

# TAX LAWYER

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**SBM** | TAXATION SECTION  
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The MICHIGAN TAX LAWYER is a publication of the Taxation Section of the State Bar of Michigan that is designed to be a practical and useful resource for the tax practitioner. THE MICHIGAN TAX LAWYER is published three times each year —September (Fall), January (Winter), and May (Summer). Features include the Section's Committee Reports, news of Section events, feature articles, and Student Tax Notes.

Input from members of the Taxation Section is most welcome. Our publication is aimed toward involving you in Section activities and assisting you in your practice. The Taxation Section web address is [www.michigantax.org](http://www.michigantax.org). If you have suggestions or an article you wish to have considered for publication for 2016, please contact Katherine Kaile Wilbur, Varnum LLP, 333 Bridge Street NW, Grand Rapids, Michigan 49504, [kkwilbur@varnumlaw.com](mailto:kkwilbur@varnumlaw.com); or (616) 336-6494

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# FIFTY-EIGHTH ANNUAL REPORT OF THE TAXATION SECTION ANNUAL MEETING

*Presented by Marjorie Gell, Taxation Section Chair (2014-2015)*

**SEPTEMBER 24, 2015, TOWNSEND HOTEL, BIRMINGHAM, MICHIGAN**

It is my honor to stand before you today and provide the 58<sup>th</sup> Annual Report of the Taxation Section of the State Bar of Michigan. Before highlighting some of the Section's accomplishments during 2014 – 2015, I would like to share a few things that I recently discovered as I combed through the Section's old annual reports in preparation for this meeting.

According to the State Bar of Michigan's archived Annual Reports, the call for the creation of a Taxation Section was first made at the State Bar's Annual Meeting in September 1947 by the Taxation Committee of the State Bar. It was not until October 4, 1957, at the SBM's Annual Meeting, that the Section was finally formed. Elected that day in the presence of 175 inaugural Section members, was our first chairperson, John J. Raymond. Also elected that day as secretary-treasurer, was our first female officer, Miss Mary N. Kolis who worked for the IRS. She served in this role for 2 years. (By the way, it was to be several decades before another female was elected as an officer when Carol Karr came up through the ranks to be elected as Section Chair in 1995).

Another interesting thing I discovered, in putting together the chronological listing of all our Past Chairs in preparation for the Past Chairs Dinner that will follow this meeting, is that we have a few long-lost Section Chairs, notable of which is Professor L. Hart Wright who served as Section chair in 1965-66. A prominent tax professor from the University of Michigan Law School, Professor Wright was active on both state and national fronts, and was an advisor to the Internal Revenue Service, Congress, and the Michigan governor's office. (By the way, Professor Wright was able to bring in some heavy hitters from Washington the year he was chair. These speakers included Sen. Al Gore, Sr., senator from Tennessee, and a member of the Senate Finance Committee.) Professor Wright's obituary was written up in the *New York Times* when he died in 1983, and the University of Michigan Law School still has a webpage devoted to him. More to come later, when we present awards to the outgoing Council members, on the topic of L. Hart Wright. For now, I now want to highlight some of the Section's accomplishments during 2014 - 2015.

## **MEMBERSHIP UPDATE**

Our membership is strong, at approximately 1,350. We represent attorneys in private practice, public service, large firms, solo firms, in-house counsel, and academia. And while our membership remains strong, we recognize that challenges lie ahead. Well over one-half of our Section membership is age 55 or older, many of them retired or soon-to-be retired. Roughly 10 percent of our membership is age 34 and under. The challenge is and will continue to be this: how do we as a Section connect with and involve younger members of the Bar? And how do we encourage more active involvement with existing members? This past year, largely through the efforts of our Young Tax Lawyers Committee headed by Katie Wilbur, we have reached out to younger Section members through social media, and networking events. We recognize the importance that our younger members play in securing the future of our Section.

## **PAST CHAIRS ADVISORY GROUP**

We recognize, too, the important role that former leaders of the Taxation Section play in maintaining and strengthening our Section. In an effort to utilize the expertise of former leaders of the Taxation Section, in October the Council approved the formation of a Past Chairs Advisory Group. The purpose of the Group is to provide advice and support to Tax Council on Taxation Section matters. Appointed members of the 2014 – 2015 Past Chairs Advisory Group were Wayne Roberts, Jay Kennedy, Jess Bahs, Eric Nemeth, and Warren Widmayer. This past year, members of the group provided us with advice on several issues that arose, and submitted comments on proposed legislation related to "pay-to-play" legislation. Their efforts are deeply appreciated.

## **SBM CONNECT AND SOCIAL MEDIA**

This year, the State Bar of Michigan rolled out its new interactive website called SBM Connect. While there have been challenges in transitioning to a new format, we have been in good hands with Council members Jackie Cook (Strategic Planning) and Marla Carew (Social

Media/Communications), along with Young Tax Lawyers Committee Chair Katie Wilbur. All three of them worked hard on developing the Taxation Section's social media presence on Facebook and LinkedIn.

#### **ANNUAL TAX CONFERENCE**

The Section's 26<sup>th</sup> Annual Tax Conference at St. John's Conference Center in Plymouth was held on May 21, 2015. Featured were national and local speakers. Under James Comb's leadership, the conference was a tremendous success. James, I know firsthand the work that goes into being the Tax Conference Chair. You did a fantastic job putting together this first-rate conference. Credit also goes to Jeff Kirkey from the Institute of Continuing Legal Education who partnered with us in presenting the conference. We look forward to next year's conference to be held on May 19, 2016 under the leadership of Conference Chair Tammie Tischler.

#### ***MICHIGAN TAX LAWYER***

Anyone who has been editor of the *Michigan Tax Lawyer* knows that, while it is rewarding, it is probably the most time consuming and intense jobs on Council. It is just a huge undertaking, and editor Bill Lentine has done a superb job maintaining the high quality of our publication. We are looking forward to a very full Summer/Fall 2015 edition in October.

#### **CONTINUING LEGAL EDUCATION**

The Section, supported by the Institute of Continuing Legal Education, continues to present "on-demand" broadcasts related to tax topics. This year's topics included "Estate Planning Tax Considerations for 2015." Upcoming broadcasts will cover "Tax Aspects of Divorce" and "An Inside Look into the IRS Appeals Process." Thank you to ICLE Director Jeff Kirkey for offering these programs, which are a convenient and effective way to stay current on tax topics.

#### **PUBLIC POLICY**

This year, the Section saw the fruition of many years of hard work on state tax policy matters.

First, after nearly ten years of the Taxation Section's involvement, on December 9, 2014, Governor Snyder signed into law Enrolled House Bill 4003 which created an Offer-in-Compromise program for Michigan taxpayers. This new law creates a program for Michigan taxpayers that will allow - for the first time - the Department of Treasury to compromise taxes in situations in which (1) the taxpayer lacks the ability to pay, (2) there was a federal compromise, or (3) the taxpayer does not owe tax under the controlling law.

Much of the credit for the adoption of this legislation goes to Taxation Section Past Chair Wayne Roberts who originally brought the need for such legislation to the attention of the Tax Council. Wayne drafted the original version of House Bill 4003 that was introduced in both 2004 and 2014. The Taxation Section is proud to have been involved in the adoption of this legislation, which represents sound tax policy and replaces Michigan's prior policy, under which no compromise of a tax liability was ever allowed regardless of the circumstances.

This past year also brought closure to another tax policy issue of longstanding importance to the Taxation Section - the "pay-to-play" requirement to file a Michigan tax dispute in the Court of Claims. On June 17, 2015, Governor Snyder signed Senate Bill 100, which permits taxpayers to appeal a tax assessment to the Court of Claims without first having to pay the tax, interest, and penalties that have been assessed. Since 2009, the Taxation Section has advocated for the elimination of the "pay-to-play" requirement.

Besides Wayne, past chairs who in the past put much work into these legislative initiatives include Jay Kennedy and Gina Torielli who are here today, as well as Warren Widmayer and Jess Bahs. We recognize that your past efforts on Council have led to the furtherance of one of the Section's core missions which is to achieve an "equitable, efficient, and workable tax system."

The Taxation Section's public policy position statements regarding Michigan tax reform are available on the Section website.

#### **GRANT PROGRAM**

The Section, once again, provided financial support to agencies that provide tax advice to low-income individuals. This year, grant awards were given to the University of Michigan Law School's Low-Income Taxpayer Clinic, the Alvin L. Storrs Low-Income Taxpayer Clinic (Michigan State University College of Law), the Accounting Aid Society, and Legal Services of Eastern Michigan.

#### **PRO BONO TAX PROGRAM**

Thanks to Council member Paul McCord and many Section volunteers, our pro bono program through the State Bar continues to grow. Case referrals for 2015 are anticipated to exceed those in 2014. So far this calendar year, there have been 36 case referrals to the program. In 2014, there were a total of 38 referrals (up from 8 referrals in 2013). The need for attorneys willing to volunteer their time is essential as demand continues to increase.

### TAX COURT LUNCHESES

This year, the Section continued its tradition of hosting visiting United States Tax Court judges. This year's lunches were held on February 3, 2015 and June 23, 2015 at the London Chop House in Detroit. Attendees included practitioners and several law students who had a unique opportunity to speak with Tax Court judges and learn about the practice of tax law. Thank you to Gina Staudacher for organizing the lunches.

### ANNUAL MEETING AND PAST CHAIRS DINNER

A huge thank you goes to Joe Pia who put together the Past Chairs Dinner tonight and made arrangements for us to be at the Townsend Hotel again this year. Joe arranged for the menu, table configurations, and entertainment, and attended to all the details that went into this event. If Joe ever decides to give up the practice of law, I think he would have a very bright future as a wedding planner. Nice job, Joe, and thank you for all of your hard work to make tonight such a special event.

### SECTION COMMITTEES

As most of us know, our committees are the lifeblood of our Section. We were very fortunate this year to have a strong group of Committee Chairs who were able to bring together members of the Section.

**Employee Benefits Committee** was headed by Mickey Bartlett, who recently passed the torch to Brian Gallagher. The Section is in very good hands with Brian who is full of energy and ideas for future meetings (including one that will be held tomorrow). Welcome, Brian.

**Estate and Trusts Committee** – Estates and Trusts Committee was chaired by Sean Cook who did a first-rate job organizing meetings and bringing in top-notch speakers.

**Federal Income Tax (FIT) Committee** For the second year, Andrew MacLeod chaired the FIT Committee and organized several, well-attended meetings. The presentations made under his direction were substantive and insightful.

**Practice and Procedure Committee** Jack Panitch served as chair of the Practice & Procedures Committee and made several contributions to the Section, including hosting a joint meeting with the SALT Committee that was attended by tax practitioners and members of the Attorney General's office.

