In This Issue:

1 Regulations Meet the Real World: The Net Investment Income Tax Sees Its First Filing Season (and Not Without Plenty of Challenges)

3 Circular 230 Changes

4 IRS Application of United States vs. Windsor to Section 401 Retirement Plans

7 Challenging the Motive of an IRS Summons – *US v. Clarke*

8 Inherited IRAs Are Not Protected from Creditor Claims – *Clark V. Rameker*

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Taxation Section

VOLUME 17, NUMBER 2 **Summer 2014**

Regulations Meet the Real World: The Net Investment Income Tax Sees Its First Filing Season (and Not Without Plenty of Challenges)

By Kim Spaulding[*]

This year marked the first filing for taxpayers and accountants grappling with the complex requirements of the new IRC Section 1411 net investment income tax (NIIT), which imposes a 3.8 percent tax on investment and “passive” income above certain thresholds: $250,000 for married taxpayers filing jointly, $125,000 for married taxpayers filing separately, $200,000 for single taxpayers and heads of household, and $12,150 for estates and trusts as of 2014. Combined with an increase in the top tax bracket from 35 to 39.6 percent, an increase in the capital gains rate from 15 to 20 percent, and a new 0.9 percent Medicare surtax on wages above the NIIT’s thresholds, many taxpayers experienced a much heavier tax burden in 2013 than they’re used to. As a result, many are paying close attention to how they can reduce their NIIT exposure.

Accountants have just seen this complex new set of regulations put into practice for the first time—and as expected, they’ve brought with them a host of challenging questions and complications. Naturally the passive activity loss rules (IRC Section 469) featured prominently in many of this year’s NIIT filing challenges because income that can be categorized as nonpassive—that is, when the taxpayer “materially participates” in the business—is exempt from the NIIT. Let’s examine a few of the particular areas that raised questions and complications for taxpayers.

Trusts

When the IRS released its guidance on the NIIT early this tax season, it didn’t address how the passive activity loss rules (Section 469) apply to trusts; it focused mainly on pass-through entities and individual taxpayers. The result was a broad gray area concerning whether and when a trust can be considered a material participant in a business that it owns—a situation that’s becoming increasingly more common as more taxpayers gift business interests to trusts as a part of their gift and estate strategies.

It’s generally been unclear whether trustees who also worked for a company owned by the trust could count their employee status toward their material participation in the business: The two roles have been treated separately with regard to the passive activity rules, and whether a trust itself can materially participate in a business has been a matter of debate. However, the US Tax Court case *Frank Aragona Trust v. Commissioner,* filed March 27, 2014, found that a trust *is* capable of performing personal services, and that activities of trustees, including their activities as employees, should be considered in determining material participation. This means a trust *can* materially participate in a business it owns—a critical factor in determining whether the trust’s income through the business is subject to the 3.8 percent NIIT. While *Aragona* may not provide a clear-cut application to every situa-

tion, it at least provides guidance in an area where there is otherwise little authority.

Another difficulty arose surrounding the AGI threshold at which trusts and estates become subject to the NIIT: $11,950 in 2013 and $12,150 in 2014. This threshold (which is after distributions to beneficiaries) is low compared with the higher thresholds given to other taxpayers, and the American Institute of Certified Public Accountants (AICPA) submitted a letter to Congress recommending the threshold for estates be raised at least to the level for a married taxpayer filing separately ($125,000). The AICPA's view is that the low threshold unfairly subjects estates to the NIIT and that Congress should treat estates as if they were a continuation of the deceased individual.

As always, state laws and what they require of trustees are vital to proper NIIT planning. To the extent a trust document is silent, state law dictates accounting for trusts—which may or may not be favorable. Many trust documents were drafted before the NIIT became a consideration, so many existing trusts are now planning strategies that will allow them to utilize options and minimize their income tax. When drafting new documents, thoughtful consideration should be given to how trusts will be impacted by the NIIT. For ideal tax results, consider giving trustees flexibility to allocate between principal and income and possibly deem discretionary distributions as having been made from capital gains. These options and ongoing planning opportunities should always be balanced with a trustor's economic objectives.

High Net Worth Individuals

While many of the challenges that arose for high net worth individuals cross over into trust or business territory, a few of the trouble spots most likely to affect high net worth individuals include the passive activity loss rules, grouping of activities, self-rentals, and self-charged interest.

