2024 FEDERAL TAX UPDATE

Recent Developments in Federal Income, Estate and Gift Taxes Affecting Individuals and Small Businesses

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These materials summarize important developments in the substantive federal income, estate and gift tax laws affecting individual taxpayers and small businesses from January, 2023, through March, 2024, with an occasional reference to some older items where relevant. The materials are organized roughly in order of significance. These materials generally do not discuss developments in the areas of deferred compensation or the taxation of business entities (except to a very limited extent).

I. INFLATION-ADJUSTED FEDERAL INCOME TAX BRACKETS FOR 2024 (from Rev. Proc. 2023-34)

<table>
<tr><th colspan="2">Taxable Income Exceeding</th><th rowspan="2">Ordinary Income</th><th rowspan="2">Adjusted Net Cap Gain* & Qualified Dividends</th><th rowspan="2">Medicare Surtax on Earned Income**</th><th rowspan="2">Medicare Surtax on Net Investment Income</th></tr>
<tr><th>Single</th><th>Married Filing Jointly</th></tr>
<tr><td>$0</td><td>$0</td><td>10%</td><td rowspan="2">0%</td><td rowspan="6">2.9%</td><td rowspan="6">0%</td></tr>
<tr><td>$11,600</td><td>$23,200</td><td rowspan="2">12%</td></tr>
<tr><td>$47,025</td><td>$94,050</td><td rowspan="6">15%</td></tr>
<tr><td>$47,150</td><td>$94,300</td><td>22%</td></tr>
<tr><td>$100,525</td><td>$201,050</td><td>24%</td></tr>
<tr><td>$191,950</td><td>AGI over $250,000</td><td rowspan="2">32%</td></tr>
<tr><td>AGI over $200,000</td><td>$383,900</td><td rowspan="4">3.8%</td><td rowspan="4">3.8%</td></tr>
<tr><td>$243,725</td><td>$487,450</td><td rowspan="2">35%</td></tr>
<tr><td>$518,900</td><td>$583,750</td><td rowspan="2">20%</td></tr>
<tr><td>$609,350</td><td>$731,200</td><td>37%</td></tr>
</table>

* Other long-term capital gains could be taxed as high as 25% (building recapture) or 28% (collectibles and §1202 stock).
** Includes employer contribution of 1.45% (§3111(b)(6)), individual contribution of 1.45% (§3101(b)(1)), and additional tax of 0.9% for adjusted gross income over $200,000 for an unmarried individual and $250,000 on a joint return (§3101(b)(2), for years after 2012).

FEDERAL INCOME TAX RATES FOR TRUSTS AND ESTATES FOR 2024
(Adapted from Rev. Proc. 2023-34)

<table>
<tr><th>Taxable Income Exceeding</th><th>Ordinary Income</th><th>Adjusted Net Cap Gain* & Qualified Dividends</th><th>Medicare Surtax on Net Investment Income</th></tr>
<tr><td>$0</td><td>10%</td><td rowspan="2">0%</td><td rowspan="5">0%</td></tr>
<tr><td>$3,100</td><td rowspan="2">24%</td></tr>
<tr><td>$3,150</td><td rowspan="3">15%</td></tr>
<tr><td>$11,150</td><td>35%</td></tr>
<tr><td>$15,200</td><td rowspan="2">37%</td></tr>
<tr><td>$15,450</td><td>20%</td><td>3.8%</td></tr>
</table>

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II. FEDERAL WEALTH TRANSFER TAX ADJUSTMENTS

A. GIFT TAX ANNUAL EXCLUSION

The Taxpayer Relief Act of 1997 provided for an inflation adjustment to the $10,000 federal gift tax annual exclusion under §2503(b), but only in increments of $1,000.

Date of gift	Annual exclusion
1997 – 2001	$10,000
2002 – 2005	$11,000
2006 – 2008	$12,000
2009 – 2012	$13,000
2013 – 2017	$14,000
2018 – 2021	$15,000
2022	$16,000
2023	$17,000
2024	$18,000

B. BASIC EXCLUSION AMOUNT

The 2017 Tax Cuts and Jobs Act doubled the basic exclusion amount under §2010(c)(3) from $5 million to $10 million, with adjustments for inflation after 2011 using a "chained-CPI" method. The 2017 Act provides that the basic exclusion amount will revert to $5 million (adjusted for post-2011 inflation under the previous "CPI" method) after 2025.

For decedents dying in	The basic exclusion amount is		For decedents dying in	The basic exclusion amount is
2011	$5,000,000		2018	$11,180,000
2012	$5,120,000		2019	$11,400,000
2013	$5,250,000		2020	$11,580,000
2014	$5,340,000		2021	$11,700,000
2015	$5,430,000		2022	$12,060,000
2016	$5,450,000		2023	$12,920,000
2017	$5,490,000		2024	$13,610,000

III. CORPORATE-OWNED LIFE INSURANCE INCREASES ESTATE TAX VALUE OF STOCK (*Connelly v. United States*, 8th Circuit, June 2, 2023)

The Eighth Circuit Court of Appeals has held that corporate-owned life insurance on the life of a deceased shareholder acquired for the purpose of redeeming the deceased shareholder's shares increased the estate tax value of the deceased shareholder's stock.

The decedent, Michael Connelly, and his brother, Thomas Connelly, were the sole shareholders of a building materials corporation based in St. Louis. Michael owned about 77 percent of the company's stock. Michael and Thomas executed a buy-sell agreement that provided that, upon the death of the first of them to die, the surviving brother would have a right to purchase the deceased bother's shares. If the surviving brother did not exercise this option, the company would redeem the deceased brother's shares. The record states that it was always the intention of Michael and Thomas that the company would redeem the deceased brother's shares. To that end, the company purchased $3.5 million of life insurance coverage on each brother.

The buy-sell agreement further provided that the price to be paid for the deceased brother's stock would be determined by a "certificate of agreed value" to be executed each year by the bothers. If they failed to do so (in fact, they never signed any such document at any point), the value of the stock would be determined by reference to at least two appraisals. When Michael died, the company received the $3.5 million death benefit. Without obtaining any appraisals, the company paid $3 million to Michael's estate in redemption of his 77-percent stake in the company. The balance of the proceeds were used in the company's business. Michael's executor (Thomas) determined the value of Michael's interest through negotiation with Michael's son, Michael Connelly, Jr.

Michael's estate filed an estate tax return that reported the value of Michael's stock at $3 million, and the estate paid federal estate tax on this amount. The valuation, remember, was determined by a private agreement, and the valuation did not factor in the value of the death benefit from the life insurance policy. On audit, the IRS determined that the estate should have had the stock appraised and that any such appraisal would have included 77 percent of the value of the death benefit. As a result, it determined that the value of Michael's stock was about

$5.3 million, resulting in a $1 million deficiency that Michael's estate paid. The estate then brought this refund action, but a federal district court granted summary judgment to the IRS.

On this appeal to the Eighth Circuit, the estate advanced two alternative arguments. First, the estate claimed that the actual redemption transaction pursuant to the buy-sell agreement established the value of Michael's stock for federal estate tax purposes at $3 million. Although IRC §2703(a) generally provides that buy-sell agreements are to be disregarded in valuing closely-held stock, the estate claimed the buy-sell agreement at issue was a bona fide business arrangement and not a device for transferring property to members of the decedent's family for less than full consideration. But the appellate court concluded that the agreement itself did not provide for a fixed price. The agreement "merely laid out two mechanisms by which the brothers might agree on a price." What's more, neither of these mechanisms (annual certification of value or multiple appraisals) was used in this case. Accordingly, the court had no trouble concluding that the value of Michael's stock had to be determined without regard to the buy-sell agreement.

The estate's alternative argument was that the value of Michael's stock should not reflect the death benefit paid under the life insurance policy because, while such proceeds are an asset of the company, that asset is offset by the corporation's liability to redeem Michael's shares. The estate cited *Estate of Blount v. Commissioner*, 428 F.3d 1338 (11th Cir. 2005), in support of its position. *Estate of Blount* famously held that while corporate-owned life insurance was an asset of the company, it had no effect on the company's value because of the offsetting liability to use the proceeds in a redemption. As the Eleventh Circuit put it, "To suggest that a reasonably competent business person, interested in acquiring a company, would ignore a $3 million liability strains credulity and defies any sensible construct of fair market value." *Id.* at 1346. But the Eighth Circuit finds fault in this approach:

> An obligation to redeem shares is not a liability in the ordinary business sense. ... Consider the willing buyer at the time of Michael's death. To own [the company] outright, the buyer must obtain all its shares. At that point, he could then extinguish the stock-purchase agreement or redeem the shares *from himself*. This is just like moving money from one pocket to another. There is no liability to be considered—the buyer controls the life insurance proceeds. A buyer of [the company] would therefore pay up to $6.86 million, having "taken into account" the life insurance proceeds, and extinguish or redeem as desired. On the flip side, a hypothetical willing seller of [the company] holding all 500 shares would not accept only $3.86 million knowing that the company was about to receive $3 million in life insurance proceeds, even if those proceeds were intended to redeem a portion of *the seller's own shares*. To accept $3.86 million would be to ignore, instead of "take[] into account," the anticipated life insurance proceeds.

(Emphasis in original.) The court further noted the inconsistency of the estate's argument by looking at the transaction from the perspective of the surviving brother, Thomas:

> If we accept the estate's view and look to [the company's] value exclusive of the life insurance proceeds intended for redemption, then upon Michael's death, each share was worth $7,720 before redemption. ($3.86 million divided by 500 shares.) After redemption, Michael's interest is extinguished, but Thomas still has 114.1 shares giving him full control of [the company's] $3.86 million value. Those shares are now worth about $33,800 each. ($3.86 million divided by 114.1 shares.) Overnight and without any material change to the company, Thomas's shares would have quadrupled in value. This view of the world contradicts the estate's position that the proceeds were offset dollar-by-dollar by a "liability." A true offset would leave the value of Thomas's shares undisturbed. … In sum, the brothers' arrangement had nothing to do with corporate liabilities. The proceeds were simply an asset that increased shareholders' equity. A fair market value of Michael's shares must account for that reality.

The court thus affirmed summary judgment for the IRS.

Many buy-sell agreements call for the entity to redeem the ownership interest from a deceased owner's estate, and life insurance is a common mechanism for funding that obligation. Appraisers, owners, and advisors of closely-held businesses must understand that entity-owned life insurance will increase the estate tax value of a deceased owner's interest in the entity, though only by a percentage of the death benefit. In *Connelly*, for instance, note that Michael's estate effectively paid estate tax on about 77 percent of the death benefit. Had Michael possessed incidents of ownership in the policy himself, of course, the full death benefit would have been subject to estate tax at his death.

The result in the case might have been different if either of the two valuation approaches suggested in the buy-sell agreement (annual certifications of value and multiple appraisals) had been employed. Following either of these approaches would have required the IRS and the courts to determine whether the buy-sell agreement qualified to be regarded in valuing the stock under IRC §2703(b). But we will never know because the parties did not follow the methods set out by their own agreement. When parties do not respect their own agreement, they cannot ask the IRS and courts to respect it.

On December 13, 2023, the Supreme Court of the United States granted the estate's petition for a writ of certiorari, presumably to resolve the conflict with the Eleventh Circuit's ruling in *Estate of Blount*. Stay tuned.

IV. TRUST MODIFICATION TO ADD TAX REIMBURSEMENT CLAUSE IS A GIFT BY THE TRUST BENEFICIARIES, RAISING MANY QUESTIONS (*Chief Counsel Memorandum 202352018*, December 29, 2023)

In an internal memorandum, the IRS Office of Chief Counsel analyzed the federal gift tax consequences of modifying an irrevocable grantor trust to add a discretionary tax reimbursement clause. It concluded:

> The modification to add the tax reimbursement clause will constitute a taxable gift by the trust beneficiaries because the addition of a discretionary power to distribute income and principal to the grantor is a relinquishment of a portion of the beneficiaries' interest in the trust.

The conclusion has caused a mild-to-moderate panic among estate planning professionals, raising more questions than it answers.

A. Facts

The memorandum posits the creation of an irrevocable grantor trust for the benefit of the grantor's child and that child's descendants, though it does not indicate what retained power or powers cause the trust to be treated as a grantor trust for federal income tax purposes. The trust instrument authorizes discretionary distributions of income and principal to the child for the child's life. After the child's death, the trustee is to distribute the remainder to the child's descendants *per stirpes*.

Because the trust is a grantor trust, the trust's undistributed income is treated as belonging to the grantor even though the grantor has not retained any beneficial interest in the trust, and even though the grantor's payment of federal income tax on that undistributed income gives the grantor no rights to receive, enjoy, or control that income. Further, under the memorandum's assumed facts, neither the trust instrument nor state law gives the trustee power to distribute to the grantor amounts needed to satisfy the grantor's income tax liability attributable to the inclusion of the trust's income on the grantor's individual income tax return.

Accordingly, in the year following the trust's formation—at a time when the child has no living descendants—the trustee petitions a court to modify the trust to give the trustee a discretionary power to reimburse the grantor for income taxes paid by the grantor that result from including the trust's income in the grantor's taxable income. The memorandum's assumed facts stop there—it does not posit an exercise of this new discretionary power to reimburse the grantor. Instead, the memorandum is concerned with whether the creation of the tax reimbursement clause is a gift by the beneficiaries to the grantor.

B. Background on Tax Reimbursement Clauses

In *Revenue Ruling 2004-64*, 2004-2 C.B. 7, the IRS distinguished a "mandatory tax reimbursement clause" from a "discretionary tax reimbursement clause." Under a mandatory tax reimbursement clause, the grantor retains a right to reimbursement from the trustee of an irrevocable grantor trust for the additional income taxes paid by the grantor attributable to inclusion of the trust's income. Because of this retained right to reimbursement, the IRS ruled that a mandatory tax reimbursement clause causes the assets of the trust to be subject to federal estate tax at the grantor's death under IRC §2036. Under a discretionary tax reimbursement clause, the trustee may (but is not required to) reimburse the grantor for the

additional income tax paid by the grantor. Because the grantor has no right to a reimbursement and has no power to compel one, the IRS ruled that a discretionary tax reimbursement clause will not, by itself, cause the trust assets to be subject to estate tax at the grantor's death.

Importantly, the ruling also concludes when the trustee reimburses the grantor, whether pursuant to a mandatory tax reimbursement clause or a discretionary tax reimbursement clause, the payment is not a gift from the trust beneficiaries to the grantor. The IRS reasoned that because the distribution is either required by the trust instrument or made pursuant to the exercise of the trustee's discretion, the beneficiaries have no say in the matter so the transfer cannot be considered to come from them.

C. The IRS's Prior Ruling and a Change of Heart

But the Office of Chief Counsel concludes that a trust modification to add a discretionary tax reimbursement clause *is* a transfer from the beneficiaries, and thus results in a gift where the beneficiaries receive no consideration for their consent to the modification. The memo reasons that "the modification constitutes a transfer by Child and Child's issue" for the benefit of the grantor. Apparently the thinking goes like this: *Before the modification, the beneficiaries did not have to share with the grantor; after the modification, they may have to share. That's a transfer that represents a completed gift.* Indeed, the memo confirms that "Child and Child's issue each have made a gift of a portion of their respective interest in income and/or principal."

In a footnote, the Office of Chief Counsel acknowledges this position is new:

> PLR 201647001 concludes that the modification of a trust to add a discretionary power to reimburse the grantor for the income tax paid attributable to the trust income is administrative in nature and does not result in a change of beneficial interests in the trust. These conclusions no longer reflect the position of this office.

In support of this new position, the Office of Chief Counsel notes that gifts can be made indirectly, "regardless of the means or device employed," citing Regulation §25.2511-1(c)(1). It then cites Regulation §25.2511-1(g)(1) for the proposition that "donative intent on the part of the transferor is not an essential element" to a gift. Finally, it considers *Revenue Ruling 67-370*, 1967-1 C.B. 324, in which the IRS ruled that a vested remainder subject to divestment at the will of another is an interest in property. It seems the memorandum thinks that if a remainder can still be property even though the interest could be canceled by another, a discretionary power to reimburse the grantor must also be an interest in property even though it might never be exercised.

D. New Questions

This new position raises a number of questions not addressed by the memorandum.

1. How to Value and Apportion the Gift?

Assuming the Office of Chief Counsel is correct that beneficiaries make a gift to the grantor by consenting to the addition of a discretionary tax reimbursement clause, a complex question arises as to the value of the gift made by the trust beneficiaries. Alarmingly, the IRS could argue that the transfer triggers the "zero-value rule" of IRC §2702, meaning the beneficiaries would be considered to have gifted the entire value of the trust to the grantor. Fortunately, it does not appear the Office of Chief Counsel takes that position. While the memo says that the gift "should be valued in accordance with the general rule for valuing interests in property for gift tax purposes in accordance with regulations under §2512 and any other relevant valuation principles," it contains this curious footnote:

> Although the determination of the values of the gifts requires complex calculations, Child and Child's issue cannot escape gift tax on the basis that the value of the gift is difficult to calculate. *See Smith v. Shaughnessy*, 318 U.S. 176, 180 (1943) ("The language of the gift tax statute, 'property … real of personal, tangible or intangible,' is broad enough to include property, however conceptual or contingent.")

No "complex calculations" would be required if the zero-value rule was supposed to apply. That's the good news. But the bad news is that the memorandum gives no explanation for how the complex calculations are to be performed. How does one appraise the value of a right to receive wholly discretionary distributions of amounts that cannot be estimated with any significant certainty? Howard Zaritsky explains:

> Presumably, an appraiser must consider: (a) the possible future trust taxable income and gains and the possible trust investments; (b) the timing of future capital gains; (c) the grantor's present and future tax rate; (d) the beneficiary's need or use for distributions; (e) the grantor's need or use for a reimbursement; and (f) the trustee's fiduciary duties to treat the grantor and the beneficiaries fairly and equitably.

Even if one could confidently determine the present value of the income tax payments the grantor will make over the period of grantor trust status, how is one to account for the fact that the trustee will not (or at least should not) distribute these amounts to the grantor each year, or that the grantor might relinquish the power(s) that make the grantor liable for tax on the trust's income? There is authority for valuing a discretionary distribution right with reference to the pattern of distributions, see *Revenue Ruling 75-550*, but in the case of a tax reimbursement that did not exist prior to the alleged gift, this would be of negligible utility.

There is an argument that valuation of the gift could be relatively straightforward. By the time the IRS examines the modification, there will likely have been some exercise of the power to reimburse the grantor. Presumably the trustee sought modification because of a documented or perceived need for reimbursement by the grantor, so once the power is added it is likely to be exercised. The value of the gift, therefore, might simply be the amounts that have been paid

to the grantor, together with a reasonable allowance for distributions reasonably expected over the future.

But even if the value can be determined, the memo contains no indication as to how the gift is to be apportioned among the trust beneficiaries. Using the facts from the memo, occasional reimbursements paid to the grantor affect the amounts available for distribution to the grantor's child and that child's descendants, and presumably that includes the interests of descendants yet to be born. Is the person who consents to a trust modification on behalf of unborn descendants seriously expected to file gift tax returns on behalf of these unborn persons, utilizing the basic exclusion amount of a hypothetical individual who may never be born?

2. Same Result for Judicial Modifications without Beneficiary Consent?

The memorandum expressly states that "The result would be the same if the modification was pursuant to a state statute that provides beneficiaries with a right to notice and a right to object to the modification and a beneficiary fails to exercise their right to object." Thus, for example, if a trustee decants the principal of an existing irrevocable trust to a "new-and-improved" irrevocable trust that contains a discretionary tax reimbursement clause pursuant to a state statute, the modification would still be a taxable gift from the beneficiaries who do not affirmatively object to the decanting.

If a beneficiary does object, though, most states allow a trustee to petition a court for modification as long as the proposed modification does not adversely affect the interests of a beneficiary that refused to consent. In such a case, would the IRS conclude that there is no gift at all? If so, then it would seem the safest course of action would be to modify the trust through court order without seeking the consent of any beneficiary, where possible. On the other hand, if a court-ordered modification would still be a gift, it would likely be a gift only by those beneficiaries who failed to object. In that case, the prudent solution would be for the trustee to seek *objection* to the proposed modification from all of the beneficiaries. As long as all beneficiaries object, a court-ordered modification could not be a gift from the beneficiaries.

3. Why Change Now?

As previously noted, the position of the IRS used to be that modification to add a discretionary tax reimbursement clause is not a gift from the trust beneficiaries. So why the change, and why now? Obviously the memo is prompted by a specific matter under examination, but we do not know which one or what other facts that matter might contain. At the 2024 Heckerling Institute on Estate Planning, Ron Aucutt observed that the memo is addressed to two seasoned Associate Area Counsel, both of whom were counsel of record in high-profile estate tax cases. "These are not newbies," Aucutt said, "so they knew the answer they would get." As Aucutt noted, "This is a mess, and we don't know where it's headed."

Indeed, this might just be the first domino to fall. If the beneficiaries in this memorandum maker a gift, then does a remainder beneficiary who does not object to a decanting that expands a lead beneficiary's testamentary power of appointment to include the creditors of the lead beneficiary's estate make a gift? A beneficiary in that case likely would not object because it would be in the beneficiary's best interest to give the lead beneficiary a power of appointment that would allow for a stepped-up basis upon the lead beneficiary's death. But under the memo's logic, it could be a gift to the lead beneficiary. We are not at that point yet, but this memorandum could just be the beginning.

4. Would a Negotiated Modification Work?

Presumably the grantor can relinquish whatever power or powers confer grantor trust status, and the grantor can do so without having to obtain anyone's consent. So could the beneficiaries avoid a gift by *selling* the discretionary tax reimbursement power in exchange for the grantor's promise agreement *not* to relinquish the power or powers that make the trust a grantor trust? Short of including a discretionary tax reimbursement clause in a trust from the outset, this might be the easiest solution if it appears the Office of Chief Counsel is correct in its opinion. But it could also come with a significant income tax bite. The sale would be a taxable event, as it would be a transaction between the beneficiaries and the grantor. While gift transfers come with a $13.61 million exclusion, sale transfers do not, meaning that even though the federal income rate might be lower than the federal gift tax rate, the total amount of tax paid could be more.

5. Collateral Consequences to Beneficiaries?

If the beneficiary is considered the transferor of a discretionary reimbursement right in property that, at the time of the gift, remains in trust, could the beneficiary's creditors claim that the beneficiary is thus a grantor and that the trust is therefore a self-settled trust? This would mean that a beneficiary's creditors could reach trust assets in satisfaction of their claims, at least under the laws of most states.

E. Final Thoughts

Internal memoranda set forth the IRS's position on various matters and the reasons for those positions. Unlike a judicial opinion or even a revenue ruling or private letter ruling, they are not binding on anyone and may not be cited as precedent. Still, when the IRS announces a position contrary to what most planners would expect, it is worth paying some attention.

Before *CCM 202352018*, few (perhaps no one) would have thought that a trust modification to add a discretionary tax reimbursement clause would be a taxable gift from the beneficiaries to the grantor. Indeed, because the IRS earlier concluded that the *exercise* of a discretionary tax reimbursement clause is not a gift from the beneficiaries, a planner would reasonably assume that the *creation* of such a power would likewise not be a gift from the beneficiaries. But here we are.

V. IRS CONFIRMS NO BASIS STEP-UP AT GRANTOR'S DEATH FOR ASSETS GIFTED TO DEFECTIVE GRANTOR TRUST (*Revenue Ruling 2023-2*, March 29, 2023).

The IRS has confirmed that the income tax basis of an asset gifted to a so-called "defective grantor trust" is not adjusted to fair market value as of the date of the grantor's death. The ruling itself is not a surprise; arguably the ruling is more noteworthy for what it does not address, namely the trust's basis in property acquired from the grantor by purchase.

A. Background

By default, trusts are separate entities for federal income tax purposes, which makes them separate taxpayers. Trusts are subject to federal income tax at progressive rates that generally correspond to those applicable to individuals, but the tax brackets applicable to trusts are significantly thinner. For example, an unmarried individual with taxable income of $15,000 in 2023 is in the 12-percent bracket for ordinary income and pays no tax at all on dividends and adjusted net capital gain, but a trust with $15,000 of taxable income in 2023 is in the 37percent bracket for ordinary income and the last dollar of dividend income and adjusted net capital gain faces a 23.8-percent rate.

To reduce the tax burden on a trust's undistributed income, the trust often will be structured as a "grantor trust." A grantor trust is not treated as a separate taxpayer. Instead, the income from a grantor trust is taxed to the grantor (or, sometimes, to another person) because the grantor or someone close to the grantor holds some prescribed interest in or control over the trust's assets. In effect, the federal income tax laws see the grantor and the grantor trust as the same taxpayer.

While a grantor may retain any of several interests in or powers over a trust's assets in order to create a grantor trust, several of those powers also subject the trust's assets to inclusion in the grantor's gross estate for purposes of the federal estate tax. Accordingly, a grantor generally seeks to hold only those powers causing grantor trust status for income tax purposes without causing gross estate inclusion for estate tax purposes. Those powers are used to create what are commonly called "defective grantor trusts" or, sometimes, "intentionally defective grantor trusts."

We know from *Revenue Ruling 85-13*, 1985-1 C.B. 184, that a grantor trust becomes a separate taxable entity for federal income tax purposes upon the death of the grantor. Once the trust becomes a separate taxpayer, it becomes necessary to compute the trust's basis in the property it acquired from the grantor, whether by gift or purchase. For discussion of this issue generally, see Jeffrey N. Pennell, Basis of Grantor Trust Assets Before the Grantor's Death (January 20, 2019), available at SSRN: https://ssrn.com/abstract=3319242. *Revenue Ruling 2023-2* relates only to property acquired by gift.

B. Analysis of the Ruling

The ruling uses this example to frame the discussion:

> In Year 1, A, an individual, established irrevocable trust, T, and funded T with Asset in a transfer that was a completed gift for gift tax purposes. A retained a power over T that causes A to be treated as the owner of T for income tax purposes…. A did not hold a power over T that would result in the inclusion of T's assets in A's gross estate under the provisions of chapter 11. By the time of A's death in Year 7, the fair market value (FMV) of Asset had appreciated. At A's death, the liabilities of T did not exceed the basis of the assets in T, and neither T nor A held a note on which the other was the obligor.

On these facts, the IRS concludes:

> If A funds T with Asset in a transaction that is a completed gift for gift tax purposes, the basis of Asset is not adjusted to its fair market value on the date of A's death under §1014 because Asset was not acquired or passed from a decedent as defined in § 1014(b). Accordingly, under this revenue ruling's facts, the basis of Asset immediately after A's death is the same as the basis of Asset immediately prior to A's death.

To reach this conclusion, the IRS observes that IRC §1014(a) provides that the fair-marketvalue-at-date-of-decedent's-death rule (known on the street as "stepped-up basis") only applies to property that has been acquired (or passes from) a decedent. Section 1014(b) then provides a finite list of the ways in which property may be acquired from a decedent or may pass from a decedent. But none of those items covers property gifted to a defective grantor trust, said the IRS.

The ruling cites legislative history from the enactment of the Internal Revenue Code of 1954 that stepped-up basis "applies basically to property in the decedent's probate estate and includible in his gross estate .... In addition, it applies to property acquired by certain specifically described methods of disposition which are treated as though the acquisition was by bequest, devise, or inheritance." Because an asset acquired by a lifetime gift from the grantor is neither part of the grantor's probate estate nor a wealth transfer related to the grantor's death, the asset should not qualify for a stepped-up basis at the grantor's death.

C. Lingering Questions

As the first significant ruling related to grantor trusts in over a decade, the IRS deserves credit for trying to provide helpful guidance. But *Revenue Ruling 2023-2* seems to raise more questions than it answers. For example, the ruling concludes that a defective grantor trust's basis in gifted property is "the same as the basis [in such property] immediately prior to A's death." But what is that basis? While the grantor was alive, of course, the trust was disregarded

for federal income tax purposes thanks to *Revenue Ruling 85*-13, supra. That must mean the trust's basis in the gifted property was the same as the decedent's basis at the time of the gift. In that way, the result is akin to the transferred basis rule that generally applies to inter-vivos gifts under IRC §1015(a). But in the case of a transaction recognized as an inter-vivos gift under the federal income tax laws, the recipient of the gift may add to the gifted property's basis a portion of the federal gift tax paid by the donor in connection with the transfer. See IRC §1015(d). That leads to an important question: what if the decedent in the ruling had paid federal gift tax on this transfer? At what point, if ever, does the trust get basis credit under IRC §1015(d)? It cannot be before death, as the income tax—which continues to see the grantor as the owner of the gifted property—would say no gift happens until the grantor's death, when the trust becomes a separate taxable entity. Does that mean, then, that any basis adjustment for gift tax paid would come into effect at death? We still lack firm guidance on this point.

Another unanswered question relates to the trust's basis in property acquired from the grantor by purchase. *Revenue Ruling 2023-2* is careful at every turn to make clear that it applies only to property transferred to the defective grantor trust by gift. The fact pattern in the ruling even notes that neither A nor T owns holds a note on which the other is an obligor. Yet a common estate planning strategy calls for the grantor to sell property to the trust, usually in exchange for a promissory note payable on an installment basis. For more about the planning advantages of installment dales to defective grantor trusts, see, e.g., Ronald D. Aucutt, *Installment Sales to Grantor Trusts*, 4 BUS. ENT. 28 (Mar./Apr. 2002); Michael Mulligan, *Sale to an Intentionally Defective Irrevocable Trust for a Balloon Note—An End Run Around Chapter 14?,* 32ND U. MIAMI PHILIP E. HECKERLING INST. ON EST. PLAN. ¶ 1505.2 (1998). So, following the grantor's death, what basis does the once-defective trust now have in property acquired by purchase? The ruling does not attempt to answer this, leaving it to continued speculation.

The default rule for basis, set forth in IRC §1012, provides that a taxpayer's basis in an asset is its cost "except as otherwise provided." In the case of assets acquired by purchase, such as through an installment sale transaction, the trust's basis in the acquired property should be the total purchase price, whether in the form of cash, property, a promissory note, or some combination of the foregoing. But arguably there are two "exceptions" to the general rule of cost basis. The first is IRC §1014, the provision for a stepped-up basis. Some commentators believe that because there is no "transfer" from the grantor to the trust for income tax purposes until the grantor's death, the trust has acquired the property "from a decedent" and thus is eligible for stepped-up basis. See Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N. 149 (Sept. 2002), at 154 – 155. Because the transfer from the grantor at death is effectively a partbequest, part-sale (because the trust is paying for the property with a promissory note), they contend, the basis rules effectively award the trust a stepped-up basis.

But as discussed above, IRC §1014(b) identifies exactly ten instances in which property is considered to have been acquired from a decedent for purposes of IRC §1014(a), and property received by the new, nongrantor trust through a deemed transfer at the grantor's death does not clearly fall within any of them. Since the property transferred to the trust at death is not

included in the grantor's gross estate (it was a defective grantor trust, remember), IRC §1014(b)(9)—the rule that confers a stepped-up basis to any asset included in a decedent's gross estate for estate tax purposes—does not apply. Nor does any of IRC §§1014(b)(2) (property held by a revocable living trust), 1014(b)(3) (property held by a trust in which the decedent retained a power to alter or amend enjoyment), 1014(b)(4) (property passing for less than full consideration by testamentary exercise of a general power of appointment), 1014(b)(5) (a now-defunct rule for certain stock in a foreign personal holding company), 1014(b)(6) (the surviving spouse's share of community property), 1014(b)(7) (a pre-1947 rule for community property), 1014(b)(8) (a pre-1954 rule for joint and survivor annuities), or 1014(b)(10) (property includible under IRC §2044 because of a marital deduction previously allowed).

Section 1014(b)(1) might come closest. It covers property "acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent." Yet from the reasoning set forth in *Revenue Ruling 2023*-2, it would seem doubtful that the death-time transfer from the grantor to the trust, which occurs by operation of federal income tax law, could be classified as "bequest, devise or inheritance" from the grantor—the transfer is not required by the decedent's will, nor does it result from application of the laws of intestate succession. At best, one could argue that the constructive transfer at death is really a two-step dance: first, the decedent's estate acquired the property from the decedent (qualifying the property for a fair market value at date of death basis); and, second, the estate then transferred the property to the trust immediately thereafter. This fiction is a stretch, however, for it assumes the estate has rights to the property and perhaps that the fiduciary would agree to a sale of the property at less than arms-length.

The second exception to the cost basis general rule that might apply to sale transactions to a defective grantor trust is found in IRC §1015(b). It provides that property acquired "by a transfer in trust (other than … by a gift, bequest, or devise)" has the same basis as it would in the hands of the donor, increased by any gain (or decreased by any loss) recognized to the grantor upon such a transfer. Thus, some commentators believe, where a trust acquires assets from a grantor by purchase, the trust takes the grantor's basis in the property purchased. See Laura H. Peebles, Death of an IDIT Noteholder, *Trusts & Estates* 28, 33 (Aug. 2005). See also Austin Bramwell and Stephanie Vara, *Basis of Grantor Trusts at Death: What Treasury Should Do*, TAX NOTES (August 6, 2018) at 793. Although the transfer of the assets to the then-defective grantor trust was not recognized as a sale transaction for federal income tax purposes, it was, commentators say, a transfer to the trust nonetheless, triggering IRC §1015(b). \

This interpretation is consistent with the reasoning in *Revenue Ruling 2023-2*, but the ruling specifically does not address sale transactions, so planners remain without a firm answer to what seemingly would be a fundamental question about the income tax treatment of property sold to a defective trust.

VI. EXERCISE OF OPTIONS TO BUY STOCK CAN RESULT IN TAXABLE GIFT (*Huffman v, Commissioner*, T.C. Memo. 2024-12, January 31, 2024)

The Tax Court has held that a son's purchase of stock in a closely-held corporation for $5 million from two entities pursuant to option agreements resulted in a taxable gift from the son's parents, the owners of the two entities. The court rejected the family's claim that the option agreements controlled the valuation of the stock purchased, finding that the terms of the agreements were not comparable those that would be entered into in an agreement negotiated at arm's length.

A. Facts of the Case

Lloyd and Patricia Huffman were employees and shareholders in an aerospace company originally known (and referred to by the court) as "Dukes," even though at all times relevant to this case its formal name was Infinity Aerospace, Inc. In 1970, Lloyd became president of Dukes. By 1990, he and Patricia owned 15.8% of the company's stock through a living trust. Patricia separately owned an additional 40.5% of the company's stock through her own wholly-owned S corporation. The largest block, representing 43% of the stock, was owned by Robert Barneson, the company's former president.