**State and Local Tax Committee** – Andrea Crumbach, as new Chair of the SALT Committee, provided the solid leadership that has been the tradition of the State and Local Tax Committee. The Section is in good hands for the coming year, and I know that Andrea will once again make significant contributions to the Section.

**Young Tax Lawyers Committee** – This year, Katie Wilbur once again chaired the Young Tax Lawyers Committee. Katie organized several events around the state, and I know she worked hard to encourage our younger members of the Section to get involved.

### OFFICERS

To my fellow officers this year – Vice Chair Michael Antovski, Treasurer Alex Domenicucci, and Secretary Carolee Smith – thank you for your professionalism, for the support you have given to me personally, and for your unwavering dedication to this Section in what has been, at least at times, a challenging year. Thank you also goes to *ex officio* Lynn Gandhi for her willingness to stay fully engaged in Taxation Section matters during the past year.

### LIAISONS

Recognition is in order for our dedicated liaisons. A special thanks goes to our SBM liaison Rick Siriani – the Section surely hit the jackpot this year having him as our liaison. Rick is a tremendous friend to the Section, and what you did for us this year – well - I can't thank you enough.

And George Gregory – your words of encouragement during the year were so helpful to me, and the information you provided me to piece together the chronology of the past chairs was extremely helpful. George – you are a remarkable man! Surely you “arrived” long ago in your established and successful career. Yet you continue to give back, not only to the Taxation Section, but to the Probate Section of the State Bar. I don't think you missed a tax Council meeting in many years. We are grateful for your steady presence, and for the thoughtful comments and guidance you continue to provide Tax Council

Thank you, too, to our IRS liaisons, Robert Heitmeyer and Eric Skinner, for continuing to serve the Taxation Section.

### SECTION ADMINISTRATOR

To Brian Figot, Esquire, our able administrator, thank you for all your hard work, and for keeping me laughing and

on track this year. It's been great fun. You might not know this, but Brian is a very talented guy. He sings professionally with a group of lawyers known as *A (habeas) Chorus Line*, a musical parody group that has performed all across the state. Brian is also the only person I've ever met who can recite, by heart, the first 19 lines of the Prologue to Chaucer's *Canterbury Tales*. Brian, you are truly a unique person, and the Section is very lucky to have the benefit of your intelligence, expertise, and support.

#### PAST CHAIRS

Finally, a special thanks goes to all of the Past Chairs in attendance this evening (and those who could not be here), for all you have done to "tee up" the Section for the future. Just as you likely felt when it was your turn to stand up here and give the annual report, I have an overwhelming sense at this moment that I am just passing through, hoping to have

had a positive impact, and full of hope for the future of the Section.

In closing, I want you to know what an honor it has been to serve on Tax Council for the past 10 years, and to serve as the Section's chair during the past year. What a privilege it has been to witness the dedication and hard work of so many bright and talented Council members, Committee chairs and other Section members. My involvement on Tax Council has truly been the icing on my professional cake, and I will be forever grateful for the opportunity of serving our Section and the State Bar of Michigan.

Thank you.

Respectfully,

Marjorie Gell



# PAST DUE: THE MICHIGAN DEPARTMENT OF TREASURY NEEDS TO UPDATE ITS INCOME EXEMPT FROM LEVY AMOUNTS

By D. Jeffrey Christensen and Nicole Appleberry

The University of Michigan Law School Low Income Taxpayer Clinic regularly assists clients who are subject to levies, but on occasion our clients' wages have been garnished to an astonishing extent. A recent client worked full time and had an annual income of roughly \$30,000, yet he was on the verge of eviction from his very modest apartment because the levy on his paycheck caused his take home pay to be only \$75 per week. A few years ago, another client had been working extremely hard for three years but had very little to show for it. By working overtime her annual income was over \$40,000. Although earning what many considered a livable salary at the time, this client's take home pay was so low that she had to live with family and friends, and paid bills by maxing out credit cards.

What both of these individuals shared in common was that their wages were subject to levy by the Michigan Department of Treasury. Currently, \$198.08 per week is exempt from IRS levy for a single taxpayer claiming one exemption.<sup>1</sup> This is in striking contrast to the "\$75 exemption per week, plus \$25 for each legal dependent" allowed by the Michigan Department of Treasury.<sup>2</sup> As the Sesame Street song said, "one of these things is not like the other[]." <sup>3</sup> Cutting expenses and budgeting can certainly be necessary and appropriate for an individual who is subject to garnishment or levy, but all the cost cutting in the world will not allow most people to support themselves on \$322.50 per month.<sup>4</sup>

## A BRIEF HISTORY OF PROPERTY EXEMPT FROM LEVY UNDER PUBLIC ACT 122 OF 1941

Section 205.1 through 205.31 of the Michigan Compiled Laws is the location of *Revenue Division Of Department of Treasury Act 122 of 1941*, also referred to as the Revenue Act.<sup>5</sup> The purpose of this act was, inter alia, "to establish the revenue collection duties of the department of treasury; to prescribe its powers and duties as the revenue collection agency of this state . . . [and] to provide procedures for the payment, administration, audit, assessment, levy of interests or penalties on, and appeals of taxes and tax liability[.]"<sup>6</sup>

In 1982, William G. Milliken was in his final year as governor of Michigan, Isiah Thomas completed his rookie season with the Detroit Pistons, and the Michigan legislature determined that all was not well with the state's revenue collection practices.<sup>7</sup> The introduction to House Bill 5723 explained

that the collection laws in place under the Revenue Act gave "the commissioner of revenue authority to 'levy on' . . . all property owned by someone who refuses to pay taxes or settle other accounts with the state."<sup>8</sup> HB 5723 was introduced to reduce the states levy power, and gave the following explanation for why the amendment was necessary:

According to an attorney general in the treasury department, this power to take everything someone owns and earns contrasts sharply with provisions on attachment and garnishment in the federal internal revenue and consumer protection statutes, both of which limit what the U.S. government can seize so that a debtor does not suffer undue hardship. Moreover, according to the attorney general, the Michigan revenue act might also violate the U.S. Constitution's restrictions on the power of states to make laws depriving citizens of their property. The revenue commissioner has therefore requested that the legislature make the Revenue Act conform to federal law.<sup>9</sup>

HB 5723 was passed and signed into law as Public Act 537 of 1982. This amended section 25 of the Revenue Act (MCL §205.25) by adding subsection 5 which read as follows:

(5) There shall be exempt from levy under this section:

(a) For an unpaid tax, the type of property and the amount of that property as provided in section 6334 of the internal revenue code.

(b) For an unpaid account, or amount due the state or any of its departments other than an unpaid tax, disposable earnings to the extent provided in section 303 of the consumer credit protection act, 15 U.S.C. 1673.<sup>10</sup>

In 1982, Internal Revenue Code section 6334 was amended to increase the amount of income exempt from levy from \$50 to \$75 per week with an additional \$25 per week for each qualifying dependent.<sup>11</sup> In 1988, Congress amended IRC section 6334 to link the amount of income exempt from levy to the taxpayer's standard deduction and personal exemptions, so it automatically updates each year.<sup>12</sup> The

amount of income exempt from levy is still determined this way today.<sup>13</sup>

If the \$75 per week exemption amount sounds familiar, you are not mistaken. As explained in the beginning of this article, the amount of an individual's income that is exempt from levy by the Michigan Department of Treasury is \$75 per week with an additional \$25 for each legal dependent.<sup>14</sup> In summary, the Michigan Department of Treasury determines the amount of a citizen's income that is exempt from levy by relying on an amendment that was made to the internal revenue code 33 years ago, using a method abandoned by Congress 27 years ago.<sup>15</sup>

**THERE ARE STRONG ARGUMENTS THAT THE MICHIGAN DEPARTMENT OF TREASURY'S INTERPRETATION OF MCL §205.25 IS INCORRECT**

MCL §205.25(5) (a) as it stands today, explains that the amount of income that is exempt from levy is determined by "section 6334 of the internal revenue code of 1986."<sup>16</sup> The only difference between this portion of the statute as it reads currently and as it read in 1982 is the addition of the phrase "of 1986."<sup>17</sup> The phrase "of 1986" was added to the text by Public Act 657 of 2002.<sup>18</sup>

At first glance, the plain meaning of the phrase "section 6334 of the internal revenue code of 1986" suggests that the legislature deliberately intended to incorporate section 6334 of the internal revenue code as it read in 1986. However, the Tax Reform Act of 1986 officially changed the name of the United States tax code from the "Internal Revenue Code of 1954" to the "Internal Revenue Code of 1986."<sup>19</sup> The Tax Reform Act of 1986 was merely the last major overhaul to the federal tax system, and the current internal revenue code is still referred to as the Internal Revenue Code of 1986.<sup>20</sup> An understanding of the official name of the internal revenue code strongly suggests that the plain meaning of the reference to the internal revenue code of 1986 in MCL §205.25(5)(a) is referring to either the internal revenue code currently in place, or the internal revenue code in place in 2002 when "of 1986" was added to the text of the statute. This inference is further supported by the use of the term "internal revenue code of 1986" in other portions of the MCL that address taxation.

While there are sections of the MCL that refer to the internal revenue code of 1986 without any additional explanation, the definition sections of certain Michigan tax laws are telling. For example, in one section of Michigan's Income Tax Act Of 1967 it says "[i]nternal revenue code' means the United states internal revenue code of 1986 in effect on January 1, 1996 or at the option of the taxpayer, in effect for the tax year."<sup>21</sup> In another section of the same act, inter-

nal revenue code is defined in the same way except "internal revenue code of 1986 in effect on January 1, 1996" is substituted for "internal revenue code of 1986 in effect on January 1, 2012."<sup>22</sup>

Although the definition sections of other taxation acts do not specifically apply to the Revenue Act (MCL §205.1-205.31), they do indicate that if the legislature intends to amend a law to apply the internal revenue code as it reads on a specific date, it knows how to do so. These sections also suggest that if the legislature truly meant to define the amount of income that is exempt from levy by the internal revenue code as it read in 1986 it would have done so in a much less ambiguous way.