Individuals who participate in multiple or related activities (either passively or as a material participant) have the option of grouping those activities together. If an otherwise passive activity is grouped together with nonpassive activities, a taxpayer may be able to create a group that is overall considered nonpassive—and therefore not subject to the NIIT. It's imperative to understand the nature of our client's involvement and the level of his or her participation in activities—and to clearly document the facts as well as the approach to grouping. In the past individuals may not have been aware of the importance of these groupings or how they impact tax exposure. Note that the grouping rules are complex and depend on the type of entity. For example, some activities—such as the sale of C corporation stock—cannot be grouped into a nonpassive activity, even if the taxpayer materially participated in the business. Clients involved in real estate who meet the definition of *real estate professional* may be able to take advantage of planning opportunities to avoid both the self-employment tax *and* the 3.8 percent net investment income tax. Choice of entity (that is, S corporation versus partnership) becomes an important aspect of this planning.

Some high net worth individuals also ran into NIIT challenges surrounding self-rentals and self-charged interest. When related entities are dealing with one another, there's a risk that the income one taxpayer receives from another will be subject to the NIIT—with restrictions on how much related deductions can offset, particularly when ownership interests begin to vary.

For high net worth individuals who have ownership interests in related entities, it may be worth restructuring transactions and related party agreements with special attention to the NIIT's impact. Consider carefully which entity charges what rent, rethink interest rates between entities, and restructure deals where possible to create better tax outcomes. Prior to the NIIT there was often little motivation for self-dealing taxpayers to consider rent and interest rates, but the NIIT changes the game.

Keep in mind too that charitable giving—particularly of appreciated securities—can be a good tool for reducing NIIT exposure, since donating such assets avoids the capital gains liability that would have been incurred had the assets been sold and often provides a deduction for their full fair-market value.

Businesses

Under Section 1411, C corporations themselves aren't subject to the NIIT. However, individuals who recognize income from the sale of C corporation stock are going to find that income subject to the NIIT regardless of their material participation in the business. But for individuals with ownership interests in a pass-through entity (an S corporation or partnership), material participation does make a difference. When an individual's ownership interest in a pass-through entity in which they materially participate is sold, some or all of the income may not be subject to the NIIT. This gives ownership in a pass-through entity a distinct advantage over ownership in a C corporation.

Pass-through entities did however experience their own difficulties, mostly concerning disclosure: What should S corporations and partnerships disclose to underlying members regarding a sale? And if you're a member with smaller ownership interests and nothing was disclosed to you, how do you calculate your NIIT liability? Fortunately, the regulations do provide guidance and some safe harbors for small entities.

In light of these challenges, consider whether your entity structure still makes sense, and plan any transactions involving the sale of a business carefully, with the NIIT in mind.

Closing Thoughts

Since some of these challenges come with no clear guidance or answers, many tax positions expose taxpayers to some tax risk. At this point thoughtful planning with an eye toward the NIIT is vital, both when drafting new documents and arranging transactions between entities. As more cases like *Aragona* are resolved and the IRS continues to develop guidance, we hope that some of the NIIT's finer points, as well as the IRS's position on complex NIIT scenarios, will become clearer.

Footnote:

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Circular 230 Changes

*By Lee D. Kersten**

Effective June 12, 2014, the IRS issued final regulations modifying what are commonly referred to as the Circular 230 regulations. They contain standards for practice before the IRS. They extend beyond explicitly covered individuals to anyone named as a power of attorney in Form 2848. Go to http://www.irs.gov/pub/irs-utl/TD_9668_6-9-14_Cir%20230_6-9-14_Final_Reg.pdf for regulations with IRS commentary.

The regulations eliminate the complex rules governing covered opinions in current §10.35 and expand the requirements for written advice under §10.37. They also broaden the requirement that an individual who is subject to Circular 230 with principal authority for overseeing a firm's Federal tax practice take reasonable steps to ensure the firm has adequate procedures in place to comply with Circular 230. There is clarification of the level of competence practitioners must exercise when representing persons before the IRS. The regulations expand the categories of violations subject to the expedited proceedings in §10.82 to include failures to comply with a practitioner's personal tax filing obligations that demonstrate a pattern of willful disreputable conduct. There are also provisions regarding negotiation of refund checks and the Office of Professional Responsibility's scope of responsibility.