Following a near-fatal car racing accident in 1987, Lloyd handed over the presidential reins to his son, Chet. Chet was soon named CEO and awarded shares representing 0.7% of the company's stock. In March of 1990, Lloyd and Robert entered into an agreement whereby Lloyd acquired an option to buy Robert's shares, exercisable at Robert's death or upon a proposed sale of Robert's shares to another party, for a price not to exceed $2 per share.

In 1993, Lloyd assigned his option rights to Chet. Two months after the assignment, Chet and Robert agreed that Chet would pay Robert $150,000 for his 322,241 shares, with $50,000 payable at closing and the balance, together with interest, to be paid over five years. Later that year, Chet entered into two more option agreements, one with Lloyd and Patricia's living trust and another with Patricia's S corporation. These agreements gave Chet, in exchange for "Two Dollars ($2.00) and for other good and valuable consideration," the right to buy the trust's 15.8% interest for a price not to exceed $1.4 million and the right to buy the 40.5% interest held by Patricia's S corporation at a price not to exceed $3.6 million. Under both agreements, Chet's options were exercisable at any time, and neither option could be transferred absent consent from the other party.

In 2007, a Korean company expressed an interest in acquiring Dukes for a tentative price between $85 million and $105 million. It wanted to buy the stock from a single buyer, so Chet exercised his options, purchasing the trust's shares with a secured promissory note in the amount of $1.4 million and purchasing the S corporation's shares with a secured promissory notice in the amount of $3.6 million. This purchase price equated to a value of $11.83 per share.

By 2009, the deal with the Korean purchaser had fizzled. Chet continued to seek a buyer for the company. Working with Deloitte, he found one: TransDigm, Inc. What the company lacks in letters it makes up for in cash: the parties put together an asset purchase agreement under which TransDigm purchased the assets of Dukes for $95.75 million, with most of the consideration allocable to goodwill.

B. Did a Gift Happen?

The IRS concluded that Chet's 2007 acquisition of Dukes stock from the trust and the S corporation represented taxable gifts from Lloyd and Patricia because Chet bought shares worth about $31.3 million for only $5 million. But Chet, Lloyd's estate, and Patricia all argued that the option agreements were bona fide business arrangements and thus are conclusive as to the value of the Dukes shares.

Recall that IRC §2703(a)(1) requires property be valued without regard to any "option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right)." But IRC §2703(b) makes an exception for rights to buy property resulting from a bona fide business arrangement that is not a device for transferring the property to a family member for less than full consideration, as long as the terms of the purchase rights are comparable to those that would be entered into by persons acting at arm's length. The parties agreed that the options in this case were bona fide business arrangements, as maintaining familial control is a legitimate business purpose. But they disagreed as to whether the option agreements were devices for transferring stock to Chet for less than full consideration and whether the agreements contained terms one would find in an arm's-length transaction.

The Tax Court concluded that the option agreements were not devices for gifting stock to Chet. While the value of the option rights he acquired under both agreements was worth more than the $4 total he paid for them, Chet also accepted a reduced salary during his reign as CEO. Plus, when he negotiated the option agreements, the shares were worth about 50 cents per share, yet Chet ultimately paid $11.83 per share for the stock. And while the agreements were negotiated among family members, the court noted the motivation of Lloyd and Patricia to insist on receiving $5 million as a retirement nest egg was at odds with Chet's motivation to pay the smallest amount possible for the shares so that he could make a gain sooner.

But the Tax Court agreed with the IRS that the terms of the option agreements were not those one would find in an agreement negotiated at arm's length. The Huffmans argued that the terms of Chet's agreements were comparable to those of the 1990 agreement between Lloyd and Robert (unrelated parties acting at arm's length), including the rights to purchase at any time and for a stated maximum purchase price. But the IRS argued that Chet's agreement contained key differences, most notably that Chet could not transfer his option right without consent from his parents and that Chet's rights were exercisable at any time and not just at death or upon the receipt of another offer to purchase. The Tax Court agreed with the IRS that these additional terms made Chet's rights superior to those Lloyd had in his arm's-length option

with Robert. Accordingly, concluded the court, the agreements must be disregarded in valuing the shares Chet purchased in 2007.

That brought the court to the issue of valuation. At trial, the IRS's expert concluded the total fair market value of the shares purchased in 2007 was $31.3 million. While the Huffmans insist that the shares were only worth $5 million pursuant to the terms of the disregarded option agreements, they presented expert testimony that the shares were worth about $16.1 million in 2007. After considering the testimony from both sides, the court concluded that the IRS's expert was largely correct, though it directed the parties to recalculate the value by disregarding revenues from certain licenses. So in the end, we know Lloyd and Patricia made a large gift to Chet when Chet exercised his options in 2007, but we don't yet know the exact size of that gift.

C. The Goodwill Issue

The court also considered federal income tax issues related to TransDigm's asset acquisition. The most noteworthy of these issues relates to the portion of the sale proceeds allocated to Chet's personal goodwill. Chet and his wife reported this portion of the consideration on their joint return as ordinary income, but the IRS claimed it should have been reported by Dukes as capital gain and then by Chet and his wife as dividend income. The IRS based its position on the fact that Chet was not a party to the asset purchase agreement, but the court noted that the agreement specifically stated that Chet's personal goodwill was among the assets purchased. The IRS argued that Chet transferred that goodwill to Dukes, but the court disagreed, noting that Chet did not have an employment agreement and was not subject to a noncompete agreement. There was thus no evidence of a transfer of goodwill to Dukes. Further, as part of the asset purchase agreement, Chet signed a noncompete agreement with TransDigm. This meant Chet still owned his personal goodwill as of the time of the sale, so it was proper that this portion of the consideration be reported by him and not by Dukes.

But the court also held that Chet overvalued the amount of his personal goodwill, meaning some of the consideration allocated to him was really entity goodwill that should have been reported by Dukes. The court thus sustained a deficiency issued to Dukes in connection with the acquisition.

VII. REQUIRED MINIMUM DISTRIBUTIONS APPLICABLE TO TEN-YEAR PAYOUT, WITH INTERIM RELIEF RULES (*Notice 2022-53*, October 7, 2022, and *Notice 2023-54*, July 14, 2023)

The IRS has clarified a rule introduced in Proposed Regulation §1.401(a)(9)-4 related to distributions to a designated beneficiary following the death of a participant that had been taking minimum distributions from an individual retirement account or qualified employee contribution plan. While the clarification suggests the proposed rule will be part of final regulations, it extends amnesty against application of penalties for failing to pay minimum distributions to designated beneficiaries in 2021, 2022, and 2023.

A. Background

The Setting Every Community Up for Retirement Enhancement Act (SECURE Act) made a number of changes related to retirement plans and individual retirement accounts. Among other things, it increased the starting age for required minimum distributions from age 70-1/2 to age 72. IRC §401(a)(9)(C)(i). It also repealed the rule that prevented individuals over age 701/2 from making additional contributions to a traditional individual retirement account. Most significantly, at least from the perspective of estate planners, the SECURE Act made a new distinction between "designated beneficiaries" and "eligible designated beneficiaries."

Prior to the SECURE Act, there were only "designated beneficiaries," generally defined as individuals and most see-through trusts for the benefit of individuals. Under the old rules, a designated beneficiary was required to withdraw the funds from a deceased participant's plan or individual retirement account over the designated beneficiary's remaining life expectancy. After the SECURE Act, the opportunity for this "lifetime stretch-out" is limited to "eligible designated beneficiaries." The Act established only four types of eligible designated beneficiaries: surviving spouses, minor children (but only until they reach the age of majority), disabled and chronically ill beneficiaries, and any individual less than ten years younger than the plan participant. IRC §401(a)(9)(E)(ii). For all other designated beneficiaries (like adult children, for example), the SECURE Act imposed a new ten-year payout period. IRC §401(a)(9)(H)(i). Under this rule, an adult child named as the beneficiary of a retirement plan or IRA has ten years to withdraw the funds from the participant's account, regardless of that adult child's own life expectancy.

The conventional wisdom was that this ten-year rule would operate like the five-year rule long in effect where, for example, trusts are named as beneficiaries of the decedent's IRA or retirement plan. Under the five-year rule, the custodian must make sure funds are fully distributed by the end of the fifth year after the decedent's year of death, but there is no requirement that a minimum distribution be made in any one year. Indeed, a custodian may make a one-time distribution of the entire account balance to the trustee at or near the end of the fifth year following the year of the participant's death.

Well, Treasury unveiled proposed regulations on February 24, 2022, relating to required minimum distributions from qualified plans, §403(b) plans, individual retirement accounts, custodial accounts, and §457 plans in light of the SECURE Act. Among (many) other things, the proposed regulations announced that where: (1) the ten-year payout period applies to an IRA or qualified plan; and (2) the participant had started taking annual required minimum distributions (RMDs) prior to death, RMDs must be taken by the designated beneficiary starting the year after the year of death of the employee, with a full and final distribution required by the end of the tenth calendar year after the year of the employee's death. In other words, heirs and beneficiaries cannot wait until the end of the ten-year period to make one lump sum distribution like they could under the five-year regime.

Since this rule was not in the statute and was only first announced in the 2022 proposed regulations, the heirs and beneficiaries of employees who died in 2020 very likely did not take an RMD in 2021 and were unsure whether they had to take an RMD in 2022. This very much matters because §4974 imposes a penalty for failure to take an RMD equal to 50 percent of the amount by which the amount actually distributed falls short of the RMD amount. In their comments to the proposed regulations, some of these individuals who would otherwise face a penalty for not taking RMDs in 2021 and 2022 asked that, if the final regulations adopt the interpretation of the ten-year rule contained in the proposed regulations, the IRS provide transition relief.

B. *Notice 2022-53*

In *Notice 2022-53* (October 7, 2022), the IRS announced that final regulations will apply no earlier than the 2023 distribution year. The IRS also announced that it will not assert the §4974 penalty for RMDs not made in 2021 or 2022 where the new ten-year payout rule applies. Presumably, then, if an employee died in 2020 and named a designated beneficiary for the account, there will be no penalty for failing to take an RMD in 2021 or 2022, but the designated beneficiary will likely need to take RMDs starting in 2023 and may have only eight calendar years (2023-2030) to deplete the employee's interest, as the ten-year period will expire at the end of 2030.

C. *Notice 2023-54*

In *Notice 2023-54* (July 14, 2023), the IRS pushed the proposed effective date even further out: "Final regulations regarding RMDs under §401(a)(9) and related provisions will apply for calendar years beginning no earlier than 2024." The Notice also provides that the IRS will not assert the IRC §4974 penalty for RMDs not made in 2023 where the ten-year payout rule applies. Though this is welcome news, the announcement signals that the final regulations will in fact retain the requirement that RMDs be made in each year of the ten-year payout period. Where the old five-year payout period applied, a taxpayer had the flexibility to wait until the fifth year after the employee's year of death to commence distributions, subject only to the requirement that the account be depleted by the end of that fifth year. Lost flexibility is never cause for celebration.

Notice 2023-54 also gave guidance related to the change in the required beginning date for RMDs made under the SECURE 2.0 Act of 2022. The SECURE 2.0 Act changed the required beginning date for RMDs from April 1 of the calendar year following the calendar year in which an individual turns 72 to April 1 of the calendar year following the calendar year in which an individual turns 73 or 75, depending on the individual's date of birth. Because it takes time to update automated payments, apparently, some individuals who reach age 72 in 2023 received (or will receive) distributions in 2023 that will be mischaracterized as RMDs, making them ineligible for rolling over into an eligible retirement plan. The Notice provides relief by announcing that any distribution made in the first seven months of 2023 to a participant born in 1951 (or to that participant's surviving spouse) that would have been an RMD under pre-

SECURE 2.0 Act law will still qualify as an eligible rollover distribution. The Notice further extended the 60-day rollover deadline in all cases to September 30, 2023.

VIII. DEVELOPMENTS IN REPORTING FOREIGN BANK ACCOUNTS

The Bank Secrecy Act of 1970 requires United States citizens and residents to file reports related to certain relationships with foreign financial institutions. Pursuant to the Act, Treasury issued regulations requiring an individual to file a Report of Foreign Bank and Financial Account (misleadingly known as an "FBAR") for any calendar year in which the individual has more than $10,000 in a foreign bank account. Today, the required disclosure is made on Form 114 of the Financial Crimes Enforcement Network ("FinCEN Form 114"), but the original FBAR "acronym" persists.

The Act provides that failing to file an FBAR can lead to a penalty of $10,000 per violation, which increases to $100,000 per violation (or, if more, 50 percent of the value in the foreign account) where the failure to file an FBAR is willful. Taxpayers have been challenging these penalties in court with mixed results. Consider the following cases.

A. Supreme Court Holds Penalty Applies on a Per-Form Basis, Not a Per-Account Basis (*Bittner v. United States*, U.S. Sup. Ct., February 28, 2023)

In a 5-4 decision, the United States Supreme Court has held that the penalty for negligent failure to file an FBAR accrues on a per-report basis and not, as the Fifth Circuit had held, on a per-account basis.

1. Facts

Alexandru Bittner, a dual citizen of the United States and Romania, learned of his obligation to file FBARs after returning to the United States from Romania in 2011. He then submitted FBARs covering the years 2007 through 2011, though the forms did not disclose all foreign bank accounts over which he had signatory authority or a qualifying interest. Ultimately, Bittner filed corrected forms disclosing 61 foreign accounts in 207, 51 accounts in 2008, 53 accounts in 2009, 53 accounts in 2010, and 54 accounts in 2011. The account balances during these years ranged from $3 million to $16 million. Because the filed FBARs were late and incomplete, the federal government imposed a penalty of $2.72 million, applying the $10,000 penalty separately to each of the accounts (272 accounts over the five years).

Bittner challenged the amount of the penalty, arguing the maximum penalty in his case should be $50,000—one $10,000 penalty for each of the five reports he failed to file timely. He had authority for this position, as the Ninth Circuit had held in *United States v. Boyd*, 991 F.3d 1077 (9th Cir. 2021), that the penalty applies on a per-report basis and not, as the government contended, on a per-account basis. A federal district court agreed with him. *Bittner v. United States,* 469 F. Supp. 3d 709 (E.D. Tex. 2020). But the Fifth Circuit rejected his argument, upholding the $2.72 million penalty. *Bittner v. United States*, 19 F.4th 734 (5th Cir. 2021).

2. Strange Bedfellows

The 5-4 split among the Court is not along the typical ideological lines. Justice Jackson, the newest member of the Court, expected to be liberal, sided with conservative Justices Gorsuch, Roberts, Alito, and Kavanaugh in reversing the Fifth Circuit and remanding the case for imposition of a $50,000 maximum penalty. Meanwhile, conservative Justice Barrett penned a dissent joined by Justice Thomas and two consistently liberal colleagues, Justices Sotomayor and Kagan. The close vote and atypical allegiances suggest this case was less of a political question and more a question of statutory interpretation in which reasonable minds could disagree.

3. The Majority Opinion

Justice Gorsuch wrote a three-part majority opinion, but only the first two parts of the opinion garnered majority support. On the last part, only Justice Jackson joined. The first part of Justice Gorsuch's opinion focuses on the language of the Bank Secrecy Act. He observes that the Act speaks only of a duty to file "reports" and not of a duty to disclose "accounts." As he states:

> the statutory obligation is binary. Either one files a report "in the way and to the extent the Secretary prescribes," or one does not. Multiple willful errors about specific accounts in a single report may confirm a violation … but even a single nonwillful mistake is enough to pose a problem.

Further, he notes, the penalty provision in the Bank Secrecy Act ties the penalty for negligent failure to file complete FBARs to the number of "violations," not the number of "accounts." The only time the Act mentions "accounts" is in relation to the penalty for the willful failure to file FBARs, where the penalty is the greater of $100,000 or 50 percent of "the balance in the account at the time of the violation." Justice Gorsuch reasons that because the statute specifically refers to accounts only in the case of willful penalties, the penalty for negligent failure to file FBARs must necessarily be applied on a per-report basis and not a per-account basis.

In the second part of the opinion, Justice Gorsuch finds additional support from the government's published guidance explaining the duty to file FBARs and from logical application of the penalty provisions. Justice Gorsuch observes that published guidance—in the form of proposed regulations, notices, fact sheets, and instructions—consistently speaks of "a civil penalty not to exceed $10,000" applicable to persons who fail to properly file an FBAR. No mention is made in any guidance indicating the penalty would be applied on a per-account basis rather than a per-report basis:

> Nowhere in these materials did the government announce its current theory that a single deficient or untimely report can give rise to multiple violations, that the number of nonwillful penalties may turn on the number of accounts, or that the

> $10,000 maximum penalty may be multiplied 272 times or more without respect to an individual's foreign holdings or net worth. … Here, the government has repeatedly issued guidance to the public at odds with the interpretation it now asks us to adopt.

Justice Gorsuch then argues that government's interpretation leads to illogical differences between willful and negligent violations of the Act:

> On the government's view, too, those who *willfully* violate the law may face lower penalties than those who violate the law *nonwillfully*. For example, an individual who holds $1 million in a foreign account during the course of a year but withdraws it before the filing deadline and then willfully fails to file an FBAR faces a maximum penalty of $100,000. But a person who errs nonwillfully in listing 20 accounts with an aggregate balance of $50,000 can face a penalty of up to $200,000. Reading the law to apply to nonwillful penalties per report invites none of these curiosities; the government's per-account theory invites them all.

The third and final part of Justice Gorsuch's opinion is where he loses the support of three colleagues. Here he argues for application of the "rule of lenity," under which statutes imposing penalties are to be strictly construed against the government and in favor of individuals. It is unclear why only Justice Jackson joined this part of the opinion. We do not know whether the others in the majority found it wrong or merely superfluous to the decision.

4. The Dissent

Justice Barrett's dissent notes that the statute requires an FBAR when an individual "maintains a relation … with a foreign financial agency." In the typical case, that "relation" is a bank account. Thus, in the dissent's view, "each relation with a foreign bank triggers the requirement to file reports. And because each relation is a matter of distinct concern under the statute, each failure to report an account violates the reporting requirement."

The dissent then argues the penalty provisions of the Act use the term "violation" in a way that refers to accounts and not just to reporting forms. The reasonable cause exception to reporting, for instance, waives any penalty for negligent failure to file where "such violation was due to reasonable cause" and "the balance in the account at the time of the transaction was properly reported." Since the exception conditions waiver on reporting information about a particular account, Justice Barrett reasons, "this language suggests that the underlying *violation* of [the Act] is similarly tied to a specific account." On this point, she sides with the Fifth Circuit's conclusion that "if the exception for non-willful violations applies on a per-account basis, then logically the violations the exception forgives must arise on a per-account basis too." 19 F.4th 734, 747-748 (5th Cir. 2021).

The dissent then argues that the statute is neutral as to whether the form by which the duty to disclose is discharged:

> For instance, rather than instructing citizens to report all accounts on a single form, [the Secretary] could have instructed citizens to report each account on a separate form. And if the Secretary had taken that route, Bittner would be hard pressed to deny that he would have violated the statute 272 times by failing to file 272 forms. That difficulty illustrates Bittner's fundamental misunderstanding of the account-specific obligation imposed by [the Act], which is indifferent to the mechanism by which the obligation is discharged.

In essence, the dissent's beef is that that majority confuses the "report" required by the statute with the FBAR form itself, when, according to the dissent, these are two different things. A single form, reasons the dissent, will contain multiple reports when the filer holds multiple foreign bank accounts. The dissent concludes with a reminder that the statute contains a reasonable cause exception which both the lower courts denied to Bittner in the present case. The statute contains a reasonable cause exception precisely because the total penalty amount can be quite high.

5. Observation

That the Fifth and Ninth Circuits would split is hardly surprising. But what was surprising was the Fifth Circuit siding with the government as the Ninth Circuit sided with the account holder. Likewise, a split decision from the current Supreme Court is par for the course. Yet, as noted above, the composition of the majority and dissenting camps was, to say the least, unique. By embracing the Ninth Circuit's view and rejecting that of the Fifth Circuit, the *Bittner* Court no doubt comforts those advising clients with foreign bank accounts.

B. Taxpayers Willfully Failed to Disclose Iranian Bank Accounts, So Large Penalties Apply (*United States v. Mahyari and Malekzadeh*, D. Oregon, January 24, 2023)

A federal district court granted partial summary judgment against an Iranian-American married couple, finding that while the couple may have willfully failed to disclose their foreign bank accounts on an FBAR for 2011, their failure to file FBARs for 2013 and 2014 was certainly willful, thus subjecting them to liability for more severe nondisclosure penalties.

The couple became United States citizens in 2006, but Farsi remains their primary language. They both testified that while they are highly skilled and educated, their poor English skills caused them to lose important career advancement opportunities. In 2011, they sold their home in Tehran for just under 23.7 billion rials, which equated to about $2.9 million. The sale proceeds were parked in Canadian and Iranian bank accounts. The couple hired a tax preparer to assist them with their federal income tax returns, and the preparer met with the couple every year to gather the information needed to prepare their returns. The couple never filed FBARs for the relevant years at issue (2012 is not at issue in this case because the balances in the foreign accounts that year did not exceed $10,000).

But was the couple's failure to fill FBARs willful? The court found a lack of controlling precedent as to what qualifies as a "willful" failure to file. But it did observe that "[t]he general consensus amount the circuits that have considered willfulness in the civil FBAR context is that willfulness includes reckless disregard for the truth." Following suit, the court announced that "a willful violation of the FBAR reporting requirements includes both knowing and reckless violations for purposes of a civil FBAR penalty."

The court held that, with respect to 2011, there are genuine issues of material fact as to whether the couple's failure to file an FBAR was willful. The couple's tax preparer never asked them about the existence of foreign bank accounts, and there is evidence to suggest they were forthright in revealing the existence of their assets. While noting "this is a close call," the court determined there was just enough evidence to raise a genuine issue of material fact as to whether the couple was reckless.

But with respect to 2013 and 2014, the court ruled that as a matter of law the couple's failure to file FBARs was willful. The tax preparer testified that his software specifically asks about the existence of foreign bank accounts in preparing federal income tax returns, and all parties concede that the preparer read through all of the questions with the couple when meeting with them about their returns. The court also found it troubling that the couple, both highlyeducated, never consulted with the preparer or their attorney about their tax obligations related to their foreign assets. So as to these years the court granted the IRS's motion for summary judgment that the couple's failure to file was willful.

C. Federal District Court Finds Willful Failure to Disclose Foreign Bank Account (*United States v. Kelly*, E.D. Michigan, May 2, 2023)

A federal district court granted summary judgment to the government, finding an individual's refusal to disclose information related to foreign bank accounts amounted to willful or reckless disregard of applicable disclosure requirements, thus justifying the imposition of penalties.

In this case, Dr. James Kelly, an anesthesiologist, moved his domestic bank accounts to a Swiss account in early 2008 after law enforcement officials started investigating alleged criminal conduct. In 2012, the Swiss bank advised Kelly of its intent to close his account because he failed to provided information regarding his compliance with United States tax laws. The bank closed access to the account and then notified the United States Department of Justice of the account's existence in 2013. Following that report, Kelly and his counsel requested to participate in the Treasury Department's Offshore Voluntary Disclosure Program. In 2016, as part of this process, Kelly filed delinquent FBARs for 2008 through 2013. They indicated the Swiss account had a maximum balance of just over $1.5 million in 2013. Kelly did not file FBARs for 2014 or 2015. In 2019, the IRS determined that Kelly owed penalties totaling over $769,000 for willful failure to file FBARs for 2013, 2014, and 2015.

The court noted precedent stating both knowing and reckless actions qualify as "willful" actions for purposes of civil penalties. Under that standard, it concluded, Kellys' failure to file timely FBARs was willful:

> He exhibited an unmistakable pattern of concealment along with a reckless disregard of his federal reporting obligations that he could have easily ascertained. The undisputed record shows Defendant Kelly took steps to conceal his [Swiss account] from the outset. He … requested the bank to retain his mail rather than have it sent to him at his residence, which is conduct meant to conceal his account from the IRS.
>
> Further, when Defendant Kelly opened [the account] he completed a document titled "Tax Form U.S. Withholding/Individual," on which [the bank] informed Defendant Kelly of his obligation to provide a completed Form W-9, Request for Taxpayer Identification Number and Certification in order to disclose his identity to the United States. Rather than disclose his identity to the IRS by completing the requested W-9 Form, Defendant Kelly chose to divest himself of U.S. securities, thereby avoiding the 30% U.S. income tax withholdings obligation of [the bank] and keeping his [Swiss] Account hidden from government detection.

The court also noted that Kelly received a letter from the bank in 2013 advising him of the need to disclose the account and file FBARs, establishing his actual knowledge of the reporting requirement. Even then he "did not reach out to any accountant, advisor, or other tax professional, or otherwise inquire about his federal reporting obligation." Finding Kelly had a "blasé attitude about his federal reporting obligations," the court had no trouble upholding the applicable penalty, together with interest and an additional late payment penalty.

D. Penalties Do Not Die with Decedent (*United States v. Gaynor*, M.D. Fla., September 6, 2023)

A federal district court granted the government's motion for summary judgment as to a decedent's requirement to disclose the existence of foreign bank accounts but reserved for trial the issue of whether the decedent willfully failed to make the required disclosures. More importantly, however, the court determined that the penalty for willful failure to disclose a foreign bank account does not abate upon the death of the account holder, granting summary judgment to the federal government on that issue.

Lavern Gaynor failed to disclose the existence of two Swiss bank accounts on FBARs that should have been filed for 2009, 2010, and 2011. The IRS assessed penalties authorized by the Bank Secrecy Act of about $5.7 million for 2009, $6 million for 2010, and $5.5 million for 2011. After Lavern died in 2021, the federal government brought this action against her son, George, in his capacity as personal representative of Lavern's estate and as trustee of her (once) revocable living trust, to collect on the penalties owed.

The parties agreed that Lavern was supposed to file FBARs for each of 2009, 2010, and 2011, and that she did not do so. Accordingly, the court granted summary judgment on that issue. It did not grant summary judgement, though, as to whether Lavern's failure to file was willful, as that involved genuine disputes of material fact that will need to be resolved at trial. The court also reserved for trial the issue of whether the IRS properly computed the penalties. It observed that in the case of willful failures to file, the statute requires that the penalty be the greater of $150,000 or half of the balance of the account "at the time of the violation." The court concluded that the "time of violation" is June 30 of the following year, the deadline date for filing the FBAR form. And the balances in the accounts on those dates were subject to some genuine disputes of fact, so the issue was saved for trial.

But are the penalties still owed now that Lavern is dead? After considering precedent from other jurisdictions, the court held that Lavern's estate and her revocable living trust are responsible for any willful failure to file FBARs. The common law makes a distinction between "remedial" penalties and "penal" penalties. A remedial penalty compensates for specific harm suffered, while a penal penalty imposes damages for wronging the public. The distinction is important, because remedial penalties survive the death of a defendant, while penal penalties die with the defendant.

Decisions from Florida federal district courts say that the way to determine if a penalty is penal is by asking whether the legislature expressed a preference for labeling the penalty as remedial or penal, and then considering seven other specific factors. In this case, said the court, Congress clearly signaled that the penalty for willful failure to file FBARs was remedial, for it titled the enabling statute as a "civil penalty" and left enforcement to Treasury rather than the Department of Justice. The other factors also pointed to the penalty being remedial, for money penalties are not traditionally seen as punishment, the penalty applies regardless of the defendant's state of mind, and there is a separate criminal penalty for willful failure to file, underscoring the intent that this penalty be remedial in nature. Finally, the court also noted that abating the penalty on account of death would grant "a windfall to estates of violators of FBAR requirements because the violator … pass[ed] away after the violation occurred and before the Government filed suit."

E. Dual Citizen's Untimely Claiming of Treaty Benefit Still Effective to Escape FBAR Penalties (*Aroeste v. United States*, S.D. Cal. November 20, 2023)

A federal district court has held that a Mexican citizen lawfully admitted for permanent residence in the United States is not required to disclose foreign bank accounts because that individual properly elected to be treated as a resident of Mexico for tax purposes under applicable provisions of an income tax treaty, albeit in an untimely way. Accordingly, the citizen was not liable for penalties related to failing to disclose foreign bank accounts, though the citizen was liable for smaller penalties related to the late invocation of the treaty benefit.

1. Requirement for United States Persons to File FBARs

Note that the filing requirement applies to United States persons. Under IRC §7701(b)(1)(A)(i), an individual lawfully admitted for permanent residence in the United States at any time during a year is considered a "United States person." Section 7701(b)(6) clarifies that one is a lawful permanent resident of the United States at any time if one holds a green card that has not been revoked or abandoned. But that paragraph also provides that:

> An individual shall cease to be treated as a lawful permanent resident of the United States if such individual commences to be treated as a resident of a foreign country under the provisions of a tax treaty between the United States and the foreign country, does not waive the benefits of such treaty applicable to residents of the foreign country, and notifies the Secretary of the commencement of such treatment.

Thus, anyone allowed to reside permanently with the United States by virtue of holding a green card is considered a United States person unless an applicable tax treaty allows that person to be treated as a resident of a foreign country for tax purposes.

2. Facts of the Case

Alberto Aroeste is a Mexican citizen who has maintained his permanent residence in Mexico City for over 50 years. In 1984, Aroeste applied for lawful permanent residency in the United States, and he has held a "green card" in all years since his application was approved. Aroeste and his spouse own a Florida condominium that they use as a vacation home, but that was their only contact with the United States during 2012 and 2013, the years at issue in the case.

During these years, Aroeste had five bank accounts in Mexico, and the aggregate balance in those accounts exceeded $10,000. But Aroeste did not file FBARs for either year. In 2014, his advisors counseled him to enter into the Offshore Voluntary Disclosure Program, which he did. But in 2016, acting on the advice of new counsel, Aroeste opted out of the program. That prompted an IRS investigation that led to the assessment of penalties totaling $100,000 in 2020. Aroeste paid just over $3,000 of that amount in 2022, then commenced this action for refund.

3. Did Aroeste Waive Treaty Benefits?

On his original United States tax returns for 2012 and 2013, Aroeste did not include a Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b). This was the form required to invoke Article 4 of the United States – Mexico Income Tax Convention, which would have allowed him to be treated as a resident of only Mexico for tax purposes. When he submitted amended tax returns for those years in 2016, he likewise did not include Forms 8833. It was only when he filed a corrected amended return for these years that he

finally attached Forms 8833. By that time, argued the IRS, it was too late—by failing to include the completed Forms with his original returns and first amended returns, he had effectively waived the benefit of the treaty, as contemplated by the language from IRC §7701(b)(6) quoted above.

But the district court agreed with Aroeste that the late submission of the Forms 8833 did not result in a waiver of treaty benefits. The court bought his argument that IRC §6712 imposes the sole consequence for failure to comply with the requirement to submit a Form 8833: a penalty of $1,000. The statute does not indicate that late filing of a Form 8833 likewise leads to waiver of applicable treaty benefits.

The IRS then argued that even if Aroeste had timely filed Forms 8833, he neglected to attach Forms 8854, Initial and Annual Expatriation Statement, as required by *Notice 2009-85*, 2009-45 I.R.B. 598. But the court agreed with Aroeste that *Notice 2009-85* is void for failing to comply with the Administrative Procedure Act's "notice-and-comment" rulemaking procedures, citing both *Green Valley Investors LLC v. Commissioner*, 159 T.C. No. 5 (2022), and *Mann Construction, Inc. v. United States*, 27 F.4th 1138 (6th Cir. 2022).

4. Result Under the Treaty

The remaining question, then, is whether Aroeste is a Mexican resident under the United States – Mexico Treaty. Article 4 of the Treaty provides that where an individual is a resident of both the United States and Mexico and has a permanent home in both countries, the individual is deemed to be a resident of the country that is the individual's "center of vital interests." In this case, said the court, Aroeste's center of vital interests is Mexico: he spends over 75 percent of the year there, "most of his friends are in Mexico, his cars and personal belongings are in Mexico, as well as his doctors and dentist, his health insurance and cell phone carrier are in Mexico, and he receives all his mail in Mexico."

The court thus granted summary judgment to Aroeste, discharging him from liability for FBAR penalties. But the court also held that he owed penalties totaling $2,000 for failure to timely claim the benefit of the Treaty, as required by IRC §6712.

F. "Willful" Failure to File FBARs Includes "Reckless" Failure to File, so Enhanced Penalties Apply (*United States v. Reyes*, E.D. New York, January 10, 2024)

A federal district court has held that a married couple owed penalties for the willful failure to disclose their interest in a Swiss bank account. The court found that the couple's failure to review the advisor-prepared tax returns denying the existence of any such interest was no excuse from the application of penalties.

Juan and Catherine, a married couple, owned a joint Swiss bank account during the years at issue (2010 through 2012). At all times during this period, the balance in the account was around $2,100,000. On their joint federal income tax returns for those years, the "no" box

was checked in response to the question of whether the couple had an interest in any financial account in a foreign country. The returns were prepared by the couple's accountant; the couple signed the returns without reviewing them. Furthermore, the couple did not file an FBAR for any of the years at issue.

The accountant was not at fault—though he asked the couple each year whether they had income from any foreign sources, the couple never told him about the account or its income. The couple reasoned that because any income would not have a United States source, there was no reason to disclose it or pay federal income tax on it.

After the account was closed in 2014, the couple's lawyer asked the accountant to prepare amended federal income tax returns for the years at issue, this time disclosing the existence of the account and reporting the interest income it generated. These amended returns were submitted as part of the couple's application to participate in the Offshore Voluntary Disclosure Program, but they withdrew their application in 2016. Thereafter, the IRS determined that the couple willfully violated the requirement to file FBARs. Although it could have imposed total penalties of over $3.1 million, the government reduced the penalty to just over $1 million. After an additional review, the total penalties were reduced to about $840,000. When the couple failed to pay any of this amount, the government commenced this lawsuit.

The government moved for summary judgment, but the couple argued that whether they willfully violated the FBAR disclosure requirement was a genuine issue of material fact. After noting that there was no controlling authority as to the meaning of a "willful" violation of the FBAR disclosure requirement, the district court observed that, in other contexts, the Supreme Court has held that "willfulness" encompasses "not only knowing violations of a standard, but reckless ones as well." *Safeco Insurance Co. of America v. Burr*, 551 U.S. 47, 57 (2007). The court also noted cases from other circuits concluding that willfulness for purposes of the FBAR penalty includes reckless violations. Adopting this rule, the court then held that the penalties will apply if the couple recklessly failed to file FBARs for the years at issue.

