this analysis such as the time elapsed since the distribution and inability to complete the rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country, postal error, errors committed by a financial institution, etc.

In the present case, the taxpayer's daughter's home was in foreclosure. As such, the taxpayer and her spouse put their vacation home up for sale in order to raise funds to purchase their daughter's home. Prior to the sale of their vacation home and in order to avert foreclosure, the taxpayer took a distribution from her IRA on April 24, 2015. The distribution was used to purchase her daughter's home on April 27, 2015.

The taxpayer intended to redeposit the distributed amount into her IRA within the 60-day rollover period which ended on June 23, 2015. Nevertheless, the sale of the vacation home was not completed until July 1, 2015, and the taxpayer did not have sufficient funds available during the 60-day period to complete the rollover. The taxpayer indicated that her spouse was willing to take a distribution from his IRA within the 60-day period to complete the rollover but that her medical condition prevented this from occurring. She attempted to complete the rollover once she received the funds from selling the vacation home, but the 60-day period had expired. Therefore, the taxpayer requested a waiver of the 60-day requirement.

Upon review, the IRS denied the taxpayer’s request for relief. Although the taxpayer represented that her inability to complete a timely rollover was caused by her medical condition during the 60-day period, the IRS was not convinced given her continued work and travels. The IRS found that her failure to complete a timely rollover was instead due to her use of the funds as a short-term loan to purchase her daughter's home which left her unable to recontribute the amount to her IRA until after the sale of her vacation home was completed.

Taxpayer Entitled to Exclude Income Under Key Insolvency Exception. The Tax Court in Newman has ruled that a taxpayer who overdrew from his checking account and failed to reimburse the bank had COD income to the extent of the unrepaid funds; however, the amount could ultimately be excluded from gross income due to the taxpayer’s insolvent position. See Newman, T.C. Memo. 2016-125.

As noted, gross income includes income from the cancellation of a debt unless an exception applies. One such exception provides that a taxpayer may exclude COD income when the taxpayer is insolvent. A taxpayer is insolvent if all of the taxpayer's liabilities exceed all of the taxpayer's assets immediately before the discharge.

In Newman, the taxpayer opened a checking account at Bank of America (BOA). Between July and August, the taxpayer made $8,858.00 in deposits to the account, $8,500.00 of which was attributable to a single check drawn from another bank account he maintained at Wells Fargo. Shortly thereafter, the taxpayer withdrew $8,000.00 in cash from the BOA account. However, the initial $8,500.00 check he deposited into the BOA account did not clear and was later returned to Wells Fargo, causing the BOA account to be overdrawn. The taxpayer did not deposit funds in the BOA account to correct the negative balance, and BOA closed the account in August of 2008.

During this period, the taxpayer owned various items of personal property including furniture, clothes, electronics of marginal value, two watches valued at $500.00, and a car valued at $35,000.00. He also had several liabilities such as a $35,000.00 car loan and $15,000.00 in student loans. In December of 2011, BOA issued the taxpayer a Form 1099-C for 2011 reporting COD income of $7,875.00. The taxpayer did not report the $7,875.00 as income on his 2011 Federal income tax return, and on November 12, 2013, the IRS issued a notice of deficiency determining that the $7,875.00 of COD income constituted unreported gross income.

The court held that the COD income was excludable under the insolvency exception. Specifically, and in 2011, the court found that the taxpayer owned assets with a total value of $35,500.00 and was liable for debts totaling $50,000.00. As such, his debts exceeded his assets by $14,500.00. The court also highlighted the taxpayer's testimony with respect to his assets and liabilities as being credible. In conclusion, the court held that he was entitled to exclude the full $7,875.00 of COD income.

Tax Court Disallows Business Deduction Where Taxpayer Lacked "Profit Objective." The Tax Court recently held that a married couple's part-time business which sustained losses during the years at issue, was not engaged in for profit. As such, the couple could not deduct the business losses. See Hess v. Commissioner, T.C. Summary Opinion 2016-

27. Under the well-established “hobby loss rules,” if an activity is not engaged in for profit, deductions generally are disallowed, except to the extent of the gross income derived from the activity for the tax year. To be entitled to business expense deductions without limitation, a taxpayer must show that they engaged in the activity with an actual and honest objective of making a profit.