Legislative intent and history also support the conclusion that section 205.25(5)(a) was not amended to tie the amounts of income that are exempt from levy in Michigan to figures used by the IRS in 1986. As stated previously, the introduction to HB 5723, the bill that added exemptions to levy in 1982, explained that the purpose of the bill was to ensure that Michigan's Revenue Act did not violate the U.S. Constitution by seizing too great of an amount of a citizen's property.<sup>23</sup> Additionally, the introduction explained that there was a concern with the disparity between the amount of property exempt from levy in Michigan and the amount exempt by the internal revenue code.<sup>24</sup>

The details surrounding the 2002 amendment to the Revenue Act also do not suggest that the legislature intended the Treasury Department's interpretation. A summary of the 2002 amendment explained that the purpose of the bill was, inter alia, to "[e]liminate the Revenue Division and the position of Revenue Commissioner in the Department of Treasury, and specify that the Department of Treasury is . . . responsible for the collection of taxes" and is given "all of the responsibilities previously assigned to the Revenue Division in the Act."<sup>25</sup> The addition of the phrase "of 1986" to "internal revenue code" in MCL §205.25(5)(a) was a minor change that was not addressed in the passing of the bill.<sup>26</sup>

In reviewing the available legislative history, the author of this article could not find a single instance where the amendment to MCL §205.25(5)(a) was mentioned.<sup>27</sup> Considering the reasons given for adding subsection 5, the lack of discussion surrounding the addition "of 1986" is significant. One purpose of adding subsection 5 was to bring the exemptions of income from levy in Michigan in line with the federal exemptions.<sup>28</sup> Had the legislature truly wanted to divert so broadly from the amounts the internal revenue code had exempted from levy, it would likely have been addressed in the passing of the 2002 amendment. Given the purpose of the 2002 amendments to the Revenue Act, and the absence of discussion by the legislature, it appears that the determina-



tion of the amount of a taxpayer's income that is exempt from levy made by the Department of Treasury is not the correct interpretation of the Revenue Act.

**EVEN IF THE DEPARTMENT OF TREASURY'S INTERPRETATION OF THE REVENUE ACT IS NOT INCORRECT, THE POLICY SHOULD STILL BE CHANGED**

Notwithstanding the facts that the Department of Treasury's interpretation of MCL §205.25(5)(a) appears to violate the plain meaning of the statute, is not supported by the legislative history, and leads to results that are arguably both unjust and absurd, the Department's interpretation should be rejected purely on policy grounds.

One problem with seizing such a large amount of a taxpayer's income is that it creates a disincentive to remain in the labor force. Next to the amount of her income that was being seized, what was most surprising about our client who had been levied by Michigan for three straight years was that she continued working. Her motivation to continue working overtime for such a long period of time when her take home pay did not cover basic living expenses was admirable. However, it seems unlikely that the majority of taxpayers who found themselves in her situation would have the resolve to keep working. The message being sent inadvertently by the Michigan Department of Treasury is obvious: if your wages are going to be garnished for an extended period of time you might as well just quit working or take odd jobs that pay "under the table." This makes taxpayers worse off, incentivizes fraud, and is also bad for the state. Michigan loses out on revenue when taxpayers do not report or pay taxes on their earnings.

There are many reasons why people end up with tax debts. Certainly some individuals have tax liabilities because of irresponsible behavior, but the debts of many are tied to lifelong poverty, illness and disability, the behavior of dishonest or abusive spouses, and an assortment of other issues that are not within their full control. Regardless of the reason for the debt, and assuming the taxpayer subject to levy continues to work, it does not make sense to force the taxpayer into a position where they are incapable of supporting themselves. With a take home pay of \$322.50 per month a levied taxpayer can quickly become at risk of being homeless, which also increases their risk of losing employment. This policy can make it incredibly difficult for levied taxpayers to become self-sufficient and capable of fully supporting themselves.

Additionally, it is apparent that the Department of Treasury's policy has not kept up with the times. The internal revenue code was amended to provide a weekly exemption of levy of at least \$75 in 1982.<sup>29</sup> An inflation calculator reveals that the buying power of \$75 in 1982 is equivalent to \$184.82 in

2015.<sup>30</sup> And sure enough, in 2015 the IRS allows a weekly exemption of at least \$198.08 per week.<sup>31</sup> This alone is sufficient reason for the Department of Treasury to update its policy. With its current interpretation of section 25 of the Revenue Act (MCL §205.25(a)), the state of Michigan has placed itself in precisely the same position as it found itself in 1982. Completely out of sync with the federal tax code, and at risk of "violat[ing] the U.S. Constitution's restrictions on the power of states to make laws depriving citizens of their property."<sup>32</sup>

**ABOUT THE AUTHORS**

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*The encouragement and support of Michigan Law students Eric Sloat and Nadji Allen is also recognized in helping produce this article.*

**ENDNOTES**

- 1 I.R.S. Publ'n 1494 (2015), Tables for Figuring Amount Exempt from Levy on Wages, Salary, and Other Income.
- 2 MICH. DEP'T OF TREASURY, TAXPAYER RIGHTS HANDBOOK 22 (2013).
- 3 JOE RAPOSO & JON STONE, ONE OF THESE THINGS (IS NOT LIKE THE OTHERS) *Sesame Street Lyrics*, METROLYRICS.COM, <http://www.metrolyrics.com/one-of-these-things-is-not-like-the-others-lyrics-sesame-street.html>.
- 4  $\$75 \times 4.3 = \$322.50$
- 5 1941 Mich. Pub. Acts 122, [http://www.legislature.mi.gov/\(S\(i5popak4zifyufmge4kedgzb\)\)/mileg.aspx?page=getObject&objectName=mcl-Act-122-of-1941](http://www.legislature.mi.gov/(S(i5popak4zifyufmge4kedgzb))/mileg.aspx?page=getObject&objectName=mcl-Act-122-of-1941) (lists the popular name of the Act as the Revenue Act).
- 6 1941 Mich. Pub. Acts 122.
- 7 William Milliken, WIKIPEDIA.COM, [https://en.wikipedia.org/wiki/William\\_Milliken](https://en.wikipedia.org/wiki/William_Milliken); Isiah Thomas,

- WIKIPEDIA.COM, [https://en.wikipedia.org/wiki/Isiah\\_Thomas](https://en.wikipedia.org/wiki/Isiah_Thomas).
- 8 MICHIGAN LAWS HOUSE BILLS 81<sup>ST</sup> LEGISLATURE 1981-1982 HOUSE BILLS 5701-5800, HOUSE BILL 5723 FIRST ANALYSIS (6-1-82) (located in the University of Mich. Law Library call no. KFM 4215.M55bx).
- 9 *Id.* (found under the heading; The Apparent Problem).
- 10 1982 Mich. Pub. Acts 537.
- 11 Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248 §347.
- 12 Technical and Miscellaneous Revenue Act of 1988, Pub. L. No 100-647 §6236 (c), IRC §6334(d).
- 13 IRC §633(d).
- 14 *See supra* note 2.
- 15 The federal exempt amount was changed to \$75 in 1982, and was again updated in 1988, *supra* notes 11 & 12.
- 16 MCL 205.25(a).
- 17 *See supra* note 10 and compare to the current reading of MCL 205.25(a).
- 18 2002 Mich. Pub. Acts 657.
- 19 Tax Reform Act of 1986, Pub. L. No 99-514 §2.
- 20 Internal Revenue Code, LEGAL-DICTIONARY.THEFREE-DICTIONARY.COM, <http://legal-dictionary.thefreedictionary.com/Internal+Revenue+Code+of+1986>.
- 21 MCL 206.12(3).
- 22 MCL 206.607(6).
- 23 HOUSE BILL 5723 FIRST ANALYSIS (6-1-82), *supra* note 9.
- 24 *Id.*
- 25 SENATE BILL 1446 REVISED ENROLLED ANALYSIS (2-7-03), LEGISLATURE.MI.GOV, [http://www.legislature.mi.gov/\(S\(ns2nazau2juh0hy1klhlmtzm\)\)/mileg.aspx?page=getObject&objectName=2002-SB-1446](http://www.legislature.mi.gov/(S(ns2nazau2juh0hy1klhlmtzm))/mileg.aspx?page=getObject&objectName=2002-SB-1446).
- 26 *Id.* The addition of the phrase “of 1986” is not mentioned in the Revised Enrolled Analysis, nor is it mentioned in the Journal of the House or Senate.
- 27 MICH. JOURNAL OF THE HOUSE 2002; MICH. JOURNAL OF THE SENATE 2002, [http://www.legislature.mi.gov/\(S\(ypwdu5bxsc0derdvwww5ldje\)\)/mileg.aspx?page=journals](http://www.legislature.mi.gov/(S(ypwdu5bxsc0derdvwww5ldje))/mileg.aspx?page=journals).
- 28 HOUSE BILL 5723 FIRST ANALYSIS (6-1-82), *supra* note 9.
- 29 Pub. L. No. 97-248, *supra* note 11.
- 30 CPI Inflation Calculator, BLS.GOV, [http://www.bls.gov/data/inflation\\_calculator.htm](http://www.bls.gov/data/inflation_calculator.htm).
- 31 IRS, *supra* note 1.
- 32 HOUSE BILL 5723 FIRST ANALYSIS (6-1-82), *supra* note 9.

# WAKING THE DORMANT COMMERCE CLAUSE

By Anthony Ilardi

Maryland imposes on individual residents two taxes: a so-called state tax, which is a progressive rate tax, and a “county tax” – although imposed and collected by the State – at a rate that varies with the county of residence, but is capped at 3.25%. Maryland also imposes the state tax and a tax equivalent to the county tax on nonresidents earning income in Maryland. Maryland residents pay the state and county taxes on all income earned by its residents. A resident taxpayer, however, may claim a credit against the state tax for taxes paid to another state, but may not claim a credit against the county tax. On these facts, the Supreme Court of the United States, in a 5-4 decision, held that the Maryland tax scheme violated the Constitution’s dormant commerce clause.<sup>1</sup>

The United States Constitution provides “the Congress shall have Power ... To regulate Commerce ... among the several States. ...”<sup>2</sup> Notwithstanding the literal language of the Commerce Clause, since the early nineteenth century the Supreme Court has found in the Commerce Clause a “dormant” or “negative” clause, which, the Court has concluded, prohibits states from burdening interstate commerce.<sup>3</sup> The difficulty in applying this essentially common law interpretation of the Constitution is determining whether a state is actually burdening interstate commerce.<sup>4</sup> Well before *Wynne*, Justices Scalia and Thomas, at least, had made known their antipathy to this non-textual reading of the Constitution.<sup>5</sup> The majority opinion, authored by Justice Alito and joined by Justices Robert, Kennedy, Breyer and Sotomayor, reaffirmed the validity of the Dormant Commerce Clause and attempted to clarify its application to a state taxing its own residents on income earned in another state. The Maryland Court of Appeals had applied the four-part test laid out by the Supreme Court in *Complete Auto Transit, Inc. v. Brady*<sup>6</sup>:

1. Whether there is substantial nexus with the taxing state;
2. Whether the tax is fairly apportioned;
3. Whether the tax discriminates against interstate commerce; and
4. Whether the tax fairly relates to the services provided by the taxing State.

The Maryland Court concluded that the Maryland tax was not fairly apportioned (test 2) and discriminated against interstate commerce (test 3). Thus, the Court held the Maryland tax to be unconstitutional.