The couple argued that because they never reviewed the tax returns prepared by their accountant, their failure could not have been willful. But the court noted that such conduct has widely been held by other courts to be reckless. It concluded that the couple's "failure to meaningfully review their tax returns before filing returns that inaccurately represented that they had no foreign accounts thus shows that they 'recklessly disregarded the FBAR reporting obligation.'" Moreover, the court concluded, the couple was reckless in never responding to the accountant's question about the existence of foreign-sourced income. Given the account represented "between 75% and 90%" of the couple's wealth during the years at issue, the court reasoned, this was especially reckless. It thus had no trouble granting the government's motion for summary judgment.

The decision from the New York district court is consistent with the overwhelming weight of authority on this issue. Indeed, there appears to be no case in which a reckless failure to file FBARs has been held not to be a willful violation of the Bank Secrecy Act.

IX. CASES INVOLVING LATE PETITIONS TO THE TAX COURT

Section 6213(a) generally gives a taxpayer 90 days after the mailing of a notice of deficiency to file a petition for redetermination of the deficiency with the Tax Court. In fact, here are the relevant provisions of that subsection:

> Within 90 days … after the notice of deficiency authorized in section 6212 is mailed (not counting Saturday, Sunday, or a legal holiday in the District of Columbia as the last day), the taxpayer may file a petition with the Tax Court for a redetermination of the deficiency. … [N]o assessment of a deficiency … and no levy or proceeding in court for its collection shall be made, begun, or prosecuted until such notice has been mailed to the taxpayer, nor until the expiration of such 90-day … period … nor, if a petition has been filed with the Tax Court, until the decision of the Tax Court has become final. … The Tax Court shall have no jurisdiction to enjoin any action or proceeding or order any refund under this subsection unless a timely petition for a redetermination of the deficiency has been filed and then only in respect of the deficiency that is the subject of such petition.

The IRS and the Tax Court read this language to mean that if a taxpayer files a petition for redetermination just minutes or even seconds after the applicable deadline, the Tax Court lacks the jurisdiction to consider the petition. But at least one federal appellate court disagrees.

A. Tax Court Says It Lacks Jurisdiction to Consider Redetermination E-Filed Five Minutes Late (*Nutt v. Commissioner,* 160 T.C. No. 10, May 2, 2023)

The Tax Court has held that a document electronically filed with the court is filed upon receipt, determined with reference to where the court is located. Accordingly, the taxpayers missed the deadline for their petition and had their case dismissed for lack of jurisdiction.

On April 14, 2022, the IRS mailed a deficiency notice to the taxpayers in connection with their joint income tax return for 2019. The deadline for filing a petition in Tax Court was July 18, 2022. The taxpayers resided in Alabama, located in the central time zone. They filed their electronic petition at 11:05pm central time on July 18, 2022, but that was 12:05am eastern time on July 19, 2022. Because the Tax Court is located in Washington, D.C., the eastern time zone applies, so the petition was five minutes too late. The IRS filed a motion to dismiss for lack of jurisdiction, and the Tax Court granted the motion.

The taxpayers did not qualify for the "timely mailing is timely filing" rule of IRC §7502(a) because their petition was not delivered by the United States Postal Service or any other approved delivery service. Thus the time of actual receipt determines the time of filing. The court justified this conclusion by noting, first, that the Tax Court's website states in bold print that "**The Court must receive your electronically filled Petition no later than 11:59 pm Eastern**

Time on the last date to file." In addition, this conclusion is consistent with Rule 6(a)(4) of the Federal Rules of Civil Procedure which provides that the deadline for electronic filing ends "at midnight in court's time zone." Finally, the court cited precedents from other federal courts that applied the same principle that electronic filing deadlines are governed by the court's local time zone.

The rule for filing electronic petitions with the Tax Court, as illustrated in *Nutt*, differs from the rule applicable to federal income tax returns filed with the IRS. Regulation §301.7502-1(d)(1) provides that a tax return is filed as of its "electronic postmark," and for this purpose Regulation §301.7502-1(d)(3)(ii) looks to the *taxpayer's* time zone to determine the timeliness of the filing.

B. Heck, Even Eleven Seconds Late is Too Late (*Sanders v. Commissioner,* 160 T.C. No. 16, June 20, 2023)

The Tax Court has held that an electronic petition for redetermination filed eleven seconds after midnight on date the due date was untimely. While the period for electronic filing may be extended where the filing system is inaccessible on the last day for filing, such was not the case here. The taxpayer's case was therefore dismissed for lack of jurisdiction.

The taxpayer received a notice of deficiency that stated the last day for filing a petition with the Tax Court was December 12, 2022. At 9:59 pm the evening of December 12, the taxpayer downloaded the PDF forms to his Android mobile phone, but he was unable to complete the forms on his phone. Later, between 11:03 pm and 11:44 pm, the taxpayer made several attempts to upload the documents from his phone to the Tax Court's electronic filing system. He finally switched to his personal computer just before midnight, logging in at 11:57 pm. The filing system logs show that the taxpayer began uploading his petition nine seconds after midnight and that the filing was complete eleven seconds after midnight.

The IRS filed a motion to dismiss for lack of jurisdiction. In his objection to the motion, the taxpayer simply argued:

> On December 12, 2022 I attempted several times to upload documents well before midnight. Finally I was able to get it uploaded and it literally did not finish the upload until exactly 12a.
>
> I am sure it can be proven that the system had errors and that my upload was loading before cut off time.

In fact, the system had no errors, so that argument went nowhere fast. "To the extent that Mr. Sanders experienced difficulties in filing his Petition, they were unique to him and not the result of the system's being inaccessible or otherwise unavailable to the general public." But an amicus brief filed by the Tax Clinic at Harvard Law School made two arguments in support of the taxpayer that the court considered at length.

The amicus brief first argued that a petition should be treated as filed when a taxpayer relinquishes control over it, akin to the mailbox rule in IRC §7502. But given the Tax Court's decision in *Nutt, supra,* the "timely mailing is timely filing" rule from IRC §7502 does not apply to petitions filed electronically. Instead, electronic petitions are considered filed when received. Moreover, said the court, the proposed rule that a petition is filed when it is outside the taxpayer's control would not change the result in this case, as the taxpayer did not begin the upload until nine seconds after the deadline.

The amicus brief also asked the court to view the taxpayer's petition "through the lens of equitable tolling." But the Tax Court observed that under its own precedent, equitable tolling does not apply to a jurisdictional deadline. This conclusion, said the court, has the support of Congress:

> Indeed, Congress reinforced the notion that section 6213(a) is jurisdictional in 2021 when it enacted section 7451(b), which extends the deadline for filing a petition when a filing location is inaccessible or otherwise unavailable to the general public. When adding this provision, Congress clearly viewed the *timely* filing of a petition as a prerequisite to the Court's jurisdiction, stating in the effective date provision: "The amendments made by this section shall apply to petitions *required* to be timely filed (determined without regard to the amendments made by this section) after the date of enactment of this Act." Infrastructure Investment and Jobs Act § 80503(c) (emphasis added). Notably, Congress made this provision applicable only to petitions, and not to documents that lack the jurisdictional significance of petitions.

Accordingly, the court dismissed the case for lack of jurisdiction.

C. But the Third Circuit Says Tax Court Can Still Consider Late Petitions (*Culp v. Commissioner,* 3d Cir., July 19, 2023)

The Third Circuit Court of Appeals has reversed a Tax Court order dismissing a petition for redetermination of tax liability due to late filing. It held that the Tax Court *has* jurisdiction to review untimely redetermination petitions, contrary to the Tax Court's interpretation of the governing statute as illustrated in *Nutt* and *Sanders*, *supra*.

In 2015, the taxpayers, a married couple, received over $17,000 in settlement of a lawsuit. They reported the payment on their 2015 joint federal income tax return, but the IRS concluded that that payments were not included on the return. In 2018, the IRS mailed a second notice of deficiency to the taxpayers in connection with this matter. After the taxpayers failed to respond to the letter, the IRS levied on their social security benefits and their federal income tax refund. The taxpayers then filed a petition with the Tax Court, but this was more than 90 days after the date the IRS mailed them the second deficiency notice.

The Tax Court concluded that because the petition was filed late, it lacked jurisdiction to consider the claim. But the Third Circuit, applying the Supreme Court's recent analysis in *Boechler, P.C. v. Commissioner*, 142 S. Ct. 1493 (2022), held that the 90-day filing requirement is merely procedural and not jurisdictional. In *Boechler*, the Supreme Court announced that a procedural requirement will be treated as limiting a court's jurisdiction only where Congress "clearly states" that it is. And in this case, ruled the Third Circuit, the statute does not so clearly state:

> The most pertinent part of §6213(a) provides that "[w]ithin 90 days ... after the notice of deficiency ... is mailed ... the taxpayer may file a petition with the Tax Court for a redetermination of the deficiency." Nothing in that language links the deadline to the Court's jurisdiction. Yet, elsewhere in §6213(a), Congress specified that "[t]he Tax Court shall have no jurisdiction to enjoin any action or proceeding or order any refund under this subsection unless a timely petition for a redetermination of the deficiency has been filed and then only in respect of the deficiency that is the subject of such petition." 26 U.S.C. §6213(a). So Congress knew how to limit the scope of the Tax Court's jurisdiction. It expressly constrained the Tax Court from issuing injunctions or ordering refunds when a petition is untimely. But it did not similarly limit the Tax Court's power to review untimely redetermination petitions.

The taxpayers then argued that if the deadline in IRC §6213(a) is not jurisdictional, the 90-day time limit is presumptively subject to the doctrine of equitable tolling. This doctrine essentially pauses the statute of limitations where a litigant pursued rights diligently but was barred from bringing a timely action because of some extraordinary circumstance. The IRS argued that it was too late for the taxpayers to assert a claim for equitable tolling, but the Third Circuit found no fault on the part of the taxpayers. The statute of limitations is an affirmative defense that the IRS did not raise before the Tax Court. Because the IRS did not raise the statute of limitations, there was no occasion for the taxpayers to ask for equitable tolling. Indeed, *Boechler* cited the rule that that "nonjurisdictional limitations periods are presumptively subject to equitable tolling." After parsing the text, context, and place of IRC §6213(a) in the broader statutory scheme, the Third Circuit found insufficient evidence that Congress sought to except the 90-day filing requirement from equitable tolling. It thus remanded the case to the Tax Court for a determination of whether the taxpayers are entitled to tolling.

The court's opinion ends with a succinct summary:

> Missing a statutory filing deadline is never ideal for the filer. But the specific consequence for doing so depends on the legislature's intent. If the statute clearly expresses the deadline is jurisdictional, the filer's tardiness deprives a court of the power to hear the case. Without a clear statement, courts will treat a filing period to be a claims-processing rule that is presumptively subject to equitable tolling. Because we discern no clear statement that §6213(a)'s deadline is jurisdictional, we hold it is not. And because the presumption that

> nonjurisdictional time limits are subject to equitable tolling has not been rebutted here, we hold it may be tolled. We thus reverse the Tax Court's dismissal for lack of jurisdiction and remand for that Court to determine whether the Culps are entitled to equitable tolling.

It will be interesting to see how the Tax Court and other jurisdictions view the Third Circuit's rejection of the Tax Court's treatment of the IRC §6213(a) deadline as jurisdictional. If appealed, this case would be heard by the Fourth Circuit. Presumably, for taxpayers residing in the Third Circuit, the Tax Court would have the power to apply equitable tolling. But would the result in the *Sanders* case, for example, really be different if equitable tolling was available? Did the taxpayer in *Sanders* "diligently pursue his rights" only to be thwarted by some "extraordinary circumstance?" Is there some degree of assumed risk in waiting until (quite literally) the last minute? If anything, these cases reinforce the basic planning tip to avoid filing at the last minute, even where electronic filing is available. Power outages, service lags, and hardware failures are always possible and should not be discounted. Electronic filings should be done sufficiently in advance such that, if they fail, traditional filings are still an option.

D. Two Time Extensions Applied to Taxpayer's Petition to Tax Court (*Sall v. Commissioner*, 161 T.C. No. 13, November 30, 2023)

The Tax Court held in a reviewed opinion that a taxpayer's deadline for petitioning the Tax Court for redetermination of an alleged deficiency was twice extended, once because the Tax Court was closed on the original deadline date, and again because the extended due date fell on a weekend.

The IRS sent the taxpayer a notice of deficiency for the 2017 and 2018 tax years by certified mail on August 26, 2022. Under IRC §6213(a), the taxpayer had 90 days to file a petition for redetermination with the Tax Court. Accordingly, the deadline for filing the petition would normally be Friday, November 25, 2022. But that was the day after Thanksgiving, and the Tax Court was closed that day. Under IRC §7451(b), where "a filing location is inaccessible or otherwise unavailable to the general public on the date a petition is due," the deadline for filing is extended by "the number of days within the period of inaccessibility plus an additional 14 days." By operation of this rule, then, the taxpayer's deadline would be extended by 15 days to December 10, 2022.

But December 10, 2022, was a Saturday. Under IRC §7503, when a deadline falls on a Saturday, Sunday, or legal holiday, the deadline is extended to the next day that is not a Saturday, Sunday, or legal holiday. That pushed the taxpayer's deadline to Monday, December 12, 2022.

Fortunately, the taxpayer mailed his petition from his home in Colorado on Monday, November 28, 2022, and it arrived at the Tax Court on Thursday, December 1, 2022. Accordingly, the court ruled his petition was timely.

One wonders why the IRS insisted that the Tax Court lacked jurisdiction, as the extensions applied by the court were plainly authorized by the Code. It's not a good look for the IRS to be contesting jurisdiction in light of a clear statutory mandate.

E. FedEx Ground Not a Delivery Service Eligible for "Timely Mailing is Timely Filing" Rule (*Nguyen v. Commissioner*, T.C. Memo. 2023-151, December 20, 2023)

The Tax Court has held that a Tax Court petition sent by FedEx Ground did not qualify for the "timely mailing is timely filing" rule. It thus dismissed a petition received one day after the applicable deadline.

In a notice dated October 13, 2022, the IRS mailed to the taxpayers, a married couple, a deficiency notice for 2017 and 2018 determining income tax deficiencies totaling nearly $2.7 million and civil fraud penalties of nearly $2 million. The notice correctly stated that the last day on which the taxpayers could petition the Tax Court for a redetermination was January 11, 2023. The taxpayers sent their petition by FedEx Ground on January 10, but the petition did not arrive until January 12, one day after the deadline. The IRS moved to dismiss the petition for lack of jurisdiction, but the taxpayers objected.

Alas, as explained above, IRC §6213 conditions the Tax Court's jurisdiction on a timely-filed petition. And, as explained above, the court has consistently recognized that it lacks the authority to extend the 90-day deadline set by the Code and that it must dismiss late petitions. The taxpayers argued that the "timely mailing is timely filing" rule of IRC §7502 applied to their petition, but that statute refers to a document "delivered by United States mail." The taxpayers, remember, used a private delivery service instead of the United States Postal Service.

The taxpayers pointed to IRC §7502(f), which provides that a "designated delivery service" will be treated as the United States mail for purposes of the "timely mailing is timely filing" rule. The statute gives the IRS authority to identify private delivery services that will qualify for this benefit, and while the IRS has in fact identified certain forms of delivery made by FedEx as eligible, FedEx Ground is not so identified. Indeed, *Notice 2016-30,* 2016-18 I.R.B. 676 even says that "FedEx … [is] not designated with respect to any type of delivery service not enumerated in this list."

The taxpayers argued that FedEx Ground is "substantially identical" (sic) to FedEx 2-Day, a delivery service that *does* qualify for the "timely mailing is timely filing" rule. But the court concluded it had no power to add to the list of approved delivery services through general equitable principles. "We are not at liberty to make a designation that Congress has explicitly committed to the Secretary's discretion," said the court.

Although the court granted the IRS's motion to dismiss, it advised the taxpayers that they still have time to pay the deficiencies and make a claim for refund that, if denied, could be heard by a federal district court or by the United States Court of Federal Claims. The taxpayers

likely thought it was safer to send the petition by FedEx ground than by regular mail, when in fact the opposite was true. Had they sent their petition through the United States mail on the same day they left their petition with FedEx, they would not have been forced to pay the deficiency before getting their day in court.

F. IRS Bound by Botched Deadline Date Stated in Deficiency Notice, So Tax Court Petition is Timely (*Dodson v. Commissioner*, 162 T.C. No. 1, January 3, 2024)

In a reviewed opinion, the Tax Court held that a petition for redetermination filed 147 days after the IRS mailed a deficiency notice was nonetheless timely because it was filed before the deadline date stated in the letter. The fact that the IRS issued a "corrected notice" the next day containing the correct deadline date was not effective in thwarting the court's jurisdiction.

In the case, the IRS mailed a deficiency notice for 2017 to the taxpayers, a married couple, on October 7, 2021. That letter stated that the deadline for filing a petition for redetermination by the Tax Court was December 5, 2022. The next day (October 8, 2021), the IRS mailed a second "corrected notice" to the taxpayers, this one stating that the "PREVIOUS NOTICE (was) SENT WITH (an) INCORRECT (deadline) DATE" (all caps in original). The corrected notice changed the deadline date to January 6, 2022. This would be the normal 90-day deadline date.

The taxpayers mailed their Tax Court petition on March 3, 2022, some 147 days after the date of the first notice and 146 days after the date of the corrected notice. The IRS thus moved to dismiss the case for lack of jurisdiction, but the taxpayers pointed to the last sentence of IRC §6213(a), which states:

> Any petition filed with the Tax Court on or before the last date specified for filing such petition by the Secretary in the notice of deficiency shall be treated as timely filed.

The taxpayers argued that, under this rule, their petition was timely as long as they filed on or before December 5, 2022, the date set forth in the first notice. But whether the Tax Court can accept that petition after issuance of the corrected notice was a case of first impression for the court, hence the reviewed opinion.

The court unanimously held that the petition filed by the taxpayers was timely. Although IRC §6212(d) gives the IRS the power to rescind a notice of deficiency, this can only happen with the taxpayer's consent. Further, *Revenue Procedure 98-54*, 1998-2 C.B. 529, requires that this consent be reflected on a Form 8626. No such form was completed, and there is no evidence the taxpayers otherwise consented to the rescission of the first notice. "Our straightforward conclusion," announced the court, "derived from the plain text of sections 6213(a) and 6212(d), is that we are required to treat the Petition as timely filed. Accordingly, we will do so."

The IRS insisted the deadline date in the first notice was an "obvious mistake," but the court found that characterization misleading. A taxpayer without counsel has no way to know the very late deadline is an obvious error. Besides, notes the court, the IRS's argument "attempts to create uncertainty about the meaning of the last sentence of section 6213(a) where there is none."

The court was careful to observe that "This is not a case where a taxpayer petitions us for redetermination of a deficiency in a notice that purports to correct a prior notice of deficiency, a circumstance for which we express no view on the application of the last sentence of section 6213(a)." It is not entirely clear what situation the court has in mind with this statement. Perhaps it refers to a case where the corrected notice contains a later deadline date, or maybe it simply refers to the fact that the taxpayers here sought redetermination of the first deficiency notice and not the corrected one, though that's a technicality since the amount contested and the grounds for imposing the deficiency are the same under both the original notice and the corrected notice.

X. SPEAKING OF LATE PETITIONS, TAX COURT LACKS JURISDICTION TO CONSIDER LATE PETITION SEEKING REVIEW OF DENIED INNOCENT SPOUSE RELIEF REQUEST (*Frutiger v. Commissioner*, 162 T.C. No. 5, March 11, 2024)

The Tax Court has held that it has no jurisdiction to hear a claim for innocent spouse relief because the petitioner filed a late petition. The court confirmed that the 90-day filing deadline for innocent spouse relief petitions set forth in IRC §6015(e)(1)(A) is jurisdictional, even though earlier precedent reaching that conclusion had been called into question by a 2022 holding of the Supreme Court.

The case involved a husband who had requested innocent spouse relief in connection with a joint return filed for 2018. The IRS issued a notice of determination denying the request in June, 2021. The husband mailed a petition to the Tax Court seeking review 92 days after the date of the determination, and the Tax Court received the petition four days after that (96 days after the date of the determination). The IRS moved to dismiss the petition for lack of jurisdiction.

Section 6015(e)(1)(A) states in relevant part that an individual:

> may petition the Tax Court (and the Tax Court shall have jurisdiction) to determine the appropriate relief available to the individual under this section if such petition is filed … at any time after the date the Secretary mails … notice of the Secretary's final determination of relief available to the individual, … and … not later than the close of the 90th day after [such] date .

Given the husband in this case filed a petition after the close of the 90th day after the date the IRS mailed its notice of determination, the question is whether the Tax Court has the power to consider the husband's petition. This, in turn, depends on whether the 90-day deadline set

forth in the Code is a "jurisdictional rule" (in which case the Tax Court does not have power to consider the husband's petition) or merely a "claim-processing rule" (in which case the Tax Court has the discretion to consider a late-filed petition on equitable grounds).

In *Pollock v. Commissioner*, 132 T.C. 1 (2009), the Tax Court concluded that the 90-day deadline in IRC §6015(e)(1)(A) is a jurisdictional rule, both because the statute expressly uses the word "jurisdiction" and because an earlier case, *Boyd v. Commissioner*, 124 T.C. 296 (2005), held that similar language in IRC §6330(d)(1) relating to petitions challenging correction determinations was a jurisdictional rule. But in 2022, the Supreme Court in *Boechler, P.C. v. Commissioner*, 142 S. Ct. 1493 (2022), held that the time limit in IRC §6330(d)(1) is but "an ordinary, nonjurisdictional deadline subject to equitable tolling." *Id.* at 1501. This effectively overruled the *Boyd* decision. Given that *Pollock* rested in part on *Boyd*, the court here observed that "*Pollock* no longer rests on a sure foundation; that foundation was eroded by *Boechler*."

Acknowledging the need to "revisit our holding *Pollock*," the court then went about determining whether Congress "clearly states" that the 90-day filing deadline in IRC §6015(e)(1)(A) is jurisdictional. After quoting the statute, the court concludes the deadline "reads as a prerequisite to the Tax Court's jurisdiction." The husband—and the Center for Taxpayer Rights, through an amicus brief—argued that the parenthetical in the statute related to the Tax Court's jurisdiction "can be interpreted to modify many parts of the provision and not specifically the filing deadline." But the court rejected the argument, noting that while IRC §6330(d)(1) contained an ambiguous reference to jurisdiction in "such matter" that could be subject to multiple interpretations, there is no similar ambiguous language in IRC §6015(e)(1)(A):

> Specifically, section 5016(e)(1)(A) is a provision that solely sets forth deadlines. Reduced to its essential terms, it provides that "an individual may petition the Tax Court (and the Tax Court shall have jurisdiction) if such petition is filed" by a specified deadline.

The court also found it probative that the *Boechler* Court even observed that IRC §6015(e)(1)(A) more clearly links the jurisdictional grant to the filing deadline than did IRC §6330(d)(1).

The amicus brief argued that the deadline in IRC §6015(e)(1)(A) is not jurisdictional because it is part of a statutory scheme that grants equitable relief. In effect, it asserted that because relief for innocent spouses is grounded in equity, any deadlines in the statute should not be considered jurisdictional. The Tax Court rejected this argument, finding that while some portions of innocent spouse relief contain equitable components, equity is not a sole grounds for relief. "The partial equitable nature of section 6015 is not enough to overcome the clear statutory text." In the end, then, the court determined that because the filing deadline is a jurisdictional rule, it had no jurisdiction to hear the husband's case.

XI. NO INCOME TAX DEDUCTION FOR DONATIONS TO NIL COLLECTIVES (*Advice Memorandum 2023-004*, June 9, 2023)

The IRS Office of Chief Counsel has concluded that operating a "name, image, and likeness" (NIL) collective does not further a tax-exempt purpose under IRC §501(c)(3). Among other things, this means that contributions to an NIL collective would not qualify for a federal income tax deduction under IRC §170.

Since the National Collegiate Athletic Association (NCAA) adopted an interim NIL policy in 2021 that allows collegiate athletes to be compensated for the use of their NIL without affecting their NCAA eligibility, booster clubs at many universities have established "collectives" to develop, fund, and, in some cases, administer NIL deals for their student-athletes. Typically, the collectives are independent of the college or university, and many are formed as nonprofit organizations under state law. Some collectives have even achieved tax-exempt status as IRC §501(c)(3) organizations.

Most collectives partner with local and regional charities to develop paid NIL opportunities for student-athletes. For instance, a student-athlete might appear in a promotional video for the charity, or the student-athlete might attend a fundraising event or a youth sports camp on behalf of the charity. The student-athletes are then compensated for the use of their NIL rights directly from the collective. The collective might also assist the student-athletes in reporting their activities in order to comply with state law and university policies. Some collectives even provide student-athletes with advice on brand development, financial planning, and tax advice.

A tax-exempt organization must be organized and operated *exclusively* for charitable, educational, religious, or other specifically identified purposes. Regulations make clear that an organization must engage primarily in activities that further an exempt purpose. Treas. Reg. §1.501(c)(3)-1(c)(1). Furthermore, an organization must serve public (as opposed to private) interests. Treas. Reg. §1.501(c)(3)-1(d)(1)(ii).

While an occasional private benefit to private interests that is incidental to an organization pursuing its exempt purpose is allowed, any such private benefit must be "clearly incidental to the overriding public interest." Rev. Rul. 76-206, 1976-1 C.B. 154. In *Revenue Ruling 70-186*, 1970-1 C.B. 128, for example, an organization formed to preserve a lake as a public recreational facility benefited both the general public and the private landowners owning lakefront property. The IRS ruled that the benefit to private interests was incidental because it would have been impossible to accomplish the tax-exempt purpose without benefiting the lakefront property owners. The benefit to the landowners was both indirect and clearly incidental to the organization's overriding purpose of preservation.

After comparing NIL collectives against several revenue rulings pertaining to activities by nonprofit organizations that provide benefits to private, noncharitable parties, the Office of Chief Counsel concluded that:

> the benefit to private interests will, in most cases, be more than incidental both qualitatively and quantitatively. Student-athletes generally benefit from a nonprofit NIL collective through the compensation paid by the collective for use of their NIL. This private benefit is not a byproduct but is rather a fundamental part of a nonprofit NIL collective's activities.

Indeed, the Office of Chief Counsel goes on to say the primary purpose of the typical NIL collective is for the private benefit of student-athletes:

> Collectives are usually organized by boosters and fans of athletic programs at particular schools. It is reasonable to assume that these organizers, as supporters of a particular school, have an interest in limiting a collective's NIL opportunities to the student-athletes at that school rather than making these opportunities available to any student-athlete willing to participate in the collective's activities. ... Given the role that NIL collectives play in student-athlete retention and recruitment, and the presence of other factors listed above, it is apparent that helping student-athletes monetize their NIL is a substantial nonexempt purpose of many nonprofit NIL collectives.

For this reason, the Office of Chief Counsel concludes that many NIL collectives are not tax-exempt because the private benefits provided to student-athletes are not merely incidental to any exempt purpose.

A June 10, 2023, story posted on the *Sports Illustrated* website states that "More than 200 collectives exist among the 131 [Division I Football Bowl Subdivision] schools, dozens of which have been granted 501(c)(3) status and are receiving millions in donations from boosters who are under the impression that their gifts fall under tax deduction." Dellenger, *IRS Says Donations Made to Nonprofit NIL Collectives Are Not Tax Exempt*, si.com (last visited June 14, 2023). Depending on how aggressively the IRS asserts the position set forth in the technical advice, some of these collectives face revocation of their tax-exempt status, and donors who were told they could deduct contributions need to be advised against taking a deduction for contributions.

XII. UNPAID CHECKS WERE NOT GIFTS IN CONTEMPLATION OF DEATH, SO (MOST OF THEM) ARE INCLUDIBLE IN DECEDENT'S GROSS ESTATE (*Estate of DeMuth v. Commissioner*, 3d. Cir., July 12, 2023)

The Third Circuit Court of Appeals has affirmed the decision of the Tax Court holding that the value of seven uncashed checks was includible in the decedent's gross estate for federal estate tax purposes. Although there were ten such checks uncashed as of the date of the decedent's death, the Tax Court had held that only seven of the checks were includible in the decedent's gross estate due to an erroneous concession by the IRS in its brief.

In 2007, the decedent gave his son a durable power of attorney that, among other things, authorized the son to make annual exclusion gifts on the decedent's behalf. For the next several years, the son did exactly that. At issue in this case are checks written by the son on the decedent's investment account with Mighty Oak Strong America Investment Co. ("Mighty Oak") on September 6, 2015, just days after the decedent received a terminal diagnosis from an undisclosed medical condition. Some 37 beneficiaries received annual exclusion gifts represented by 11 checks. Mighty Oak only paid one of the 11 checks before the decedent's death on September 11, 2015. The other ten checks were paid by Mighty Oak between September 14 and September 30 of that year. In computing estate tax liability, the estate excluded the value of the checks from the decedent's gross estate, presumably under the theory that the checks represented completed gifts to the recipients. In a deficiency notice issued in 2019, the IRS determined that the value of the ten unpaid checks should have been included in the gross estate. That sent the parties to the Tax Court.

The first issue before the Tax Court was whether the gifts represented by the checks were complete before the decedent's death since they were delivered to the donees but were uncashed as of the date of death. Regulation §25.2511-2(b) provides that a gift is not complete until the donor has so "parted with dominion and control as to leave him in no power to change its disposition." Whether the decedent had parted with dominion and control of the gifted funds before death thus because a question of state law. Under applicable state law (Pennsylvania), mere delivery of a check does not complete a gift because the donor can always stop payment on the check until it has been presented for payment. Because Mighty Oak did not accept, certify, or make final payment on any of the ten checks at issue until after the decedent's death, the power to stop payment never expired before death, meaning none of the ten checks represented completed gifts. Gross estate inclusion of the value of these checks is therefore proper. *Estate of DeMuth v. Commissioner*, T.C. Memo. 2022-72 (2022).

Normally that would be the end of the matter. But here the IRS conceded on brief that three of the checks were not includible in the decedent's gross estate because they had been "credited by drawee banks" before the decedent's death. While it's true that those checks had been presented to the recipients' depository banks before death, only Mighty Oak is the drawee bank. In fact, Mighty Oak had not paid or credited those three checks. It appears that the IRS's failure to distinguish between the depository bank and the drawee bank led to the concession. The IRS at the last minute tried to withdraw its concession on this point, but the Tax Court held it was too late: "to ignore the concession respondent made in his brief *sua sponte* would be prejudicial to the petitioner" in that the estate relied on this concession in preparing a reply brief. The Tax Court thus concluded that seven of the checks were includible in the decedent's gross estate.

Not content with this partial victory, the estate appealed to the Third Circuit, claiming that the seven includible checks were completed gifts *causa mortis*. Under state law, checks delivered to a recipient before death as gifts *causa mortis* are completed gifts even if the checks are paid after death. But to be a valid gift *causa mortis*, the decedent had to "apprehend death" at the time of the gift. The only evidence indicating the checks were made in contemplation of

death were: (1) the decedent's receipt of a terminal diagnosis days before the gifts; and (2) the fact that these checks were delivered in September when the custom was for annual exclusion gifts from the decedent's account to made in December. While this evidence might be probative of the state of mind of the decedent's son (the agent under the power of attorney), it does nothing to prove the decedent's state of mind. Since there was no evidence that the decedent contemplated death when the checks were written on his behalf, the value of the seven checks was properly includible in the decedent's gross estate.

This case applies the overwhelming majority view that uncashed checks are not completed gifts because of the donor's power to stop payment. But there are a number of ways to make completed gifts from one's deathbed. A dying donor can make a completed gift by a certified check, by wire transfer, or even through apps like Venmo and Zelle.

Planners should keep in mind that a different rule applies for inter vivos charitable gifts. Checks delivered to charities are treated as donations made in the taxable year of delivery, even if the charity does not cash the check until the next taxable year, provided the check "subsequently clears in due course." Treas. Reg. §1.170A-1(b).

XIII. TRANSFERS BETWEEN TWO S CORPORATIONS TREATED AS EQUITY, NOT DEBT (*Estate of Fry v. Commissioner*, T.C. Memo. 2024-8, January 23, 2024)

The Tax Court has held that transfers between two S corporations owned by the taxpayer were not loans but instead constructive distributions to the taxpayer from one corporation followed by constructive contributions from the taxpayer to the other corporation. This gave the taxpayer sufficient basis in the other corporation to deduct pass-through losses for the taxable year at issue. The case is interesting because usually it is the IRS arguing that inter-corporate transfers are constructive dividends to the common owner, but here it was the taxpayer seeking constructive distribution treatment.

The taxpayer was the sole shareholder of two S corporations that together conducted an integrated business operation involving the collection of trash and recyclables and processing them into commodities for sale to third parties. The two corporations shared the same payroll staff, corporate officers, and accountant. In 2011, a contract between one of the corporations and the City of Los Angeles was repudiated by the city following an accident that resulted in the deaths of two corporate employees. From that moment, the corporation began losing between $5 and $7 million per year.

Starting around that time, the other, more profitable corporation, started providing financial support to the distressed corporation. These transfers were at the taxpayer's direction and took the form of entity-to-entity transfers. No distributions were made to the taxpayer by the profitable corporation, and the taxpayer made no contributions to the distressed corporation during this time. By the end of 2013, over $36.2 million in transfers had been completed. The distressed corporation gave no promissory note, the profitable corporation

never sought a security interest, and neither corporation made any mention of interest payments. But the distressed company accounted for the transfers as "loans payable."

The distressed company's federal income tax return for 2013 showed a net loss of $4.7 million, which the taxpayer deducted on his joint federal income tax return. The IRS contended the taxpayer could only deduct about $1.3 million of this amount because that was the extent of the taxpayer's basis in the corporation's stock. The taxpayer argued that he had enough basis because the corporate transfers were constructive distributions and contributions rather than debt owed by one company to the other.

The Tax Court thus had to decide whether the corporate transfers were bona fide debt or, instead, constructive distributions and contributions giving rise to equity. As an appeal would head to the Ninth Circuit, the court applied the 11-factor test from *Hardman v. United States*, 827 F.2d 1409 (9th Cir. 1987). The court explained the 11 *Hardman* factors as follows:

> (1) the names given to the certificates evidencing the debt; (2) the presence or absence of a fixed maturity date; (3) the source of the payments; (4) the right to enforce payments of principal and interest; (5) whether the advances increase participation in management; (6) whether the "lender" has a status equal or inferior to that of regular creditors; (7) objective indicators of the parties' intent; (8) whether the capital structure of the "borrower" is thin or adequate; (9) the extent to which the funds advanced are proportional to the shareholder's capital interest; (10) the extent to which interest payments come from "dividend" money; and (11) the ability of the "borrower" to obtain loans from outside lending institutions.