Final §10.37 replaces the covered opinion rules in former §10.35 with principles which all practitioners must adhere to when rendering written advice. It requires, among other things, that the practitioner base all written advice on reasonable factual and legal assumptions, exercise reasonable reliance, and consider all relevant facts that the practitioner knows or reasonably should know. A practitioner must also use reasonable efforts to identify and ascertain the facts relevant to written advice on a Federal tax matter. §10.37, unlike former §10.35, does not require that the practitioner describe in the written advice the relevant facts (including assumptions and representations), the application of the law to those facts, and the practitioner's conclusion with respect to the law and the facts. Rather, the scope of the engagement and the type and specificity of the advice sought by the client, in addition to all other appropriate facts and circumstances, are factors in determining the extent to which the relevant facts, application of the law to those facts, and the practitioner's conclusion with respect to the law and the facts must be set forth in the written advice. Also, under §10.37, unlike former §10.35, the practitioner may consider these factors in determining the scope of the written advice. The determination of whether a practitioner has failed to comply with the requirements of §10.37 will be based on all facts and circumstances, not on whether each requirement is addressed in the written advice. The removal of former §10.35 eliminates the provisions concerning covered opinions and disclosures in written opinions. Because amended §10.37 does not include the disclosure provisions in the current covered opinion rules, Treasury and the IRS expect that these amendments will eliminate the use of a Circular 230 disclaimer in e-mails and other writings.

The regulations provide that a practitioner must not, in evaluating a Federal tax matter, take into account the possibility that a tax return will not be audited or that an issue will not be raised on audit. The IRS will apply a heightened standard of review to determine whether a practitioner has satisfied the written advice standards when the practitioner knows or has reason to know that the written advice will be used in promoting, marketing, or recommending an investment plan or arrangement a significant purpose of which is the avoidance or evasion of any tax imposed by the Code. Otherwise, the Service will apply a reasonable practitioner standard that considers all facts and circumstances with an emphasis given to the additional risk associated with the practitioner's lack of knowledge of the taxpayer's particular circumstances. The Regulations modify provisions governing reliance on another practioner's advice with a "knows or reasonably should know" standard. They clarify that the competence standard requires the "appropriate level of" knowledge, skill, thoroughness, and preparation necessary for the matter for which the practitioner is engaged.

Footnote:

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IRS Application of United States vs. Windsor to Section 401 Retirement Plans

By Hertsel Shadian[*]

In early April, 2014, the IRS issued Notice 2014-19,[1] the purpose of which was to provide guidance on the application (including the retroactive application) of the decision in *United States v. Windsor*,[2] and the prior holdings of Rev. Rul. 2013-17,[3] to same-sex spouses and retirement plans qualified under section 401(a) of the Internal Revenue Code ("IRC," or the "Code").

I. Background

Qualified Retirement Plan Rules Relating to Married Participants

As set out in notice 2014-19, several Code sections provide special rules with respect to married participants in qualified retirement plans, including, but not limited to, the following:

