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New 2018 unified credit

Last fall the IRS announced that the federal estate and gift unified credit for 2018 would be \$5.6 million. When the exempt amount was doubled in the Tax Cuts and Jobs Act (TCJA), most people assumed that meant the 2018 exemption would be \$11.2 million. Close, but no cigar.

TCJA changed the manner for determining inflation adjustments for the tax code. Instead of the consumer price index, a chained CPI will be used, which takes into account the fact that consumers may make substitutions in purchases as prices rise. The change is expected to slow the rate of increases to inflation-linked tax provisions.

The new rule applies to the unified credit. Accordingly, the IRS has announced that the 2018 unified credit will be \$11.18 million, a reduction of \$20,000.

—*Rev. Proc. 2018-18, 2018-10 IRB 392, modifying Rev. Proc. 2017-58*

COMMENT: The CPI is reported monthly, but the chained CPI is reported annually, in February, and is finalized one year later. Unless the government alters its schedule for the calculations, this may at times make it impossible to know the exact current value of the unified credit.

Politics and gifting

The latest *Statistics of Income Bulletin* from the IRS reports a roughly 20% surge in gift tax collections in 2016, to \$2.457 billion, up from \$2.069 billion in 2015. The number of taxable gift tax returns rose to 2,719 from 2,515 the year before.

Part of the increase may be attributed to the increase in total household wealth, which reached \$91.7 trillion in the fourth quarter of 2016, according to Federal Reserve data. But there also may have been an expectation that in the event Hillary Clinton became President, she would follow through on her promise to decrease the amount exempt from federal transfer taxes to \$3.5 million, while boosting the tax rate to 45%.

An even larger spike in gift tax collections was observed in 2013, reporting on gifts made in 2012. That year \$5.778 billion in gift tax was collected, because some gifts were made in 2012 out of a fear that the exempt amount might fall to \$1 million in 2013, as called for in the tax law. As it turned out, the \$5 million exempt amount was made permanent in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act, enacted as 2012 came to a close.

Nontaxable gifts also soared in 2013, as more than 350,000 such returns were filed that year. Nearly \$400 billion in nontaxable transfers was reported.

COMMENT: Those who had “used up” their lifetime exclusion from federal gift tax may be expected to make additional nontaxable transfers in the coming years. The phenomenon may peak in 2025, the final year before the exclusion is scheduled to drop back to \$5 million (plus inflation since 2011).

Extension granted for basis election

2010 was the year without an estate tax. The trade-off was that it was also the year without an automatic basis step-up for inherited property. Instead, estate executors were required to allocate basis adjustments to the property passing through the estate. The general allocation was \$1.3 million (reduced to \$60,000 for nonresident noncitizens), and an additional \$3 million was allowed for property received by a surviving spouse.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 reinstated the estate tax for 2010, but it also gave executors of estates of decedents dying in that year a choice. They could elect to dodge the estate tax and have the basis adjustment rules apply instead. The date for making that election was set at November 15, 2011 [*Notice 2011-66, 2011-35 I.R.B. 184*], and later was extended to January 17, 2012 [*Notice 2011-76, 2011-40 I.R.B. 479*]. However, the IRS did leave the door ajar, by stating that executors might get an extension of the due date under IRC §301.9100-3.

That was the relief requested in this private ruling. Decedent was a nonresident alien who died in 2010. His surviving spouse received his U.S. situs property. The spouse did not make the election in a timely manner, but no reasons are suggested in the ruling for the failure. Nevertheless, the spouse now wants to make the election.

The IRS holds that the spouse reasonably and in good faith relied on a qualified tax professional, and the tax professional failed to make, or failed to advise the spouse to make, the election. Another 120 days was granted for filing the paperwork.

—Private Letter Ruling 201749003

Uncertain deductions

Catherine Hughes from the Treasury Office of Tax Legislative Counsel told a February meeting of the ABA Section of Taxation that there is some uncertainty about the deductibility of executor and trustees fees, now that miscellaneous itemized deductions no longer are permitted. There's also a question concerning those fees when an estate or trust terminates. Excess deductions may be miscellaneous deductions in the hands of the beneficiaries, even if they were not so characterized in the hands of the terminating entity.

Hughes also told the group that the Service is working on guidance to avoid clawbacks in the event the unified credit drops back to \$5 million, as now scheduled. Gifts that were not taxable when made should not become taxable in an estate in a later year simply because the unified credit is reduced (something that never has happened in the history of the federal transfer tax). The concept is easy to state, but the guidance may prove difficult to write.

Form and substance

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

Mazzei was a member of the Western Growers Association (WGA). Sometime in the 1990s, WGA began a program that combined interests in a foreign sales corporation (FSC) with an IRA. In 1998 the Mazzei family signed up. Mazzei, his wife, and his daughter each funded a Roth IRA with \$2,000. An FSC was formed to handle Mazzei's foreign sales, and

each Roth IRA purchased a one-third interest in the FSC. The family accountant looked over the arrangement and declared it to be legitimate.

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

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

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

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

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

About face?

Senate Democrats have released a proposal for funding more government spending on infrastructure. Revenue would be obtained by scaling back the just-enacted Tax Cuts and Jobs Act. Specific targets include:

- reversal of the enlarged exemption from the alternative minimum tax;
- reversal of the doubling of the unified credit against estate and gift taxes;
- raising the corporate tax rate to 25%;
- closing the carried interest loophole; and
- bringing back a 39.6% top income tax rate.

All told, these changes are projected to increase federal revenue by roughly \$1 billion over the next ten years. An increase in the gas tax was not a part of the proposal.

COMMENT: Have the Democrats finally given up on the idea of lowering to \$3.5 million the amount exempt from federal estate tax?

Phishing evolves

Tax scamming is not going away. In February the IRS warned of a new scam variation that begins when scammers steal information from tax professionals. The criminals then deposit money in the taxpayer’s real bank account.

In one version of the scam, criminals posing as debt collection agency officials acting on behalf of the IRS contacted taxpayers to say that a refund was deposited in error, and they asked the taxpayers to forward the money to their collection agency. In another version, the taxpayer who received the erroneous refund gets an automated call with a recorded voice saying that he is from the IRS and threatens the taxpayer with criminal fraud charges, an arrest warrant, and a “blacklisting” of their Social Security Number. The recorded voice gives the taxpayer a case number and a telephone number to call to return the refund.

Erroneous refunds are possible, and the IRS has a process in place to return them. They do not involve buying gift cards or doing wire transfers.

—*IR-2018-27*

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