The first factor was neutral since there was neither evidence of a debt instrument, nor evidence of a capital contribution. The second factor weighed in favor of equity since there was no fixed date for repayment. The third factor also weighed in favor of equity since the payments came to the distressed company at the direction of the taxpayer, together with evidence showing he was determined to make sure the distressed company stayed in existence. The fourth factor likewise weighed in favor of equity, as the successful company had no ability to enforce repayment. The fifth factor was neutral, as the taxpayer was already the 100-percent owner of both companies. The sixth factor pointed to equity, as there was no evidence the advancing company was repaid before other creditors or had any priority over other creditors.

The seventh factor pointed to debt, as evidence showed the taxpayer intended that once the distressed company became profitable, transfers back to the successful corporation would begin. The court said the eighth factor was neutral for want of financial statements that could establish whether the distressed corporation was thinly capitalized. The ninth factor indicated equity because the interests of the taxpayer and both companies "were significantly intertwined." The tenth factor weighed in favor of equity for the same reasons as the third factor. Finally, the eleventh factor was neutral since there was no evidence of the distressed company's credit worthiness.

Following this analysis, the court determined that the transfers did not constitute debt. Rather, said the court, the transfers were constructive distributions from the successful corporation to the taxpayer, followed by his constructive contributions to the distressed corporation. This gave him sufficient stock basis to be able to deduct the pass-through losses from 2013.

XIV. ORDINARY INCOME ALLOCATED TO LIMITED PARTNERS IN NAME ONLY IS SELF-EMPLOYMENT INCOME OF A PARTNERSHIP (*Soroban Capital Partners LP v. Commissioner*, 161 T.C. No. 12, November 28, 2023)

The Tax Court has held that the exception from self-employment taxes for distributive shares allocable to "limited partners, as such" only applies to distributive shares allocable to those actually functioning as limited partners and not to the shares allocable to those acting as limited partners in name only. The court also held that the determination of whether a partner is truly a limited partner or one acting in name only is a partnership-level determination over which the Tax Court has jurisdiction in a partnership-level proceeding.

The case involves a Delaware limited partnership that operates as an investment firm. The partnership has one general partner (a limited liability company) and five limited partners, consisting of three individuals and two limited liability companies, each of which is wholly owned by one of the individuals. Thus, for federal income tax purposes, there are only three limited partners since the two LLCs are disregarded.

On its federal income tax return for 2016, the partnership reported about $2 million in net earnings from self-employment, and its 2017 return reported about $1.9 million in net earnings from self-employment. In both cases, while the reported amounts included the guaranteed payments made to the limited partners, the reported amounts did not reflect the limited partners' distributive shares of the partnership's ordinary income. In 2022, the IRS determined that the limited partners' distributive shares of the partnership's ordinary income should have been included, which brought the parties to the Tax Court.

A. Statutory Background

Under IRC §1401, individuals must pay a tax on "the net earnings derived from self-employment" during the year. The Code defines net earnings from self-employment as "the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member." IRC §1402(a). Thus, an individual's distributive share of a partnership's ordinary business income is included as net earnings from self-employment.

But under IRC §1402(a)(13), net earnings from self-employment *does not include* "the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services." This is often referred to as the "limited partner exception."

B. What's a "Limited Partner" for Purposes of the Limited Partner Exception?

The partnership argued that because its three limited partners were…wait for it…limited partners in a state law limited partnership, the limited partner exception applied without any further examination. But the Tax Court rejected this argument, agreeing with the IRS that the exception only applies to limited partners whose roles are functionally like that of a true limited partner.

The court observed that the purpose of the exception was to prevent limited partners who merely invested in a partnership and did not actively participate in business operations from earning social security coverage on what was, effectively, investment income. It thus makes sense to construe the exception as applying only to the distributive shares of limited partners who are involved merely as investors and not as active participants in the partnership's business. Invoking its decision in *Renkemeyer, Campbell & Weaver LLP v. Commissioner*, 136 T.C. 137 (2011), the court again proclaimed that limited partners who performed services for a partnership in their capacities as partners should be liable for self-employment taxes. In *Renkemeyer*, the court used a "functional analysis test" to determine whether a limited partner was truly a "limited partner, as such" or one who performed services for the partnership in the way in which a self-employed person would act.

But the court also noted that the *Renkemeyer* case involved law partners in a limited liability partnership, while this case involves an entity organized as a state law limited partnership. So the court had to determine whether the functional analysis test should be applied to limited partners in a state law limited partnership. The court concluded in the affirmative, noting simply that:

> If Congress had intended that that limited partners be automatically excluded, it could have simply said "limited partner" [in IRC §1402(a)(13)]. By adding "as such," Congress made clear that the limited partner exception applies only to a limited partner who is functioning as a limited partner.

161 T.C. No. 12 at 11. The partnership pointed to excerpts from the legislative history and other cases to support its argument that the exception applied to all limited partners regardless of their roles in the partnership, but the court found those references to be either out of context or merely statements of general rules and not official interpretations of the limited partner exception.

C. When Does the Court Have Jurisdiction to Examine the Role of Limited Partners?

Having determined that the limited partner exception only applies to those limited partners who truly function as limited partners, the court then had to consider whether the examination of the functions and roles of the limited partners should happen now at a partnership-level proceeding or whether it must wait until a partner-level proceeding. Under IRC §6226, the court has jurisdiction to redetermine "partnership items" when the tax matters matter petitions the court.

So is the substance of the limited partners' roles and activities for the partnership a "partnership item?" IRC §6231(a)(3) defines a partnership item as "any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level." Accepting the statutory invitation for guidance, Regulation §301.6231(a)(3)-1(b) identifies items that are more appropriately determined at the partnership level as including "the accounting practices and the legal and factual determinations that underlie the determination of the amount, timing, and characterization of items of income, credit, gain, loss, deduction, etc." The court concluded that because a functional analysis of the roles and activities of the limited partners involves factual determinations necessary to determine the partnership's total amount of net earnings from self-employment, this is a "partnership item" that can be considered in the current proceeding without having to await a partner-level proceeding.

D. More to Come

In mid-2024, the Tax Court is scheduled to consider another case in which the taxpayer is a limited liability limited partnership. The decisions in *Renkemeyer* (involving an LLP) and, now, *Soroban* (involving an LP) suggest that the same result will apply to LLLPs, but we will soon know more.

XV. CONSERVATION EASEMENT DEVELOPMENTS

A. New §170(h)(7) and Related Amendments (enacted December 29, 2022), Together with Proposed Regulations (published November 20, 2023)

Section 605 of the SECURE 2.0 Act of 2022 (itself part of the Consolidated Appropriations Act, 2023, signed by President Biden on December 29, 2022) enacted new §170(h)(7). Then, on November 20, 2023, Treasury issued proposed regulations implementing this new rule. Following is the text of the new Code provision with an annotated explanation, including relevant provisions from the proposed regulation.

§170(h)(7) – Limitation on deduction for qualified conservation contributions made by passthrough entities.
(A) In general. A contribution by a partnership (whether directly or as a distributive share of a contribution of another partnership) shall not be treated as a qualified conservation contribution for purposes of this section if the amount of such contribution exceeds 2.5 times the sum of each partner's relevant basis in such partnership.
(B) Relevant basis. For purposes of this paragraph –
(i) In general. The term "relevant basis" means, with respect to any partner, the portion of such partner's modified basis in the partnership which is allocable (under rules similar to the rules of section 755) to the portion of the real property with respect to which the contribution described in subparagraph (A) is made.
(ii) Modified basis. The term "modified basis" means, with respect to any partner, such partner's adjusted basis in the partnership as determined –
(I) immediately before the contribution described in subparagraph (A)
(II) without regard to section 752, and
(III) by the partnership after taking into account the adjustments described in subclauses (I) and (II) and such other adjustments as the Secretary may provide.

Subparagraph (A) sets forth the general rule, consistent with the proposed regulation, that denies a partner any conservation easement deduction where the amount of the deduction exceeds 2.5 times the applicable portion of the partner's basis in the partnership. Subparagraph (B) implements the "anti-stuffing rule" from Proposed Regulation §1.6011-9 to avoid an easy evasion of the 2.5 times rule.

The 2023 proposed regulations explain how an owner's modified basis should be computed for purposes of this rule. Proposed Regulation §1.170A-14(l)(2) provides for four adjustments to be made in this order:

- First, increase the owner's adjusted basis for any **contributions** made after the start of the entity's taxable year and ending with the moment immediately prior to the qualified conservation contribution.

- Second, adjust this figure for the owner's **hypothetical distributive share** of entity items from the start of the entity's taxable year to the moment immediately prior to the qualified conservation contribution.

- Third, reduce this figure (but not below zero) by the amount of any **distributions** made to the owner from the start of the entity's taxable year to the moment immediately prior to the qualified conservation contribution.

- Finally, in the case of a partnership, reduce this figure by the owner's share of **partnership liabilities**, if any. Although this adjustment may cause the modified basis amount to go negative, the 2.5 times rule is applied to the sum of each owner's relevant

basis, and that sum may still be a positive number after the relevant basis of each partner is considered.

The proposed regulations recognize that these adjustments do not always make sense in the context of an S corporation. For one thing, S corporation shareholders do not get basis credit for entity debt, like partners in a partnership. For another, the subchapter S pass-through rules require that all items pass through to shareholders on the last day of the taxable year. Accordingly, the proposed regulations provide that only the first two adjustments apply in the case of an S corporation. Prop. Reg. §1.170A-14(l)(3)(i).

(C) Exception for contributions outside 3-year holding period. Subparagraph (A) shall not apply to any contribution which is made at least 3 years after the latest of –

(i) the last date on which the partnership that made such contribution acquired any portion of the real property with respect to which such contribution is made,

(ii) the last date on which any partner in the partnership that made such contribution acquired any interest in such partnership, and

(iii) if the interest in the partnership that made such contribution is held through 1 or more partnerships –

(I) the last date on which any such partnership acquired any interest in any other such partnership, and

(II) the last date on which any partner in any such partnership acquired any interest in such partnership.

The exception in subparagraph (C) essentially narrows the scope of subparagraph (A) to deny a deduction only where the partnership makes the conservation easement contribution within three years of the partnership's acquisition of the real property or the partner's acquisition of the partnership interest. In the typical syndicated conservation easement scheme, the entity purchases the subject land and immediately places an easement on the property. So where the entity has held the subject property for a long time, the transaction apparently no longer resembles a syndicated conservation easement transaction.

Yet while the statute does not define the phrase "acquired any interest," the 2023 proposed regulations provide that, in the case of an S corporation, it refers to "any transfer, issuance, redemption, or other disposition of stock in the S corporation" except for any proportionate issuance or redemption. Prop. Reg. §1.170A-14(n)(2)(iii). In the case of a partnership, any "variation" within the meaning of Regulation §1.706-4(a)(1) will suffice. The preamble to the 2023 proposed regulations explains that variations include acquisitions, partial dispositions, and complete dispositions. Rather than re-invent the wheel, the IRS found it simpler to incorporate those rules by reference.

(D) Exception for family partnerships.

(i) In general. Subparagraph (A) shall not apply with respect to any contribution made by any partnership if substantially all of the partnership interests in such partnership are held,

directly or indirectly, by an individual and members of the family of such individual.

(ii) Members of the family. For purposes of this subparagraph, the term "members of the family" means, with respect to any individual –

(I) the spouse of such individual, and

(II) any individual who bears a relationship to such individual which is described in subparagraphs (A) through (G) of section 152(d)(2).

(E) Exception for contributions to preserve certified historic structures. Subparagraph (A) shall not apply to any qualified conservation contribution the conservation purpose of which is the preservation of any building which is a certified historic structure (as defined in paragraph (4)(C)).

Subparagraphs (D) and (E) create two more exceptions from the general rule, one applicable where substantially all of the partnership interests are owned by one family, and another for contributions that preserve certified historic structures if the contributing partnership reports the contribution and provides information about the donation on its federal income tax return.

As for the family partnership exception, note that the statute defines "family" as one's spouse and dependents, but it does not define when "substantially all" of the entity interests are held by one family. The 2023 proposed regulations fill this gap, stating that "substantially all" means at least 90-percent ownership. Prop. Reg. §1.170A-14(n)(3)(i). In the case of a partnership, the family must own 90 percent of the interests in capital and profits. Prop. Reg. §1.170A14(n)(3)(ii)(A). In the case of an S corporation, the family must own 90 percent of the voting power and value of the stock. Prop. Reg. §1.170A-14(n)(3)(ii)(B). The 2023 proposed regulations include anti-abuse rules under which the family must have held the subject real property for at least one year and the family must be allocated at least 90 percent of the resulting charitable contribution deduction. This latter rule prevents a partnership from allocating most of the deduction to a non-family member.

(F) Application to other passthrough entities. Except as may be otherwise provided by the Secretary, the rules of this paragraph shall apply to S corporations and other pass-through entities in the same manner as such rules apply to partnerships.

(G) Regulations. The Secretary shall prescribe such regulations or other guidance as may be necessary or appropriate to carry out the purposes of this paragraph, including regulations or other guidance –

(i) to require reporting, including reporting related to tiered partnerships and the modified basis of partners, and

(ii) to prevent the avoidance of the purposes of this paragraph.

Subparagraph (F) makes clear that the term "partnership" includes all pass-through entities, including S corporations. Finally, subparagraph (G) gives Treasury the authority to issue implementing regulations, which it did through the 2023 proposed regulations herein discussed.

B. The Eleventh Circuit's Decision in *Hewitt* Persists (*Glade Creek Partners LLC v. Commissioner*, T.C. Memo. 2023-82, June 29, 2023)

On remand from the Eleventh Circuit, the Tax Court has held that a limited liability company's conservation easement deduction was limited to its basis in the real property subject to the easement because that property was inventory in the hands of the member that contributed it to the LLC.

An investment entity acquired about 2,000 acres in Tennessee for just over $9 million in 2006. That entity transferred the property to Hawks Bluff Investment Group, Inc., an S corporation, in 2010. In 2012, Hawks Bluff contributed the land to the taxpayer in exchange for a 98-percent interest in the taxpayer. Shortly thereafter, the taxpayer granted an easement on the land to Atlantic Coast Conservancy, Inc., and claimed a charitable contribution deduction of $17.5 million on its 2012 income tax return. The IRS initially disallowed the deduction on the grounds that the deed violated the so-called "proceeds regulation," Reg. §1.170A-14(g)(6)(ii), because it provided that the charity would receive only a share of the *net* proceeds in the event of a judicial extinguishment and sale and not a share of the *gross* proceeds. The Tax Court agreed, consistent with its precedent. *Glade Creek Partners LLC v. Commissioner*, T.C. Memo. 2020-148. But in an unpublished opinion dated August 22, 2022, the Eleventh Circuit vacated the Tax Court's decision, holding the proceeds regulation was invalid under *Hewitt v Commissioner,* 21 F.4th 1336 (11th Cir. 2021). (*Hewitt* held that the proceeds regulation was not promulgated in compliance with the Administrative Procedure Act, though the Sixth Circuit in *Oakbrook Land Holdings, LLC v. Commissioner*, 28 F.4th 700 (6th Cir. 2022), found the proceeds regulation was enacted in compliance with the APA and thus valid. The taxpayer in *Oakbrook* appealed to the Supreme Court of the United States but the Court denied the petition for certiorari in January, 2023.) It thus remanded the case back to the Tax Court for further determination as to the amount deductible.

The well-accepted practice in valuing a conservation easement is to subtract the value of the property now subject to the perpetual restriction on its use from the value of the property at its highest and best use. The taxpayer initially claimed this resulted in a value of $17.5 million, but the Tax Court originally held that the taxpayer's expert had failed to follow industry practice and thus overstated the value of the land at its highest and best use. Ultimately, the Tax Court found that the value of the easement was just under $8.9 million. Because the taxpayer claimed a deduction nearly double that amount, the Tax Court held that a substantial valuation understatement penalty applied and that the taxpayer did not qualify for the "reasonable cause" exception from that penalty.

The Eleventh Circuit's unpublished opinion affirmed all of these decisions. It found no clear error in the Tax Court's computation of the easement's value. It likewise affirmed the lower court's conclusion that the taxpayer did not qualify for the reasonable cause exception for there was no evidence of a good faith investigation by the taxpayer into the value of the property but instead just a blind acceptance of the appraisal.

Because the Eleventh Circuit upheld the Tax Court's original calculation of the fair market value of the easement, one would think the Tax Court would have little left to determine. But on this latest remand, the IRS argued for the first time that the taxpayer's deduction should be limited to its basis in the property to which the easement relates because the property was inventory in the hands of Hawks Bluff, the contributing member. If the land was inventory, IRC §170(e)(1)(A) would effectively limit the deduction to basis, as it requires the amount of the deduction to be reduced by "the amount of gain which would not have been long-term capital gain … if the property contributed had been sold by the taxpayer at its fair market value." As for whether the land was inventory to the LLC, IRC §724(b) states that if a partner contributes inventory property to a partnership, any gain or loss recognized by the partnership upon a disposition of the property within five years is treated as ordinary income or loss.

The taxpayer argued that the easement was investment property in the hands Hawks Bluff, but the Tax Court rejected this contention. The court noted that precedent in the Eleventh Circuit identifies seven factors to be considered in determining whether property is "held for sale to customers in the ordinary course of business" and, thus, inventory:

> (1) the nature and purpose of the acquisition of the property and the duration of the ownership; (2) the extent and nature of the taxpayer's efforts to sell the property; (3) the number, extent, continuity, and substantiality of the sales; (4) the extent of subdividing, developing, and advertising to increase sales; (5) the use of a business office for the sale of the property; (6) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and (7) the time and effort the taxpayer habitually devoted to the sales.

While the court acknowledged that most of the factors relate to sales and marketing activities (of which there were none), the court quickly noted that the factors do not have equal weight. Instead, said the court, significant weight should be given to the fact that Hawks Bluff took the position on its 2012 federal income tax return that it was in the business of selling real estate and that the subject property was inventory. Indeed, when Hawks Bluff then sold its interest in the taxpayer the day after contribution, it reported the resulting loss as an ordinary loss. The taxpayer argued that Hawks Bluff improperly reported the loss as an ordinary loss just to get better tax treatment for the loss, but the court faulted the taxpayer for presenting no evidence that Hawks Bluff or its predecessor ever held the land for investment purposes. With such evidence lacking, the position taken by Hawks Bluff on its 2012 federal income tax return gets significant weight.

The taxpayer argued that even a dealer in real property can hold land for investment, but the court observed that in such cases the burden of proof is on the taxpayer to prove that any given parcel was held for investment and not as inventory. Here again, said the court, proof was lacking. "Hawks Bluff did not segregate the easement property … in a manner sufficient to meet petitioner's burden to show that the easement property was investment property."

Accordingly, the court held that the deduction would be limited to the taxpayer's basis in the underlying land. Based on evidence in the record, that would reduce the amount of the deduction to just over $3.86 million.

C. Safe Harbor Deed Language Published

Section 605(d)(1) of the SECURE 2.0 Act of 2022 (enacted on December 29, 2022) mandates that "The Secretary of the Treasury (or such Secretary's delegate) shall, within 120 days after the date of the enactment of this Act, publish safe harbor deed language for extinguishment clauses and boundary line adjustments." Section 605(d)(2)(A) then provides that:

> During the 90-day period beginning on the date of publication of the safe harbor deed language under paragraph (1), a donor may amend an easement deed to substitute the safe harbor language for the corresponding language in the original deed if (i) the amended deed is signed by the donor and donee and recorded within such 90-day period, and (ii) such amendment is treated as effective as of the date of the recording of the original easement deed.

This 90-day "opportunity to correct" is not available in four situations: (1) the contribution is part of a reportable transaction; (2) the contribution is described in *Notice 2017-10*; (3) the claimed deduction exceeds 2.5 times the donor's basis and thus comes within new §170(h)(7); or (4) the contribution is the subject of a case that is either already docketed in a federal court or for which a penalty has already been determined administratively or judicially. See §05(d)(2)(B).

In *Notice 2023-30* (April 10, 2023), the IRS, pursuant to this statutory mandate, issued safe-harbor language for extinguishment clauses and boundary line adjustment clauses in conservation easement deeds. Here is the safe harbor deed language related to **extinguishments**:

> *Pursuant to Notice 2023-30, Donor and Donee agree that, if a subsequent unexpected change in the conditions surrounding the property that is the subject of a donation of the perpetual conservation restriction renders impossible or impractical the continued use of the property for conservation purposes, the conservation purpose can nonetheless be treated as protected in perpetuity if (1) the restrictions are extinguished by judicial proceeding and (2) all of Donee's portion of the proceeds (as determined below) from a subsequent sale or exchange of the property are used by the Donee in a manner consistent with the conservation purposes of the original contribution.*
>
> <u>*Determination of Proceeds*</u>*. Donor and Donee agree that the donation of the perpetual conservation restriction gives rise to a property right, immediately vested in Donee, with a fair market value that is at least equal to the proportionate*

value that the perpetual conservation restriction, at the time of the gift, bears to the fair market value of the property as a whole at that time. The proportionate value of Donee's property rights remains constant such that if a subsequent sale, exchange, or involuntary conversion of the subject property occurs, Donee is entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction, unless state law provides that the donor is entitled to the full proceeds from the conversion without regard to the terms of the prior perpetual conservation restriction.

Here is the safe harbor language related to **boundary line adjustments**:

Pursuant to Notice 2023-30, Donor and Donee agree that boundary line adjustments to the real property subject to the restrictions may be made only pursuant to a judicial proceeding to resolve a bona fide dispute regarding a boundary line's location.

Notice 2023-30 makes clear that while an amended deed may use this language verbatim, it is enough to use terms that have the same meaning. Thus, for example, if the original deed speaks of a "Grantor" and "Grantee," the amended deed may use those terms instead of "Donor" and "Donee" in the safe harbor language, and if the original deed spoke of an "easement" or "servitude" instead of a "restriction," the amended deed can still use those terms.

Notice 2023-30 was published on April 24, 2023. The ninetieth day following that was July 22, 2023, but because that was a Saturday, the deadline for amending conservation easement deeds and have the new language take retroactive effect was Monday, July 24, 2023. Still, the language is helpful for future conservation easement deeds.

It is not clear why the SECURE 2.0 Act required safe harbor deed language for boundary line adjustment clauses in addition to safe harbor language for extinguishment clauses. Indeed, *Notice 2023-30* even states that "[n]either the Code nor the regulations specifically address boundary line adjustments." Perhaps this is a solution in search of a problem, or maybe Congress simply anticipated that a boundary line dispute would pose the same conceptual risk to the perpetuity requirement as is presented from an extinguishment of the easement due to changed circumstances. While neither an extinguishment nor a boundary line adjustment is likely to happen, donors will want to take advantage of this form language to assure themselves that these provisions in their deeds will not cause them to lose the income tax deduction resulting from the donation.

D. Deduction Allowed, But at Reduced Valuation (*Mill Road 36 Henry, LLC v. Commissioner*, T.C. Memo. 2023-129, October 26, 2023)

The Tax Court has held that the donation of a conservation easement on 33 acres of a 40-acre tract held by the taxpayer, a limited liability company, was a qualified conservation contribution and that the LLC substantiated the donation with a qualified appraisal. But the

court also held that the taxpayer greatly overstated the value of the easement, that the taxpayer's deduction was limited to its adjusted basis in the contributed property, and that negligence penalties applied.

In 2015, two real estate professionals, acting through business entities, partitioned a 117-acre parcel of land on the southern edge of Atlanta, Georgia, into separate tracts. This case involves one of the tracts, a 40-acre parcel consisting of undeveloped land with a "wetland area" and "riparian buffer." That tract was contributed to the taxpayer, while the remaining tracts were sold to other entities. At the time of contribution, the adjusted basis of the 40-acre tract was about $416,000.

In September, 2016, an investment fund paid $1 million for a 97-percent interest in the taxpayer. Three months later, the taxpayer donated a conservation easement covering 33 acres of the property to the Southern Conservation Trust, a qualified charity. On its federal income tax return, the taxpayer claimed a charitable contribution deduction in the amount of $8,935,000, representing the value of the easement as determined by an appraisal submitted with the return. After an examination, the IRS determined that the taxpayer's deduction should be disallowed or, in the alternative, that the amount of the deduction be limited to no more than $510,400. This led the taxpayer to seek a determination from the Tax Court.

1. Was the Donation a Qualified Conservation Contribution?

The IRS argued that the taxpayer should get no deduction because the taxpayer sought only to create a federal income tax deduction for its members and therefore lacked donative intent, pointing to a private placement memo given to investors in the investment fund promising a tax benefit of 4.25 times their original investments. But the Tax Court held it is sufficient that the taxpayer in fact donated an easement to charity. That a donor might be motivated by an income tax deduction does not detract from the fact that a donor makes a gift by transferring cash or property to a charity for less than full consideration.

The IRS also argued that the contribution does not serve a conservation purpose, as required by IRC §170(h)(2). According to the IRS, the easement does not protect a significant habitat or ecosystem, but the court noted that while the subject property is not home to any endangered or rare species, it contains four "high priority habitats" including forests, a beaver pond, and streams. That is sufficient to be a conservation purpose. Moreover, the easement preserves open space, ensuring that a "forested view will exist in perpetuity along Mill Road." In response to the IRS's claim that the parcel was too small to serve a conservation purpose, the Tax Court observed:

> The easement area is 33 acres of the 40-acre Mill Road Tract. Admittedly, this is not Yellowstone, with its 2.2 million acres. But in a suburban setting, an easement covering 33 acres is hardly negligible. It may be illuminating to compare the Mill Road easement not to Yellowstone but instead to something like the 50-acre Boston Common, which is the oldest and one of the best known city parks in the

> United States. … An undeveloped area, even on this modest scale—and especially when surrounded by development in an urban or suburban setting—can be a noteworthy and beneficial feature.

Finally, the IRS claimed the contribution did not serve its purpose in perpetuity because of rights to enjoy the property for recreational purposes that were retained by the taxpayer. The Tax Court rejected this, too, finding that even if the reserved rights were exercised to the fullest extent allowable under the deed, the conservation purposes would still be served. Having rejected all of the claims against the validity of a deduction, the Tax Court concluded that the taxpayer made a qualified conservation contribution.

2. Was There a "Qualified Appraisal" by a "Qualified Appraiser?"

But where the amount of a charitable contribution deduction exceeds $500,000, IRC §170(f)(11) requires a taxpayer to substantiate the deduction by attaching a "qualified appraisal" to the return. The taxpayer attached an appraisal, but the IRS claimed that it was deficient in two respects.

First, said the IRS, the taxpayer's appraiser was not a "qualified appraiser," one of the requirements for a qualified appraisal. Regulation §1.170A-13(c)(5)(ii) states that an appraiser is not qualified where "the donor had knowledge of facts that would cause a reasonable person to expect the appraiser falsely to overstate the value of the donated property." Here, said the IRS, the taxpayer's members knew the value claimed by the appraiser was far in excess of the actual value of the appraisal. But even if that was so, ruled the court, the regulation asks whether the taxpayer knew that the *appraiser* was crooked enough to overstate the value of the easement, not whether the taxpayer knew of facts that make the honest appraiser's assessment obviously overstated. And here there was no evidence that the taxpayer's appraiser was knowingly inflating the value of the easement. Although information furnished to the appraiser suggested that the property had been approved for a use as a large-scale senior living facility when in fact such approval had only been recommended, there was no evidence that the appraiser knew of this distinction. Thus, an appraisal based on the assumption that the property was approved for such use is not evidence that the appraiser was "in on" any scheme to manufacture an arbitrarily high deduction amount.

Second, said the IRS, two other appraisers involved in the valuation did not sign the final appraisal report, as required by Regulation §1.170A-13(c)(5)(iii). The Tax Court held this was not an error, as the two individuals were employees of the appraiser who did sign the report, and at all times they were acting under his direction and supervision. Accordingly, the court ruled that the taxpayer in fact submitted a qualified appraisal with its return.

3. What is the Value of the Easement?

But even where a taxpayer submits a qualified appraisal, the IRS can claim the appraisal reaches the wrong conclusion as to value, which is where the court next heads. At the Tax

Court, both sides presented reports from experts as to the value of the donated easement. The taxpayer's expert concluded that the easement was worth $6,695,000, but the IRS's expert concluded it was worth no more than $900,000.

The Tax Court rejected the report of the taxpayer's expert, noting it too was based on the assumption that the property was approved for use as a high-occupancy assisted living facility. Although the county had in fact recommended approval of the use of the property for this purpose, the taxpayer withdrew its application on the eve of donation. The court noted that the county only approved a finite number of assisted living facilities, so there was hardly any guarantee that a new application would be recommended for approval. And even if there was approval of a later application, the Georgia Division of Healthcare Facilities would very likely not allow the 677-unit facility assumed by the taxpayer's expert, as the typical capacity approved by the state ranges from 60 to 120 units. Finding the taxpayer's expert assumption "extraordinary" and "grossly excessive," coupled with the use of evidence of comparable sales from outside the subject property's county, the Tax Court opted to adopt the report from the IRS's expert that the value of the easement was $900,000. That report used in-county comparables and more accurately assumed the highest and best use of the property would be for a much smaller assisted living facility.

4. Was the Deduction Limited to Basis?

Having determined the value of the easement was only $900,000—about ten percent of the amount originally claimed by the taxpayer on its federal income tax return—the Tax Court went on to hold that because the property was inventory in the hands of the taxpayer, the deduction was limited to the taxpayer's $416,000 basis in the contributed property under IRC §170(e)(1)(A). That provision requires the amount of the deduction to be reduced by any amount that would not be long-term capital gain upon sale of the donated property. If the property given to charity is inventory, therefore, the deduction is reduced to the taxpayer's basis in the donated inventory.

The taxpayer argued the property was not inventory because the land was the taxpayer's sole asset and because 97 percent of the taxpayer was owned by a fund controlled by investors who were not themselves dealers in real property. But the Tax Court observed that the taxpayer's original members (and the parties that contributed the land to the taxpayer) were engaged in the business of buying and selling real estate. Where a partnership acquires inventory from a contributing partner, that property is inventory to the partnership, at least for purposes of sales within five years of contribution. See IRC §724(b). It does not matter that at the time of donation that 97 percent of the taxpayer's equity was held by non-dealer investors. Because the taxpayer donated a conservation easement on inventory, its deduction was limited to its $416,000 basis in that property.

5. What Penalties Apply?

The IRS argued that the taxpayer owed a fraud penalty on top of a 40-percent gross valuation misstatement penalty on the amount deducted in excess of $900,000 and a 20-percent substantial understatement penalty on the amount deducted in excess of $416,000 but not in excess of $900,000. The Tax Court rejected the fraud penalty, finding just the opposite: the taxpayer had disclosed everything required to be reported on its return, to the point of flagging that this was a syndicated conservation easement transaction with a value well in excess of the basis of the contributed property. But because the claimed value of the deduction was so far in excess of the finally determined amount, the court upheld the understatement penalties.

E. Conservation Easement Deduction Denied on Two Grounds (*Oconee Landing Property, LLC v. Commissioner*, T.C. Memo. 2024-25, February 21, 2024)

The Tax Court has held that a syndicated conservation easement transaction resulted in no charitable contribution deduction, both because the taxpayer did not attach a qualified appraisal of the contributed property and because the taxpayer did not prove that its basis in the ordinary income property donated to charity exceeded zero.

1. Facts

The case involves a conservation easement on 355 acres of land just south of Interstate 20 in Greene County, Georgia. The property abuts Reynolds Plantation, a vast retirement, vacation, and golfing destination along Lake Oconee. It was contributed to the taxpayer, a limited liability company, on December 21, 2015, along with about $4 million in cash from investors. Most of the cash was paid to the entity that contributed the land, effectively making for a total investment of about $4 million. Ten days later, on December 31, 2015, the taxpayer donated a conservation easement on the property to the Georgia-Alabama Land Trust. Two other LLCs made similar donations of adjoining parcels of real property on the same date.

The taxpayer claimed a charitable contribution deduction of $20.67 million for the donation, an amount more than five times the value paid by the taxpayer's investors for the property. After an examination, the IRS determined that the taxpayer was not entitled to a deduction because the transfer to the land trust lacked donative intent. In the alternative, the IRS determined that the value of the easement was only about $1.4 million. In either case, the IRS concluded, the taxpayer owed a 40-percent "gross valuation misstatement" penalty or, alternatively, a 20-percent accuracy-related penalty.

2. Donative Intent

The IRS argued that the taxpayer was not entitled to a deduction because the primary purpose of the transaction was to generate a substantial income tax deduction for the taxpayer's investors. But the Tax Court held that such a motive does not suffice to disallow a

charitable contribution deduction. The IRS argued the transaction was a *quid pro quo* arrangement, but the court observed that cases denying a deduction for lack of donative intent involve the taxpayer receiving something of value *from the donee*, and in this case the land trust did not provide any consideration for the donation. In this case, the benefit to the investors came from the government in the form of a tax deduction, not from the land trust. No other case has treated income tax benefits as negating a donor's charitable intent, and this court was not going to be the first to do so.

3. Qualified Appraisal

The IRS had more success challenging the status of the taxpayer's appraisers as "qualified appraisers." Recall that IRC §170(f)(11) generally requires that a taxpayer deducting non-cash contributions in excess of $500,000 attach to the income tax return a "qualified appraisal" that has been prepared by a "qualified appraiser." The taxpayer's 2015 tax return attached an appraisal performed by two individuals that generally meet the requirements of "qualified appraisers," but the IRS argued that the exception in Regulation §1.170A-13(c)(5)(ii) applied. Under that exception, an individual is not a "qualified appraiser" if the taxpayer "had knowledge of facts that would cause a reasonable person to expect the appraiser falsely to overstate the value of the donated property" because, for instance, the taxpayer and the appraiser had "an agreement concerning the amount at which the property will be valued and the donor knows that such amount exceeds the fair market value of the property."

Sure enough, there was evidence that the taxpayer, through its ultimate managers, knew that the subject property was worth considerably less than the amount stated on the appraisal. Those managers had "persistently marketed" the subject property for sale in the years leading up to the taxpayer's formation and donation, all at prices far below the amount indicated on the appraisal. The managers "may have believed that the property had considerable intrinsic value and might ultimately be developed into the [property] of their dreams," noted the court. "But they were shrewd, experienced, and highly sophisticated real estate developers." And because they could not sell the property for the price they wanted, "they were determined to get proceeds of at least $7 million through the easement transaction."