- Under IRC § 401(a)(11), certain qualified retirement plans must provide a qualified joint and survivor annuity (QJSA) upon retirement to married participants (and generally must provide a qualified preretirement survivor annuity (QPSA) to the surviving spouse of a married participant who dies before retirement). If a plan is subject to these rules, the QJSA (or QPSA) may be waived by a married participant only with spousal consent pursuant to IRC § 417. If such a plan permits loans to participants, then IRC § 417(a)(4) requires a plan to obtain the consent of the spouse of a married participant before making a loan to the participant.
- Under IRC § 401(a)(11)(B)(iii), certain qualified defined contribution retirement plans are exempt from the QJSA and QPSA requirements provided that a married participant's benefit is payable in full, on the death of the participant, to the participant's surviving spouse, unless the surviving spouse consents to the designation of a different beneficiary.
- Under the required minimum distribution rules of IRC § 401(a)(9) and the rollover rules of IRC § 402(c), additional alternatives are provided for surviving spouses that are not available to non-spousal beneficiaries.
- Under IRC § 1563(e)(5), generally a spouse is treated as owning shares owned by the other spouse for purposes of determining whether corporations are members of a controlled group under IRC § 414(b).
- Under IRC § 318(a)(1), generally a spouse is treated as owning shares owned by the other spouse for purposes of determining whether an employee is a key employee under IRC § 416(i)(1), including whether an employee is considered a 5% owner.
- Under IRC § 409(n), an employee stock ownership plan (ESOP) that acquires certain employer securities generally must prohibit the allocation or accrual of those securities for the benefit of certain individuals, including the spouse of the seller and the spouse of any individual who owns 25% or more of the securities.
- Under IRC § 409(p), no portion of the assets of an ESOP attributable to employer securities consisting of S corporation stock may accrue during a nonallocation year for the benefit of any disqualified person or certain family members of the disqualified person (including the spouse) in certain circumstances.
- Under IRC § 401(a)(13)(B), the anti-alienation rules do not apply to the creation, assignment, or recognition of an alternate payee's right to receive all or a portion of the benefits payable to a participant under a plan pursuant to a qualified domestic relations order (QDRO) described in IRC § 414(p), and, under IRC § 402(e)(1), an alternate payee who is a spouse or former spouse of the participant is treated as the distributee of a distribution under a QDRO.

Defense of Marriage Act

Until the decision of the Supreme Court in *Windsor* found it unconstitutional, section 3 of the Defense of Marriage Act (DOMA) prohibited the recognition of same-sex spouses for purposes of Federal tax law. Specifically, section 3 of DOMA provided that:

> In determining the meaning of any Act of Congress, or of any ruling, regulation, or interpretation of the various administrative bureaus and agencies of the United States, the word 'marriage' means only a legal union between one man and one woman as husband and wife, and the word 'spouse' refers only to a person of the opposite sex who is a husband or a wife.[4]

As a result, same-sex spouses were not recognized for purposes of the Code with respect to qualified retirement plans.

Effect of the Windsor Decision and Rev. Rul. 2013-17

In the *Windsor* decision, the Supreme Court held on June 26, 2013 that section 3 of DOMA was unconstitutional because it violates Fifth Amendment principles.

Subsequent to the *Windsor* decision, the IRS issued Rev. Rul. 2013-17, which held as follows:

(1) For Federal tax purposes, the terms "spouse," "husband and wife," "husband," and "wife" include an individual married to a person of the same sex if the individuals are lawfully married under state law, and the term "marriage" includes such a marriage between individuals of the same sex.

(2) For Federal tax purposes, the Internal Revenue Service (Service) adopts a general rule recognizing a marriage of same-sex individuals that was validly entered into in a state whose laws authorize the marriage of two individuals of the same sex even if the married couple is domiciled in a state that does not recognize the validity of same-sex marriages.

(3) For Federal tax purposes, the terms "spouse," "husband and wife," "husband," and "wife" do not include individuals (whether of the opposite sex or the same sex) who have entered into a registered domestic partnership, civil union, or other similar formal relationship recognized under state law that is not denominated as a marriage under the laws of that state, and the term "marriage" does not include such formal relationships.

The holdings of Rev. Rul. 2013-17 apply for all Federal tax purposes, including for purposes of the Federal tax rules that apply to qualified retirement plans under section 401(a). The ruling provides that the holdings will be applied prospectively as of September 16, 2013. The ruling also provides that taxpayers may rely on the holdings retroactively with respect to any employee benefit plan or arrangement (or any benefit provided thereunder) for limited purposes with respect to certain employer-provided health coverage and fringe benefits that are specified in the ruling. The ruling further states that:

> The Service intends to issue further guidance on the retroactive application of the Supreme Court's opinion in Windsor to other employee benefits and employee benefit plans and arrangements. Such guidance will take into account the potential consequences of retroactive application to all taxpayers involved, including the plan sponsor, the plan or arrangement, employers, affected employees and beneficiaries. The Service anticipates that the future guidance will provide sufficient time for plan amendments and any necessary corrections so that the plan and benefits will retain favorable tax treatment for which they otherwise qualify.

Remedial Amendment Period under Section 401(b)

Code § 401(b) provides a period during which a plan may be amended retroactively to comply with the Code's qualification requirements. The deadline for amending a plan generally is the time prescribed by law for filing the return of the employer for its taxable year in which the amendment was adopted or such later time as the Secretary may designate.