While the Supreme Court affirmed the Maryland Court, it took a modestly different approach. First, the Supreme Court reaffirmed that the Dormant Commerce Clause doctrine continues to apply, rejecting the assertion of Justices Scalia and Thomas that the Constitution did not incorporate the concept of a dormant or negative Commerce Clause. The majority opinion then concluded that the Maryland Court of Appeals reached the right result, especially in light of early twentieth century Supreme Court cases in which the Court held certain taxes imposed unconstitutional constraints on interstate commerce.<sup>7</sup>

The majority opinion rejected the dissent’s argument that the cases on which the majority relied were distinguishable because those cases concerned the taxation of gross receipts and not net income. Rather, the majority concluded, the test now is to look to the “economic impact of the tax.” Second, the majority opinion further rejected the notion that prior law only served to protect against taxes on corporations but not, as in *Wynne*, taxes on individuals. Indeed, in *Wynne*, the income at issue was pass-through income of an S corporation doing business outside Maryland.

The contention that only corporations received protection under prior cases is predicated on the distinction that individuals receive benefits from their state of residence and have the power of the ballot box to eliminate discriminatory taxes. The majority rejected this argument since, in its view, corporations also received benefits, such as police protection. Further, the majority rejected, as “fanciful” the argument that individual victims of tax discrimination had recourse at the polls. Justice Alito noted that the affected individuals likely would be in the minority and effectively would be powerless to reverse a discriminatory tax policy. The majority opinion also rejected the argument that the tax scheme should be upheld because it complied with the Fourteenth Amendment’s Due Process Clause. The majority pointed out that even if the tax satisfies the Due Process Clause, it must separately satisfy the Commerce Clause.<sup>8</sup>

To pass muster under the Commerce Clause, the tax scheme must pass an internal consistency test.<sup>9</sup> This test asks the question whether if every state applied the tax scheme, interstate commerce would be at a disadvantage compared to intrastate commerce. Under this test, the Maryland tax scheme failed.

The three dissenting opinions took different approaches. Both Justices Scalia and Thomas argued that there is no

dormant or negative Commerce Clause, although Justice Scalia stated, under principles of *stare decisis*, he would find a violation of the Commerce Clause if the express terms of the statute at issue discriminate on its face, *e.g.*, a tariff imposed on goods from another state, or cannot be distinguished from an earlier case. Justice Ginsburg's dissent took a different approach. At bottom, Justice Ginsburg argued that whether a state should give a credit for taxes paid to another state is a policy decision, best left to legislative bodies, not the courts.

In large measure, *Wynne* does not appear to break new ground, but only incrementally revises prior case law. The internal consistency rule is drawn from earlier cases, but outside of a scheme like Maryland's may be hard to apply. Moreover, the Court gave no guidance on what changes to its tax scheme Maryland would have to make to comply with the Commerce Clause. To the contrary, the majority instructed:

“Whenever government impermissibly treats like cases differently, it can cure the violation by either ‘leveling up’ or ‘leveling down.’”<sup>10</sup>

In short, the State retains flexibility to respond.<sup>11</sup>

It is difficult to predict the reach of *Wynne*. At a minimum, if there were doubt whether the dormant Commerce Clause applied to an individual's taxes, that doubt is gone. More important, the message is that every state tax scheme should be examined for “internal consistency.” Given the limited guidance that the Court offered, the analysis of existing statutes may be more difficult than the Court acknowledges.

#### ABOUT THE AUTHOR

**Anthony Ilardi, Jr.** is senior counsel in Dykema's Taxation Practice Group, concentrating in federal and state tax credits and other economic development incentives; tax planning for businesses and individuals, particularly partnerships and limited liability company formation and operation; and tax aspects of municipal finance. He is also a member of the Firm's Economic Development Team.

#### ENDNOTES

- 1 *Comptroller of the Treasury of Maryland v. Wynne*, No. 13-485 (May 18, 2015).
- 2 U.S. Const. Art. I, § 8, Cl. 3.
- 3 See, Denning, *Reconstructing the Dormant Commerce Clause Doctrine*, 50 Wm. & Mary L. Rev. 417 (2008).
- 4 See, *e.g.*, Denning & Williams, *Wynne: Lose or Draw*, 67 Vand. L. Rev. 245 at 247 (2014).
- 5 At least one commentator has speculated that the Court granted certiorari because these two justices, as well as at least two others, wanted to reexamine the dormant commerce clause. Greer, *The Dormant Coordination Clause*, 67 Vand. L. Rev. 269 (2014).
- 6 430 U.S. 274 (1977).
- 7 *J.D. Adams Mfg Co. v. Stoiën*, 304 U.S. 317 (1938) (tax levied on sales made out of state); *Gwin, White & Prince, Inc. v. Henneford*, 305 U.S. 434 (1939) (unconstitutional tax imposed on all residents, including tax on income for shipping fruit out of state); *Central Greyhound Lines, Inc. v. Mealey*, 334 U.S. 653 (1948) (portion of New York domiciliary's tax on gross receipts derived from services provided in other states violated dormant commerce clause).
- 8 *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).
- 9 *Oklahoma Tax Comm'r v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995).
- 10 *Wynne*, Slip Op. at 26 (Alito, J.)
- 11 *Id.*

# TAX BASIS OPTIMIZATION UNDER THE NEW ESTATE AND GIFT TAX REGIME

By Jay A. Kennedy and Nicholas J. Monterosso, Warner Norcross & Judd LLP

## OVERVIEW OF TRADITIONAL ESTATE PLANNING TO MINIMIZE ESTATE AND GIFT TAXES

Traditional estate planning before the recent estate and gift tax changes generally involved strategies to minimize the taxable estate. Under the old rules the maximum federal estate/gift tax rate was 55%, and the federal estate tax “unified credit” exemption was low. For example, in 2001 the federal unified credit exemption was \$675,000. This meant that many families utilized discount planning, “freezing” techniques and other strategies to minimize the taxable estate.

Discount planning generally involves the gift of a minority interest to a family member or Trust. This technique is illustrated in the following example:

*Example:* Alex gifts 10% LLC interests to each of his three children. The LLC’s only asset is commercial real estate leased to the family manufacturing business. While the real estate is valued at \$1,000,000 at the time of the gift, a qualified appraiser determines that each of the 10% interests in the LLC is valued at \$65,000 due to a combined minority interest/marketability discount of 35%. Alex has effectively removed \$105,000 (3 x 35,000) from his taxable estate, together with future appreciation on the gifted LLC interests.

Freezing techniques are generally designed to transfer future appreciation to the next generation at a reduced estate/gift tax cost. Grantor Retained Annuity Trust (GRAT) planning involves the transfer of assets to a GRAT, with the grantor retaining an annuity interest for a term of years. The amount of the gift to the GRAT is generally the value of the gifted property less the value of the retained annuity. The value of the retained annuity is generally dependent on the amount of the annual payment, the number of annuity payments and prevailing interest rates, and is computed using IRS tables. In general, GRATs are effective to transfer post-gift appreciation to future generations if the transferred property appreciates at a rate that exceeds the interest rate used to compute the value of the retained annuity.

Another freezing technique is the sale of property to an Intentionally Defective Grantor Trust (IDGT). Under this

strategy an individual establishes an irrevocable trust that includes terms that exclude the trust from the individual’s taxable estate. However, trust terms include administrative provisions that require the trust to be treated as a *grantor trust* for income tax purposes. Income of grantor trusts is taxed to the grantor.<sup>1</sup> This technique is illustrated in the following example:

*Example:* John establishes an IDGT, and transfers \$10,000 to the Trust. The \$10,000 is used as a down payment for the purchase of \$100,000 of stock in John’s family business. John takes back a note for the remaining \$90,000 of the selling price. The note contains a low interest rate based on the minimum IRS rates needed to avoid imputed interest. The family business is an S Corporation with pass-thru tax treatment. John is taxed each year on the pass-thru income of the S Corporation, and his payment of taxes is not treated as additional gifts to the Trust. Assume that the value of the stock in the IDGT appreciates to \$500,000 at the time of John’s death. Upon John’s death the Trust passes to John’s children, the beneficiaries of the IDGT, outside of John’s taxable estate, and John has effectively removed \$400,000 of appreciation from his estate.

The downside of utilizing the discount planning, freezing and other techniques to reduce the taxable estate is the loss of income tax basis. Income tax basis is used to determine a seller’s gain on the sale of property. Assets includible in the taxable estate, other than accrued income items (“income in respect of a decedent” or “IRD”) such as IRA and retirement plan income, generally receive a “stepped-up” (or “stepped-down”) basis equal to the fair market value of the assets at death.<sup>2</sup> On the other hand, the recipient of gifted assets generally receives a carryover tax basis equal to the donor’s basis.<sup>3</sup> The impact of lifetime gifts of appreciating property on the recipient’s income tax basis is illustrated in the following example:

*Example:* In the above Example Alex made gifts of 10% interests in an LLC owning real estate to three of his sons. Assume that Alex’s basis in the LLC was \$200,000 at the time of the gifts. In this case each of his children would receive an income



tax basis of \$20,000 for their 10% interests. Assume that the LLC is sold for \$2,000,000 shortly after Alex's death, with each son receiving \$200,000 for his 10% interest. In this case, and assuming no change in the sons' basis in their LLC interests due to income, distributions, etc., then each son would recognize \$180,000 of taxable gain at the time of the sale ( $\$200,000 - \$20,000 = \$180,000$ ). If the sons had received their 10% interests from Alex's estate or trust at the time of Alex's death, then they would receive a stepped-up basis and would have no gain on the sale.

*Observation:* The lost basis results from the carryover basis with the lifetime gifts, the discount planning, and the removal of post-gift appreciation from the taxable estate.

*Observation:* There may be a "stepped down" tax basis on death if the decedent's basis exceeds the fair market value on the date of death.

## THE NEW ESTATE AND GIFT TAX REGIME

The American Taxpayer Relief Act of 2012 (the "Act") reduced the top marginal estate and gift tax rate to 40%.<sup>4</sup> In addition, the Act provides for a \$5,000,000 per individual lifetime estate/gift tax exemption, adjusted for inflation (the "basic exclusion amount").<sup>5</sup> The 2015 basic exclusion amount is \$5,430,000.

The following chart shows the projected growth of the basic exclusion amount over the next 20 years assuming various levels of inflation.<sup>6</sup>

Forecasted Basic Exclusion Amount			
Year	2015	2025	2035
Low Inflation	---	\$5,740,000	\$6,340,000
Median Inflation	\$5,430,000	\$6,820,000	\$9,360,000
High Inflation	---	\$8,880,000	\$17,180,000

The Act also made permanent the "portability" of the predeceasing spouse's unused exclusion amount.<sup>7</sup> The operation of the portability of the "deceased spouse's unused exclusion amount" (the "DSUEA") is illustrated in the following example:

*Example:* Fred has not made lifetime gifts in excess of the annual exclusion amount, and dies in 2015 with a \$3,000,000 taxable estate. His DSUEA is \$2,430,000 ( $\$5,430,000 - \$3,000,000 = \$2,430,000$ ). The Personal Representative of Fred's Estate files a Form 706 federal estate tax re-

turn to make the portability election. Assume that some years later Fred's widow Wilma dies with an \$8,000,000 taxable estate (with no lifetime gifts in excess of the annual exclusion amount) at a time when the basic exclusion amount has increased to \$6,000,000. Under these assumptions Wilma's estate's combined exclusion (the "applicable exclusion amount") is \$8,430,000 ( $\$6,000,000 + \$2,430,000 = \$8,430,000$ ).