There was also evidence that the taxpayer's managers, acting through intermediaries, had communicated to the appraisers the valuation range that would be required to generate the intended tax savings. The taxpayer argued that it had put a "wall" in place to make sure the managers never communicated directly with the appraisers, but the Tax Court concluded the wall "was both transparent and porous" because there was a "daisy chain of intermediaries … who ensured that all critical information was passed back and forth across the chain." Thus, concluded the court, the appraisers were not "qualified appraisers" in this matter, meaning the taxpayer did not substantiate the claimed deduction, resulting in its disallowance.

4. Ordinary Income Property

Under IRC §170(e)(1), the deduction for a donation of ordinary income property is limited to the taxpayer's basis in the property. The taxpayer claimed that the subject property was a capital asset, but the IRS determined the property was held primarily for sale to customers and thus not a capital asset under IRC §1221(a)(1). The taxpayer is a partnership for federal income tax purposes, and under IRC §724(b), property that is not a capital asset in the hands of a contributing partner is likewise not a capital asset in the hands of the partnership where the partnership disposes of the property within five years of the contribution. So here, the character of the real property to which the taxpayer's conservation easement relates depends on its character in the hands of the entity that contributed it to the taxpayer.

Because an appeal in this case would head to the Eleventh Circuit, the Tax Court applied precedent from the Eleventh Circuit stating that whether a taxpayer holds property for sale to customers depends on a consideration of seven factors:

> (1) the nature and purpose of the property's acquisition and the duration of the taxpayer's ownership; (2) the extent of the taxpayer's efforts to sell the property; (3) the number, extent, continuity, and substantiality of the sales; (4) the extent of subdividing, developing, and advertising to increase sales; (5) the use of a business office for sale of the property; (6) the degree of supervision exercised by the taxpayer over any broker hired to sell the property; and (7) the time and effort the taxpayer habitually devoted to the sales activity. *Boree v. Commissioner*, 837 F.3d 1093, 1100 (11th Cir. 2016) (citing *United States v. Winthrop*, 417 F.2d 905, 909-10 (5th Cir. 1969))….

The court concluded that these factors indicated that the subject property was held for sale to customers and, thus, was ordinary income property. That the property came to the LLC through two real estate developers who spent several years marketing the property in an effort to sell it convinced the court that the real estate was, in the hands of the developers and the entity they created, inventory property.

The taxpayer argued that even if the *underlying land* was ordinary income property, the *easement* was necessarily a capital asset because no one was in the business of selling easements to customers. The court had little tolerance for this position, stating "This argument has little appeal to common sense." Just as the charitable donation of an auto engine by a car dealership would be a donation of ordinary income property, the donation of an interest in land by one who holds the land as inventory is likewise a donation of ordinary income property.

Thus, under IRC §170(e)(1), the amount of the deduction was limited to the taxpayer's basis. The taxpayer's completed Form 8283 stated that the basis of the property was about $3.3 million, derived from the contributing partner's 2014 tax return. But there was no evidence substantiating this claimed amount, and the court noted that "An entry on a tax return simply states the taxpayer's position as to an item; it does not constitute evidence." And when the

court says there is no evidence, it means there is *no evidence*: nothing about the original price paid by the developers, nothing about the costs of any improvements, and nothing to support a claim that any purchase price should be apportioned equally among each individual acre. And where a taxpayer cannot prove that basis exceeds zero, the basis is treated as zero. Accordingly, the taxpayer is entitled to a deduction of zero.

5. Valuation of the Easement and Penalties

In order to determine whether the taxpayer is subject to penalties in connection with the claimed deduction, the court had to determine the value of the easement. The court first determined that the highest and best use of the land was as "a speculative hold for future mixed-use development." It then employed a comparable sales approach to determine the "before value" of the land. The IRS's expert claimed this came to just over $5.3 million. The taxpayer's experts based their analysis on the highest and best use of the property being residential development. Because the Tax Court rejected this position, it thus rejected the valuation estimates from those experts. This led the court to adopt the valuation of the IRS's expert. The court also accepted that the "after value" of the land—now encumbered by a perpetual conservation easement—was just over $350,000. Thus the value of the easement was just over $4.9 million.

But the taxpayer, remember, claimed the value of the easement was $20.67 million, an amount over four times the value computed by the court. Since the value claimed on the return was more than double the correct amount, the 40-percent gross valuation misstatement penalty applies.

6. Observation

Under current law, the transaction in this case would offer a limited benefit even if the subject property was a capital asset. Specifically, IRC §170(h)(7), enacted at the end of 2022, provides that a partnership will not be entitled to a charitable contribution deduction if the claimed value of a donated conservation easement exceeds 2.5 times the aggregate bases of the partners in the partnership. What's more, the "gross valuation misstatement" penalty applies to any deduction rejected pursuant to this rule, and there is no "reasonable cause" defense to the penalty, even for reasonable reliance on qualified professionals.

XVI. PROPOSED REGULATIONS CLARIFY DONOR ADVISED FUND DISTRIBUTIONS SUBJECT TO EXCISE TAXES (*Proposed Regulation §§53.4996-1 through 53.4996-6*, November 14, 2023)

Treasury has announced draft guidance related to taxable distributions from "donor advised funds" (DAFs) under IRC §4966(a)(1). That statute imposes a 20-percent excise tax on a DAF's "sponsoring organization" for each "taxable distribution." The proposed regulations supplement the statutory definitions of these terms. Prop. Reg. §53.4966-1. Special attention is given to the definition of a DAF, Prop. Reg. §53.4966-3, and to exceptions from this definition,

Prop. Reg. §53.49566-4. The proposed regulations also go into greater detail as to the definition of a "taxable distribution" for purposes of the excise tax. Prop. Reg. §53.4966-5. The proposed regulations would become effective when published as final regulations. Prop. Reg. §53.4966-6.

A. Definition of a DAF

It is important as a threshold matter to know whether a distribution has been made from a DAF as opposed to an account that is not a DAF, for only distributions from a DAF face the 20percent excise tax. If the account is not a DAF, the excise tax cannot apply.

The Code requires that a DAF must be "separately identified" by a sponsoring organization. IRC §4966(d)(2)(A)(i). Under the proposed regulations, if the sponsoring organization "maintains a formal record of contributions to the fund or account relating to a donor or donors," this requirement is met. Prop. Reg. §53.4966-3(b)(1). In the absence of a formal record, the requirement can still be met if all the facts and circumstances indicate that a fund or account is so held. *Id.* Among the factors to be considered are whether the fund is named for one mor more donors or persons related to them, whether the sponsoring organization refers to the account as a DAF, and whether the donor receives regular accountings from the sponsoring organization. Prop. Reg. §53.4966-3(b)(2). A commingling of account funds with other assets of the sponsoring organization is not fatal to a claim that the organization has separately identified the account as a DAF. Prop. Reg. §53.4966-3(c).

The Code also requires that at least one donor has (or reasonably expects to have) "advisory privileges" with respect to distribution and investment decisions related to the account. This does not require that the donor actually give such advice or exercise such privileges to any extent. Prop. Reg. §53.4966-3(c)(1)(i). But it does require an examination of all facts and circumstances. *Id.* The proposed regulations state that a donor is deemed to have advisory privileges where: (1) the sponsoring organization allows the donor to give nonbinding advice as to distributions or investments; (2) the sponsoring organization and the donor have a written agreement stating the donor has advisory privileges; (3) the donor receives a document or marketing material indicating the donor may provide advice regarding distributions or investments; or (4) the sponsoring organization generally solicits such advice from the donor. Prop. Reg. §53.4966-3(c)(2). The proposed regulations offer eleven examples illustrating the application of these rules. Prop. Reg. §53.4966-3(e).

The proposed regulations also make clear that a fund established to make distributions to a single organization generally will not qualify as a DAF, except where the donor likewise has advisory privileges with respect to the recipient organization's use of a distribution for the benefit of other individuals or entities or where distributions to that entity will provide a "more than incidental benefit" to the donor or to another person related to the donor. Prop. Reg. §53.4966-4(a). The proposed regulations offer three examples illustrating these rules.

The proposed regulations also clarify that certain funds used to grant scholarships may not qualify as DAFs. Prop. Reg. §53.4966-4(b). Specifically, an account is not a DAF if the donor's

advisory privileges relate “to which individuals receive grants for travel, study, or other similar purposes” if:

- The sole purpose of the account is to make grants for travel, study, or similar purposes;

- The donor’s advisory privileges extend only to serving on the selection committee selecting award recipients;

- All members of the selection committee are appointed by the sponsoring organization;

- No combination of donors or related persons controls the selection committee;

- Grants from the account are based on objective and nondiscriminatory criteria pursuant to an approved, written procedure; and

- The account maintains adequate records proving recipients were selected on an objective and nondiscriminatory basis.

Id. The proposed regulations offer guidance for determining whether the selection committee is “controlled” by donors or related persons, as well as three examples illustrating application of these rules.

B. Taxable Distributions

The proposed regulations generally provide that a “taxable distribution” is any distribution to a “natural person” or any distribution to “any other person” where the distribution is for any purpose other than a charitable purpose or where the sponsoring organization does not exercise “expenditure responsibility” with respect to the distribution. Prop. Reg. §53.49665(a)(1). The proposed regulations defer to Regulation §53.4945-5(b) – (e) for procedures to be followed for the sponsoring organization to have expenditure responsibility for a distribution. Prop. Reg. §53.4966-5(d).

Any distribution from a DAF to a public charity, to the sponsoring organization, or to another DAF will not be treated as a taxable distribution. Prop. Reg. §53.4966-5(a)(2). But where, for example, a donor advises a distribution from a DAF to a charity subject to an agreement between the charity and the donor that the charity will use the funds for the benefit of individuals selected by the donor, the distribution will be treated as having been made directly to those individuals (thus making the distribution subject to the excise tax). Prop. Reg. §53.4966-5(a)(3).

XVII. QUALIFIED PERSONAL RESIDENCE TRUSTS ARE BECOMING POPULAR AGAIN, AND CASES ARE STARTING TO APPEAR

In the past 15 years, very few qualified personal residence trusts ("QPRTs") were created, largely because the strategy works best when the applicable federal rates of interest are high. With recent increases in interest rates, some planners have pulled QPRTs from the deep freeze and have started adding them to some client estate plans. The following cases offer helpful reminders about potential traps from using QPRTs.

A. QPRT Loses Claim for Stepped-up Basis of House at Grantor's Death (*Palermo v. United States*, S.D. Florida, August 7, 2023)

A federal district court has granted the IRS's motion to dismiss a federal income tax refund claim made by the trustee of a qualified personal residence trust. The trust's claim was rejected on procedural grounds, but the trust may well have lost on the merits had the court been forced to consider them. Let's consider the facts in this rather unique case.

In 2002, Peter Palermo created a qualified personal residence trust to which he conveyed his home, retaining a right to occupy the home for a five-year term. The trust named Peter's son, Gregory, as trustee. In 2007, after Peter's retained interest terminated, Gregory, acting in his capacity as trustee, leased the property back to Peter under two consecutive one-year leases. When those leases terminated in 2009, Gregory and Peter entered into a 99-year lease that would expire upon Peter's death.

Peter died in 2015. The next year, the trust sold the house for $1.875 million. On its federal income tax return for 2016, the trust claimed a "stepped-up basis" in excess of $2 million for the house, resulting in a capital loss of about $126,000. The IRS determined that the trust could not use a stepped-up basis and assessed a deficiency. The trust paid the deficiency (plus penalties and interest) in 2021. Gregory, still in his capacity as trustee, then filed a Form 843, Claim for Refund or Request for Abatement, seeking a refund of the amount paid. When the IRS did nothing, Gregory brought this refund action.

The IRS moved to dismiss the action for lack of jurisdiction, and the district court judge granted the motion. Before a taxpayer can bring a refund suit, the taxpayer must first make a proper claim for refund with the IRS. In this case, Gregory failed to bring a proper claim for refund because he filed the wrong form. Form 843 is used when seeking a refund of taxes other than income taxes. Furthermore, Regulation §301.6402-3(a)(4) provides that a claim for refund of income taxes paid by an estate, trust, tax-exempt organization must be made on an amended income tax return. Gregory never filed an amended income tax return for the trust. Because he never made a proper claim for refund with the IRS, then, a refund suit in federal district court is premature.

Gregory then argued that even if the Form 843 was the wrong method for seeking a refund from the IRS, the form gave the IRS fair notice of the nature of his claim. There is precedent for the proposition that an "informal claim," one that lacks the formal requirements for a refund, may be sufficient to give a court jurisdiction if it gives the IRS fair notice of the taxpayer's claim, but that precedent also requires that any defect in the formal claim be corrected. In other words, Gregory's argument for an "informal claim" requires that an amended return to be filed by the trust at some point. As of the time of the court's decision, however, no amended return had been filed. Accordingly, the court granted the IRS's motion to dismiss, but did so without prejudice, presumably leaving Gregory with the option to file an amended income tax return on behalf of the trust to restart the refund process, assuming there is still time for an amended return.

Gregory's suit also sought injunctive and declaratory relief "to determine that … income tax was incorrectly determined and to have the estate tax return reviewed" because "the IRS took a position that was arbitrary and contrary to previous positions taken," but the court likewise dismissed this claim. An injunction "would constitute judicial intervention that challenges the IRS's method for determining taxes," which the court held would violate the Anti-Injunction Act, set forth in IRC §7421(a). It also determined the claim was premature under the Administrative Procedure Act since there is still a remedy available to the trust. 5 U.S.C. §704.

Although the trust's refund claim failed on procedural grounds, it is worth considering the merits of the trust's suit. From the facts as presented by the court, it is uncertain whether the value of the home was included in Peter's gross estate for federal estate tax purposes. Presumably, it was not – the purpose of a qualified personal residence trust is to limit the wealth transfer taxation of the residence to the value of the remainder interest at the time of its transfer to the trust. Peter survived the trust term, and died holding only an expired leasehold interest in the property. Assuming the lease arrangement was bona fide and not a sham by which Peter effectively retained the right to occupy the residence until his death, the date-of-death value of the home would not be subject to estate tax.

But that also means the house would not get a stepped-up basis at Peter's death. To qualify for a stepped-up basis under IRC §1014(a), property must be "acquired from a decedent," a term of art defined in IRC §1014(b) to mean that it passed from a decedent in one of eight ways. Property held in an irrevocable trust that is not included in the decedent's gross estate is not "acquired from a decedent" for purposes of this rule, meaning it does not get a stepped-up basis. So if the date-of-death value of the house was not included in Peter's gross estate, the trust would not have a stepped-up basis in the house.

On the other hand, if an examination of the estate tax return resulted in a determination that the value of the home is included in Peter's gross estate (perhaps because the leasehold arrangement was a sham arrangement by which Peter retained the right to occupy the home until his death), the house would get a stepped-up basis. This might in fact be the case, though the court's opinion is not clear on this point. If so, the trust had a valid claim on the merits, only to lose it through a procedural *faux pas*.

The case is unusual in that, in the typical case, a qualified personal residence trust terminates after the grantor's retained right of occupancy expires. The trustee usually conveys the home to a named remainder beneficiary or to a trust for the benefit of the remainder beneficiary. It is the remainder beneficiary that can then decide whether to lease the property back to the grantor and, if so, on what terms. Peter's trust, however, continued to hold title to the home after expiration of his retained interest. Perhaps Gregory simply never took the time to make a terminating distribution. While the continued existence of Peter's trust is unusual, it would not affect the determination of whether there is a stepped-up basis at Peter's death.

B. Federal Tax Liens Attach to Property Owned by an Invalid QPRT (*Sohn v. United States*, N.D. California, March 18, 2024)

A federal district has held that a federal tax lien on residential property once owned by a QPRT was valid because nominal title to the property was held by the grantors rather than by the trust at the time the lien arose. The court also implied that even if the trust held title to the property at that time, the result would be the same because the trust was not a valid QPRT because the trust agreement did not comply with regulatory requirements prohibiting transfer back to the grantors.

In March of 1996, Jeffrey and Olivia, a married couple, purchased a home in Saratoga, California. Shortly thereafter, they transferred their home to a QPRT, retaining the right to occupy the residence for a term generally ending upon the earlier of: (1) the death of either grantor; (2) the expiration of 25 years; or (3) the date the trust ceases to be a QPRT.

In February of 1998, for reasons not disclosed in the case, Jeffrey and Olivia conveyed the property from the trust to themselves as joint tenants with rights of survivorship. They then reconveyed the house to the trust two months later. Then, in April of 2004, they again transferred title back to themselves individually. They retained individual ownership of the house at all relevant times thereafter.

In 2014, the IRS placed federal tax liens on Jeffrey's property related to some $4.5 million in unpaid penalties and interest attributable to the years 1997 through 2004. These liens were recorded in 2016. But now Olivia and other family members have brought this quiet title action seeking a determination that the liens do not encumber the Saratoga residence. The IRS counterclaimed, arguing that the trust is not a QPRT and that it has the power to foreclose its liens on the residence.

In arguing the trust is not a QPRT, the IRS pointed to regulations requiring that the governing instrument of a QPRT must prohibit the trust from conveying the residence during the term of the trust to the grantor, the grantor's spouse, or an entity controlled by the grantor. Reg. §25.2702-5(c)(9). That regulation was promulgated in December, 1997, nearly two years after the trust at issue in this case was created and funded. In finalizing the regulation, Treasury said it would apply retroactively, but that noncompliant trusts formed before the date of

finalization would have 90 days to begin a trust modification to incorporate the new rule. The trust in this case was never modified to reflect the anti-buyback rule in the regulation. What's more, said the IRS, the grantors conveyed the property to themselves in 1998, after the effective date of the regulation. Accordingly, it claimed the trust was no longer a QPRT.

The court agreed, granting summary judgment to the United States on the issue. "Because the Trust Agreement not only fails to prohibit buy-backs, as required by Section 25.27025(c)(9) clause (sic), but also contains a buy-back provision specifically prohibited by that provision, the [trust] does not meet 'all' the requirements under the paragraph. Therefore, it does not qualify as a QPRT.

The court also held the IRS could foreclose its federal tax liens on the residence. When the liens arose and were recorded, recall, title to the house was in the names of Jeffrey and Olivia. Though the house would be community property, California law allows the tax liens of one spouse to attach to the entire community property. The plaintiffs contended that because the trust was irrevocable, the trust was still the actual owner of the home. Apparently their thinking is that the Jeffrey and Olivia could not covey property from an irrevocable trust and any attempt to do so would be ineffective. But the court didn't buy it, observing that while the trust purports to be irrevocable, they had the power to terminate the trust by ceasing to reside in the trust property or by buying the house from the trust. Either event would cause the trust to dissolve by its own terms. As the court concluded:

> Given that the terms of the [trust agreement] made the trust terminable under certain circumstances, including when it ceased to be a QPRT, plaintiffs cannot overcome the presumption under California law that when legal title to the [house] was subsequently transferred from the trust to [Jeffrey and Olivia], that transfer validly transferred full beneficial title in the property … as their community property. Under California law, that community estate is liable for the debt of [Jeffrey].

Thus, the government could foreclose on the liens.

This case serves as a reminder both that QPRT instruments must affirmatively restrict transfers back to the grantor, the grantor's spouse, or an entity controlled by the grantor and that a QPRT can offer some creditor protection. If the house had been held by a valid QPRT when the federal tax liens arose, the court noted that Jeffrey's federal tax liens would not attach to the property.

XVIII. BENEFICIARIES RECEIVING PROPERTY AFTER DEATH ARE LIABLE FOR UNPAID ESTATE TAX (*United States v. Paulson*, 9th Circuit, May 17, 2023)

A divided panel of the Ninth Circuit Court of Appeals has held that certain persons receiving property includible in a decedent's gross estate at any time after the decedent's death are liable for unpaid federal estate taxes. It thus reversed a federal district court's decision

holding that only persons who owned or received property at or as of the decedent's death are personally liable for unpaid federal estate taxes.

Transferee liability for federal estate taxes is governed by IRC §6324(a)(2). It states in relevant part as follows:

> If the estate tax imposed by chapter 11 is not paid when due, then the spouse, transferee, trustee…, surviving tenant, person in possession of the property by reason of the exercise, nonexercise, or release of a power of appointment, or beneficiary, *who receives, or has on the date of the decedent's death*, property included in the gross estate under sections 2034 to 2042, inclusive, to the extent of the value, at the time of the decedent's death, of such property, shall be personally liable for such tax.

(Emphasis added.) This case is about the construction of the italicized language. Specifically, the issue before the Ninth Circuit was whether the phrase "on the date of the decedent's death" modifies only "has" or both "has" and "receives." If the former, then those specified transferees who either "had on the date of death" or at any point "received" property included in the decedent's gross estate under the indicated Code sections would face personal liability for unpaid estate tax. But if the latter construction is correct, then only those specified transferees who "had on the date of death" assets included in the decedent's gross estate or "received at the date of death" such assets would be personally liable; beneficiaries receiving property *after* the date of death would not be liable.

The decedent, Allen Paulson, died in 2000 with a gross estate of over $193 million. His estate filed an estate tax return showing a taxable estate of just over $9.2 million and an estate tax liability of nearly $4.46 million. The estate elected under IRC §6166 to pay about $3.75 million of the tax in installments over 15 years. Litigation in 2005 resulted in additional estate tax liability of about $6.7 million, which the estate likewise elected to pay in installments. After the estate missed some installment payments, the IRS terminated the IRC §6166 election in 2010, an action approved by the Tax Court in 2011. By the time the IRS got to collecting on the unpaid estate taxes, though, the assets of the decedent's revocable living trust (the entity that owned substantially all of the decedent's assets as of his death and which held and administered those assets afterward) had been depleted. In 2015, then, the United States brought this case against five individuals, in their capacities as beneficiaries and fiduciaries of the trust. The federal district court held that four of the individuals were not liable for the unpaid estate taxes because they were not in possession of estate property at the time of the decedent's death.

The majority of the Ninth Circuit panel reversed, holding that transferee liability applies to those "who have or receive estate property, either on the date of the decedent's death or any at any time thereafter, subject to the applicable statute of limitations." *Paulson* at 16. The majority applied "the rule of the last antecedent," a canon of statutory interpretation that reads

a limiting clause as modifying only the noun or phrase it immediately follows. Under this rule, the limiting phrase "on the date of the decedent's death" would modify only the verb "has" and not also the verb "receives." It rejected the argument of the beneficiaries that the "series-qualifier" canon of interpretation should apply. Under the series-qualifier rule, a modifier at the end of a list applies to the entire list. But the majority noted that this canon is better suited to statutes where the modifier is separated from all antecedents by a comma, and such is not the case in this particular statute.

The majority reasons that its interpretation leads to a logical result. There is no reason to limit transferee liability only to those individuals in possession of the assets included in the gross estate at the time of the decedent's death and those who have an ownership interest immediately as of the date of the decedent's death, like survivors in a joint tenancy. The purpose of transferee liability is to make sure the government can collect estate tax from the assets giving rise to the tax. If the argument of the beneficiaries was correct, then the government could only collect tax from surviving joint tenants and those in physical possession of property included in the gross estate; it could never collect estate tax from assets held by the revocable living trust at death once the trust distributed those assets to the beneficiaries. This does not seem consistent with the intent of transferee liability.

The beneficiaries argued that if anyone receiving property after death would be subject to transferee liability, then unpaid estate tax could be collected from persons who purchased estate assets. The beneficiaries also argued that if the property depreciates in value after death, transferees could be liable for taxes that exceed the value of the property they received. The majority rejected both of these arguments as failed attempts to invoke the "canon against absurdity," a rule that courts should avoid construing a statute that would produce an absurd and unjust result. Regarding the first argument, purchasers of estate assets are not among the categories of persons listed in IRC §6324(a)(2), and the statute also provides that any estate tax lien is divested upon transfer to a "purchaser or holder of a security interest."

As for the second argument, the majority observes that the statute sets estate tax liability based on date-of-death values. Just as post-death increases in value inure to the benefit of a beneficiary, post-death decreases in value are a risk borne by the beneficiary. It is on this last point that the panel's dissenting judge takes the greatest exception. That a beneficiary could be liable for tax in an amount exceeding the value of what they have received from the estate, says the dissent, is "not logical." The majority explains at great length why it is unlikely that a beneficiary would be forced to pay more than the value of the bounty they received from a decedent's estate, but the dissent finds the explanations "unpersuasive, even on their own terms."

Finally, the majority determined that the defendants all fall within the categories of persons listed in IRC §6324(a)(2) and, thus, are liable for the unpaid estate tax. The defendants were all trustees, beneficiaries, or both.

You see that comma after the word “receives” in IRC §6324(a)(2)? It makes all the difference. Absent the comma, the argument of the beneficiaries would be much stronger. But that comma has to give one pause. (Pun intended.) It serves to set “receives” apart from “has on the date of the decedent’s death,” indicating pretty strongly that the “at date of death” modifier only applies to those in actual possession of assets included in the gross estate as of the decedent’s death.

The dissent is rightly concerned with the possibility that a beneficiary could, years down the road, be called upon to pay estate tax in an amount greater than the value of what that beneficiary received from the estate. But valuation declines are always a risk. If Congress does not want the IRS to collect more from a beneficiary than the value of what that beneficiary receives from an estate, it can do so easily by amending the statute to cap the amount of transferee liability.

XIX. CASES INVOLVING SUBSTANTIATION OF CHARITABLE CONTRIBUTIONS

Section 170(f)(11)(C) provides that, in substantiating charitable contributions of $5,000 or more, a taxpayer must, among many other things, obtain and attach to the federal income tax return both: (1) a qualified appraisal, and (2) such other information as the Secretary of the Treasury may provide by regulation. In turn, Regulation §1.170A-13(c)(2)(i)(B) requires a taxpayer to attach to the federal income tax return a completed “appraisal summary” in addition to the qualified appraisal. That summary must include, among other things, the date the taxpayer acquired the donated property, the taxpayer’s basis in the property, and the date the donee organization received the property. Treas. Reg. §1.170A-13(c)(4)(ii). Form 8283 is used for this purpose. For some reason, taxpayers find it hard to submit all of the information required to be listed on the Form 8283, resulting in lost deductions. The following cases illustrate the risks in submitting incomplete Forms 8283.

A. *Lim v. Commissioner*, T.C. Memo. 2023-11, January 23, 2023

The Tax Court has held that an alleged donation of LLC interests to charity was not adequately substantiated because the appraisal, performed by the attorney that recommended the strategy, was not a qualified appraisal under §170(f)(11).

Late in 2016, one Michael L. Meyer, an attorney, pitched what he called the “The Ultimate Plan” to the taxpayers, a married couple that owned all of the shares of an S corporation engaged in business activities that apparently have no relevance to this case. “The Ultimate Plan” consisted of the formation of a “charitable limited liability company” to which the taxpayers would transfer five promissory notes with an aggregate face value of just over $2 million payable in seven years. The taxpayers would then donate “units” in the LLC to charity and the couple would claim an income tax deduction for the value of the units donated. Meyer agreed to draft all the documents, to supply any appraisals required to claim an income tax deduction, and to represent the couple before the IRS and any court in connection with the plan, all for a fee computed as a percentage of the “deductible amount” of assets transferred to

the LLC. Magically, the exact amount of Meyer's fee was computed up front, before any transfers took place and more than a month before Meyer completed his "appraisal" reaching his conclusion as to the deductible amount.

A few days later, after the formation of the LLC, the taxpayers and their S corporation signed the LLC's operating agreement. It listed the corporation as the sole member of the LLC and the taxpayers as the LLC's managers. Attached to the operating agreement were five promissory notes made by the taxpayer-wife in favor of the LLC. Supposedly, on the last day of 2016, the S corporation, as the LLC's sole member, donated an unspecified number of units in the LLC to the Indiana Endowment Foundation, a charitable organization. But there is absolutely no evidence to prove that any units were in fact transferred. The only proof of a donation is through an acknowledgment letter from the charity dated January 1, 2017. The letter, a form letter in which taxpayer-specific information has been inserted in bold print, acknowledges receipt of 1,000 units in an LLC with a different name (the LLC created for the taxpayers would later change its name to match the name supplied on the acknowledgment letter). The letter was addressed to taxpayer-wife, not the corporation. Furthermore, the letter was unsigned. It was clear to the court that the letter had been prepared by Meyer because of his drafting habit of inserting client-specific terms into form documents using bold print.

It gets better. The appraisal performed by Meyer, said the court, "has the legalistic form of an appraisal but none of the substance." It contains a number of factual and typographical errors (all in bold print, helpfully). It states that the LLC's only assets were the five promissory notes but contains no discussion of the value of those notes and ignores that they are not payable for seven years. The document then "incoherently applies a discount for lack of control in determining the value" of the donated units. And, for the coup de grace, Meyer attached a onepage "certification" to the appraisal in which he stated that his compensation was "not contingent on … the analysis, opinions, or conclusions in, or the use of, this report." Given Meyer's compensation was, in fact, dependent on the value of the gifted units, this statement was false.

In claiming a charitable deduction on its income tax return, the corporation attached a completed Form 8283 that had been prepared by Meyer. The Form 8323 described the donated property as "LLC units" without identifying the number of units or the identity of the LLC. The form falsely stated that the corporation acquired the LLC units by "purchase." To the surprise of no one, the IRS disallowed the deduction in full, bringing the matter to the Tax Court.

The court held there was no evidence indicating any units were ever transferred to the charity. The only proof of their donation is the acknowledgment letter, but, as the court says, "this letter suffers from several obvious defects" identified above. Despite the lack of proof to this point, however, the court denied the IRS's motion for summary judgment as to the existence of the donation, saying that it's premature to hold that no transfer occurred as a matter of law, though "petitioners would face a decidedly uphill task in attempting to prove that [the corporation] actually transferred [LLC] units to the [charity] in 2016."

But the court granted summary judgment to the IRS as to the validity of the appraisal substantiating the amount of the deduction. Regulation §1.170A-13(c)(6)(i) requires that "no part of the fee arrangement for a qualified appraisal can be based, in effect, on a percentage (or set of percentages) of the appraised value of the property." Since Meyer's fee was, in fact, based on the appraised value of the property, the appraisal is, as a matter of law, not a qualified appraisal. So even if the taxpayers could prove the LLC actually donated units to the charity, the deduction would still fail for lack of substantiation. The court did not reach any conclusions as to the application of penalties, finding genuine issues of material fact that required more investigation.

Post-script: In 2019, a federal district court in Florida permanently enjoined Meyer from promoting "The Ultimate Plan," preparing federal income tax returns, and furnishing tax advice regarding charitable contributions. That same year, the taxpayers sued Meyer, but the case was dismissed for undisclosed reasons.

B. *Bass v. Commissioner*, T.C. Memo. 2023-41, March 27, 2023

The Tax Court has upheld the disallowance of a charitable contribution deduction for used clothing and other items of tangible personal property donated to Goodwill and the Salvation Army because the taxpayer failed to obtain an appraisal of the donated items. The taxpayer maintained that an appraisal was not required because no single donation exceeded $250, but the court determined that an appraisal was required since the aggregate amount of clothing and other tangible personal property donated during the taxable year exceeded $5,000.

In 2017, the taxpayer made 173 separate trips to Goodwill and the Salvation Army to donate various items of used clothing and "various nonclothing items." For each trip, the taxpayer received a donation acknowledgment receipt from the charity. The total fair market value of the items on any one receipt did not exceed $250, but in the aggregate, they totaled $13,852 to Goodwill and $11,594 to the Salvation Army. On his 2017 federal income tax return, the taxpayer claimed a total charitable contribution deduction of $18,899. (The court noticed the discrepancy between the amount deducted and the value of the donated property but found no explanation for it in the record.)

In order to deduct a donation of property worth more than $5,000, a taxpayer must obtain a qualified appraisal of the property, attached a completed "appraisal summary" to the taxpayer's federal income tax return, and maintain other records containing certain information about the donated property. See Reg. §1.170A-13(c)(2). In determining whether the value of donated property exceeds the $5,000 threshold, all "similar items of property" donated to one or more charities is treated as one property. IRC §170(f)(11)(F); Reg. §1.170A13(c)(1)(i). Regulations define "similar items of property" as "property of the same generic category or type, such as … paintings, photographs, books, … clothing, jewelry, furniture, electronic equipment, household appliances, toys, [and] everyday kitchenware." Reg. §1.1.70A13(c)(7)(iii). While the taxpayer in this case submitted two partially completed Forms 8283 (Noncash

Charitable Contributions), he did not obtain an appraisal and did not attach appraisal summaries for the donated items to his 2017 tax return.

The taxpayer argued that because the donated items on any one receipt did not exceed $250 in value, no appraisal was required, but the court concluded that the donated clothing items were all "similar items of property" claimed to have an aggregate value of more than $20,000. Because there was no appraisal, the taxpayer was not entitled to a deduction for the clothing.

The court did allow the taxpayer to deduct various nonclothing items donated to Goodwill and Salvation Army, however, because those items were not similar items of property and, thus, did not require an appraisal since none of them had a claimed value in excess of $5,000.

C. *Murphy v. Commissioner*, T.C. Memo. 2023-72 (June 15, 2023) and *Murfam Enterprises LLC v. Commissioner*, T.C. Memo. 2023-73 (June 15, 2023)

In *Murphy*, the Tax Court held that while the taxpayers failed to comply with applicable substantiation requirements in connection with their contribution of a conservation easement, they were excused from compliance for reasonable cause. The court upheld the donations as "qualified conservation contributions" but determined that the value of the donations was less than the value claimed by the taxpayers on their income tax returns.

The taxpayers, a father and son, together with their spouses, formed an S corporation in 1993 to acquire two adjacent parcels of raw land that they developed into a residential community with two 18-hole golf courses, a clubhouse, recreation facilities, and nature trails. In 2010, they had the S corporation donate conservation easements on the two properties to the North American Land Trust, a qualified charitable organization. The deeds in both easements restricted use of the subject property to its current use as a residential community with golf courses. Based on appraisals, the taxpayers filed federal income tax returns in which they claimed charitable contribution deductions totaling about $8.4 million (specifically, about $7.3 million for the value of the easement on one lot and about $1.1 million for the value of the easement on the second lot). The IRS disallowed the claimed deductions, resulting in the deficiencies at issue in the case. According to the IRS, the contributions did not qualify for the income tax deduction, and furthermore, if they did, the deductions were not adequately substantiated because the taxpayers failed to comply with applicable substantiation requirements.