Rev. Proc. 2007-44[5] provides rules regarding the timing of amendments made to qualified retirement plans. Section 5.05 of Rev. Proc. 2007-44 provides that when there are changes to the plan qualification requirements that affect provisions of the written plan document, the adoption of an interim amendment generally is required by the later of the end of the plan year in which the change is first effective or the due date of the employer's tax return for the tax year that includes the date the change is first effective.

II. Application Of Windsor To Section 401 Retirement Plans

General Rules

In question and answer format, Notice 2014-19 provides guidance on the application (including the retroactive application) of the decision in *Windsor*, and the prior holdings of Rev. Rul. 2013-17, to same-sex spouses and retirement plans qualified under IRC § 401(a). The general rules are summarized as follows:

1) In the absence of section 3 of DOMA, any retirement plan qualification rule that applies because a participant is married must be applied with respect to a participant who is married to an individual of the same sex. For example, a participant in a plan subject to the rules of IRC § 401(a)(11) who is married to a same-sex spouse cannot waive a QJSA without obtaining spousal consent pursuant to IRC § 417.[6]

2) Qualified retirement plan operations must reflect the outcome of *Windsor* as of June 26, 2013. Accordingly, a retirement plan will not be treated as failing to meet the requirements of IRC § 401(a) merely because it did not recognize the same-sex spouse of a participant as a spouse before June 26, 2013. For Federal tax purposes, effective as of September 16, 2013, Rev. Rul. 2013-17 (i) adopted a general rule recognizing a marriage of same-sex individuals that is validly entered into in a state whose laws authorize the marriage of two individuals of the same sex, even if the individuals are domiciled in a state that does not recognize the validity of same-sex marriages, and (ii) provided that individuals (whether part of an opposite-sex or same-sex couple) who have entered into a registered domestic partnership, civil union, or other similar formal relationship recognized under state law that is not denominated as a marriage under the laws of that state are not treated as married. Thus, a retirement plan will not be treated as failing to meet the requirements of IRC § 401(a) merely because the plan, prior to September 16, 2013, recognized the same-sex spouse of a participant only if the participant was domiciled in a state that recognized same-sex marriages.[7] (See below for the deadline to adopt plan amendments pursuant to Notice 2014-19.)

3) A qualified retirement plan will not lose its qualified status due to an amendment to reflect the outcome of *Windsor* for some or all purposes as of a date prior to June 26, 2013, if the amendment complies with applicable qualification requirements (such as IRC § 401(a)(4)). Recognizing same-sex spouses for all purposes under a plan prior to June 26, 2013, however, may trigger requirements that are difficult to implement retroactively (such as the ownership attribution rules) and may create unintended consequences. Therefore, provided that applicable qualification requirements are otherwise satisfied, a plan sponsor's choice of a date before June 26, 2013, and the purposes for which the plan amendments recognize same-sex spouses before June 26. 2013, do not affect the qualified status of the plan. For example, for the period before June 26, 2013, a plan sponsor may choose to amend its plan to reflect the outcome of *Windsor* solely with respect to the QJSA and QPSA requirements of IRC § 401(a)(l 1) and, for those purposes, solely with respect to participants with annuity starting dates or dates of death on or after a specified date.[8]

Plan Amendments

Notice 2014-19 further provides guidance on the amendment of qualified plans. The guidance is summarized as follows:

1) Whether a plan must be amended to reflect the outcome of *Windsor* and the guidance in Rev. Rul. 2013-17 and Notice 2014-19 depends on the terms of the specific plan, as described above.[9]

2) If a plan's terms with respect to the requirements of IRC § 401(a) define a marital relationship by reference to section 3 of DOMA or are otherwise inconsistent with the outcome of *Windsor* or the guidance in Rev. Rul. 2013-17 or Notice 2014-19, then an amendment to the plan that reflects the outcome of *Windsor* and the guidance in Rev. Rul. 2013-17 and Notice 2014-19 is required by the date specified below.[10]

3) If a plan's terms are not inconsistent with the outcome of *Windsor* and the guidance in Rev. Rul. 2013-17 and Notice 2014-19 (for example, the term "spouse," "legally married spouse" or "spouse under Federal law" is used in the plan without any distinction between a same-sex spouse and an opposite-sex spouse), an amendment generally would not be required. If no amendment to such a plan is made, the plan nonetheless must be operated in accordance with the outcome of *Windsor* and the guidance in Rev. Rul. 2013-17 and Notice 2014-19.[11] (Notice 2014-19 also stated that though not required, a clarifying amendment may be useful for purposes of plan administration.)