*Observation:* Note that while the lifetime exclusion amount increases with inflation, the DSUEA amount does not increase with inflation.

## ESTATE PLANNING FOR FAMILIES WHO WILL MOST LIKELY NOT PAY FEDERAL ESTATE TAXES

Individuals who are unlikely to have assets with a value (together with prior year taxable gifts) in excess of the inflation-adjusted basic exclusion amount should generally forego strategies to remove appreciation from the taxable estate, and should instead focus on maximizing the date-of-death value of their assets to increase the tax basis of the assets for the next generation. These individuals would include, for example, elderly couples with total wealth significantly below the combined basic exclusion amounts. In 2015 the combined basic exclusion amounts would be \$10,860,000. The Joint Committee on Taxation, in an article entitled "History, Present Law, and Analysis of the Federal Wealth Transfer Tax System" dated March 16, 2015, estimated that only .2% (2 out of every 1,000) estates will owe federal estate tax under the current exclusions.

In addition to foregoing discount planning and freezing techniques, as described above, individuals should consider taking steps to undo prior planning strategies that were designed to reduce the taxable estate.

*Example:* Assume Andrew is 80 years old, and he and his wife Mary have combined assets with a value of \$5,000,000. Utilizing a traditional estate planning strategy to reduce his taxable estate, Andrew has made lifetime gifts of stock in his closely-held corporation to his wife Mary and his children, and now holds 49% of the stock in his revocable trust. The total value of Andrew's life gifts, including the stock gifts, is \$100,000. Upon Andrew's death the valuation of this 49% block of stock will take into account discounts for lack of control and lack of marketability. These discounts will reduce the stepped-up basis in the stock. Andrew may consider reacquiring 3% of the stock from Mary in order to eliminate these discounts so that his family will receive a higher stepped-up basis upon his death.



Married couples with wealth significantly below the combined basic exclusion amounts should consider other, somewhat sophisticated strategies to obtain stepped-up basis for all of the family assets upon the death of *either* spouse. This planning may include the establishment of Joint Exempt Step-Up Trusts (“JESTs”) and other similar strategies. A detailed explanation of the JEST strategy is found in Alan S. Gassman’s October, 2013 Estate Planning Magazine article entitled *JEST Offers Serious Estate Planning Plus for Spouses- Part I*”.

#### TAX BASIS ISSUES WITH THE PORTABILITY ELECTION

A significant estate planning consideration for families that may be subject to estate tax is whether the estate plan of the predeceasing spouse should incorporate the marital trust/credit shelter trust split found in many “traditional” estate plans, or alternatively should rely on portability to minimize overall taxes.

*Example- Credit Trust:* Brian’s Trust owns a closely-held business and various investment assets with a combined value of \$8,000,000. His wife Laura owns a home and other assets with a value of \$2,000,000. Neither spouse has made gifts in excess of the annual exclusion amount. If Brian predeceases with these assets, his current estate plan, executed in 1990, provides for a split of his Trust into a Marital Trust of \$2,570,000 and a Credit Trust with a value of \$5,430,000 (the basic exclusion amount). Assume that 10 years later Laura dies with assets of \$3,000,000, and that the basic exclusion amount has increased to \$6,000,000. Assume further that upon Laura’s death the value of the assets in the Marital Trust is \$4,000,000 and the value of the Credit Trust is \$7,000,000. Under this scenario the assets in Laura’s taxable estate would be \$7,000,000- the value of Laura’s assets plus the amount in the Marital Trust. Her basic exclusion amount would be \$6,000,000, and her family would pay estate tax on \$1,000,000, or \$400,000.

*Example- Portability:* Assume the same facts in the prior Example except that all of Brian’s assets are transferred to a Marital Trust upon his death. In this case the Marital Trust would be worth \$11,000,000 upon Laura’s death. Laura’s taxable estate would be \$14,000,000. With portability, her total estate tax exclusion would include her basic exclusion amount of \$6,000,000 plus the \$5,430,000 DSUEA, for a total of \$11,430,000. Laura’s estate would therefore pay estate tax on \$2,570,000 (\$14,000,000 - \$11,430,000 = \$2,570,000). This tax would be approximately \$1,028,000, or \$628,000 more than the estate taxes payable with a Marital Trust/Credit Trust estate plan.

*Observation:* The value of the DSUEA does not increase with inflation.

*Observation:* The tax basis of the assets in the Credit Trust in the prior Example does not get stepped-up to the value on Laura’s date of death.

*Observation:* See the discussion below regarding the use of the portability election and the IDGT swapping technique.

#### TAX BASIS OPTIMIZATION CONSIDERATIONS FOR WEALTHY FAMILIES

Families with wealth significantly in excess of the basic exclusion amounts should generally pursue “traditional” strategies to reduce the taxable estate, including discount planning and “freezing” techniques, if the estate tax savings is expected to exceed the tax cost of the loss of basis step-up.

The current 40% top federal estate tax rate means that there has been a significant reduction in the spread between the estate tax and income tax rates. The addition of the 3.8% Net Investment Income Tax (“NIIT”) in 2013, which generally applies to capital gains income of high-income taxpayers, has further narrowed the gap between the estate tax and the total tax cost of lost basis.<sup>8</sup> For example, this spread would be only 11.2% assuming there is no state estate tax, the gain on the sale of assets with lost basis would be taxed at the 20% long-term capital gains rate, and this gain would be subject to the 3.8% NIIT and a 5% state income tax. This spread could be significantly reduced, or even eliminated, if gain on the sale of assets would be subject to ordinary income tax rates, and/or this gain would be subject to a high state income tax rate. The state death tax rate, and the income tax rate of the decedent and her beneficiaries, is therefore an important factor in determining the relative advantages of traditional planning versus maximizing income tax basis.

Another significant factor for determining the tax cost of reducing the tax basis of assets with “traditional” planning is the nature of the assets. Gain of the sale of certain assets, such as creator-owned copyrights, trademarks, patents and artwork, is subject tax at ordinary income tax rates. The current top ordinary income tax rate is 39.6%. Other assets, such as IRAs and other deferred income IRD will not receive a stepped-up basis on death. The following is a listing, from best to worst, of certain assets and how they will benefit (if at all) from basis step-up:

- **Creator-owned copyrights, trademarks, patents and artwork-** Gain on the sale of these assets will generally result in ordinary income. Gifts of these assets will result in ordinary income when sold by the donee.

- **“Negative Basis” commercial real property-** This is generally depreciated real estate that is subject to debt. A sale of the property with the assumption of the debt will generally result in gain equal to the sale proceeds, plus the amount of debt assumed, less the property’s tax basis. The tax basis may be low due to depreciation deductions. In some cases, there may be “depreciation recapture” subject to ordinary income tax rates. “Unrecaptured depreciation” is generally taxed at a 25% rate.<sup>9</sup>
- **Artwork, gold and other “collectibles”-** Gain on the sale of these assets is generally subject to a 28% tax rate.<sup>10</sup>
- **Low Basis Stock-** These assets will benefit from a stepped-up basis. Gains on the sale of these assets will generally be taxed at a top federal capital gains rate of 20%. These gains may also be subject to the 3.8% NIIT.<sup>11</sup>
- **High Basis Stock with basis in excess of fair market value-** These assets will not benefit from a stepped-up basis on death, but will instead receive a “stepped-down” basis.
- **IRAs and Qualified Plan Assets-** These assets are IRD, as described above, and will not receive a stepped-up basis on death.

Another consideration for determining the relative advantage of “traditional” planning to reduce the taxable estate is whether the assets are likely to be sold after the death of the owner. For example, closely-held business stock that will pass to children who are actively managing a business is arguably less likely to be sold upon the death of the business owner.

#### TAX BASIS PLANNING WITH INTENTIONALLY DEFECTIVE GRANTOR TRUSTS

As described above, sales to IDGTs are generally used to “freeze” the value of assets includable in the Trust grantor’s taxable estate. Under this strategy an individual establishes an irrevocable trust that includes terms that exclude the trust from the individual’s taxable estate. However, trust terms include provisions that require the trust to be treated as a *grantor trust* for income tax purposes. Income of *grantor trusts* is taxed to the grantor.

Grantors of IDGTs are treated as the “owners” of trust assets for income tax purposes under the grantor trust rules. This means that the sale of assets to an IDGT is disregarded for federal income tax purposes.

While there are several alternative provisions that trigger grantor trust treatment for income tax purposes, estate plan-

ners should consider including a “power of substitution” provision that allows the grantor of the IDGT to reacquire trust assets by substituting other property of an equivalent value.<sup>12</sup> While this retained power treats the trust as a grantor trust for income tax purposes, it does not cause the trust assets to be included in the grantor’s taxable estate for estate tax purposes. As discussed below, this “power of substitution” can be a valuable tax basis management tool.

#### PAY OFF IDGT INSTALLMENT NOTE PRIOR TO GRANTOR’S DEATH

There is substantial uncertainty regarding the date-of-death income tax basis of an installment note held by the grantor who sold assets to an IDGT. While some commentators believe that the note should receive a stepped-up tax basis, other experts believe that there is no step-up. There is general consensus that steps should be taken to have the IDGT pay off the installment note prior to the death of the grantor to avoid these issues.<sup>13</sup> The installment note could be paid using a portion of the appreciated assets held by the IDGT.

#### SWAP HIGH BASIS ASSETS FOR LOW BASIS ASSETS IN IDGT

As described above, Grantors of IDGTs are treated as the “owners” of trust assets for income tax purposes under the grantor trust rules. This means that transactions between the IDGT and that grantor are disregarded for federal income tax purposes. Grantors of IDGTs that include “power of substitution” provisions should consider exchanging high basis assets for low basis assets, as illustrated in the following example.