In this matter, Mr. Hess was a software manager for Verizon, and Mrs. Hess was a housewife who looked after their six children. Amway is a supplier of household, health, and cosmetic products that are sold by individual distributors through direct marketing. Amway distributors can generate revenue by: (1) selling products directly to consumers; and (2) sponsoring other individuals who join Amway as distributors. In the latter case, the original distributor is called an “upline” distributor, or a sponsor, in relation to their new recruit, the “downline” distributor.

The Hesses were sponsored as Amway distributors in 2005. Amway was the Hesses' first independent business venture, and they did not consult with anyone other than their sponsoring distributors before deciding to become Amway distributors. The Hesses conducted their Amway activity in their free time on evenings and weekends. They met with prospective distributors and showed them promotional materials in an effort to have them become members of the Hesses' downline. In the seven years from 2005 through 2011, the Hesses' annual gross income from their Amway business never exceeded $2,178.00, and they took tax losses over those years totaling approximately $99,000.00.

The court concluded that the Hesses lacked a profit motive and disallowed the business losses. In its analysis, the court noted that the Hesses did not create a business plan, budget, or estimate of revenues and expenses, nor did they introduce records demonstrating the amount of product they sold, who their customers were, or how many customers they had, or who their downline distributors were, or how many downline distributors they had. Although the Hesses carefully maintained receipts, they did not use those receipts to maintain a general ledger, create profit and loss statements, or improve the performance of their Amway activity. On these facts, the court concluded that the Hesses maintained receipts for substantiation purposes only, rather than to monitor the income and expenses of, and ultimately improve, their Amway activity.

Moreover, the court observed that Amway was the Hesses' first independent business venture, and they had no experience operating a direct marketing distributorship before becoming Amway distributors. The Hesses obtained advice only from their sponsoring distributors, people who had a direct financial interest in recruiting the Hesses as members of their downline. The Hesses did not seek advice from a disinterested third party at any time during which they conducted their Amway activity. Furthermore, the court highlighted that the Hesses generated total gross receipts of only $5,098.00 from 2007 to 2011 and reported a total net loss of $99,000.00 during the same period. The court remarked “the magnitude of the activity's losses in comparison with its revenues is an indication that the taxpayer did not have a profit motive with respect to the activity.” Based upon these factors, the taxpayers’ activity was held to be at the very most a hobby, and therefore the deduction was unwarranted.

IRS Disallows Deduction for Work Clothing. The Tax Court recently determined whether a salesperson for a major designer who was required to wear the designer's apparel while representing the company could deduct the cost of such clothing as unreimbursed employee expenses. Clothing worn by a taxpayer in connection with his trade or business is normally nondeductible unless: (1) the clothing is required or essential in the taxpayer's employment; (2) the clothing is not suitable for general or personal wear; and (3) the clothing is not so worn. After examining all of the facts in this matter, the court opined that the clothing was clearly suitable for regular wear and therefore disallowed the tax deduction.

Tax Court Scrutinizes Charitable Contribution. The Tax Court has upheld the IRS's denial of the vast majority of $169,000.00 worth of noncash charitable contribution deductions claimed by married taxpayers. See Payne v. Commissioner, T.C. Summary Opinion 2016-30. In general, charitable contribution deductions are allowable where the taxpayer satisfies the pertinent substantiation requirements. It is noteworthy that the nature of the required substantiation depends upon the size of the contribution and on whether it is a gift of cash or property. For contributions of $250.00 or more, a taxpayer generally must obtain a contemporaneous written acknowledgment from the donee. Additional substantiation requirements are imposed for contributions of property with a claimed value exceeding $500.00, and contributions of property with a claimed value exceeding $5,000.00 must include a qualified appraisal.