4) If a plan sponsor chooses to apply the rules with respect to married participants in qualified retirement plans in a manner that reflects the outcome of *Windsor* for a period before June 26, 2013, an amendment to the plan that specifies the date as of which, and the purposes for which, the rules are applied in this manner is required. The deadline for this amendment is the date specified below.[12]

5) The deadline to adopt a plan amendment pursuant Notice 2014-19 is the later of (i) the otherwise applicable deadline under section 5.05 of Rev. Proc. 2007-44, or its successor, or (ii) December 31, 2014. Moreover, in the case of a governmental plan, any amendment made pursuant to Notice 2014-19 need not be adopted before the close of the first regular legislative session of the legislative body with the authority to amend the plan that ends after December 31, 2014.[13]

Note: This plan adoption provision of Notice 2014-19 subsequently was amplified by Notice 2014-37[14] which Notice provides guidance on any plan amendment made to reflect the outcome of *Windsor* that is adopted after the beginning of a plan year and is effective during a plan year ("mid-year amendment") to a plan described in IRC § 401(k)(12) or (13) ("§ 401(k) safe harbor plan") or IRC § 401(m)(11) or (12) ("§ 401(m) safe harbor plan") pursuant to Q&A-8 of Notice 2014-19. Notice 2014-37 notes that under Treas. Reg. § 1.401(k)-3 (e)(1), a § 401(k) safe harbor plan must be adopted before the beginning of the plan year and be maintained throughout a full 12-month plan year, except as otherwise provided in Treas. Reg. § 1.401(k)-3(g) (relating to the reduction or suspension of safe harbor contributions) or in guidance of general applicability published in the Internal Revenue Bulletin. Under Treas. Reg. § 1.401(m)-3(f)(1), similar rules apply to § 401(m) safe harbor plans, including IRC § 403(b) plans. Notice 2014-37 stated that the IRS was asked whether an IRC § 401(k) or (m) safe harbor plan may adopt a mid-year amendment pursuant to Q&A-8 of Notice 2014-19. In Notice 2014-37, amplifying Notice 2014-19, the IRS answered affirmatively, advising that a plan will not fail to satisfy the requirements to be an IRC § 401(k) or (m) safe harbor plan merely because the plan sponsor adopts a mid-year amendment pursuant to Q&A-8 of Notice 2014-19.[15]

6) In general, under IRC § 436(c), an amendment to a single-employer defined benefit plan that increases the liabilities of the plan cannot take effect unless the plan's adjusted funding target attainment percentage is sufficient or the employer makes the additional contribution specified under IRC § 436(c)(2). However, Notice 2014-19 provides a special rule pursuant to Treas. Reg. § 1.436-l(c)(4)(iii). Under this special rule, a plan amendment that is described in Q&A-5 of Notice 2014-19 (as described above, i.e., to implement the outcome of *Windsor* and the guidance in Rev. Rul. 2013-17 and Notice 2014-19) and that takes effect on June 26, 2013, is not treated as an amendment to which IRC § 436(c) applies. In contrast, a plan amendment that is described

in Q&A-7 of Notice 2014-19 (i.e., that reflects the outcome of *Windsor* for a period before June 26, 2013) is an amendment to which IRC § 436(c) applies.[16]

Footnote:

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1. 2014-47 I.R.B. 979, amplified by Notice 2014-37, 2014-24 I.R.B. 1100.
2. 570 U.S. __, 133 S. Ct. 2675, 186 L.Ed.2d 808, (2013).
3. 2013-38 I.R.B. 201, amplified by Notice 2014-1, 2014-2 I.R.B. 270, amplified by Rev. Proc. 2014-18, 2014-7 I.R.B. 513.
4. See 1 U.S.C.A. § 7.
5. 2007-28 I.R.B. 54.
6. Notice 2014-19, Q&A 1.
7. Notice 2014-19, Q&A 2.
8. Notice 2014-19, Q&A 3.
9. Notice 2014-19, Q&A 4.
10. Notice 2014-19, Q&A 5.
11. Notice 2014-19, Q&A 6.
12. Notice 2014-19, Q&A 7.
13. Notice 2014-19, Q&A 8.
14. 2014-24 I.R.B. 1100.
15. Notice 2014-37, 2014-24 I.R.B.
16. Notice 2014-19, Q&A 9.