*Example:* In a previous Example John sold stock to his IDGT for \$1,000,000, and this stock appreciates to a value of \$5,000,000 at the time of John’s death. While John has effectively removed \$4,000,000 of appreciation from his taxable estate, the Trust’s tax basis in the stock is its \$1,000,000 purchase price, and the Trust would recognize a \$4,000,000 gain if it sells the stock for \$5,000,000. Assume that John retained a “power of substitution” in his IDGT. Using the “swap” strategy, prior to his death John exchanges high basis assets worth \$5,000,000 for the low basis stock in the Trust. If the basis of the exchange assets is \$5,000,000, then the Trust will have a basis in these assets of \$5,000,000. Under the grantor trust rules this exchange is disregarded for tax purposes, so John will not recognize any gain on the exchange. If John owns the low basis stock at the time of his death, then this stock will receive a date of death stepped-up basis.

**UTILIZE SWAP TECHNIQUE FOR IDGT  
CREATED UPON DEATH OF FIRST SPOUSE**

As described above, The Act made permanent the “portability” of the predeceasing spouse’s unused estate tax exclusion amount.

A significant consideration for many families is whether the estate plan of the predeceasing spouse should incorporate the marital trust/credit shelter trust split found in many “traditional” estate plans, or alternatively should rely on portability, to minimize overall taxes.

*Example- Credit Trust:* Brian’s Trust owns a closely-held business and various investment assets with a combined value of \$8,000,000. His wife Laura owns a home and other assets with a value of \$2,000,000. Neither spouse has made gifts in excess of the annual exclusion amount. If Brian predeceases with these assets, his current estate plan, executed in 1990, provides for a split of his Trust into a Marital Trust of \$2,570,000 and a Credit Trust with a value of \$5,430,000 (the basic exclusion amount). Assume that 10 years later Laura dies with assets of \$3,000,000, and that the basic exclusion amount has increased to \$6,000,000. Assume further that upon Laura’s death the value of the assets in the Marital Trust is \$4,000,000 and the value of the Credit Trust is \$7,000,000. Under this scenario the assets in Laura’s taxable estate would be \$7,000,000- the value of Laura’s assets plus the amount in the Marital Trust. Her basic exclusion amount would be \$6,000,000, and her family would pay estate tax on \$1,000,000, or \$400,000.

*Example- Portability:* Assume the same facts in the prior Example except that all of Brian’s assets are transferred to a Marital Trust upon his death. In this case the Marital Trust would be worth \$11,000,000 upon Laura’s death. Laura’s taxable estate would be \$14,000,000. With portability, her total estate tax exclusion would include her basic exclusion amount of \$6,000,000 plus the \$5,430,000 DSUEA, for a total of \$11,430,000. Laura’s estate would therefore pay estate tax on \$2,570,000 (\$14,000,000 - \$11,430,000 = \$2,570,000). This tax would be approximately \$1,028,000, or \$628,000 more than the estate taxes payable with a Marital Trust/Credit Trust estate plan.

*Observation:* The value of the DSUEA does not increase with inflation.

*Observation:* The tax basis of the assets in the Credit

Trust in the prior Example does not get stepped-up to the value on Laura’s date of death.

These two Examples suggest that high-wealth families can benefit from a “traditional” marital trust/credit trust strategy because the appreciation of the credit trust assets is removed from the second spouse’s taxable estate. However, this strategy results in a loss of basis step-up for the credit trust assets. As illustrated in the following example, these families should consider a strategy that incorporates portability and the IDGT asset swap technique to increase the basis in assets that would not have received a stepped-up basis under “traditional” marital trust/credit trust planning:

*Example-* Assume the same facts as the *Portability* example above, except that Brian’s estate plan provides for an outright distribution of assets with a value equal to the \$5,430,000 DSUEA amount to Laura, with the remainder of Brian’s assets passing to a Marital Trust. Laura then gifts the \$5,430,000 to an IDGT, retaining a power of substitution. The IDGT invests the \$5,430,000. Assume further that over time the IDGT assets appreciate to \$7,000,000, and that Laura swaps assets with a basis and fair market value of \$7,000,000 for the IDGT assets.

In this Example Laura’s gift to her IDGT utilizes Brian’s DSUEA amount. The DSUEA is applied first to lifetime gifts of the surviving spouse.<sup>14</sup> The appreciation of assets in Laura’s IDGT is excluded from Laura’s taxable estate. Also, the swap of high basis for low basis assets will not be a taxable transaction under the grantor trust rules.

**A WORD OF CAUTION**

President Obama’s 2015 budget proposals, contained in the March, 2014 “Green Book” include provisions that would essentially eliminate estate planning strategies that take advantage of the disparate estate tax and income tax treatment of IDGTs. These proposals would coordinate the estate and income tax treatment, and grantor trusts for income tax purposes would be includable in the grantor’s gross estate. While the passage of these proposals does not appear to be imminent due to the current makeup of Congress and other factors, families that hope to take advantage of the IDGT strategies described above, and their advisors, should carefully monitor future proposals affecting these trusts.

**TAX BASIS MANAGEMENT WITH PARTNERSHIP  
DISTRIBUTIONS**

Estate planners should consider taking advantage of tax basis planning opportunities available under the partnership dis-

tribution rules. For example, assume that a partnership distributes a high-basis asset to a partner with a zero tax basis in the partnership. The partner's tax basis in the distributed asset would be zero under the partnership distribution rules.<sup>15</sup> This distributed asset would receive a stepped-up basis upon the death of the partner.<sup>16</sup> If the partnership makes an election under IRC §754, then the "stripped" basis—which is the partnership's basis in the asset at the time of the distribution that is "lost" upon the distribution to the zero-basis partner—would allow an upward basis adjustment to the assets remaining in the partnership.<sup>17</sup>

*Example:* Assume that a father and his two sons each own one-third interests in a partnership that owns two parcels of undeveloped land that have been held in the partnership for 10 years. Parcel A has a fair market value of \$5,000,000 and a tax basis of \$1,000,000. Parcel B has a value of \$1,000,000 and a tax basis of \$3,000,000. The partnership has no debt. If the father receives Parcel B as a distribution in partial redemption of his partnership interest, then his basis in Parcel B will be zero. The partnership will receive an increase in the basis of Parcel A equal to the \$3,000,000 "stripped basis". Upon the father's death, Parcel A will receive a stepped-up basis equal to the value on his date of death. Also, the father's estate will receive a stepped-up basis in the father's remaining 20% partnership interest, and would receive a step-up in the inside basis of the partnership assets with a Sec. 754 election.

The use of this and other basis management techniques with partnerships requires an understanding of other partnership tax provisions of Subchapter K, including the "mixing bowl" transaction and disguised sale rules.<sup>18</sup>

## CONCLUSION

The new estate and gift tax regime, with a significantly higher exclusion amount, means that most families are no longer subject to these taxes. The lower estate and gift tax rate has also compressed the spread between the estate and gift tax rate and the income tax rate. These changes have caused estate planners to reconsider traditional estate planning strategies to minimize the taxable estate, and a new focus on optimizing income tax basis.

Tax basis optimization techniques include swapping high basis assets for low basis assets held in IDGTs, and tax basis management of assets held in partnerships using the tax basis "stripping" rules.

While the new estate and gift tax regime has eliminated these taxes for many families, it has also refocused attention on new- and old- strategies to optimize income tax basis.

## ABOUT THE AUTHORS

*Mr. Kennedy's primary practice areas include corporate tax planning, including structuring of mergers and acquisitions, exempt organization qualification and planning, estate planning and individual income tax planning. He is a former Chairperson of the Metropolitan Detroit Bar Association Taxation Committee, and a former Chairperson of the State Bar of Michigan Taxation Section and Editor of the Michigan Tax Lawyer. Jay has written many articles on tax-related subjects for the Michigan Tax Lawyer and other publications and has been an instructor for several tax seminars, including the Michigan Institute of Continuing Legal Education's After-hours Tax Law Series and the Taxation Section's Summer Tax Conference. He became a Certified Public Accountant in 1981.*

*Mr. Monterosso is a former associate of Warner Norcross & Judd LLP who is currently pursuing his LLM in Taxation at the University of Florida.*

## ENDNOTES

- 1 IRC Sec. 675.
- 2 IRC Sec. 1014.
- 3 IRC Sec. 1015.
- 4 IRC Sec. 2001(c).
- 5 IRC Sec. 2010(c)(3).
- 6 See Paul S. Lee, *Run the Tax Basis and Catch Maximum Tax Savings—Part 1*, Estate Planning Journal (WG&L), Volume 42, Number 1, (January 2015).
- 7 IRC Sec. 2010(c)(4).
- 8 IRC Sec. 1411.
- 9 IRC Sec. 1(h)(1)(E).
- 10 IRC Sec. 1(h)(4).
- 11 IRC Sec. 1411.
- 12 IRC Sec. 675(4)(C).
- 13 See discussion of these issues in Deborah V. Dunn and David A. Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates*, Journal of Taxation Volume 95, No. 1, July 2001.
- 14 IRC Sections 2010(c) and 2505.
- 15 IRC Sec. 732(a)(2).
- 16 IRC Sec. 1014(a).
- 17 IRC Sec. 734(b).
- 18 IRC Sections 704(c)(1)(B), 707(a)(2)(B), 731(c), 737, and 751(b). For a detailed discussion of these planning opportunities see Paul S. Lee, *Run the Basis and Catch Maximum Tax Savings- Part 2*, Estate Planning Journal (WG&L), Volume 42, Number 2 (February 2015).



## TAXATION SECTION'S L. HART WRIGHT CHAIR'S SERVICE AWARD



*Winners of the L. Hart Wright Chair's Service Award, pictured from left: Rick Siriani (SBM Board of Commissioner's Liaison), and Wayne Roberts (Chair of the Taxation Section, 2012-13)*

At the Annual Meeting on September 24, 2015, the Taxation Section's first L. Hart Wright Chair's Service Award was given by Outgoing Chair Marjorie Gell to Rick Siriani of Miller Canfield, and Wayne Roberts of Varnum, in recognition of their exemplary service to the Section over the last year. Mr. Siriani, the Section's State Bar of Michigan's Board of Commissioners Liaison, was a tremendous help to the Section and the Sections' Chair on matters relating to tax policy and tax legislation. His "behind the scenes" work on the Section's behalf this past year was extraordinary and greatly appreciated. Mr. Roberts, who chaired the Section's Past Chair Advisory Group, assisted the Section this past year in making recommendations on "pay-to-play" tax

legislation. He was largely responsible for the Section's tax reform work over the last decade that led to the enactment of two enrolled tax bills in 2015 (offer-in-compromise legislation, and "pay-to-play" legislation).

The Taxation Section's L. Hart Wright Chair's Service Award is given in memory of Professor L. Hart Wright, State Bar of Michigan Taxation Section Chair (1965-1966). Each year, up to two recipients are selected by the Outgoing Chair of the Taxation Section, and presented with a plaque at the Section's Annual Meeting. The plaque is paid for by the L. Hart Wright Endowment Fund funded by a private foundation.