1. Conservation Purpose

The IRS argued that the easements were not used "exclusively for conservation purposes" and thus were not "qualified conservation contributions" as defined in the Code. See IRC §§170(f)(3); 170(h)(1)(C). The deed for one of the easements stated the intended conservation purpose of the donation was "Preservation of … a relatively natural habitat," and

the deed for the other easement stated the intended purpose was "preservation … for outdoor recreation." The taxpayers claimed that other conservation purposes could also be considered by the court, but the court, citing precedent, determined that only those purposes set forth in the deed are considered in determining whether the easements are exclusively for conservation purposes.

With respect to the first parcel, the IRS forcefully argued that preservation of a golf course is hardly the preservation of a "relatively natural habitat" since a golf course is about as humanmade as one can get. But there was evidence that the subject parcel was home to 25 rare species of bird, one rare species of insect, and six rare species of mammals. That was enough to convince the Tax Court that the easement served a conservation purpose:

> [T]he statute does not restrict the charitable contribution deduction to an easement that protects a wilderness area or a "natural area"; rather, the statute allows a deduction where an easement protects "relatively natural habitat", §170(h)(4)(A)(ii), provided (as we have noted) that it is a "*significant* relatively natural habitat", Treas. Reg. § 1.170A-14(d)(3)(i) (emphasis added). We are persuaded that the relatively natural habitat afforded by the [subject property] easement is significant.

As for the second parcel's deed—the one claiming a conservation purpose of "outdoor recreation"—the court had an easier time. Preservation for outdoor recreation is a recognized conservation purpose and the continued use of the property as a residential community with a golf course is certainly consistent with that purpose. See IRC §170(h)(4)(A)(i).

2. Substantiation

The taxpayers filed a Form 8283 but it was incomplete—it did not contain any information about the basis of the properties to which the donated easements related. The taxpayers argued this information was disclosed elsewhere in their return, but the Tax Court cited precedent that this was not sufficient to comply with the requirement that the basis be disclosed on a Form 8283. As the court explained:

> The IRS reviews millions of returns each year for audit potential, and the disclosure of cost basis on the Form 8283 itself is necessary to make this process manageable. Revenue agents cannot be required to sift through dozens or hundreds of pages of complex returns looking for clues about what the taxpayer's cost basis might be.

The court cited further precedent that omitting information about cost basis on the Form 8283 could not be considered substantial compliance with the substantiation requirements. Because the taxpayers did not comply with the substantiation requirements, then, a deduction would appear to be lost.

But if the failure to comply with substantiation requirements was "due to reasonable cause and not willful neglect," a deduction may still be allowed. IRC §170(f)(11)(A)(ii)(II). Because the IRS did not raise the Form 8283 issue until after the deficiency notices were sent, the IRS bears the burden of proving that the failure of the taxpayers to report their basis in the subject lands on the Forms 8283 was not due to reasonable cause. The Tax Court held the IRS did not satisfy this burden. The evidence showed that the taxpayers relied on "a well-known CPA firm with a good reputation" to prepare the required returns and that the taxpayers supplied the firm with all of the information it requested in order to prepare and submit the returns on behalf of the taxpayers. The IRS argued the taxpayers declined to provide information about basis to the return preparers, but the court said "[t]he cited evidence does not make this showing." As the court observed:

> There is simply no evidence as to whether the advisors *asked* for basis information. There is no evidence as to whether petitioners *provided* basis information — except that they manifestly *did* provide enough information to enable the advisors to know the "combined basis" which (as the Commissioner acknowledges) appears "in the body of the return". To the extent there was basis information not provided by petitioners, there is no evidence to show *why* they did not provide it. The reason that there is no such evidence is that the Commissioner did not cross-examine the witnesses on the point.

(emphasis in original). Simply stated, there was no evidence one way or the other as to whether there was reasonable reliance by the taxpayers, but since the burden of proof was on the IRS, the failure to state basis on the Form 8283 was excused under the reasonable cause exception.

3. Valuation of the Easements

Having determined the taxpayers were eligible for a deduction, the court turned to the valuation of the donated easements. For the first property, the court used the highest and best use determined by the taxpayer's expert (about $5.14 million) and subtracted the value of the property as its current use as determined by the IRS's expert (about $2.35 million) to determine a deduction of about $2.79 million. For the second property, the court adopted the view of the IRS expert that the only feasible use of the property, given its landlocked location adjacent to the first parcel, would be continued use as a golf course. It thus accepted the IRS expert's determination that the value of the easement was $100,000.

Recall that the taxpayers claimed total deductions of $8.4 million in connection with the easements even though the Tax Court determined the combined value of the donation was about $5.24 million. The $3.2 million discrepancy resulted in a substantial understatement penalty that the taxpayers resisted. The court upheld the penalty, noting that the statute contains no reasonable cause exception to the substantial understatement penalty.

4. The Other Case

On the same day the Tax Court released the opinion in *Murphy*, it also announced the result in *Murfam Enterprises*, another case involving a conservation easement donated by an entity owned by the Murphy family. The property at issue in *Murfam Enterprises* was a 6,171-acre tract of land in North Carolina that was approved by the state for hog farming activities. On its 2010 federal income tax return, the LLC claimed a charitable contribution deduction of $5.74 million from its donation of a conservation easement on the property to the North American Land Trust. The IRS challenged the amount of the deduction (but not its legitimacy) in a notice of deficiency, but the IRS later maintained that the deduction should be disallowed for failure to complete the Form 8283. (Here too, there was no disclosure of the property's cost basis.) The court, in an opinion that duplicates the format and much of the language from the *Murphy* opinion, held that the failure to complete the Form 8283 was excused for the same reasonable cause. The only substantive difference between the cases relates to valuation, for in *Murfam Enterprises* the court determined the value of the easement to be about $5.64 million, only $100,000 less than the amount originally claimed by the taxpayer on its federal income tax return. Accordingly, the court held that the substantial understatement penalty did not apply on these facts.

It appears the only reason *Murfam Enterprises* was not consolidated with the *Murphy* case was because of the different result with respect to the penalty. In both cases, the taxpayer got lucky that the IRS did not challenge the validity of the deduction before issuing the notice of deficiency. Had the burden of proof been on the taxpayers, precedent suggests their deductions very likely would have been disallowed.

D. *Braen v. Commissioner*, T.C. Memo. 2023-85, July 11, 2023

The Tax Court has upheld the disallowance of a charitable contribution deduction in connection with the sale of real property to a local government. While the taxpayers thought they had made a deductible bargain sale, they lost the deduction for failing to value all of the consideration received in the transaction and for failing to obtain a contemporaneous written acknowledgement of the donation that complied with the strict substantiation requirements.

In 1998, an S corporation owned by the taxpayers (seven family members) purchased 505 acres of land in Ramapo, New York, for $3.5 million. The plan was to operate the land as the company's fifth granite quarry, but the corporation struggled with getting permits. In 2004, Ramapo enacted a comprehensive zoning ordinance that changed the zoning of most of the land from a "planned industrial" district to a "low-density rural residential" district. The company filed suit opposing the change, resulting in a settlement under which Ramapo agreed to buy 425 acres of the property for $5.25 million in a "bargain sale" transaction. Ramapo also agreed to rezone the remaining 80 acres back to its industrial status.

The sale closed in 2010. On its 2010 federal income tax return, the corporation claimed a charitable contribution deduction of $5.22 million. In an attachment to the return, the

corporation stated that the property sold had a fair market value of $17.47 million (reflecting both the property's land value and its mineral value). While under normal bargain sale rules that would generate a deduction of $12.22 million ($17.472 million less $5.25 million sale price), the company explained it was "only" claiming a deduction of $5.22 million to avoid a valuation dispute and the potential imposition of a valuation misstatement penalty. On their individual income tax returns for 2010, the taxpayers claimed their proportionate shares of the company's $5.222 million deduction. The IRS disallowed the deductions, bringing us to the current matter before the Tax Court.

1. Consideration Received in a Bargain Sale

The IRS based its disallowance in part on its conclusion that neither the corporation nor the taxpayers established that the conveyance of 425 acres to Ramapo was a "bargain sale;" that is, that the value of the property transferred to the city exceeded the value of any consideration it received from the city. The Tax Court agreed, noting that in addition to the sale proceeds, the city also agreed to rezone the unsold 80 acres back to its former status as industrial property. This was "central to the overall deal," and therefore should have been valued for purposes of establishing the amount of the deduction. Because it was not, the court held the taxpayers were not entitled to the claimed deduction.

2. Contemporaneous Written Acknowledgment

The IRS also based disallowance of the deduction on the taxpayers' failure to secure a contemporaneous written acknowledgement of the contribution from the city. Although the city furnished an acknowledgment letter to the corporation in 2011, the letter did not comply with the requirements for a contemporaneous written acknowledgment because it only identified the cash proceeds as the consideration furnished—it neither mentioned the zoning change that was part of the settlement agreement nor provided a good-faith valuation of the zoning change. The taxpayers argued that the acknowledgment letter's reference to the sale being approved by court order was sufficient for this purpose, but the Tax Court had no patience for the claim. The IRS should not have to look beyond the acknowledgment itself for all of the information required to substantiate the deduction, said the court, and even if that was not the case, the court order gives no good-faith estimate of the value of the zoning change. On this ground too, then, the court upheld disallowance of the deduction.

3. Substantial Valuation Misstatement Penalty

The corporation's income tax return reported the value of the property sold to Ramapo at $10.47 million. If that figure is 150 percent or more of the property's value, IRC §6662 imposes a 20-percent accuracy-related penalty. After considering reports from experts retained by the taxpayers (concluding the property was worth $11 – 12.19 million) and the report from the expert hired by the IRS (concluding the property was worth $4.85 million), the court determined that the value of the property sold to the local government was $5.22 million.

The significant difference in the valuations was largely attributable to the different conclusions as to the highest and best use of the property. To the taxpayers' experts, the highest and best use of the property was for quarrying; to the IRS's expert, it was "limited residential development." Given the significant trouble the corporation had in seeking to commence mining operations on the land, reasoned the court, quarrying could not reasonably be the highest and best use of the property. That left residential development as the highest and best use of the land, resulting in a valuation much closer to the conclusion offered by the IRS's expert. And because the reported value of the land was double the value determined by the court, the accuracy-related penalty applied. The court also rejected the claim of the taxpayers that any penalty would be excused for reasonable cause.

XX. LESSONS IN HOW TO DONATE BUSINESS INTERESTS THAT ARE ABOUT TO BE SOLD (*Estate of Hoensheid v. Commissioner*, T.C. Memo. 2023-24, March 15, 2023)

The Tax Court has held that a donation of closely-held stock just two days before the company's sale to a third party did not qualify for a charitable contribution deduction and was not effective to escape income tax liability on the resulting gain from the sale. The case offers an instructive lesson in the timing of charitable donations of stock in advance of company sales.

As of the start of 2015, Commercial Steel Treating Corp. was owned in equal shares by three brothers: Scott, Craig, and Kurt. Kurt had just announced to his brothers that he wanted to retire, and under the terms of their buy-sell agreement, this would force the company to redeem Kurt's shares. Not wanting the company to incur that level of debt, Scott and Craig decided to put the company up for sale. They hired an investment banking firm to help identify and court a prospective purchaser. On April 1, 2015, a buyer submitted a letter of intent to acquire the company for $92 million. Two weeks later, Scott considered donating some of his stock to a donor advised fund administered by Fidelity Charitable Gift Fund. When his estate planning attorney advised that any stock donation be completed well in advance of signing the definitive purchase agreement, Scott replied in an email that read in part as follows:

> Anne and I have agreed that we want to put 3.5MM in the fund, but I would rather wait as long as possible to pull the trigger. If we do it and the sale does not go through, I guess my brothers could own more stock than I and I am not sure if it can be reversed.

Two days later, Scott and his brothers signed a nonbinding letter of intent calling for the sale of the company for total consideration of $107 million. By May 21, 2015, a draft of the purchase and sale agreement had been completed, and the next day Scott executed a notarized affidavit in which he stated the company had a good faith intention of completing the transaction.

A signed letter of understanding in connection with a proposed donation of shares was provided to Fidelity on June 1, 2015, but it did not indicate the number of shares that would be transferred to the donor advised fund. The letter specifically provided that "No contribution is complete until formally accepted by Fidelity Charitable." In an email to his estate planning

attorney the same day, Scott asked that a corporate consent resolution authorizing the transfer be prepared but that "I do not want to transfer the stock until we are 99% sure we are closing." The consent resolution was approved and signed on June 11, 2015, but the resolution left the specific number of shares to be donated blank.

A revised purchase and sale agreement, dated July 1, 2015, indicated that shares were held by a donor advised fund, but the number of shares still was left blank. On July 7, the company distributed its cash to the three brothers, with nothing paid to the donor advised fund. On July 9, correspondence indicated that Scott had finally decided to convey 1,380 shares to the donor advised fund, and on that same day he set up an online giving account with Fidelity Charitable.

By July 10, contingencies to the sale had been satisfied, save only for execution of a "minority stock purchase agreement" by the donor advised fund. On July 13, Fidelity communicated that it would not sign such an agreement until it had assurances that it had shares to sell. On that date, Fidelity received a pdf file containing an undated stock certificate signed by Scott reflecting a total of 1,380.4 shares owned by the donor advised fund. Fidelity Charitable signed the minority stock purchase agreement, and the transaction closed on July 15.

On their 2015 federal income tax return, Scott and his wife, Anne, claimed a charitable contribution of over $3 million in connection with the stock donation to the donor advised fund. The return indicated that the donation occurred on June 11, 2015. While Scott and Anne reported capital gain from the stock sale, they did not report any capital gain from the stock donated to the donor advised fund.

A. When Did the Gift Happen?

The first issue before the Tax Court was whether there was a valid gift of shares to the donor advised fund and, if so, when the gift occurred. The court applied Michigan law (though on this point Michigan law is in accord with the law of practically every other American jurisdiction), which holds that a valid gift requires: (1) the donor's present intent to make a gift; (2) actual or constructive delivery of the gift; and (3) acceptance by the donee. The Tax Court concluded that:

> The record does not support a finding of present intent to make a gift until July 9 when petitioner settled on a number of 1,380 shares. From that point on, petitioner took a number of actions that confirmed his present intent to transfer. On July 9 or 10 petitioner delivered the physical stock certificate to [his estate planning attorney]. Similarly, on July 10 petitioner created an online giving account with Fidelity Charitable. Taken together, these actions provide sufficient credible evidence of petitioner's intent. We conclude that, as of July 9, petitioner had present intent to make a gift.

As for delivery, the court held that although a printout of a purported stock ledger showed the issuance of shares to Fidelity on July 10, that printout had no evidence to corroborate the July 10 transfer date. Instead, said the court, the best evidence of the shares leaving Scott's dominion and control was the July 13 email of the pdf stock certificate. "Providing Fidelity Charitable with a copy of a stock certificate issued in its name was an objective act evidencing an 'open and visible change of possession.' … Further, we find that this act placed the shares … in Fidelity Charitable's dominion and control, by providing Fidelity Charitable with an instrument that it could present to … exercise its rights as shareholder." Thus, delivery did not occur before July 13.

Finally, as to acceptance, Fidelity did not sign the minority stock purchase agreement until July 13, when it received the PDF file of the stock certificate. That act, ruled the court, sufficiently established acceptance of the gift as of that date. Thus, the gift was not made until July 13, after all contingencies to the sale had been met and just two days before closing.

B. Assignment of Income

The next issue before the court was whether Scott and Anne had to pay the income tax on the capital gain attributable to the shares donated to the donor advised fund just two days before the closing of the stock sale. Under the assignment of income doctrine, a taxpayer with a fixed right to receive income from property cannot avoid taxation by gifting the property to another before the income is received. Thus, if Scott's right to the gain attributable to the gifted shares was "fixed" by the time of the gift, Scott is the proper party to be taxed on the gain. In order to be "fixed," said the Tax Court, the sale of the shares had to be "virtually certain to occur" at the time of the gift. Here, ruled the court, that was the case.

Although Fidelity did not have an obligation to sell the stock it received, a number of events prior to the July 13 gift suggested the transaction was a virtual certainty: (1) the buyer formed a new holding company to acquire the shares one week before the gift; (2) the corporation amended its bylaws three days before the gift to allow for written shareholder consent, an action requested by the buyer; and (3) six days before the gift the company distributed out all of its cash to the three brothers. The court said it was "highly improbable that petitioner and his two brothers would have emptied [the company] of its working capital if the transaction had even a small risk of not consummating."

Moreover, all substantial contingencies related to the sale were resolved by the time of the gift. "We find that petitioner, consistent with his '99% sure' statement, waited until all material details had been agreed to with [the buyer] before he transferred the shares to Fidelity Charitable. In light of all of these facts, said the court, the right to income was fixed before the gift, meaning Scott and Anne were liable for the tax on the gain from the donated shares:

> We echo prior decisions in recognizing that our holding does not specify a bright line for donors to stop short of in structuring charitable contributions of appreciated stock before a sale. … However, as petitioners' tax counsel seems to

> have recognized in her advice to petitioner, "any tax lawyer worth [her] fees would not have recommended that a donor make a gift of appreciated stock" so close to the closing of a sale. … By July 13, 2015, the transaction … had simply "proceeded too far down the road to enable petitioners to escape taxation on the gain attributable to the donated shares."

C. Problems with the Charitable Contribution Deduction

The next issue before the court was whether Scott and Anne were entitled to an income tax deduction for the value of the donated shares. Since a valid gift to a donor advised fund was made on July 13, 2015, a charitable contribution deduction would normally follow. But the IRS denied a deduction on the grounds that the taxpayers did not receive a contemporaneous written acknowledgment from Fidelity that complied with statutory requirements and that the taxpayers did not secure a qualified appraisal of the donated shares.

The acknowledgment letter from Fidelity described the contributed property as stock. The IRS claimed that because of the assignment of income doctrine, the gift in fact was of cash, not stock. That, said the IRS, made the acknowledgment ineffective. But the Tax Court rejected this argument:

> We do not interpret section 170(f)(8)(B) to require that a donee ascertain and correctly describe a contributed property interest in accordance with how that interest should be classified for federal tax law purposes. It is sufficient here that the CWA provided by Fidelity Charitable described the contributed property as shares of stock. We conclude that the CWA issued by Fidelity Charitable satisfied the requirements of section 170(f)(8)(B).

But the court agreed with the IRS that the appraisal obtained by the taxpayers was not a qualified appraisal. The IRS pointed to no less than eight flaws in the valuation report, including the use of an incorrect date of contribution, an insufficient description of the valuation methods used, a failure to state the appraiser's qualifications, and a failure to describe the property in sufficient detail. Conceding that the appraisal had some defects, the taxpayers argued that the appraisal should be accepted under the doctrine of substantial compliance. But that doctrine does not excuse the failure to meet substantive requirements in the substantiation regulations or the omission of entire categories of required information. In this case, said the court, the appraiser was the investment banker that helped the brothers find their buyer. While he is familiar with the type of property being valued, that does not make him a qualified appraiser. Even if he had the requisite expertise, the appraisal provided no information about his valuation experience. By omitting this information, the IRS lacked the ability to evaluate whether the appraisal was reliable.

Finally, the appraisal used a June 11, 2015, valuation date. While this is consistent with the taxpayer's claim that the gift occurred on June 11, the court observed that the period between June 11 and July 13 saw over $6 million in cash distributions and the virtual certainty

of the acquisition. These events would significantly affect the value of the gifted shares, making the appraisal unhelpful in determining the value of the stock as of July 13. Thus, the appraisal could not be saved on the grounds of substantial compliance with the substantiation requirements.

D. Lessons from the Case

Although the court emphasized that there is no bright line for determining when it becomes too late to assign income from a pending sale of property, the case offers some helpful lessons. First, a seller should understand the risk in waiting to pull the trigger on a potential assignment until the sale is essentially assured. Had Scott completed the gift before all contingencies to the sale had been resolved, the assignment of income doctrine would not have been applied. The doctrine may have been avoided had the gift been made before the cash distributions occurred on July 7. While Scott's desire to defer the gift until he was certain the stock sale would happen is certainly understandable, his desire to keep control over the stock until the sale was a done deal precluded him from being able to assign away some of the gain from the transaction.

Second, a donor should select a qualified appraiser, not just someone with considerable valuation experience but also someone independent of the transaction. Having someone affiliated with the investment banking firm hired to attract potential bidders who had little formal experience in business valuation and the preparation of appraisals was not good optics.

Finally, in order to avoid an understatement penalty, the taxpayer asserted reasonable reliance on the advice of advisors. To prove eligibility for this defense, the taxpayer had to reveal communications that otherwise would have been privileged. The fact that Scott told his lawyer he wanted to wait until the deal was "99% sure" likely would not have come to light had the taxpayer not sought to apply the reasonable cause exception to an accuracy-related penalty. Clients should be aware that communications they may expect to be privileged might in fact be discoverable.

XXI. DIABETIC TAXPAYER WAS NOT "DISABLED," SO EARLY WITHDRAWAL PENALTY APPLIED (*Lucas v. Commissioner*, T.C. Memo. 2023-9, January 17, 2023)

The Tax Court has held that an individual diagnosed with diabetes still had to include amounts withdrawn from his retirement account in gross income. The court further held that the taxpayer did not qualify for the disability exception to the ten-percent early withdrawal penalty contained in IRC §72(t).

The taxpayer lost his job in 2017. That year, he withdrew $19,365 from his 401(k) account. The taxpayer reported the distribution on his 2017 federal income tax return but included no portion of the distribution in his gross income. The distribution was fully includible in gross income. What's worse, because the taxpayer had not yet attained age 59-1/2, this

taxable distribution was subject to a ten-percent penalty tax under §72(t). The taxpayer timely petitioned to challenge the IRS's assessed deficiency.

The taxpayer claimed that due to his being diagnosed with diabetes in 2015, he was under the impression the distribution was not includible in gross income. Unfortunately, there is no authority supporting this impression, so the court upheld the deficiency with respect to the taxability of the transaction.

As for the ten-percent early withdrawal penalty, §72(t)(2)(A)(iii) excepts from the penalty distributions "attributable to the employee's being disabled within the meaning of subsection (m)(7)." Section 72(m)(7), in turn, defines an employee as disabled where the employee is "unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of longcontinued and indefinite duration." Here, the taxpayer's diabetes did not render him unbale to engage in a substantial gainful activity. He has been able to work since his diagnosis in 2015 by treating his diabetes with insulin and other medications. Accordingly, the early withdrawal penalty does apply.

XXII. WORKERS' COMPENSATION OFFSET MEANS TAXPAYER TAXED ON SOCIAL SECURITY BENEFITS NOT RECEIVED (*Ecret v. Commissioner*, T.C. Memo. 2024-23, February 14, 2024)

The Tax Court has held that a taxpayer had to include in gross income 85 percent of all Social Security benefits for which the taxpayer was eligible even though the taxpayer received only a portion of that amount because of the "worker's compensation offset," a rule that caps the amount of Social Security payable to any individual also receiving workers' compensation benefits. The case is a reminder that a taxpayer may end up paying federal income tax on an amount in excess of the Social Security benefits actually received.

Where an individual receives both Social Security and workers' compensation benefits, a federal statute caps the maximum combined benefits that an individual can receive to 80 percent of the individual's "average current earnings." 42 U.S.C. §424a(a). If the scheduled Social Security benefits payable to an individual would, when added to the individual's workers' compensation benefits, exceed this limitation, the Social Security Administration stops paying benefits. This is known as the "workers' compensation offset."

In this case, the taxpayer, a nurse, became disabled in 2014. In 2019, she received $42,000 in workers' compensation benefits from the State of New York. Based on her average current earnings, she was only entitled to $7,200 of the $19,866 in Social Security benefits she would otherwise receive. Accordingly, the Social Security Administration withheld $1,080 of federal income tax and paid $6,120 to the taxpayer. The taxpayer did not receive the remaining $12,666 that would have been paid because of the workers' compensation offset.

The taxpayer's 2019 return included 85 percent of the $6,120 in Social Security benefits received, but the IRS argued that 85 percent of the entire $19,866 benefit was includible in gross income. The taxpayer argued that the workers' compensation offset amount should not be subject to federal income tax, but IRC §86(d)(3) provides otherwise. It specifically requires inclusion of 85 percent of the workers' compensation offset in order to equalize the tax treatment of taxpayers residing in "reverse offset" states, where the receipt of Social Security benefits reduces workers' compensation benefits. The Tax Court thus had no choice but to conclude that the taxpayer also needed to include 85 percent of the workers' compensation offset in gross income for 2019.

XXIII. WTF? NFTs IN IRAs? LOL (*Notice 2023-27*, March 21, 2023)

The IRS has announced its intent to issue guidance on the treatment of nonfungible tokens (NFTs) as collectibles under IRC §408(m). That Code section treats the acquisition of a collectible by an individual retirement account (IRA) as a distribution from the IRA to the individual in an amount equal to the collectible's cost. This constructive distribution is ordinary income to the individual and, if the individual is not yet age 59-1/2, the constructive distribution will be subject to the 10-percent penalty applicable to early distributions.

Section 408(m)(2) defines a "collectible" for purposes of this rule "as any work of art, any rug or antique, any metal or gem, any stamp or coin, any alcoholic beverage, or any other tangible personal property specified by the Secretary for purposes of this subsection." But an NFT is not tangible personal property; it is a unique digital identifier that certifies the authenticity and ownership of a digital file such as an image or sound. At first glance, then, the acquisition of an NFT would not appear to result in a constructive distribution.

But an NFT can certify ownership of an item of tangible personal property. The Notice indicates that the IRS will apply a "look-through analysis," under which an NFT will be considered a collectible where the NFT's "associated right or asset" is a collectible. The Notice says that, for example, an NFT that certifies ownership of a gem will be a collectible because the gem is a collectible. But an NFT that certifies a right to use or develop a "'plot of land' in a virtual environment" will not be a collectible because the right to use or develop such a "plot of land" is not itself a collectible.

The Notice also indicates that the IRS is considering the extent to which a digital file might be a "work of art" and, thus, a collectible *per se*. The Notice does not give any indication as to how the IRS is leaning on that issue.

XXIV. DONATION OF CRYPTOCURRENCY REQUIRES QUALIFIED APPRAISAL (*Technical Advice Memorandum 202302012*, January 13, 2023)

The IRS has ruled that taxpayers claiming charitable contribution deductions of more than $5,000 from donations of cryptocurrency must obtain qualified appraisals in order to qualify for the deductions. The IRS further ruled that a taxpayer may not rely on the value

reported by a cryptocurrency exchange on which the cryptocurrency is traded in lieu of obtaining a qualified appraisal, concluding this approach would not qualify for the "reasonable cause" exception to the qualified appraisal requirement under IRC §170(f)(11)(A)(ii)(II).

The memorandum offers a helpful introduction to cryptocurrency for those who might otherwise avert their eyes from the topic:

> Cryptocurrency is a type of virtual currency that utilizes cryptography to secure transactions that are digitally recorded on a distributed ledger, such as a blockchain. Units of cryptocurrency are generally referred to as coins or tokens. Distributed ledger technology uses independent digital systems to record, share, and synchronize transactions, the details of which are recorded in multiple places at the same time with no central data store or administration functionality.

As such, cryptocurrency coins, tokens, or units are "property" for federal income tax purposes.

The memorandum considers a case where an individual taxpayer bought cryptocurrency units on a cryptocurrency exchange as an investment. The taxpayer then donated all of the units to charity and claimed a charitable contribution deduction of $10,000. The value was determined based on the value of the cryptocurrency as listed at the exchange on which the cryptocurrency was traded at the time of the donation. The taxpayer did not obtain an appraisal for the donation, arguing none was required since the cryptocurrency had a readily ascertainable value based on the value published by the exchange.

The IRS concluded otherwise. Generally speaking, contributions of property to charity for which a deduction of more than $5,000 is claimed require the taxpayer to obtain a qualified appraisal to substantiate the claimed value. See IRC §170(f)(11)(C). A qualified appraisal, however, is not required for publicly traded securities. See IRC §170(f)(11)(A)(ii)(I). The regulations defer to the definition of publicly traded securities under IRC §165(g)(2) for purposes of IRC §170. And IRC §165(g)(2) defines a security as "a share of stock in a corporation; a right to subscribe for, or to receive, a share of stock in a corporation; or a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or a government or political subdivision thereof, with interest coupons or in registered form." The memorandum concludes that cryptocurrency "is none of the items listed in section 165(g)(2), and therefore does not satisfy the definition of a security in section 165(g)(2)." Accordingly, an appraisal is required.

The IRS then concluded that the use of values listed on a cryptocurrency exchange did not give the taxpayer "reasonable cause" for the failure to obtain a qualified appraisal, citing *Pankratz v. Commissioner*, T.C. Memo. 2021-26. As the IRS reasons:

> The reasonable cause exception was not intended to provide taxpayers with the choice of whether to obtain a qualified appraisal, but to provide relief where an unsuccessful attempt was made in good faith to comply with the requirements of

> section 170. [citations omitted] As such, claims that [the donated units had] a readily ascertainable value because it is listed on a cryptocurrency exchange does [sic] not establish reasonable cause for failing to obtain, or attempting to obtain, a qualified appraisal.

Consequently, said the IRS, the taxpayer could not claim a deduction.

Qualified appraisals are not cheap. They must be performed by qualified appraisers in accordance with generally accepted appraisal standards. To be a qualified appraiser, an individual must have earned an appraisal designation from a recognized professional appraiser organization or meet minimum education and experience requirements set by the IRS, and the person must also regularly perform appraisals for compensation. The appraisal itself must be performed within a certain timeframe and must contain specified information. Donors in a position like that of the taxpayer in the memorandum might well decide that the extra expense and effort required for the deduction may be more hassle than the deduction is worth.

XXV. EXCISE ON EXCESS IRA CONTRIBUTIONS IS A TAX, NOT A PENALTY (*Couturier v. Commissioner*, T.C. Memo. 2024-6, January 17, 2024)

The Tax Court has granted the IRS's motion for partial summary judgment, finding that the excise tax imposed on excess contributions to an individual retirement account is indeed a "tax" and not a "penalty" that would require supervisory approval before imposition. IRC §4973(a) imposes a tax equal to six percent of the amount of excess contributions a taxpayer makes to an individual retirement account in any taxable year. A taxpayer continues to owe this tax until the excess contribution is distributed to the taxpayer and included in the taxpayer's gross income.

The taxpayer in this case was a corporate executive until, as part of a reorganization in 2004, he accepted a $26 million buyout in exchange for stock in an employee stock ownership plan and for surrender of his interests in various nonqualified retirement plans. The payment, consisting of $12 million cash and a $14 million promissory note, was made to his individual retirement account. On his 2004 income tax return, the taxpayer characterized the payment as a "rollover contribution," but in 2016 the IRS determined that most of the payment was attributable to his interest in the nonqualified plans, none of which were eligible for a tax-free rollover. Specifically, it determined that about $25.1 million of the $26 million payment was an "excess contribution" to his IRA. And given this amount had not been distributed to the taxpayer, the IRS concluded that the taxpayer owed over $8.47 million in excise taxes.

In challenging this assessment, the taxpayer argued that the exaction imposed by IRC §4973(a) is a penalty and not a tax. If it's a penalty, then under IRC §6751(b)(1) the IRS could not collect it without first obtaining supervisory approval for the penalty's assessment, which he claimed did not happen in this case. But the Tax Court agreed with the IRS that IRC §4973(a) imposes a "tax" and not a "penalty," so supervisory approval was not required.

For one thing, the plain text of the statute supports this conclusion. The title of the section is "Tax on excess contributions to certain tax-favored accounts and annuities," and subsection (a) is captioned "Tax imposed." Throughout its text, the provision describes the amount owed as a "tax," with no mention of a "penalty."

For another, the provision appears in subtitle D of the Code ("Miscellaneous Excise Taxes") and not with other penalty provisions in subtitle F. While location of a Code provision within the Code is not determinative of whether a provision is a tax or a penalty, the court observed that location "is not irrelevant either." Moreover, an older Third Circuit case held that a neighboring Code provision, IRC §4975, was likewise a "tax" and not a "penalty."

The taxpayer argued that where exactions "function as penalties," the supervisory approval process of IRC §6751(b) should apply. But the court rejected this argument, noting that all taxes can feel punitive to the parties paying them. It observed that subtitle D imposes more than 60 excise taxes, many of them using language that parallels IRC §4973. These taxes, explained the court, do not function as penalties. "The taxes imposed by Chapters 41 through 43 in particular serve what is principally a regulatory function—persuading public charities, private foundations, employee trusts, and other tax-favored plans to comply with the requirements Congress has ordained for continued tax-exempt status." The court thus granted the IRS's motion for partial summary judgment.

XXVI. IMPRISONED TAXPAYER STILL TAKED ON FORFEITED IRA (*Hubbard v. Commissioner*, T.C. Memo. 2024-16 (February 6, 2024)

The Tax Court has held that a taxpayer had gross income from the forfeiture of his individual retirement account following a criminal conviction for charges that included allegations related to the account. The payment of the account to the federal government was deemed a constructive taxable distribution to the taxpayer.

The taxpayer, a Kentucky pharmacist, was indicted for various crimes related to the distribution of controlled substances. Apparently some of the ill-gotten gains landed in his individual retirement account, as the account was condemned and forfeited to the federal government following the taxpayer's conviction following a jury trial. In addition to forfeiting assets, the taxpayer was sentenced to three years in prison. In 2017, while the taxpayer was incarcerated, the IRA custodian, T. Rowe Price, issued the taxpayer a Form 1099-R reporting a taxable distribution of $427,518 from the taxpayer's IRA, all of which was paid to the federal government.

The taxpayer did not file an income tax return for 2017. In 2020, the IRS determined a deficiency of over $165,000 in connection with the failure to report and pay tax on the constructive distribution. The taxpayer timely petitioned the Tax Court for review, arguing that he did not owe federal income tax on the amounts forfeited to the United States since he neither actually nor constructively received them. But the Tax Court agreed with the IRS that

the taxpayer constructively received gross income when the IRA was forfeited to the government.

The court cited a long line of cases supporting the rule that by forfeiting funds, a taxpayer realizes the benefit of them and must therefore include in gross income the same amount the taxpayer would have to include if the taxpayer actually received the funds and then paid them over to the government. The taxpayer valiantly attempted to distinguish his case from those cited by the court, but the Tax Court was not persuaded.

The court also upheld penalties for failing to file a return and for failing to pay tax in a timely manner, noting that "incarceration is not a reasonable cause for the failure to pay tax."