In Payne, the taxpayers had adjusted gross income exceeding $150,000.00 for 2010 and 2011. They resided in a 1,600-square-foot home and also owned an unfurnished condominium that they intermittently rented out during the years at issue. For 2010, the taxpayers deducted $455.00 in cash charitable contributions and $79,000.00 in noncash charitable contributions. Similarly, in 2011, they deducted $1,500.00 in cash contributions and $90,000.00 in noncash charitable contributions. The total deductions reflected almost half of their adjusted gross income for each year. They attached a Form 8283, "Noncash Charitable Contributions," which furnished the names of four charitable organizations and included 27 receipt forms that they obtained from three of the organizations in support of their contributions. Most of the forms were not signed and did not have any indication of the specific items donated; rather, the subject forms merely listed dollar amounts ranging from $2,000.00 to $3,500.00.

The IRS examined their returns and requested that they provide substantiation. In response, the taxpayers supplied summary spreadsheets prepared after the returns were filed that contained some detailed information not shown on their returns but generally just reflected generic descriptions such as "women's shoes—lots [$2,000.00]." The summaries reflected a fair market value for each category of 50 percent of the cost or basis shown in most instances (with no actual evidence as to cost) and indicated that most of the property was acquired within a year or two of its contribution. Clothing made up $56,600.00 of the amount claimed for 2010 and $53,840.00 of the amount claimed for 2011. The IRS disallowed the bulk of the claimed deductions and determined deficiencies of $22,369.00 and $26,788.00 and accuracy-related penalties of $4,474.00 and $5,358.00 for 2010 and 2011, respectively.

Upon review, the Tax Court found that the taxpayers failed to establish that they were entitled to noncash charitable contribution deductions in excess of those allowed by the IRS. The returns, receipts, and spreadsheets failed to satisfy the substantiation requirements, and the testimony provided by Mr. Payne was interpreted as "vague, illusive, and broad-brushed." The court stated that the "enormity and repeated volume of the numbers and costs of the items . . . without one scrap of evidence of the purchase or acquisition" was entirely lacking in credibility. In addition to their failure to meet the applicable substantiation requirements, the court found their claims as to the quantity and value of the purportedly contributed goods to be wholly unrealistic. For example, the quantity of furniture and large items that they claimed to have possessed and donated would not have even fit in their home.

ACA Premium Credit and Individual Mandate 2017 Indexing Adjustment. The IRS has provided indexing adjustments for the Sec. 36B premium tax credit and Sec. 5000A individual mandate (also called the “individual shared responsibility payment”) for 2017. These inflation adjusted percentages are used to determine whether an individual is eligible for affordable employer-sponsored minimum essential coverage (and so ineligible for the premium tax credit to help afford health insurance purchased through an Exchange) and to determine whether an individual is eligible for an exemption from the individual shared responsibility payment because of a lack of affordable minimum essential coverage. Taxpayers are not treated as eligible for employer-sponsored minimum essential coverage if their required contribution with respect to the plan exceeds 9.69 percent of their household income for plan years beginning in 2017 (up from 9.66 percent for 2016). An individual is exempt from the requirement to maintain minimum essential coverage for a month in which the individual lacks affordable coverage-i.e., a month in which his required contribution (determined on an annual basis) for coverage for the month exceeds 8.16 percent of the individual's household income for plan years beginning in 2017 (up from 8.13 percent for 2016).

IRS Issues Proposed Regulations Clarifying Controversial Debt v. Equity Issue. The IRS recently clarified whether a direct or indirect interest in a related corporation is treated as stock, debt, or as in part stock and in part debt, for federal tax purposes. While the proposed regulations were intended to target related parties that engage in certain transactions using U.S. debt to "strip" U.S.-source earnings (through interest deductions) to lower-tax jurisdictions, they apply to many routine financial transactions (including cash pooling arrangements) and common subchapter C transactions of U.S. based and non-U.S. based multinational corporations. Widespread concern over the regulations’ broad impact has been expressed not only by the business community, but by Democratic and Republican lawmakers as well. The IRS has so far refused to bend to pressure.