# THE IRS ANNOUNCES AN OVERHAUL TO THE DETERMINATION LETTER PROCESS: WHY IT MATTERS AND WHAT PLAN SPONSORS NEED TO KNOW

By Eric Gregory

The Internal Revenue Service (“IRS”) has announced that its periodic review of individually designed retirement plans to determine the plans’ qualified status will end effective January 31, 2017.<sup>1</sup> Under current IRS practices, this review is critical for plan sponsors to ensure that a plan’s form meets the requirements for favorable tax treatment under the Internal Revenue Code (“Code”). Additionally, auditors, fiduciaries and other third parties rely on favorable determination letters to ascertain that a plan’s terms comply with the Code. Therefore, it will be crucial for plan sponsors to review all of their qualified retirement plans and consider the best way to move forward.

## BACKGROUND: THE HISTORY OF DETERMINATION LETTERS

A plan must comply with §401(a) of the Code in order to remain qualified. The substantial tax advantages of maintaining tax qualification under §401(a) include:

- The current deductibility of employer contributions (subject to Code limitations);
- Tax-free growth of plan investments held in plan trust;
- Retirement plan funds generally are not subject to claims of creditors of either the plan sponsor or the plan participants; and
- Tax deferral of contributions to employees until amounts are actually received, including the ability to make tax-free rollovers to other qualified plans or IRAs.

For decades, determination letters served as a “backstop” for employers to ensure compliance with §401(a). Typically, plan provisions that were subject to a favorable determination letter could not result in plan disqualification, even if the IRS made an error in reviewing the plan document.<sup>2</sup> Instead, the IRS would usually propose prospective corrective amendments to be adopted by the plan sponsor.

Qualification is of obvious importance to employers that maintain qualified plans, but is even more crucial to third parties. Company and plan auditors as well as investment

managers who rely on SEC exemptions will examine favorable determination letters. Additionally, companies involved in mergers or acquisitions will typically present a favorable determination letter to demonstrate qualification requirement compliance.

For many years, plan sponsors could request determination letters at any time. This created a problem where requests for favorable determination letters would come in troves coinciding with changes in the law. In order to counteract that problem the IRS began a five-year cycle for determination letters starting in 2007.<sup>3</sup>

Under the five-year cycle system, plan sponsors were offered the ability to request a determination letter once every five years. Each sponsor was assigned a cycle based on the last digit of the sponsor’s employer identification number (“EIN”) (each cycle is assigned a letter: Cycles A through E). This cycle period became the plan’s remedial amendment period where a plan, under certain circumstances, can be amended retroactively to comply with Code requirements. For example, Cycle E ends January 31, 2016 for individually designed plans sponsored by employers with EINs ending in zero or five. Thus, the remedial amendment period for a timely adopted amendment effective in 2013 by a plan that is a Cycle E filer is January 31, 2016.

Under the cycle system, plans were technically permitted to submit “off-cycle” determination letter requests. The IRS, however, would not review off-cycle applications submitted in a particular year until all on-cycle plans had been reviewed and processed. In practice, this meant that off-cycle applications were rarely, if ever, reviewed. Certain off-cycle applications were given higher priority, however, including terminating plans, new plans and applications supported by “urgent business need.”

With the frequency of law changes that would arise for plans during “off-cycle” periods, the IRS permitted plan sponsors to adopt “interim” amendments within shorter timeframes after law changes. Interim amendments were merely subject to a “good faith” standard.



## THE CHANGES: ANNOUNCEMENT 2015-19

As the IRS revealed in Announcement 2015-19, the current remedial amendment period remains unchanged for Cycle E filers. Additionally, the following remedial amendment period for Cycle A sponsors (with EINs ending in one or six) may submit determination letter applications until January 31, 2017. Due to the change in policy, the IRS “expects” that a remedial amendment period will extend until at least December 31, 2017. After that time, the IRS will no longer accept determination letter applications based on the five-year cycle and will only accept applications from plans on initial qualification and termination.

A number of changes, however, have gone into effect immediately. Beginning July 21, 2015 through December 31, 2016, the IRS will no longer accept off-cycle applications unless the plan is terminating or it is a new plan that would otherwise have to wait a year before becoming eligible to submit an on-cycle application. If a sponsor would like to file an application for a favorable determination letter for a new plan that does not meet these requirements, they must wait until after December 31, 2016.

## NO CHANGES FOR PRE-APPROVED PLANS

The IRS will leave the determination letter program in place for “pre-approved plans” (referred to as “master,” “prototype” and “volume submitter” plans). Employers may adopt pre-approved retirement plans that are sold by service providers, financial institutions and advisors. The document providers typically ensure that the plan is amended to comply with law changes, thus lowering compliance costs for plan sponsors. Over the years, the IRS has made the pre-approved program more attractive for plan sponsors by lowering determination letter fees for these plans. Many sponsors use some type of pre-approved plan; some rough estimates suggest that two-thirds of all plans use pre-approved documents.<sup>4</sup>

Pre-approved plans have their limitations, however. Plan sponsors with numerous business lines may find that pre-approved plans do not have enough flexibility. Additionally, plans with both union and non-union employees, some ESOPs and cash balance plans may necessitate individual design.<sup>5</sup> There are no multiemployer pre-approved plans. Older pension plans frequently maintain multiple benefit formulas and grandfathered rights and features that cannot be handled by pre-approved plans. Finally, pre-approved plan documents are long and complex, as they must address all contingencies, whether or not applicable to a particular situation. Therefore, it is difficult for plan sponsors to determine answers to straightforward questions by merely reviewing a plan document. This creates the possibility for operational errors.

## LACK OF IRS RESOURCES IS THE BIGGEST FACTOR

Clearly, the IRS prefers that additional sponsors begin using pre-approved plans, as resources to review individually designed plans are limited. Even though the IRS charges a user fee of \$2,500 to review individually designed determination letter requests, budget cuts have had their impact. The IRS’ budget is down 17 percent from 2010, adjusted for inflation, while Congress has mandated massive new enforcement efforts including the Affordable Care Act and the Fair and Accurate Credit Transactions Act. There are now fewer than 100 agents reviewing determination letter applications, typically only spending 3 hours on each application.<sup>6</sup> It is likely that this is insufficient time for staff to effectively review the applications.

## POSSIBLE FUTURE IRS COMPLIANCE PROGRAMS

In the preamble to the announcement, the IRS indicated that it may: (1) provide model amendments; (2) not require certain amendments to be adopted if they are not relevant to a particular plan; or (3) expand plan sponsors’ options to document qualification requirements through “incorporation by reference.” Additionally, the IRS requested comments on: (1) requirements for the adoption of interim amendments; (2) guidance to assist plans in converting from an individually designed plan into a pre-approved plan; and (3) modifications to other IRS programs to facilitate changes to the determination letter process including the Employee Plans Compliance Resolution System (“EPCRS”).

In addition to the above, the IRS has informally floated other ideas. At a recent American Bar Association meeting, the IRS discussed: (1) making it easier to correct plan document failures using EPCRS; (2) expanding the determination letter program for pre-approved plans; and (3) allowing sponsors to make minor changes to model amendments.

IRS officials have indicated that a notice or announcement would be issued later this year providing more details about coming changes in the determination letter program.

## UNANSWERED QUESTIONS

While the IRS suggests useful future developments, none of them squarely address some of the particular issues that can be addressed in an IRS individual determination letter review. For instance, in 2012 the American Society of Pension Professionals & Actuaries (“ASPPA”) submitted a comment letter to the IRS regarding an IRS interpretation of regulatory language that requires safe harbor contributions to be fully vested when contributed.<sup>7</sup> It only became apparent to practitioners that the IRS was interpreting the regulation in this way until after it required amendments to plans being

submitted for determination letters. Therefore, so long as the IRS provides interpretations of existing regulations that may change without notice, it will be even more difficult for individually designed plans to comply.

Even if attorneys review plan documents to determine that they meet all qualification requirements, there is simply no way for them to anticipate how the IRS might internally choose to apply existing law. Therefore, while formal opinions from counsel on the qualified status of a plan may increase in frequency, the weight that they will carry will be significantly less than that of a determination letter.

Additionally, there are more specific unknowns with regard to the future determination letter process. It is not clear what will constitute a “new” plan for determination letter purposes: for instance, query whether a spin-off plan from a qualified plan in connection with a merger would constitute a new plan. It is unclear how these changes will impact the filing of an S-8 registration statement with the Securities and Exchange Commission, which requests either an opinion of counsel or a determination letter. Additionally, it is not clear what internal and external auditors will use to determine the qualified status of a plan.

#### STEPS TO TAKE

At this time, there are a number of steps that plan sponsors should take to ensure continued compliance:

- Sponsors of individually designed plans on Cycles E and A should file in their current cycles;
- Cycle C and D plans with letter submissions currently pending should check the status of their determination letters with the IRS;
- When feasible, plan sponsors should consider transitioning to a pre-approved plan. Additionally if a pre-approved plan document was modified by a service provider in such a way that IRS submission was recommended, this plan should be reviewed to determine if it should be standardized;
- Newly adopted individually designed plans should be submitted to the IRS for a determination letter no later than the due date, including extensions, of the sponsor’s tax return for the year the new plan is effective;
- Any off-cycle individually designed plan that has never applied for a determination letter should prepare to file for a determination letter in 2017; and
- Any plan that is terminated should be submitted to the IRS for a determination letter upon termination.

#### CONCLUSION

Announcement 2015-19 is merely the first step in a long process. Plan sponsors should carefully watch for additional guidance from the IRS. In the meantime, it is imperative that sponsors ensure that individually designed plans are regularly reviewed by counsel to ensure document compliance. The absence of future determination letters will only make maintaining compliance more difficult for longstanding plans, and may give rise to serious consequences should the plan be subject to IRS audit.

#### ABOUT THE AUTHOR

*Eric W. Gregory graduated from Wayne State University Law School and received an LL.M. in taxation with a certificate in employee benefits law from Georgetown University Law Center. He is vice-chair of the Oakland County Bar Association Employee Benefits Committee and is an employee benefits lawyer at Dickinson Wright PLLC in Troy.*

#### ENDNOTES

- 1 Announcement 2015-19, 2015-19 I.R.B.
- 2 Code §7805(b).
- 3 Rev. Proc. 2007-44, 2007-2 C.B. 54.
- 4 Hazel Bradford, *IRS to Halt Issuing Certain Determination Letters*, PENSIONS & INVESTMENTS, June 15, 2015, (<http://www.pionline.com/article/20150615/PRINT/306159976/irs-to-halt-issuing-certain-determination-letters>).
- 5 In Rev. Proc. 2015-36, 2015-25 I.R.B., the IRS announced that it will allow prototype and volume submitter ESOP plan documents that meet certain requirements.
- 6 Tim Berry, *IRS Wait Times*, IRA IDEAS, May 19, 2015 (<http://iraideas.com/irs-wait-times/>)
- 7 ASPPA, *Re: Forfeitures Used to Fund Safe Harbor Contributions*, May 8, 2012 (<http://www.asppa.net/document-vault/pdfs/GAC/2012/forfeitures.aspx>).