Challenging the Motive of an IRS Summons – *US v. Clarke*

By Erin K. MacDonald[*]

In *US v. Clarke*, 134 S.Ct. 2361 (2014), the Supreme Court was presented with the issue of what amount of evidence was enough to challenge the motive of an IRS summons. In *Clarke*, a respondent failed to comply with an IRS-issued summons, and the IRS brought an enforcement action in District Court. The respondent challenged the IRS's motives for issuing the summons, alleging that (1) the summons was issued as retaliation for the respondent's refusal to grant the IRS a third one-year extension of the 3-year limitations period for assessing a tax liability, and (2) the IRS was using the summons as a means for obtaining discovery in a Tax Court case (a separate law suit involving the same parties was pending) that would not have otherwise been available in the Tax Court proceeding.

The District Court denied the respondent's request and ordered the respondent to comply with the summons. The District Court found that the respondent had not made any meaningful allegations of improper purpose on behalf of the IRS. The 11th Circuit reversed the District Court, holding that a simple allegation of improper purpose, even if lacking any factual support, was sufficient to entitle the taxpayer to question the IRS reasons for issuing the summons. The Supreme Court, in a unanimous opinion, rejected the 11th Circuit's position that a bare allegation of improper purpose is sufficient. The Court held that a taxpayer has a right to conduct an examination of IRS officials regarding their reason for issuing a summons when the taxpayer points to specific facts or circumstances plausibly raising an inference of bad faith. A taxpayer must offer something more than a mere allegation; however, circumstantial evidence can be sufficient to meet the burden. The case was vacated and remanded to the 11th Circuit.

Footnote:

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Inherited IRAs Are Not Protected from Creditor Claims – *Clark V. Rameker*

*By David C. Streicher**

In *Clark v. Rameker*, 134 S.Ct. 2242 (2014), the Supreme Court ruled that an inherited IRA is part of the bankruptcy estate subject to creditor claims. The taxpayer filed for Chapter 7 bankruptcy in 2010 and listed an inherited IRA (received back in 2001) as an exempt asset. The focus was on Section 522(b)(3)(C) of the Bankruptcy Code, which exempts "retirement funds" from the bankruptcy estate. The court noted several key differences between inherited and traditional IRAs. In particular, the holder of an inherited IRA (i) may not invest additional funds, (ii) must take required minimum distributions no matter how far away from retirement, and (iii) may withdraw the entire balance at any time (even to purchase a vacation home or sports car) without the 10% penalty. Primarily because of these distinctions, the court held that inherited IRAs are not "retirement funds," and are not exempt from the bankruptcy estate. The fallout from *Rameker* continues. Some commentators believe *Rameker* might be extended to spousal rollovers. In all events, practitioners should consider *Rameker* before making the usual recommendation that clients name their children (rather than trusts for their benefit) as inherited IRA beneficiaries.

Endnote:

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Future Events

Sep 16, 2014
Mid-Valley Tax Forum Luncheon Series: Retirement Plan Update/ Affordable Care Act

Salem
Presenters: Dave Roth, Heltzel Williams PC, Christine Moehl, Saalfeld Griggs PC

Sep 18, 2014
Portland Luncheon Series: Cases and Rulings in Federal Tax
Portland
Presenter: Gwendolyn Griffith, Tonkon Torp LLP

Oct 16, 2014
Portland Luncheon Series: Department of Revenue Update
Portland
Presenter: James Bucholz, Oregon Department of Revenue

Nov 18, 2014
Mid-Valley Tax Forum Luncheon Series: Circular 230

Salem
Presenter: Larry Brant, Garvey Schubert Barer

Nov 20, 2014
Portland Luncheon Series: Oregon Tax Court Magistrate Division Update

Portland
Presenter: Presiding Magistrate Jill A. Tanner, Oregon Tax Court