XXVII. RETIREMENT DISTRIBUTIONS PAID TO SCAMMER STILL SUBJECT TO TAX (*Gomas v. United States*, Middle D. Fla., July 17, 2023).

A federal district court has awarded summary judgment against the taxpayers in case described by the court as "disturbing," "egregious," and "unjust." Nonetheless, the court correctly determined that amounts withdrawn from retirement accounts and paid to a con artist are still includible in gross income. The court further determined, again correctly, that amounts paid to the con artist were neither deductible as theft losses—thanks to a current suspension of that deduction—nor as business expenses.

The taxpayers, Dennis and Suzanne Gomas, a married couple, inherited an online raw pet food business in 2010. The couple relocated the business from New York to Florida in 2014 and hired Suzanne's daughter, Suzanne Anderson, to assist. When the taxpayers decided to close operations in 2016, Anderson convinced them to transfer the business to her. In 2017, Anderson conned the taxpayers into thinking that Dennis was facing arrest because former employees of the business had opened accounts using Dennis's birthdate and social security number and used those accounts to defraud customers. Anderson suggested that the couple hire a lawyer that required a $125,000 retainer. They provided the money to Anderson, thinking she would forward the money to the lawyer. But there was no lawyer. Heck, there were no opened accounts and no defrauded customers. When the taxpayers insisted on meeting with the lawyer, Anderson created a fake email account and posed as the lawyer in correspondence with the taxpayers. Over the next several months, Anderson coaxed the taxpayers into transferring more and more cash to her, ostensibly for payment to the lawyer. By the end of 2017, the taxpayers had forked over about $700,000 total to Anderson, all funded by withdrawals from their IRA and pension plan. The taxpayers did not realized they were duped until 2019, when friends who had likewise been taken by Anderson informed them of her scam. Anderson was ultimately arrested on multiple charges of theft and fraud, and she pleaded guilty to seven total felonies in 2022.

The taxpayers originally reported their pension and IRA distributions as gross income on their 2017 joint federal income tax return. In 2020, they filed an amended return in which they claimed a deduction for the amounts paid to Anderson as "fictious invoices, fake attorneys' fees,

and other fraudulent mechanisms." When the IRS rejected the amended return, the taxpayers brought this refund action. But the court granted summary judgment to the IRS. Although the facts give rise to a theft loss, it is well accepted that a theft loss occurs in the year the theft is discovered. In this case, discovery was in 2019, which is most unfortunate. Under IRC §165(h)(5), the deduction for theft losses is suspended for the tax years 2018 – 2025. The taxpayers therefore cannot deduct the amounts paid to Anderson as a theft loss.

The taxpayers then tried to "salvage a tax benefit from their immense losses" under two other theories. They first argued the distributions from the IRA and the retirement plan should not be included in gross income because they did not enjoy the benefit of those funds. The problem with this theory, though, is that the distributions were first paid to the taxpayers' bank account before they then authorized transfer to Anderson. Everything was under the authorization of the taxpayers, and since they had control over these funds, they did enjoy the benefit of them, however briefly.

The taxpayers then argued that the payments to Anderson were deductible as business expenses because they related to their former pet food business. But they were barking up the wrong tree, for the taxpayers were no longer carrying on their business activity in 2017. Remember, they retired in 2016 and transferred the business to Anderson that year. The couple claimed the payments were related to the business since they thought Anderson used the money to pay legal fees related to past business operations, but their subjective belief as to the use of the funds does not matter. In fact, no legal fees were ever paid. Since there were no legal expenses, there could be no deduction for legal expenses.

The court summarizes the case aptly:

> In view of the egregious and undisputed facts presented here, it is unfortunate that the IRS is unwilling—or believe it lacks the authority—to exercise its discretion and excuse payment of taxes on the stolen funds. It is highly unlikely that Congress, when it eliminated the theft loss deduction beginning in 2018, envisioned injustices like the case before this Court. Be that as it may, the law is clear here and it favors the IRS.

XXVIII. PAYMENTS TO VARIOUS INDIVIDUALS ARE GIFTS, AND ESTATE CANNOT DEDUCT PAYMENTS PURSUANT TO PRENUP AGREEMENT (*Estate of Spizzirri v. Commissioner*, T.C. Memo. 2023-25, February 28, 2023)

The Tax Court has held that payments made to a daughter, a stepdaughter, and multiple women with whom the decedent had social and intimate relationships were taxable gifts and not compensation for caregiving services. The court also ruled that payments made to each of the children of the decedent's fourth wife pursuant to a prenuptial agreement were not deductible as claims against the estate.

The decedent was a lawyer that made his fortune investing in biotech companies. He lived an extravagant lifestyle, fathering several children with his four spouses and others. His fourth and final marriage lasted 18 years, though the parties were estranged in the final years. A prenuptial agreement, modified several times before the decedent's death, obligated the decedent to write a will that would leave the wife his New York City penthouse apartment and the right to reside free of charge at the decedent's home in Easthampton for five years after his death. The prenup also required that the decedent's will would bequeath $1 million to each of the wife's three children. Alas, the decedent's will contained no provision for the fourth wife or her children. During the probate of the decedent's estate, the wife and her children filed claims as creditors under the prenuptial agreement. The estate paid $1 million plus interest to each of the stepchildren and also agreed to a settlement of the wife's claims.

On the federal estate tax return, the estate deducted the payments made to the stepchildren and the value of the wife's right to reside in the Easthampton property as claims against the estate. The IRS disallowed the deduction, and the Tax Court upheld the disallowance. The prenup stated that the required bequests to the wife and the stepchildren were "in lieu of any other rights which may be available to [the wife] as [the decedent's] surviving spouse." In effect, then, the promised bequests were testamentary gifts and not bona fide claims supported by an adequate and full consideration in money or money's worth. Section 2043(b) provides that "a relinquishment or promised relinquishment of dower or curtesy, or of a statutory estate created in lieu of dower or curtesy, or of other marital rights in the decedent's property or estate, shall not be considered to any extent a consideration 'in money or money's worth.'" As the court observed, the prenup "makes plain that the consideration for the claims at issue is [the wife's] waiver of her marital rights, which runs directly contrary to the prohibition staked out in section 2043(b)." So the estate lost the deduction for the amounts paid pursuant to settlement of claims based on the prenup.

The estate tax return further claimed the decedent had made no adjusted taxable gifts during life. But the record revealed that the decedent in fact made taxable gifts in excess of $193,000 in the last years of his life, including transfers to one of his daughters, a stepchild, and to seven other women with whom the decedent enjoyed social or intimate relationships. The estate claimed the payments were not gifts but instead payments for "care and companionship services during the last years" of the decedent's life. The estate offered testimony from one of the decedent's lawyers, the executor, and one of the decedent's daughters. But the Tax Court rejected this claim, noting that the decedent did not issue or file Forms 1099 or W-2 to any of the recipients, and he did not report any of the payments as medical expenses on his federal income tax returns. The court found it telling that the estate did not call the recipients of the transfers as witnesses, suspecting their testimony might not have supported the estate's position. Ultimately, the testimony offered failed "to clear up the murky relationship between [the decedent] and the recipients of his payments, and thus is insufficient to establish that the payments at issue were not gifts."

XXIX. PROPOSED REGULATIONS IDENTIFY MICRO-CAPTIVE INSURANCE ARRANGEMENTS AS LISTED TRANSACTIONS AND TRANSACTIONS OF INTEREST (*Proposed Regulations §§1.6011-10 and 1.6011-11*, April 11, 2023).

In proposed regulations the IRS identifies certain micro-captive insurance arrangements as "listed transactions" and "transactions of interest, respectively. The proposed regulations follow on the heels of a federal district court case, *CIC Services, LLC v. Internal Revenue Service* (E.D. Tenn. 2022), which held that *Notice 2016-66*, 2016-47 I.R.B. 745—the guidance that first identified these arrangements as transactions of interest—was invalid for failing to comply with the Administrative Procedure Act. Relying on *Mann Construction v. United States*, 27 F.4th 1138 (6th Cir. 2022), the district court determined that because the notice was not first issued in proposed form so that the IRS could receive and consider public comments, the notice was invalid. By publishing the essential provisions of the invalidated notice in the form of proposed regulations, then, the IRS hopes to validate its position that certain "captive" insurance arrangements are abusive.

As the IRS explained in a press release accompanying the unveiling of the proposed regulations:

> Treasury and the IRS disagree with these decisions [*CIC Services* and *Mann Construction*] that the IRS lacks authority to identify listed transactions by notice and continue to defend listing notices in litigation except in the Sixth Circuit. Treasury and the IRS will, however, no longer take the position that transactions of interest can be identified without complying with notice and public comment procedures. Treasury and the IRS issued the proposed regulations to ensure that these decisions do not disrupt the IRS' ongoing efforts to combat abusive tax shelters throughout the nation.

IR-2023-74 (April 10, 2023). The proposed regulations essentially restate and update the definitions set forth in the 2016 guidance. A detailed summary of those rules is beyond the scope of this Tax Report, but advisors to closely-held business owners that have been encouraged to implement captive insurance arrangement transactions should examine the proposed regulations with care.

XXX. TAX COURT RELUCTANTLY APPLIES TAX AFFECTING IN VALUING TRANSFERS OF S CORPORATION STOCK (*Cecil v. Commissioner*, T.C. Memo. 2023-24, February 28, 2023).

In this case, the Tax Court determined the value of three blocks of S corporation stock transferred by a married couple to their children and to trusts for the benefit of their grandchildren. In so doing, the court "tax affected" the value of the shares, but only because experts for both the taxpayers and the IRS did so, and only after throwing more shade on the concept.

In 2010, Bill and Mary Cecil, a married couple, owned four of the seven Class A voting shares and just over 93 percent of the nearly 10,000 nonvoting Class B nonvoting shares in the Biltmore Company, an S corporation that owns and operates the celebrated Biltmore House in Asheville, North Carolina. The company owns not only the house and the surrounding grounds but also a multi-million-dollar collection of artwork, 46 registered trademarks, a registered trade name, and other properties. Its 2010 balance sheet listed over $53.5 million in assets and $33.4 million in liabilities.

In November of that year, the couple gave one share of Class A voting stock to their two children as tenants in common. On the same day, they transferred all of their Class B nonvoting shares to five trusts, one for each grandchild. The couple effectively split the gift among their grandchildren *per stirpes*, so the trusts for the three issue of their son each received a 15.57 percent interest while the trusts for the two issue of their daughter each received a 23.36 percent interest. On their federal gift tax returns, where they elected to split gifts, the couple each reported total gifts of over $10.4 million. The IRS challenged the valuation and determined a combined deficiency of over $13 million, bringing us to the Tax Court for resolution.

At trial, the taxpayers offered testimony from two experts, both of which concluded that the gift tax returns overstated the value of the gifts. The IRS presented two experts of its own, but one of the experts was retained only for the purpose of appraising the art collection (which came in at $13.25 million). So in valuing the shares, the court had to evaluate reports from three different experts. The following table summarizes the conclusions of those experts and compares them to the values reported on the gift tax returns:

Class of Stock	Per Share Value			
	Form 709	Taxpayer Expert 1	Taxpayer Expert 2	IRS Expert
Class A (voting)	$3,308	$1,019	$1,131	$4,000
Class B (nonvoting) (smaller block of 15.57% interest)	$2,236	$1,019	$1,108	$3,276
Class B (nonvoting) (larger block of 23.36% interest)	$2,236	$1,019	$1,108	$3,066

The Tax Court rejected the approach of the IRS's expert to value the company on the basis of net asset value. While that method might be suitable for valuing an operating company on the eve of partial or total liquidation, it does not work well where, as here, existing officers, directors, and shareholders have no intention of selling the business for at least the foreseeable future. Indeed, the court assigns "zero weight" to the opinion from the IRS's expert.

The court also rejected the "guideline public company" valuation method used by the taxpayers' second expert since it only used one comparable. It likewise lacked confidence in that expert's use of the "capitalization of net cashflow" method as the expert used financial

statements from the height of the Great Recession (including the statements from the one year in its 70-year history that the property generated a loss) without adjustment.

But the court was generally persuaded by the "discounted cashflow" method used by the taxpayers' first expert. It liked how the expert used both this method and the guideline public company method in reaching his conclusion, and it found all but two of the comparable companies used in the report to be, in fact, comparable to the Biltmore Company. So the court starts by embracing the overall valuation from the taxpayers' first expert.

The court accepted the 20-percent minority interest discount used by the taxpayers' first expert. Because the IRS expert used the wrong method, the court rejected the minority interest discount used on that report.

The court rejected the 2-percent "lack of voting control" discount claimed by the taxpayers' second expert since it relied on data that was too old and ignored the fact that the nonvoting shares in fact had limited voting rights on some matters. Differences in the voting rights are already reflected in the minority interest discount.

Regarding the discount for lack of marketability, the court agreed with the IRS that the different stock blocks deserved different discounts. The smaller nonvoting blocks would be easier to sell, making them more marketable than the larger nonvoting blocks. (In this way, the court is indirectly applying a so-called "blockage" discount, though it is framed as part of the marketability discount.) Still, the smaller nonvoting blocks would be less marketable than the voting block that has far more voting rights, making that block more marketable. Ultimately, the court applied a marketability discount of 19 percent to the voting shares, 22 percent to the smaller block of nonvoting shares, and 27 percent to the larger block of nonvoting shares.

All three experts used "tax affecting" to value the shares. Because the data used to value S corporation shares are almost always based on data from C corporations, the thinking goes, the values calculated for S corporation stock have to be adjusted to account for the fact that the S corporation is a pass-through entity and not a separate taxpayer like a C corporation. As the Tax Court explains, tax affecting "is the discounting of estimated future corporate earnings on the basis of assumed future tax burdens imposed on those earnings, such as from the loss of S corporation status and imposition of corporate-level tax."

The court, citing a long list of cases, observed that tax affecting is "improper in valuing an S corporation." Indeed, the only time the Tax Court has applied the concept was in *Estate of Jones v. Commissioner*, T.C. Memo. 2019-101, and only then because the parties had stipulated to its application. Alas, that appears to be the case here, too, so the court felt it had little choice but to "tax affect" the valuations. As the court notes:

> Now given that each side's experts … totally agree that tax affecting should be taken into account to valuer the subject stock, and experts on both sides agree on the specific method that we should employ to take that principle into account,

> we conclude that the circumstances of this case require our application of tax affecting.

Holding its nose, the court chose to set the rate for tax affecting at 17.6 percent, the smaller of the two rates proffered by the experts. But the court could not resist one last shot: "We emphasize, however, that while we are applying tax affecting here, given the unique setting at hand, we are not necessarily holding that tax affecting is always, or even more often than not, a proper consideration for valuing an S corporation."

Consider yourself on notice.

XXXI. VALUE OF QTIP TRUST NOT REDUCED BY AMOUNTS DISTRIBUTABLE TO SPOUSE'S ESTATE (*Estate of Kalikow v. Commissioner*, T.C. Memo. 2023-21, February 27, 2023).

In reviewing a $32.7 million estate tax deficiency, the Tax Court has concluded that the decedent's gross estate included the value of assets held in a trust created under the will of the decedent's spouse for which the spouse's executors had made a qualified terminable interest property ("QTIP") election under IRC §2056(b)(7), without diminution for the amount that the trustees must pay to the decedent's estate in settlement of the estate's claim for undistributed income. The court also rejected the estate's argument that the settlement amount could be deducted as an administration expense.

When the decedent's husband died in 1990, his will devised the residue of his estate to a trust for the benefit of the decedent. The will provided that upon the decedent's death, the trust would terminate, with the remainder passing in equal shares to two separate trusts, one for each of their two children and their issue. The executors of the husband's estate properly elected to treat this trust as a QTIP trust, thus enabling the husband's estate to claim an estate tax marital deduction for the value of the assets passing to the trust.

The QTIP trust initially consisted of interests in ten New York City apartment buildings. Shortly after formation, the trustees transferred these interests to a family limited partnership in exchange for a 98.5-percent limited partner interest. At the decedent's death in 2006, the trust owned the limited partner interest and $835,000 in liquid assets. These assets are subject to estate tax at the decedent's death as a condition to allowing the husband's estate a marital deduction for the assets passing to the QTIP trust. Specifically, IRC §2044 requires inclusion in a surviving spouse's gross estate of the date-of-death value of the assets of a QTIP trust in which the surviving spouse held the right to annual income distributions. An estate tax return reported the value of the partnership interest at about $42.5 million, but the IRS determined that the value of the interest was nearly $105.7 million, resulting in a deficiency. By the time the dispute reached the Tax Court, however, the parties had stipulated that the value of the partnership interest was about $54.5 million.

But wait, there's more. When one of the decedent's grandchildren petitioned the trustees for an accounting, the co-trustees filed competing accounts. One of the reports showed

the decedent did not receive some $16.9 million in income to which she was entitled. Under a QTIP trust, recall, a surviving spouse must receive all of the trust's net income at least annually. The report from the other co-trustee concluded that the decedent had received nearly $3.3 million *too much* from the trust. The $20 million difference led to litigation that lasted a decade. In 2019, a settlement was reached under which the trust would pay $9.2 million to the decedent's estate. Of this amount, about $6.5 million represented undistributed income that should have been paid to the decedent while she was alive. The decedent's will left her entire estate to a foundation she created, so the undistributed income payable under the settlement agreement would ultimately pass to charity. The balance of the settlement agreement represented legal fees and trustee commissions.

The estate tax return filed by the decedent's estate reduced the amount of the QTIP trust includible in her gross estate by the $6.5 million settlement payable to the decedent's estate. But the Tax Court rejected this position, noting that the parties had already stipulated to the value of the partnership interest. The settlement agreement imposes liability for the settlement payment jointly on the QTIP trust and the two trusts that will receive the remainder of the QTIP trust. Importantly, the partnership itself is not liable for any portion of the payment. "Consequently," said the court, "there is no basis to conclude that this liability would affect the date-of-death fair market value of the [partnership interest], i.e., the liability would not affect the price of this partnership interest as determined between a hypothetical willing buyer and seller as of the date of the decedent's death." The court rejected the estate's argument that the decision has the effect of imposing estate tax on $6.5 million that will ultimately pass to charity. "Inclusion of the [QTIP] trust assets in decedent's gross estate will give rise to neither double taxation nor any estate tax on any charitable bequest but rather will merely give effect to the provisions of section 2044(a)."

The estate then argued that if the $6.5 million is not subtracted from the value of the QTIP trust assets, then that amount should be deductible as an administrative expense under IRC §2053(b). While the IRS conceded that the portion of the settlement allocable to trustee commissions was deductible, it claimed no other portion of the settlement payment was deductible. Here too, the court sided with the IRS. The settlement agreement created a claim *in favor of* the decedent's estate. The deduction under IRC §2053(b), on the other hand, relates to claims *against* the estate. So the settlement payment is an asset of the estate, not a liability of the estate.

XXXII. TAXPAYER SELLING LLC INTERESTS AS A BUSINESS RECOGNIZES ORDINARY INCOME, NOT CAPITAL GAIN (*Technical Advice Memorandum 202309015*, March 3, 2023).

The IRS has concluded that where an individual taxpayer is engaged in the business of promoting and selling interests in limited liability companies, the taxpayer's gains from such sales are ordinary income and not capital gains. Although IRC §741 provides that "[i]n the case of a sale or exchange of an interest in a partnership, … gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751

(relating to unrealized receivables and inventory items)," the IRS concludes that this rule does not apply where the taxpayer holds partnership interests for sale to customers.

The taxpayer promoted what IRC §170(h)(7) would now call "syndicated conservation easement" transactions. Through this scheme, the taxpayer would form a limited liability company for the purpose of acquiring undeveloped land. The taxpayer would then sell interests in the LLC to investors. Shortly after the LLC acquired the land, the LLC would then donate a conservation easement on the property to a charity, generating a federal income tax deduction for the LLC's owners, the tax savings from which would more than offset the purchase price the investors paid for the LLC interests. Over a four-year period, the taxpayer repeated this process many times. The taxpayer reported the gains from the sales of LLC interests as capital gain, as allowed by IRC §741.

The IRS first concluded that the LLC interests sold by the taxpayer were not capital assets under IRC §1221. Section 1221(a)(1) expressly provides that property held by a taxpayer primarily for sale to customers in the ordinary course of business is not a capital asset. Whether property is held primarily for sale to customers is determined by weighing eight separate factors enumerated by the Fifth Circuit in *Byram v. United States*, 705 F.2d 1418, 1424 (5th Cir. 1983). These factors include (among others) the frequency and regularity of sales, the length of ownership, and the time and effort devoted to the sales. In this case, all eight factors pointed to the conclusion that the taxpayer held the LLC interests primarily for sale to customers. Clearly, then, the interests were not capital assets.

Nevertheless, IRC §741 persists. It plainly states that the sale of a partnership interest gives rise to capital gain or loss except as provided in IRC §751, and the IRS concludes that IRC §751 does not apply on these facts because each LLC held land as a capital asset and not as inventory. Further, the land owned by each LLC would not be considered inventory in the hands of taxpayer. So the exception in IRC §751 does not apply at all in this case. That would suggest the taxpayer is correct to rely on IRC §741 in claiming capital gain treatment. But the IRS concludes that:

> While the general rule under §741 treats the sale of partnership interests as a sale of a capital asset, here §1221 applies, despite §741, because the legislative history indicates that §741 contemplates only the sale of partnership assets (sic) that are in fact capital assets.

The context suggests that the IRS meant to refer to "partnership interests" at the end of that statement instead of "partnership assets."

In support of this conclusion, the IRS cites legislative history from 1954 that IRC §741 retains "the general rule of present law that the sale of an interest in a partnership is to be treated as the sale of a capital asset." That the legislative history speaks to a "general rule" suggests that exceptions are possible (indeed, contemplated). And while cases decided before the enactment of IRC §741 provided that a partner's sale of a partnership interest should be

treated as the sale of a capital asset as opposed to a sale of the partner's interest in the partnership assets:

> courts were not given the opportunity to consider whether capital gain or ordinary income treatment would apply when a taxpayer was engaged in the business of holding partnership interests for sale to customers. Given the facts of the pre-1954 cases and Congress's intent to codify a line of cases that held that the entity approach should determine the consequences of the sale of a partnership interest, Congress intended to give capital asset treatment only to the sale of partnership interests that are in fact held as capital assets.

Accordingly, says the IRS, IRC §741 does not foreclose ordinary income treatment on the sale of LLC interests where, as here, such interests are frequently created and sold to customers to the point that they are not capital assets within the definition of IRC §1221.

XXXIII. CASES INVOLVING INCOME FROM THE DISCHARGE OF INDEBTEDNESS

It is well established that a taxpayer's gross income includes income from the cancelation of debt. On the street, it's referred to as "COD income" ("cancelation of debt"). The rule is codified at IRC §61(a)(11). But not all forms of COD income are taxed. Section 108 lists a number of ways in which some COD income can be excluded from gross income, including where the discharge arises in a bankruptcy proceeding or occurs while the taxpayer is insolvent. Though the tax treatment of debt is a fundamental concept, it continues to raise difficult issues, as illustrated in these cases.

A. Relief from Nonrecourse Debt Upon Sale of Property is Not C.O.D. Income, It's Part of Amount Realized (*Parker v. Commissioner*, T.C. Memo. 2023-104, August 10, 2023)

The Tax Court has held that income from the cancelation of nonrecourse debt is includible in the amount realized from an S corporation's sale of real property subject to that debt, rejecting the taxpayer's argument that it is COD income that could be excluded to the extent of the corporation's insolvency or the insolvency of the taxpayer. The case is a reminder of the distinction in tax treatment of debt discharged in connection with a sale or exchange or property and debt discharged separately from any such sale or exchange.

The taxpayer's S corporation purchased 23.6 acres of property in 2007 with the intent to develop it. The purchase was financed in part through loans that were nonrecourse to the corporation, even though the taxpayer had personally guaranteed the loans, making them recourse as to him. In 2012, the corporation sold the property to a pair of unrelated buyers. As part of the deal, the buyers agreed to assume the personal guarantees, and the lender agreed to terminate all of the loan agreements with the corporation. The total amount of debt assumed and canceled in the transaction was over $53.2 million.

On its original 2012 federal income tax return, the S corporation reported this amount in its gross receipts for the taxable year, resulting in taxable income of just over $2.7 million. But the corporation later filed an amended return that just so happened to exclude $2.7 million of the discharged debt on the grounds that the corporation was insolvent to that extent. This resulted in a taxable income of zero for the year. The IRS was unimpressed, issuing a deficiency notice in 2016 to the tune of $3.1 million, together with almost $780,000 in interest and penalties.

It is well accepted—even if not entirely supported among commentators—that the amount of any debt, whether recourse or nonrecourse, is included in the amount realized from the sale or other disposition of property encumbered by the debt. *Commissioner v. Tufts*, 461 U.S. 300 (1983); *Crane v. Commissioner*, 331 U.S. 1 (1947). The debt relief is seen as part of the sale proceeds, and not as COD income that is eligible for potential exclusion under IRC §108(a). As the court here noted: “If nonrecourse debt is conditioned upon a sale or exchange of property or is otherwise a part of that underlying sale or exchange, the amount of debt relief is properly included in the amount realized and is not COD income.” Quite clearly, the loans in this case were either assumed by the buyers or terminated by the lender as part of the sale of the property.

The taxpayer stressed that it mattered that the corporation was insolvent and that he had personally guaranteed the loans. But the court observed that the status of the loans as to the taxpayer does not control the status of the loans as to the corporation, a separate taxpayer. All that matters is that the loans were nonrecourse to the corporation, the seller. As a result, the court upheld the IRS’s deficiency.

The result would have been different if the loans were “recourse loans” as to the corporation. When a debt is recourse, the amount realized from the sale of the underlying encumbered property consists only of the actual consideration received by the taxpayer; the amount of the canceled debt is not included in the amount realized. This is confirmed in Regulation §1.1001– 2(a)(2): “The amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness....” Instead, to the extent the recourse loan is canceled, the taxpayer has COD income, potentially excludible under §108(a). See Treas. Reg. §1.1001–2(c), Example (8).

B. Disregarded Entity’s C.O.D. Income is Reportable by Owner (*Jacobowitz v. Commissioner*, T.C. Memo. 2023-107, August 16, 2023)

The Tax Court has held that the COD income of a taxpayer’s single-member limited liability company was gross income to the taxpayer, despite increasingly desperate arguments from the taxpayer to the contrary. The taxpayer was the sole member of a limited liability company created in 2003. In 2006, the entity obtained a line of credit with a local bank, secured by the entity’s business assets. The entity drew on the account over the next few years. The entity last made a payment on the line of credit in 2010. In 2017, the bank sent the entity a

Form 1099-C, Cancellation of Debt. The form indicated that, as of December 30, 2016, the bank had discharged the total principal balance owed, together with accrued interest. This amounted to nearly $35,000. The form also indicated that the reason for the discharge was "Statute of limitations or expiration of deficiency period." When the taxpayer did not include this amount in gross income, the IRS determined a deficiency.

Before the Tax Court, the taxpayer first argued that the COD income should be attributed to the entity and not to him because he never personally guaranteed the entity's loan. Alas, that's not how disregarded entities work. All of the tax items of a disregarded entity (items of income, gain, loss, deduction, and credit) are reportable by the entity's owner, and that includes COD income. The taxpayer could have elected corporation status for the entity, and doing so would have made the entity a separate taxpayer for federal tax purposes. But the taxpayer did not do so. Under the default rules, then, the entity is disregarded, meaning the entity's COD income is taxable to the taxpayer.

The taxpayer then argued that any COD income arose in 2008 and not in 2016. The bank did not cancel the debt until 2016, but the taxpayer claims that the debt was really discharged in 2008 because the property that secured the line of credit was abandoned in that year and because no payments were made on the line of credit since that time (even though there was evidence of payment as late as 2010). The court observed that a debt is discharged when it becomes clear the debt will never have to be paid. In any given case, that requires examination of the facts and circumstances. Notably, Reg. §1.6050P-1(b)(2) provides a list of "identifiable events" that qualify as the discharge of debt. Of relevance here, "A cancellation or extinguishment of an indebtedness upon the expiration of the statute of limitations for collection of an indebtedness … or upon the expiration of a statutory period for filing a claim or commencing a deficiency judgment proceeding" is an identifiable event. Reg. §1.6050P-1(b)(2)(i)(C). Under applicable state law, a bank seeking repayment on a delinquent account faces a six-year statute of limitations. Thus, after a final payment in 2010, the bank had until 2016 to commence an action to enforce repayment. Since the bank did not undertake this action, the debt was canceled in 2016, when the statute of limitations ran. Therefore, said the court, the COD income arose in 2016 because that's when the bank lost the ability to collect on the amount outstanding.

The taxpayer then argued that the COD income should be treated as capital gain, but as the cancelation of debt is not a "sale or exchange" of a capital asset, the court summarily rejected this claim. Finally, the taxpayer argued that the portion of debt representing accrued interest should be excluded from gross income under IRC 108(e)(2), which states that COD income does not include that portion of a discharged debt that would have been deductible if paid. But the court held that the taxpayer did not prove that the interest that accrued on the debt related to the entity's business. Indeed, the interest discharged by the bank accrued from 2010 to 2016, when the entity was no longer in business. Having rejected all of the taxpayer's arguments, then, the court upheld the IRS's determination.

XXXIV. FINAL REGULATIONS UPDATE ACTUARIAL TABLES AND MOVE THEM ONLINE (*T.D. 9974*, June 7, 2023)

Treasury has issued final regulations relating to the use of actuarial tables in valuing annuities, interests for life or a term of years, and remainder or reversionary interests. The final regulations adopt regulations proposed in May, 2022. The new regulations contain updates to the mortality tables used to compute life expectancies. The updated tables apply to interests valued on or after June 1, 2023.

Section 7520(a) generally provides that the value of any annuity, any interest for life or a term of years, or any remainder or reversionary interest shall be determined under tables prescribed by Treasury and by using an interest rate equal to 120 percent of the Federal midterm rate in effect under IRC §1274(d)(1) for the month in which the valuation date falls, rounded to the nearest two-tenths of one percent. Section 7520(c)(2) requires Treasury to update the applicable tables at least once every ten years using "the most recent mortality experience available as of the time of the revision." The new regulations employ Table 2010CM, one based on data compiled from the 2010 census. Going forward, the regulations will reference tables that will be available online and in IRS publications; Table S (Single Life Remainder Factors) and Table U1 (Unitrust Single Life Remainder Factors) will be available only online and will not be published in the regulations.

Unsurprisingly, the updated tables reflect slightly longer life expectancies. Under the old Table S, for example, the value of a life estate retained by a 60 year-old donor was worth 44.795 percent of the value of the transferred property (assuming interest at 3.0 percent). Under the new table, that same life estate is worth 47.149 percent of the value of the transferred property.

XXXV. LOSSES IN 2020 DON'T WIPE OUT CRYPTOCURRENCY GAINS FROM EARLIER YEARS (*Kim v. Commissioner*, T.C. Memo. 2023-91, July 20, 2023)

The Tax Court has held that despite suffering significant losses from cryptocurrency transactions realized in 2020, the taxpayer was still liable for tax on capital gains from cryptocurrency transactions recognized in 2013 and 2017, rejecting the taxpayer's "unclean hands" argument.

The taxpayer reported gains from cryptocurrency transactions on timely-filed returns for the years 2013 through 2017. That last year was a big one, with the taxpayer reporting over $18.5 million in sale proceeds from virtual currency transactions. But the 2017 return showed a shortterm capital gain of only $42,069. The IRS examined the return, and when the taxpayer did not supply records to prove how he computed the gain, the revenue agent used records received from the virtual currency exchanges to reconstruct the various sale transactions. That led to the determination that the taxpayer had the following net short-term gains and losses:

Year	Net Short-Term Gain (Loss)
2013	$75,400
2014	($35,408)
2015	($14,125)
2016	$23,422
2017	$4,066,629

The $49,000 of losses from 2014 and 2015 carried over to 2016, wiping out the short-term gain for that year and leaving the taxpayer with a $26,000 carryforward loss coming into 2017. But that still leaves the taxpayer with short-term capital gain of over $4 million for 2017, leading the IRS to assert a $1.57 million deficiency for 2017 and a $12,310 deficiency for 2013.

The taxpayer did not contest the math. Instead, he argued that the crypto assets giving rise to the 2017 gains "were completely wiped out" in 2020, that the federal government's mishandling of the COVID pandemic "directly caused" that loss, and that "under the Clean Hands doctrine of US law" (stet), the IRS was estopped from collecting on the deficiencies. But the Tax Court rejected the argument for having "no legal basis." As the court noted:

> [T]he "unclean hands" principle is designed to withhold equitable relief from one who has acted improperly. (citation omitted) Respondent is not seeking equitable relief but is endeavoring to recover taxes determined to be due from petitioner under the Internal Revenue Code. And while petitioner may disagree with the Government's policy response to the COVID epidemic, he has not shown that any agency of the Government (much less the IRS) acted improperly.

Accordingly, the court confirmed that the taxpayer owed tax on the net gains from both 2013 and 2017.

While corporations have the luxury of carrying net capital losses both forward and backward, see IRC §1212(a)(1), individuals may only carry such losses forward. See IRC §1212(b)(1). The fact that the taxpayer may have suffered significant losses in 2020 does not absolve him from paying tax on gains from earlier years, even where the later losses effectively offset the entirety of the prior gains. This case underscores one of the side effects of the annual accounting principle, the notion that "every year stands alone." The tax treatment of gains in one year is not affected by losses in a subsequent year.

XXXVI. GIFT TRANSFERS REPORTED IN VOLUNTARY DISCLOSURE PROGRAM DOCUMENTS WERE ADEQUATELY DISCLOSED (*Schlapfer v. Commissioner*, T.C. Memo. 2023-65, May 22, 2023)

The Tax Court has held that a gift made in 2007 was adequately disclosed on a 2006 federal gift tax return included as part of an Offshore Voluntary Disclosure Program (OVDP) packet, thus precluding the IRS from assessing a deficiency because the applicable statute of limitations had expired.

The IRS generally has three years to assess gift tax after a gift tax return has been filed. IRC §6501(a), (c). But, as to any particular gift, the three-year clock only starts once the gift has been adequately disclosed on a gift tax return or on a statement attached to a gift tax return. Treas. Reg. §301.6501(c)-1(f)(1). Indeed, adequate disclosure of a transfer starts the three-year clock "even if the transfer is ultimately determined to be an incomplete gift." Treas. Reg. §301.6501(c)-1(f)(5). The Tax Court has earlier announced that a disclosure is "adequate" if it is "sufficiently detailed to alert the Commissioner and his agents as to the nature of the transaction so that the decision as to whether to select the return for audit may be a reasonably informed one." *Thiessen v Commissioner*, 146 T.C. 100, 114 (2016).

