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THE ROBERT KEEBLER TAX & ESTATE PLANNING BULLETIN

A Consolidated Monthly Update for Estate Planning Professionals

TAX REFORM

On November 3, House Republicans unveiled the Tax Cut and Jobs Act. The primary author of the bill was the House Ways and Means Committee Chairman Kevin Brady. The 429-page bill is a comprehensive overhaul of the tax code, slashing the corporate tax rate, removing a number of smaller deductions, and reducing the number of individual tax brackets. Following is a summary of a select number of provisions contained in the bill.

- The rule allowing recharacterization of IRA contributions and conversions would be repealed. The provision would be effective for tax years beginning after 2017. Because of the worry of volatility in the stock market, one important reason why a taxpayer may want to consider converting to a Roth IRA is the ability for him/her to recharacterize a prior Roth IRA conversion. In essence, under the tax law, a taxpayer has all the way up until October 15 of the year following the year of a Roth IRA conversion to recharacterize (i.e., undo) the prior year Roth IRA conversion. The elimination of the ability to recharacterize would kill strategies like the Roth Segregation Strategy discussed in last month's newsletter.

- The basic exclusion amount for estate tax would be doubled to $10 million, indexed for inflation. This provision would apply to tax years beginning after 2017. In addition, beginning after 2023, the estate and generation-skipping taxes would be repealed while maintaining a beneficiary's stepped-up basis in estate property.

- The gift tax would be lowered to a top rate of 35 percent and retain a basic exclusion amount of $10 million and an annual exclusion of $14,000 (as of 2017), indexed for inflation.

- The current seven tax brackets would be consolidated and simplified into four brackets: 12%, 25%, 35%, and 39.6%. The threshold amounts for the rates would be as follows (the income levels would be indexed for chained CPI):

	Single	Married	Head of Household
12% Rate	> $0	> $0	> $0
25% Rate	> $45,000	> $90,000	> $67,500
35% Rate	> $200,000	> $260,000	> $230,000
39.6% Rate	> $500,000	> $1,000,000	> $500,000

- The standard deduction would be increased to $12,000 for single filers, $18,000 for heads of household, and $24,000 for joint filers (currently $6,350 for single filers, $9,350 for heads of households, and $12,700 for married filers filing joint). The additional standard deduction and personal exemption would be eliminated. Single filers with at least one qualifying child could claim a standard deduction of $18,000. These amounts would be adjusted for inflation based on chained CPI.

- Under current law, individuals who have medical expenses over 10% of their income are allowed to deduct part of those costs from their taxes. The new bill would take away that deduction.

- The bill limits the mortgage interest deduction to $500,000 (reduced from $1 million) and to primary residences only. Interest on home equity indebtedness incurred after the effective date would not be deductible. In the case of refinancings of debt incurred prior to November 2, 2017, the refinanced debt generally would be treated as incurred on the same date that the original debt was incurred for purposes of determining the limitation amount applicable to the refinanced debt. In the case of a taxpayer who enters into a written binding contract before November 2, 2017, the related debt would be treated as being incurred prior to November 2, 2017.

- The deductibility of local property taxes is limited to $10,000 and the deduction for state income taxes is eliminated.

On November 9, Senate Republicans revealed their own version of the Act. This bill would include seven, rather than four, individual tax brackets including the retention of a 10% rate for lower income individuals. The Senate bill also would continue to allow individual taxpayers to deduct medical expenses that exceed a certain amount of their income, while the House bill would disallow such deductions. Another difference in this version is that it would delay cutting the corporate tax rate to 20 percent from 35 percent until 2019. The House version would reduce this tax beginning in 2018. This bill would also the double the gift, GST and estate tax exemptions but, unlike the House version, the estate tax would not be fully repealed.

2018 GIFT AND ESTATE TAX

For 2018, the estate and gift tax exemption will be $5.6 million per individual, up from $5.49 million this year. The annual gift exclusion amount will be $15,000 for 2018, an increase from the current $14,000.

UBTI LOSS DEDUCTION

The Ninth Circuit has held that an individual couldn't deduct from his personal income the unrelated business taxable income (UBTI) losses sustained by two partnerships held in his IRA.

In Fish v. Commissioner, the taxpayer maintained an IRA and used it to buy shares of two master limited partnerships. For 2009, the taxpayer received two Schedule K-1s from the partnerships reporting ordinary business losses. A loss may be recognized in an individual's IRA if all IRA accounts have been distributed and the amounts distributed are less than the individual's unrecovered basis in the IRAs. The taxpayer in Fish deducted the losses reported on the Schedules K-1 by the two partnerships held in his IRA on his 2009 tax return. The IRS disallowed the deduction, determined a deficiency, and imposed an accuracy-related penalty.