The proposed regulations are intended to prevent taxpayers from aggressively using debt in situations in which debt is hardly distinguishable from equity, but in which substantial U.S. tax benefits come from the use of debt rather than equity. A classic example involves a foreign parent corporation that funds its wholly owned U.S. subsidiary with a mixture of interest bearing debt and equity to minimize the U.S corporate tax of the U.S. subsidiary through interest deductions. In many cases, the interest payments are not subject to U.S. interest withholding tax under an income tax treaty. Due to the control that the parent has over the subsidiary and because the parent is both the sole equity holder and sole lender, the economic significance of the shareholder debt (when compared with equity) is quite minimal or even non-existent as compared to the large tax benefit of the annual interest deduction. Accordingly, the proposed regulations seek to recharacterize debt as equity in those situations that the Treasury and IRS find objectionable.

Court Rules Obamacare Reimbursements - Unconstitutional. A district court has granted summary judgment to the House of Representatives in their challenge to the funding of health insurance providers' reimbursements in the Affordable Care Act (ACA, i.e., Obamacare). The ACA explicitly provides a permanent appropriation for the Sec. 36B premium tax credit which makes insurance premiums more affordable for low-income taxpayers. Nevertheless, such funding is not specified for the reimbursements of "cost-sharing reductions" by insurers that reduce deductibles, coinsurance, copayments, and similar charges in the qualified health plans they offer through an Exchange. The court found that the ACA impermissibly appropriated money for the reimbursements to insurers in violation of the Constitution which requires that such monies can only be appropriated by Congress. Accordingly, the court enjoined any further reimbursements until a valid appropriation was in place, but stayed its injunction pending an appeal by the parties.

Employers Granted Extension to Claim Revived "Work Opportunity Tax Credit." The work opportunity tax credit allows employers who hire members of certain "targeted groups" to obtain a credit against income tax. The credit was retroactively revived by the Protecting Americans from Tax Hikes Act of 2015. The previous transitional relief for eligible employers who want to claim credit has been extended. Specifically, the transitional relief gives employers three extra months - until September 28, 2016 - to file the forms necessary to claim the credit for certain eligible workers. An employer that hires a member of a targeted group, including a long-term unemployment recipient, who begins work for that employer on or after September 1, 2016, is not eligible for this transition relief with respect to any such new hire.

Social Security Wage Base Could Increase to $126,000 for 2017. The Social Security Administration's Office of the Chief Actuary (OCA) has projected that the Social Security wage base will increase from $118,500.00 for 2016 to $126,000.00 for 2017. Based upon the OCA estimate on a salary of $126,000.00 (or more), an employee and his employer each would pay $7,812.00 in Social Security tax in 2017. A self-employed person with at least $126,000.00 in net self-employment earnings would pay $15,624.00 for the Social Security part of the self-employment tax in 2017.

New Jersey Joins "Top Ten List" of Most Audited States. Finally, a new study puts New Jersey among the top ten states which are audited by the IRS. The other unlucky states include New York, California, Delaware, Colorado, Nevada, Florida, Massachusetts, New Hampshire, and Vermont. Not surprisingly, the most notable factor in the study was income as the IRS audits more taxpayers in higher income brackets. New Jersey continues to be ranked as one of the richest states in the union. The study also found that New York had one of the highest state tax audits per capita for 2014 tax returns. Meanwhile, Oklahoma reportedly had the lowest number of IRS audits per capita, and Texas was found to have the least state tax audits in 2015.

The above excerpts reflect just some of the recent tax developments that you should be aware of. Please contact us if we may be of assistance in any way.

Very truly yours,

GENOVA BURNS LLC

Judson M. Stein, Esq.

John A. Grey, Esq.

For more information, please contact: Judson M. Stein at jstein@genovaburns.com or John A. Grey at jgrey@genovaburns.com.