# PORTABILITY- THE FINAL REGULATIONS

By Lorraine F. New

Portability operates as an inexpensive insurance for estate tax as it can prevent the loss of the \$5,430,000 basic exclusion amount should a spouse die with less than that amount of assets. Prior to 2011, if a spouse died without planning or in the wrong order, unused exclusion amounts would be lost. Surviving spouses obtained the ability to make a portability election in order to retain the basic exclusion amounts unused by the estate of their spouse as a part of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, and made permanent by the American Taxpayer Relief Act of 2012 (ATRA). To elect portability, an executor must file a timely, complete, and properly prepared Form 706, Estate Tax Return, for the deceased spouse, and compute and claim a portability amount, the Deceased spouse's unused exclusion (DSUE). Preparers do have to follow the rules, which include the regulations, and surprisingly enough, the instructions to Form 706, which are referred to in the regulations as providing guidance. Temporary regulations were issued on June 18, 2012 regarding the portability election, and the final portability regulations are effective as of June 12, 2015. These final regulations indicate:

1. No portability election will be allowed if the estate tax return *is required* by IRC section 6018 based upon the amount of the gross estate plus adjusted taxable gifts equal to or exceeding the basic exclusion amount then in effect. A timely filing is necessary, which is within nine months after death, with one six month extension that can be requested. The regulations confirm that relief to make a late portability election can be granted when a return is not required. That now involves a Private Letter Ruling request (with a fee to file of \$2200-\$9800) pursuant to Section 301.9100-3 of the Procedure and Administrative Regulations.
2. Treasury refused to revise the definition of "executor" but allows for someone with actual or constructive possession of any property of the decedent to file an estate tax return and elect portability. However, a subsequent contrary election made by an appointed executor of that estate filed on or before the due date of the return, including extension, will supersede the election by the non-appointed executor. Commentators had asked that documents such as prenuptial agreements, trusts, or other documents could give a spouse direction and permission to file for portability, as there is sometimes tension between members

of a first family and a surviving second spouse about paying for an estate tax return to be prepared, obtaining necessary information, and cooperating with obtaining the portability amount.

3. There is a requirement that the portability election be made in a return that is timely filed, complete and properly prepared. This standard is higher than the four requirements for a return to be valid for purposes of commencing the statute of limitations indicated in an Office of Chief Counsel memorandum CAM 2015-2101F ( May 22, 2015) regarding Forms 841 and Form 944. The four are: it provides sufficient data to calculate the tax liability, it purports to be a return, it makes an honest and reasonable attempt to satisfy the requirements, and it is executed under penalties of perjury. Treasury also refused to include any guidance regarding the materiality of an omission. While the regulations indicate that some errors and omissions are considered minor and correctible, they have left it to IRS to decide on a case-to-case basis if a return is "complete and properly prepared". This leaves questions such as whether appraisals are necessary, the credentials of the appraiser, inclusion of documents showing the right of the spouse to inherit property, amount of financial data to support value of closely held businesses and of course, support for discounts that may be taken on assets on the return. Post-filing adjustments can be made to create or enlarge the DSUE amount when a protective refund claim has been filed and gets resolved. The statute for the DSUE amount does not toll until three years after it is used for a gift or in the subsequent spouse's estate. The IRS can consider the effectiveness, amount and legality of the portability election during the extended audit period. Treasury also refused to limit the broad statutory authority given the IRS to examine the correctness of returns, "to make determinations with respect to the (DSUE) amount for purposes of carrying out (section 2010c of the Code)".
4. A recommendation for the IRS to issue a short form 706 for portability election was not adopted. However, simplified reporting where a good faith estimate of value and not actual fair market value is used under Reg. 20.2010-2(a)(7)(ii) is available for estates that were not required to file an estate tax return, for

marital bequests or transfers or charitable bequests that meet certain conditions. Simplified reporting is available when transfers of property to the spouse or charity occur, and only the description, ownership, and support for the deduction is necessary to be shown on the Form 706 and not a determination of fair market value. This does not work if the value of the property relates to, affects or is needed to determine the value passing from the decedent to another recipient, such as when a portion of closely held stock goes to the spouse or charity when other stock passes to non-spouses. Simplified reporting cannot be used when the value of the property is necessary to determine the estate's eligibility for special valuations sections such as IRC 2032, 2032A or 6166. If less than the entire value of an interest in property is passing to the spouse or charity, or a partial disclaimer or partial QTIP election is made with respect to property, simplified reporting cannot be used.

5. If the surviving spouse is not a U.S. citizen, and is the beneficiary of a Qualified Domestic Trust (QDOT) no part of the DSUE from a prior deceased spouse can be used until the QDOT terminates. The final regulations provide that when the surviving spouse who becomes a citizen and satisfies requirement of IRC section 2056(b) (12), the spouse can use DSUE in making taxable gifts. A non-citizen, non-resident surviving spouse or the spouse's estate) cannot use the DSUE amount of a prior deceased spouse except to the extent allowed by treaty.
6. No adjustment to the DSUE amount is allowed because of unused credits arising under IRC sections 2012-2015. The amount of the DSUE is therefore calculated without any gift tax credit on gifts made prior to 1977, prior transfer credit or foreign death tax credit.
7. Still undecided is the controversial Qualified Terminable Interest Property (QTIP) election taken when it is not necessary in order to reduce or eliminate estate tax. The fear that such a portability election will be disallowed at some future date is based upon

Revenue Procedure 2001-38. At that time, an occasional QTIP election was made that was not needed, and the succeeding estate requested relief so as not to include the QTIP in the surviving spouse's estate. Despite the fact the "A QTIP election is irrevocable" the IRS National office issued the revenue procedure to provide relief and indicated that the QTIP election is void when the estate does not need it. However, now with a portability election, an "unnecessary QTIP election" might be preferred to transfer property to heirs with an income interest to the surviving spouse in order to obtain a new step up in basis at the surviving spouse's death or to insure that property will eventually pass to the children of the first marriage. IRS is still studying this situation and promises to issue future guidance. This author finds this hesitation surprising, as Revenue Procedure 2001-38 clearly states that the onus is on the taxpayer to show why the election made in the first return should be void, and the taxpayer needs to submit the request with the surviving spouse's Form 706 or with a request for a Private Letter Ruling to obtain the relief from inclusion of an unnecessary QTIP election in the second spouse's estate.

We have only had the possibility of portability elections since 2011, and only now have permanent regulations. For a period, IRS was issuing closing letters for Forms 706 filed only for portability. Since their new policy, no closing letters will automatically be issued for any Form 706, unless requested four or more months after filing. It may be some time before we have enough experience with portability in practice to know how the power of the IRS to question values interacts with DSUE elections and use.

#### ABOUT THE AUTHOR

*Lorraine F. New is an attorney with George W. Gregory PLLC. She consults on estate, gift tax, probate and income tax controversies, prepares returns and serves as an expert witness. This follows 14 years as an Estate and Gift Tax Attorney with the IRS and 5 years as the Estate and Gift Tax Manager in Detroit.*



## I WANT TO HEAR FROM THE I.R.S. HOW ABOUT YOU?

By Lorraine F. New

Have you heard that you will be hearing less from the IRS, especially if you prepare and file estate tax returns, Form 706? Recently IRS announced that it is no longer, as a matter of course, issuing closing letters for estate tax returns filed after June 1, 2015. You will get one at the conclusion of an audit but you will not automatically hear if a return is accepted as filed. You can request a closing letter, but not with the return or for four months after filing. We are told that information about closing letter requests can be obtained from the IRS Service Center in Cincinnati at (866) 699-4083. However, the information does not say that a telephone call will result in a closing letter being issued.

Since the Closing Letter was routinely requested by Probate Courts, necessary for property transfers from an estate and as a green light for distribution of an estate's property, questions may arise about when the decedent's property can be distributed and about potential liability of the personal representative/executor during the three year statutory period. At this time, one can still file Form 5495, Request for Discharge from Personal Liability under Internal Revenue Code section 2204 or 6905. It must be filed separately from the return. This reduces the time for notifying the Executor of the amount of the tax to 9 months from the date the written request for discharge of personal liability was received. Of course, even if the executor is discharged from liability, the IRS can still assess tax deficiencies against the executor if he or she has any of the decedent's property. In addition, debts due to the IRS must be paid first if the executor knew or should have had notice or failed to exercise due care in determining if such obligations existed before distribution of the estate's assets.

Form 4810, Request for Prompt Assessment under Internal Revenue Code section 6501(d) can be used to request prompt assessment of tax, such as for the decedent's final 1040. It cannot be used for federal estate taxes. Form 4810 must be filed separately from any other document and tax should then be assessed within 18 months of the written request. If the decedent failed to report substantial amounts of gross income (more than 25% of the gross income reported) or filed a false or fraudulent return, Form 4810 will not work to shorten the assessment period. However, it may relieve the executor of personal liability if he did not have knowledge of the unpaid tax.

Use of Forms 4810 and 5495 can help reduce the liability of Personal Representatives/Executors but they do not help

with the problem of distribution of estate assets before the federal estate tax has been determined.

At a recent American College of Trust and Estate Counsel (ACTEC) meeting, a Treasury representative suggested that one could, if it was needed at all, request a transcript by completing Form 4506T. This form is not designed for obtaining a Form 706 transcript but for income tax. An estate tax return is much more complex than an income tax return, and has more opportunity for challenges and surprises, making a closing letter more important. We normally do not have heirs waiting for a release on a 1040 for distribution, for example, and audit potential on a 706 is much greater than a 1040. We find the form 4506T a totally unacceptable alternative, since one does not know when the Service will complete their review of the 706 and does not know when to request such a transcript. It may have to be done multiple times. Our experience in requesting transcripts by mail which are promised in ten working days is a lack of response even after months. Calling the IRS to request a transcript is a multi-hour project, which results in our calls being lost half the time. As a result, we suggest a form and a practice of requesting a closing letter four months after submission of an estate tax return. Requests should be carefully documented and sent by registered mail, return receipt requested. Given the demands on the diminished staff at the Service Center, it is difficult to predict how long the response to closing letters will take. While the IRS will save some printing and mailing costs, requesting a closing letter puts the responsibility on the practitioner. Don't be waiting for the closing letter that will not come!

Practitioners have raised the question whether a closing letter request will force a review of the return, perhaps triggering an audit that might not otherwise happen. Prior practice had IRS doing an initial review to distinguish between returns with audit potential and those that should be accepted as filed. If audits regularly occur following the request for the closing letter, one might choose to wait patiently or call the Service Center for updates.

### ABOUT THE AUTHOR

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