The taxpayer argued to the Tax Court that the law and regulations do not support the Service’s position that a taxpayer may recognize a loss from IRA investments only when all amounts from all IRAs have been distributed. He maintained that restricting an IRA holder's ability to deduct a loss thwarts congressional intent to encourage individuals to save for retirement. He also claimed that requiring retirees to completely liquidate their IRAs in order to recognize a deductible loss was unreasonable. The Tax Court, however, stated that although the taxpayer may not agree with the way the law is written, the Court could not change the law for him. The Tax Court therefore sustained the deficiency and the penalty and the taxpayer appealed. The only issue on appeal was whether the taxpayer could deduct the UBTI losses sustained by the partnerships owned by his IRA from his personal taxable income. The taxpayer argued that he should be allowed deduct UBTI losses within his IRA.

Although IRAs are generally tax-exempt, they are subject to the taxes imposed on UBTI. Under the UBTI rules, tax exempt entities, such as IRAs, that engage in a trade or business not directly related to that entity’s exempt purposes must pay tax on UBTI. The UBTI rules were established to redress the balance when tax-exempt organizations engage in a for-profit business that would typically be carried out by non-tax-exempt organizations. The thought is that a tax-exempt entity is granted its tax exemption to advance its exempt purposes, rather than enabling the entity to compete with businesses that are subject to tax. Generally, as we see in the Fish case, UBTI comes into play with an IRA when the IRA owns partnerships or other passthrough entities. The Tax Code also provides that UBTI losses may be carried forward or backward to deduct against gains within an IRA.

The Ninth Circuit Court noted that the IRC Sections which cover UBTI do not provide for the pass-through of UBTI losses to an IRA beneficiary’s personal tax return. Accordingly, they affirmed the judgment of the Tax Court and denied the loss deduction.

DEDUCTIBLE LOSS

In Mihelick v. U.S., 120 AFTR 2d 2017-6146, a US District court determined that a payment made by a taxpayer to her ex-husband, pursuant to their divorce settlement, didn't qualify as a deductible loss under IRC Sec. 1341 (the claim of right doctrine).

Mihelick and her ex-husband, Bluso, both worked for "the Company" during their marriage. The Company was founded and owned by Bluso's family. Eventually Bluso became the CEO and majority shareholder, drawing a large salary. During the couple's divorce, Bluso's sister and minority shareholder in the Company, sued Bluso alleging that Bluso was excessively compensating himself from 1999 to 2004 and therefore wrongfully depleting company assets. Although Mihelick was not a party to this litigation, Bluso desired that she pay a portion of liability he might incur in the litigation. Therefore, the divorce decree incorporated a separation agreement containing a provision stating that liability from the lawsuit that arose from the acquisition of marital assets and which assets were equally divided between the parties, was to be deemed to be a marital liability. Pursuant to this provision, in 2009 Mihelick paid Bluso $300,000, which was one-half of a portion Bluso paid to his sister for her excess compensation claims.

In 2012, Mihelick submitted an amended 2009 income tax return stating she is entitled to deduct $300,000 of her income for 2009 due to a payment she made to her ex-husband stemming from a settlement of liability that arose during their marriage. The deduction would have resulted in a refund of $111,802 to Mihelick. The IRS denied the refund, resulting in this case.

The IRS argued that the payment is not a taxable event that generates a deduction in the first instance, and there is no substantial nexus between the right to the income at the time of the receipt and the circumstances necessitating its return. The IRS further asserted that Mihelick's claim fails because the return of the income was voluntary and a taxpayer is not entitled to use IRC Sec. 1341 for amounts voluntarily repaid.

The Court explained that to qualify for favorable treatment under Sec. 1341, a taxpayer must establish three elements: (1) that an item was included in the taxpayer's gross income in a prior year because it appeared that the taxpayer had an unrestricted right to the item in the prior year; (2) that after the close of the prior year it is established that the taxpayer did not have an unrestricted right to such item; and (3) that the taxpayer is entitled to a deduction (in excess of $3,000) under another section of the Internal Revenue Code for the loss resulting from the payment of the item to another in the current tax year.

The dispute was whether Mihelick could establish the final two elements. The Court agreed that it must first determine whether another code section would provide a deduction for the item in the current year. The taxpayer contended that she was entitled to a deduction for payment under IRC Sec. 165(c)(2) which allows individuals to deduct losses incurred in any transaction entered into for a profit though not connected to a trade or business. No deduction was allowed, however, because the payment wasn't a loss incurred in a transaction entered into for profit but, rather, a payment entered into by the parties as part of a divorce settlement. Mihelick pointed to no evidence that she entered into the settlement agreement with a profit motive or economic advantage; rather it was a bargain entered into by the parties as one part of the divorce settlement.

PLAN AND IRA CONTRIBUTION LIMITS

Notice 2017-64 provides a listing of dollar limitations applicable to qualified retirement plans as adjusted for cost-of-living adjustments for 2018. Following is a select number of those limitations.

- The limitation for defined contribution plans is increased to $55,000.

- The limitation on the exclusion for elective deferrals described is increased to $18,500.

- The annual compensation limit under IRC Sections 401(a)(17), 404(l), 408(k)(3)(C), and 408(k)(6)(D)(ii) is increased to $275,000.

- The limitation regarding SIMPLE retirement accounts remains unchanged at $12,500.

- The limitation on deferrals concerning deferred compensation plans of state and local governments and tax-exempt organizations is increased to $18,500.

- Taxpayers can deduct contributions to a traditional IRA if they meet certain conditions. If during the year either the taxpayer or their spouse was covered by a retirement plan at work, the deduction may be reduced, or phased out, until it is eliminated, depending on filing status and income. The phase-out ranges for 2018 are as follows:

    - For single taxpayers covered by a workplace retirement plan, the phase-out range is $63,000 to $73,000, up from $62,000 to $72,000.

    - For married couples filing jointly, where the spouse making the IRA contribution is covered by a workplace retirement plan, the phase-out range is $101,000 to $121,000, up from $99,000 to $119,000.

    - For an IRA contributor who is not covered by a workplace retirement plan and is married to someone who is covered, the deduction is phased out if the couple's income is between $189,000 and $199,000, up from $186,000 and $196,000.

    - For a married individual filing a separate return who is covered by a workplace retirement plan, the phase-out range is not subject to an annual cost-of-living adjustment and remains $0 to $10,000.

- The limit on annual contributions to an IRA remains unchanged at $5,500. The additional catch-up contribution limit for individuals aged 50 and over remains $1,000.

- The catch-up contribution limit for employees aged 50 and over who participate in 401(k), 403(b), most 457 plans and the federal government's Thrift Savings Plan remains unchanged at $6,000.
- The income phase-out range for taxpayers making contributions to a Roth IRA is $120,000 to $135,000 for singles and heads of household, up from $118,000 to $133,000. For married couples filing jointly, the income phase-out range is $189,000 to $199,000, up from $186,000 to $196,000. The phase-out range for a married individual filing a separate return who makes contributions to a Roth IRA is not subject to an annual cost-of-living adjustment and remains $0 to $10,000.

LATE IRA ROLLOVER

In PLR 201742034, the IRS ruled on whether a taxpayer could receive an extension of time to rollover an IRA distribution.

The taxpayer had received a distribution from her IRA. The taxpayer was going through a divorce from her husband and her husband informed her that she would be unemployed because he was closing his medical practice. This action was in violation of an injunction issued during the divorce proceedings. Subsequently, her husband assured her that, given the upcoming divorce mediation, he would provide her with the funds necessary to purchase a place to live. Based on these assertions and the husband's legal obligations, the taxpayer withdrew money from her IRA in order to purchase a residence. However, her husband failed to provide her with any funds in connection with the divorce mediation. After the 60-day rollover period had expired, a district court judge ordered the transfer of money from the husband's IRA to the taxpayer's IRA. Rev.

Proc. 2003-16 provides that the Service will issue a ruling waiving the 60-day rollover requirement in cases where the failure to waive such requirement would be against equity or good conscience, including casualty, disaster or other events beyond the reasonable control of the taxpayer. In this case, the Service found that the taxpayer's failure to complete the rollover within the required 60 days was because her spouse failed to fulfill legal requirements under the state law during divorce proceedings. Therefore, she was granted a waiver of the 60- day rollover requirement with respect to the IRA distribution.

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Keebler & Associates, LLP was started by its current partners and some of the nation's leading tax and estate planning experts - - Robert S. Keebler, CPA/PFS, MST, AEP (Distinguished), CGMA, Michelle L. Ward, JD, LLM, CSEP, Stephen J. Bigge, CPA, CSEP, and Peter J. Melcher, JD, LL.M., MBA.

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