In this case, Ronald Schlapfer, a Swiss citizen lawfully admitted for permanent residence in the United States, gifted stock in an entity he owned to his mother, aunt, and uncle, all of whom lived in Switzerland. Later, in 2008, Schlapfer became a citizen of the United States. In a disclosure packet submitted to the IRS in 2013 as part of its OVDP, Schlapfer included, among dozens of other forms, a gift tax return for 2006 that included a statement that Schlapfer "made a gift of controlled foreign company stock valued at $6,056,686" and that Schlapfer did not owe gift tax on the transfer because he did not intend to reside permanently in the United States until he obtained citizenship in 2008. The specific information about the gift transfers appeared in an "offshore entity statement" that was also part of the disclosure packet, though the statement indicates the gift was entirely to his mother and made no mention of his aunt or uncle. The IRS, however, determined that the gift transfers were made in 2007 and that, because he did not file a gift tax return for 2007, the gifts were not adequately disclosed so as to start the statute of limitations on assessment. In 2019, the IRS prepared a substitute gift tax return for 2007 and issued a notice of deficiency for 2007 determining a gift tax liability of over $4.4 million.

Before the Tax Court, Schlapfer argued the gifts were adequately disclosed on the 2006 gift tax return which was supplied in late 2013. He thus claimed it was too late for the IRS to collect gift tax on these transfers. The Tax Court agreed. In doing so, the court rejected the IRS's argument that there was no adequate disclosure because the gift transfers were only specified on the offshore entity statement and not on the gift tax return or the statement attached to the gift tax return. The court concluded that the gift tax return statement's reference to "controlled foreign company stock" was enough to alert the IRS to look at other documents in the disclosure packet. "When deciding whether an item has been adequately disclosed," said the

court, "we may consider not only a return, but also documents attached to the return *plus informational documents referenced in the return.*" (Emphasis added.)

The IRS also argued that the disclosure was inadequate since the offshore entity statement only mentioned a gift transfer to his mother and made no mention of his aunt or uncle as sharing in the gift made to the mother. But the Tax Court ruled there was substantial compliance with the requirement to identify all gift transfers since the disclosure did mention the gift of stock. The identity and relationship of each donee, said the court, is "not essential to the overall purpose of the (disclosure) requirement, which was to provide the IRS with enough information to understand the nature of the transfer." That the statement suggested a single gift to one recipient as opposed to a gift split between three recipients "does not make a meaningful difference in understanding the nature of the transfer."

Because Schlapfer adequately disclosed the gifts on his gift tax return and offshore entity statement, the three-year assessment period began in late 2013 when the documents were furnished to the IRS. It was thus too late for the IRS to collect gift tax on the transfers in 2019.

XXXVII. NO MORTGAGE INTEREST DEDUCTION FOR TAXPAYER WHO PROVES NEITHER HOME OWNERSHIP NOR LIABILITY FOR MORTGAGE (*Shilgevorkyan v. Commissioner*, T.C. Memo. 2023-12, January 23, 2023)

The Tax Court has upheld the IRS's disallowance of a claimed mortgage interest deduction of $66,354 because the taxpayer could not prove that he owned the property to which the mortgage applied and because there was no evidence the taxpayer was the borrower in the loan arrangement giving rise to the mortgage.

The taxpayer, his two brothers, and the rest of his family immigrated to the United States from Armenia in 1987 and 1988. The three brothers together own and operate a number of small businesses. Alas, one of their activities was a check cashing scheme that involved filing false S corporation income tax returns. All three brothers were liable for additional tax and civil fraud penalties, but only one of the brothers (Edvard) served time in prison.

The home involved in the case is located in Paradise Valley, Arizona. Edvard and his wife paid almost $400,000 of the $1,525,000 purchase price in 2005 and financed the balance through a mortgage with Wells Fargo. When the loan was refinanced in 2006, the other brother (Artur) became another obligor on the new mortgage. Artur, though, never contributed to the downpayments and never resided at the home.

In 2010, Artur quitclaimed his interest in the Paradise Valley property to the taxpayer, all without the knowledge of Wells Fargo. There was no consideration for the conveyance. While the taxpayer did reside at the property during the taxable year at issue (2012), he also resided in a condo complex owned by the family. The taxpayer paid utility and cable bills in connection with the condo property he occupied. On a home loan application of his own dated in early 2013, the taxpayer stated he was leasing the Paradise Valley property.

But on his federal income tax return for 2012, the taxpayer (listing his new home in Phoenix as his address) deducted $66,354 in mortgage interest in connection with the home in Paradise Valley. The IRS disallowed the deduction, and the Tax Court had little trouble upholding the resulting deficiency.

The Tax Court unveiled and applied a helpful framework for its decision:

> Petitioner must satisfy the following three requirements to be entitled to a deduction pursuant to section 163(a) and (h)(2)(D): (1) the indebtedness must be his obligation, (2) he must either be the legal or equitable owner of the property subject to the mortgage, and (3) the residence is (sic) his qualified residence.

Unfortunately for the taxpayer, he satisfied none of these requirements.

First, there was no evidence that the taxpayer made any payments on the Paradise Valley property. He claimed to have made payments to Edvard, but these could not be substantiated. There was no evidence of payments to Wells Fargo and no evidence of correspondence from Wells Fargo to the taxpayer. Edvard—who served time for participation in a tax fraud scheme, remember—testified that he and the taxpayer had an arrangement under which the taxpayer would pay half of the costs and would receive half of the profits from a sale of the home, but there was no documentation to support this claim.

Second, the taxpayer acquired no interest in the home from Artur because Artur had nothing to convey to the taxpayer in quitclaim deed. Although Artur was listed on the mortgage, the court found that he was a mere "accommodation party" with no ownership interest in the property. That meant the taxpayer acquired no ownership interest in the Paradise Valley property through the deed, and there was no other evidence by which the taxpayer would have acquired an ownership interest.

Finally, the court held that the Paradise Valley home was not a "qualified residence" of the taxpayer. It certainly was not his principal residence, as most of his correspondence was sent to a different address, he never used the property's address on his bank statements or personal checks, and the record shows he spent a lot of time at the condo complex. Further there was no evidence the taxpayer selected the Paradise Valley home as his "one other residence" for purposes of claiming the mortgage interest deduction.

Having gone 0-for-3 in proving his case, the court concluded that the taxpayer was not entitled to the mortgage interest deduction claimed on the return.

XXXVIII. DEDUCTION FOR ACCRUED BUT UNPAID DEFERRED COMPENSATION IS NO SLAM DUNK (*Hoops, LP v. Commissioner*, 7th Cir., August 9, 2023)

The Seventh Circuit Court of Appeals affirmed a Tax Court decision that disallowed a deduction claimed on an amended partnership income tax return by an accrual method partnership for unpaid deferred compensation liabilities assumed by the buyer in a transaction involving the sale of the partnership's assets and liabilities. The case considers the extent to which the "matching rule" applicable to nonqualified deferred compensation arrangements meshes with the "economic performance" requirement applicable to deductions claimed by accrual method taxpayers. As if that's not compelling enough, the case also involves professional basketball. But just as new basketball players must first learn dribbling, bounce passes, and chest passes before getting to the flashy stuff, so too must we first master the fundamentals of deferred compensation and the accrual method before looking at what happened in the case.

A. Background on the Matching Rule for Nonqualified Plans

In a deferred compensation arrangement, an employee (or independent contractor) agrees to let an employer keep an amount of wages, bonuses, salary, or other compensation that would otherwise be payable for a certain period of time. At the end of that time, the employer pays the compensation, plus interest, to the employee. Because the employee is neither in actual nor constructive receipt of the deferred compensation, the employee is not subject to tax until the compensation (and interest) is distributed to the employee.

The Internal Revenue Code generally recognizes two types of deferred compensation arrangements: qualified plans and nonqualified plans. A qualified plan does not discriminate in favor of highly compensated employees. In other words, it must be available to the rank and file and not just to the top executives. Qualified plans are subject to a number of significant restrictions related to participation rates, contribution amounts, and distribution amounts. What's more, qualified plans generally must be funded through a trust, and once an employer deposits sums into the trust it cannot later reclaim them.

Nonqualified plans, on the other hand, are much more flexible. Employers can limit participation in nonqualified plans to highly paid executives, and there is no requirement to set aside any particular amount of funds beyond the reach of employers. Under a nonqualified arrangement, therefore, the employer can keep and use the deferred funds as a source of working capital.

Given all of the restrictions and limitations applicable to qualified plans, employers prefer nonqualified deferred compensation arrangements. To incentivize qualified plans, therefore, the Code imposes a "matching rule" under IRC §404(a). Under this rule, generally, contributions to a nonqualified plan are not deductible by the employer until the employee includes those amounts in gross income. In that way, the timing of the employer's deduction "matches" the timing of the employee's inclusion in gross income. By contrast, contributions to

a qualified plan are deductible when paid to the trust, even though the employee will not have gross income until a later taxable year. The offer of an earlier deduction is the carrot given to the employer to create a qualified plan that will provide retirement savings for more employees.

B. Background on the Economic Performance Requirement

Most business entities use the accrual method of accounting. Under the accrual method, a taxpayer may claim a deduction when all events have occurred that fix the obligation to pay a liability, the amount of the liability can be determined with reasonable accuracy, and "economic performance" with respect to the liability has occurred. Reg. §1.461-1(a)(2)(i). Congress introduced the "economic performance" requirement with the enactment of §461(h) as part of the Deficit Reduction Act of 1984.

The statute sets forth several rules for determining when economic performance of a liability occurs and authorizes the IRS to issue regulations explaining when economic performance occurs in situations not expressly addressed in the statute. IRC §461(h)(2)(D). In the context of deferred compensation arrangements, regulations issued in 1992 provide that "the economic performance requirement is satisfied to the extent that any amount is otherwise deductible under section 404 (employer contributions to a plan of deferred compensation)." Reg. §1.4614(d)(2)(iii)(A). This language indicates that "economic performance" of the liability to pay deferred compensation follows the matching rule of §404(a). In other words, an accrual method taxpayer does not deduct amounts contributed to a nonqualified plan until the employee includes them in gross income.

But the taxpayer in this case found another regulation that, it argued, suggested a different result could apply. So let's now consider what happened in the case.

C. Facts of the Case

Business mogul Michael Heisley bought the Vancouver Grizzlies, a National Basketball Association team, for $160 million in 2000, through Hoops, LP ("Hoops"), a partnership formed by his S corporation and that corporation's qualified subchapter S subsidiary. Hoops is an accrual method taxpayer. After promising to keep the franchise in Vancouver, Heisley (technically, Hoops) moved the team to Memphis and admitted a couple of new partners to the team.

In 2012, upstart billionaire Robert Pera bought the team through Memphis Basketball LLC, his Nevada entity (the "Buyer"). The purchase involved the acquisition of all of the assets and liabilities of Hoops. Included among the liabilities assumed by the Buyer in the 2012 sale were player contracts for two of the team's star players, Zach Randolph and Mike Conley. At the time of sale, Hoops owed about $11.8 million in deferred compensation to Randolph for games played in prior seasons but which would not be payable until sometime after the sale. Hoops also owed about $800,000 in deferred compensation to Mike Conley for games played prior to the sale but which would not be payable until after the sale.

On its 2012 partnership tax return, Hoops reported an amount realized of just over $419 million from the sale of its assets and liabilities to the Buyer. Claiming an adjusted basis of $120 million in the assets sold, Hoops reported a recognized gain of $299 million. Included as part of the amount realized from the sale was the $10.68 million present value of the $12.6 million in deferred compensation owed to Randolph and Conley. This is correct, as the sale relieved Hoops of the liability to make the future payments to those players: the present value of that relieved future liability represents income from the discharge of indebtedness.

About a month after filing its return, however, Hoops filed an amended return in which it claimed a deduction for the $10.68 million present value of the deferred compensation liability. Hoops based this deduction on another provision in the economic performance regulations. Regulation §1.461-4(d)(5)(i) states in relevant part:

> If, in connection with the sale or exchange of a trade or business by a taxpayer, the purchaser expressly assumes a liability arising out of the trade or business that the taxpayer but for the economic performance requirement would have been entitled to incur as of the date of the sale, economic performance with respect to that liability occurs as the amount of the liability is properly included in the amount realized on the transaction by the taxpayer.

Hoops claimed that this regulation authorized a deduction for the deferred compensation to offset the amount realized from the discharge of the liability from the Buyer's assumption of the obligation. When the IRS disallowed the additional deduction, Hoops cried foul and went to the Tax Court.

D. The Tax Court Played Referee

The Tax Court held that the matching rule of §404(a) still applies and that the result does not change just because Hoops uses the accrual method. The regulation cited by the taxpayer offers an early deduction for an assumed liability "that the taxpayer but for the economic performance requirement would have been entitled to incur as of the sale." In other words, the liability must be deductible but for the economic performance requirement and no other requirement. Here, though, said the court, "it is the section 404(a)(5) limitation as to the amount deductible for any year that precludes deduction for the year of the 2012 sale, not any purported failure to satisfy the economic performance requirement." So even the regulation cited by the taxpayer does not yield the result it wants.

Hoops argued the call, claiming that if it cannot claim a deduction on the 2012 return it will never get a deduction for the deferred compensation liability, leading to what Hoops called "the ridiculous result" of recognizing income with no corresponding deduction. But the Tax Court, citing the Ninth Circuit's decision in Albertson's, Inc. v. Commissioner, 42 F.3d 537 (9th Cir. 1994), found that "in the light of Congress' intent to deviate from the clear reflection of income principle and to ensure matching of income inclusion and deduction between employee and

employer under nonqualified plans, we conclude that disallowing a deduction for the year of sale would not lead to a 'ridiculous result.' To the contrary, under the facts of this case, such a result comports with the purpose of section 404."

Hoops argued in the alternative that if it gets no deduction for the liability then it should not have gross income from the Buyer's assumption of the liability. But the Tax Court observed the simple fact that the debts owed to players Randolph and Conley were bona fide and, thus, a real liability of Hoops. "When Buyer assumed the deferred compensation liability, Hoops was discharged from its obligation to pay deferred compensation as a result of the 2012 sale, Thus, pursuant to section 1001, Hoops was required to take into account the amount of the deferred compensation liability in computing its gain or loss from the sale."

E. Upon Review, The Ruling Stands as Called

On appeal, Hoops insisted that the aforementioned regulation outweighs the matching rule in IRC §404(a)(5) because the regulation specifically applies in the context of asset sales. In effect, it claims, the matching rule is a rule of economic performance that, like any other rule of economic performance, is subject to the special rule in the case of asset sales. But the Seventh Circuit concluded the argument has it backwards: the matching rule is the special rule that outweighs the rule in the regulation about asset sales. The appellate court concluded that the matching rule reflects congressional intent "to treat the deductibility of deferred-compensation salary plans differently than ordinary service expenses—and that this special treatment prevails over any general provisions otherwise applicable to liabilities assumed in asset sales."

The court likewise rejected Hoops's claim that the matching rule is a rule of economic performance, calling it "the fundamental flaw" in Hoops's argument:

> It was not §461(h)'s economic performance requirement that prevented Hoops from taking the deduction in 2012, but the rule in §404(a)(5) governing nonqualified deferred-compensation plans. Hoops's decision not to pay the players in 2012 and its decision not to contribute to a qualified plan precluded its ability to claim the deduction that same year. Hoops cannot assert that either of these are economic performance barriers as that term is defined in 26 U.S.C. §461(h)—but that is what Hoops would need to prove to show that the [regulation] applies. We cannot agree with Hoops that the definition of economic performance sweeps broadly enough to include the specific, deferred compensation provision in §404(a)(5).

The court also noted that nothing in IRC §404 or the regulations thereunder contains any reference to an exception for asset sales, reflecting the intent "to displace the accrual method" (and the regulation thereunder containing a special exception for asset sales) with the matching rule.

Hoops continued to insist that the assumption of the deferred compensation liability was a “deemed payment” of the compensation that would allow a deduction at the time of sale. But the Seventh Circuit observed that the assumption of the liability by the buyer has nothing to do with payment of the compensation to the athletes, and only actual payment triggers a deduction for the payor under the matching rule.

Finally, Hoops argued that if it does not get a deduction in the year of sale it might never get the deduction. The court concedes this could happen, but quickly notes this was a foreseeable risk that Hoops could have avoided “by adjusting the sales price to reflect the deductibility, contributing to qualified plans for the players to take earlier deductions, or renegotiating the players’ contracts and accelerating their compensation to the date of sale.”

XXXIX. WITHHOLDING IS NOT SYNONYMOUS WITH TAX LIABILITY (*Patrinicola v. Commissioner*, T.C. Memo. 2023-16, February 14, 2023)

The Tax Court has upheld a deficiency assessed against a married couple for failing to include certain pension distributions in gross income on their 2016 joint federal income tax return. The taxpayers misunderstood guidance furnished to them from their pension plan administrator regarding an exemption from withholding tax as meaning that the distributions they received were not subject to federal income tax. Alas, the error caused the couple to be liable both for additional income tax and for alternative minimum tax.

In 2016, the taxpayers received pension distributions from several different sources. But while the Forms 1099-R they received indicated some $31,000 in taxable distributions made to the couple, they included only $24,610 of those amounts in gross income. In contesting the resulting deficiency, the taxpayers argued that the omitted portion of the distributions were not taxable because of a rule that provides:

> Monthly pension payments will be subject to Federal income tax withholding if the taxable portion of the sum equals to or exceeds are less than (sic) $1,990.00 per month. Your pension is not taxable if it is in the allowable range.

Needless to say, there is no rule excluding from gross income monthly pension distributions of less than $1,990. The Tax Court concluded that this must have been advice about withholding given to the taxpayers by one of the pension plan administrators. But as the court observed:

> Federal income tax withholding is not the same thing as the federal income tax that is owed on the pension distributions. Withholding is the amount that the payer deducts from the pension payments and sends to the IRS on the taxpayer’s behalf. In general, pensions are subject to federal income tax withholding, but taxpayers can choose not to have federal income tax withheld. … Pension distributions are included in the taxable income regardless of the taxpayer’s decision regarding withholding.

Accordingly, the court upheld the deficiency. It is easy to scoff at the argument of the taxpayers, but the court indicates that this has quite an ordeal for the couple. The court concluded that:

> We understand and are sympathetic to Mr. Patrinicola's frustrations in dealing with the proposed adjustments to his return that have been largely conceded as well as the multiple notices that he received from different IRS offices that seemingly were inconsistent and confusing.

Neither party comes out looking especially well in this case.

XL. PARTNERSHIP TAX MEETS INTERNATIONAL TAX WHEN A NONRESIDENT ALIEN SELLS AN INTEREST IN A PARTNERSHIP WITH INVENTORY (*Rawat v. Commissioner*, T.C. Memo. 2023-14, February 7, 2023)

The Tax Court has held that $6.5 million of the proceeds from the sale of a partnership interest by a nonresident alien individual was attributable to inventory items of the partnership and could therefore be United States-source income on which the individual would owe federal income tax. The case offers a helpful primer on the intersection of partnership taxation and the United States taxation of international transactions.

The taxpayer owned a 30-percent interest in a limited liability company that manufactures and sells a variety of consumer products including 5-hour Energy drinks. She sold her interest in 2008 for a 20-year promissory note with a face amount of $438 million. (Gulp!) At the time of the sale, according to a stipulation between the taxpayer and the IRS, the taxpayer's share of inventory items held by the LLC was $6.5 million. The taxpayer argued that no portion of this "inventory gain" from the sale should be treated as a sale of inventory since she did not sell any inventory—she sold a partnership interest. But as the Tax Court found, this argument ignores §751(a)(2), which provides that the portion of the proceeds from the sale of a partnership interest attributable to inventory items must be treated as sold separately from the partnership interest.

The taxpayer then argued that the inventory gain would be sourced outside the United States because it was not effectively connected with the conduct of a trade or business within the United States. But the Tax Court concluded this is not necessarily true. For purposes of sourcing the income, said the court, the inventory gain is "income derived from the sale of inventory property" under §865(b) and, thus, must be sourced under the rules in §§861(a)(6), 862(a)(6), and 863. Since the application of these sourcing rules has not yet been argued by the parties, however, all the court could do at this point was deny the taxpayer's motion for summary judgment. It remains to be seen how the inventory gain will be sourced under these additional rules, which will depend on additional facts about the LLC's inventory that were not discussed in the opinion.

XLI. TAX COURT DETERMINES DEDUCTIBLE GAMBLING LOSSES THROUGH CASINO RECORDS (*Bright v. Commissioner*, Docket No. 10095-22, May 4, 2023).

In a bench opinion, the Tax Court used casino records to determine that the taxpayer, a recreational gambler, had gambling losses of no less than $191,756 for 2019. It thus allowed the taxpayer to deduct this amount against his reported gambling winnings for that year. But the court rejected the taxpayer's argument that his gambling winnings were less than the amount originally reported on his federal income tax return because he lacked evidence that the amount of winnings was in fact less than the reported amount.

The taxpayer performs storm restoration work as an employee but spends most of his paychecks gambling at three casinos in Minnesota and Iowa. Casino records show he had net losses of $22,375, $16,850, and $894 from the three casinos in 2019. But the taxpayer received 24 Forms W-2G for that year showing wins totaling over $110,000. Oddly, though, the taxpayer's 2019 federal income tax return, prepared with the assistance of a tax preparer, reported over $240,000 in winnings as Schedule C business profits. Against those profits, the taxpayer deducted an equal amount of expenses on the Schedule C to reduce the net profit from the gambling business to zero.

The IRS determined that the taxpayer was not in the business of gambling, so it disallowed the claimed expenses. The taxpayer then filed an amended return reporting the gambling losses to the extent of his winnings as an itemized deduction on Schedule A, but the IRS rejected this reporting position and issued a deficiency notice.

Section 165(d) allows amateur gamblers to deduct gambling losses to the extent of gambling winnings, but the losses must be reported as an itemized deduction on Schedule A. At issue in this case is both the amount of the taxpayer's gambling winnings and the amount of his gambling losses. While his 2019 return indicated winnings of over $240,000, he argued that only the amounts shown on the Forms W-2G should be included in gross income. But the Tax Court ruled that because the taxpayer could not prove that his winnings were less than what he reported on his return, he was bound by that figure. The taxpayer did not know how the return preparer derived the amount included in gross income, but that was no excuse. Besides, casinos are only required to issue Forms W-2G for slot machine jackpots of $1,200 or more, and based on the taxpayer's tendency to engage in both table games and sports betting in addition to slot machine play, it is certain that he had winnings beyond what was reported on the forms.

As for the losses, the only proof came from the casino records that tracked his overall losses on a monthly basis. So the court compared the Form W-2G winnings from each casino for any given month against the monthly loss shown on the casino's records to compute the minimum overall loss for that month. "For example," said the court, "his Form W-2G winnings at Mystic Lake for January totaled $8,162, but he had an overall net loss of $1,192, [so] he must have lost $9,354. … Thus, we conclude that [the taxpayer] lost at least that much at Mystic Lake in January." After adding all the monthly amounts from each of the three casinos, the court

determined that the taxpayer incurred gambling losses of at least $191,756, so it allowed the taxpayer to deduct that amount against the $240,000 in reported winnings.

The case is a reminder that taxpayers must be careful in choosing their return preparers and cannot simply endorse whatever returns they are asked to sign without confirming where the preparer derived the numbers reported. The taxpayer got lucky in that the court was willing to wade through the casino records to compute the taxpayer's minimum net loss instead of simply rejecting the offered records as incomplete proof of the claimed loss.

XLII. PAYMENTS FROM TAXPAYER'S BUSINESS ARE COMPENSATION, NOT LOANS (*Nath v. Commissioner*, T.C. Memo. 2023-22, February 27, 2023).

The Tax Court has held that $1.95 million in wire transfers from the taxpayer's Cambodian construction company to his personal bank account for paying living expenses represented taxable compensation to the taxpayer. The taxpayer claimed the transfers were loans, but the evidence supporting this claim was suspect.

The taxpayer and his father were the sole and equal owners of Grand Lion Group Co., Ltd., a Cambodian company engaged in the business of building hotels. The taxpayer performs project oversight and contractor selection services on behalf of the company. In 2014, the taxpayer transferred about $1.5 million from the company's account to his own United States bank account. The taxpayer transferred another $450,000 from the company in 2016. These transfers required only the consent of the taxpayer and his father. Neither transfer was reported as gross income on the taxpayer's joint federal income tax returns.

After conducting a bank deposits analysis, the IRS discovered the unreported deposits and determined that the amounts should have been reported as gross income. Before the Tax Court, the taxpayer argued that the transfers were loans from the company, but the court was not persuaded:

> Mr. Nath's evidence regarding the wire transfers from Cambodia was unreliable and often conflicting. He testified that he was borrowing money from [the company] and that the transfers represented advances of income from [the company]. At times, he referred to the advances as salary…. And at other times, he referred to the advances as part loan, part salary.
>
> He offered various unreliable trial exhibits. Two exhibits purported to be loan agreements between Mr. Nath and [the company] for loans made in 2014 and 2016. Mr. Nath signed the agreements both on his own behalf as the borrower and on behalf of [the company] as the lender. Neither agreement is dated. They are identical except for the loan amounts and effective dates. … They require him to pay interest 'at a rate of 8% per annum' within 14 business days of receiving an annual invoice from [the company]. Mr. Nath testified that he made

monthly (not annual) payments, but he did not provide any documents evidencing those payments.

In light of this (lack of) evidence, the court had little trouble concluding the transfers were not bona fide loans. The loans were unsecured, and because the taxpayer signed as both borrower and lender there was no adversity between the parties. The court found it unlikely that the company would enforce its "right" to repayment if the taxpayer was unable to repay the obligation, and the only evidence of repayment was the taxpayer's own testimony, which the court did not find credible. In addition to upholding the IRS's income determination, the court also upheld the imposition of an accuracy-related penalty on these facts.

XLIII. LEGAL FEES PAID IN PATENT INFRINGEMENT SUITS ARE EXPENSES, NOT COSTS FACILITATING ACQUISITION OF F.D.A. APPROVAL (*Mylan Inc. & Subsidiaries v. Commissioner*, 3d. Cir., July 27, 2023)

The Third Circuit Court of Appeals has affirmed a decision of the Tax Court holding that a manufacturer of generic pharmaceutical drugs could deduct legal expenses incurred to defend patent infringement suits as ordinary and necessary business expenses because the patent litigation was distinct from the Food and Drug Administration (FDA) approval process. The IRS had argued that the fees should have been capitalized as costs that facilitate the FDA's approval to market and sell generic version of several brand-name drugs. The case illustrates the difficulty in distinguishing between immediately deductible expenses and capital expenditures that may be recovered, if at all, over the useful life of the asset.

The taxpayer manufactures generic drugs. Even though the brand-name drugs the taxpayer replicates have already received approval from the FDA, the taxpayer must still get agency approval before marketing and selling their products. To incentivize the development of generic alternatives to brand name drugs, Congress passed the Hatch-Waxman Act in 1984. The Act created an expedited process for obtaining FDA approval to sell a generic drug. Under this procedure, the applicant must show that the generic version has the same active ingredient and is biologically equivalent to the brand-name drug. Because the brand-name drug is very likely patented, the applicant must also certify either that: (1) no patent on the branded drug has been submitted to the FDA; (2) any relevant patents on the branded drug have expired; (3) any relevant patents will expire by the time the generic drug goes to market with FDA approval; or (4) any relevant patents are either invalid or will not be infringed by the manufacture or sale of the generic version.

That last option—certifying that any existing patent is invalid or will not be infringed—happens to be the most common. When the last option is used, applicants have to give notice to the brand-name manufacturer, who then has 45 days to file a patent infringement claim against the applicant. If the brand-name manufacturer does so, FDA approval of the generic version is stayed for 30 months. If the FDA approves the generic version, the maker of the generic drug has to wait until the end of the 30-month stay unless the litigation is sooner resolved in the applicant's favor. But no matter whether the brand-name manufacturer files suit,

the FDA's regular approval process still applies. In other words, any litigation does not impact the FDA's approval process, and the approval process has no effect on any lawsuit.

In the tax years at issue (2012 through 2014), the taxpayer paid about $123 million in legal fees in connection with preparing notice letters and litigating resulting lawsuits. The taxpayer deducted all of these fees on its federal income tax returns, taking the position that the legal fees were ordinary and necessary business expenses. The IRS determined that the fees had to be capitalized, however, because they were part of the cost of obtaining FDA approval and thus were costs that "facilitated" the acquisition of an intangible asset. This resulted in deficiencies totaling $50 million, leading the taxpayer to petition the Tax Court for redetermination. The Tax Court held that the legal fees incurred to prepare notice letters are required to be capitalized because they were necessary to obtain FDA approval of the generic drugs. 156 T.C. No. 10 (2021). But the Tax Court also held that the legal fees incurred in connection with lawsuits arising from the notice letters were deductible as business expenses. That led the IRS to bring this appeal.

Amounts paid to facilitate the acquisition or creation of an intangible asset must be capitalized. See Reg. §§1.263(a)-4(b)(1)(v), -4(e)(1)(i). For several years, the IRS did not challenge the accepted practice of generic drug manufacturers to deduct litigation expenses in connection with lawsuits resulting from the notice required by the Hatch-Waxman Act. But in 2011 and in 2014, the Office of Chief Counsel issued memoranda concluding that drug companies had to capitalize and amortize the costs of defending patent infringement suits filed in response to a notice letter. The IRS's rationale is that litigation in these cases is part of the process of obtaining FDA approval and thus should be treated as part of the cost of the resulting intangible asset (i.e., regulatory permission to make, market, and sell the generic drug).

The Third Circuit rejected this reasoning, noting that litigation is not required to secure FDA approval:

> Nothing prevents a generic manufacturer from commercially marketing its approved drug under the cloud of patent litigation, as long as it has an effective FDA-approved [application]. … Win or lose, the outcome of patent litigation is irrelevant to the FDA's review; the generic is considered either safe and effective, or not. And all of this assumes that the patent owner chooses to file suit in the first place, which, according to evidence before the Tax Court, does not happen in a substantial percentage of instances where [notice letters are sent].
>
> … While it is true that, for up to 30 months, the Hatch-Waxman Act delays the effective approval of an [application] during follow-on litigation, that interplay between regulatory approval and litigation is unrelated to the FDA's final safety and effectiveness review.

The court further observed that lawsuits brought in response to an application are functionally identical to any other patent infringement suit, just that they operate under different time

constraints. But the differences in timing "does not justify disparate tax treatment of litigation expenses for generic manufacturers defending against patent infringement." And since it is well accepted that legal fees arising from defending against patent infringement suits are deductible business expenses, that same conclusion should arise here.

Both the Tax Court and the Third Circuit got this one right. Prevailing in a patent infringement suit does not give the applicant any more rights than it already had, and winning a lawsuit guarantees neither a patent nor FDA approval. Further, since patent holders in a significant number of cases never file a lawsuit to protect their patent, undergoing litigation is hardly just "part of the price" paid to get FDA approval of a generic drug application.

XLIV. DEDUCTIBLE HOBBY EXPENSES ARE MISCELLANEOUS ITEMIZED DEDUCTIONS (*Gregory v. Commissioner*, 11th Circuit, May 30, 2023)

The Eleventh Circuit Court of Appeals has affirmed a decision of the Tax Court that deductible expenses in connection with a hobby activity are miscellaneous itemized deductions and not, as the taxpayers contended, above the line deductions used in computing adjusted gross income.

Deductions in connection with hobby activities are limited to those expressly allowed in IRC §183. IRC §183(a). That section generally allows taxpayers engaged in a hobby to take deductions allowable under other Code provisions without regard to whether the activity is engaged in for profit. Those deductions are permitted regardless of the income generated from the activity. IRC §183(b)(1). In addition, a taxpayer may take "a deduction equal to the amount of deductions … allowable under this chapter … only if such activity were engaged in for profit." IRC §183(b)(2). But this deduction cannot exceed the taxpayer's gross income from the hobby activity, less the amount of deductions claimed under IRC §183(b)(1). In other words, a net loss from a hobby activity is generally not deductible.

Once a deduction is allowed, an individual taxpayer must determine whether the deduction is: (1) an above the line deduction; (2) a regular itemized deduction; or (3) a miscellaneous itemized deduction. An individual taxpayer generally prefers that a deduction be above the line because it is allowable in addition to the standard deduction and because an above the line deduction is used to compute the taxpayer's adjusted gross income. IRC §63(b). Generally, the lower a taxpayer's adjusted gross income, the better the chance a taxpayer can take even more deductions, as some deductions are limited or denied once a taxpayer's adjusted gross income exceeds a certain amount. As between regular and miscellaneous itemized deductions, a taxpayer prefers regular itemized deductions because miscellaneous itemized deductions are subject to a significant limitation. For years prior to 2018 and after 2025, miscellaneous itemized deductions are deductible only to the extent that, in the aggregate, they exceed two percent of a taxpayer's adjusted gross income. IRC §67(a). For the years 2018 through 2025, miscellaneous itemized deductions are disallowed altogether. IRC §67(g).

Whether a deduction is above the line is answered by IRC §62(a). It contains a finite list of the several specific deduction provisions that are deductible above the line. All other allowable deductions are "below the line" (or "itemized" deductions). Whether an itemized deduction is "regular" or "miscellaneous" is answered by IRC §67(b), which lists the 12 itemized deductions that are regular; all other itemized deductions are miscellaneous.

In the case at bar, Carl and Leila Gregory, a married couple, formed a Cayman Islands corporation to own and charter a yacht, the *Lady Leila*. For the taxable years at issue (2014 and 2015), the yacht activity generated some income but also a lot of expenses. The taxpayers deducted the expenses associated with the activity (to the extent of their income from the activity) on Schedule C to their Forms 1040 for both years as above the line deductions. When the IRS determined that the deductions were allowable as miscellaneous itemized deductions, it resulted in a deficiency. That's because the taxpayers reported taxable income of $19.67 million in 2014 and $80.15 million for 2015. While the record does not reveal their adjusted gross incomes for those years, it is safe to conclude that two percent of adjusted gross income in each year would be so high that none of the hobby expenses would be deductible. The taxpayers ran to Tax Court, arguing their hobby deduction should be above the line, but the Tax Court ruled for the IRS. That brought this appeal to the Eleventh Circuit.

The parties agreed about the amount of the deduction; the dispute was whether the deduction was above the line or a miscellaneous itemized deduction. The IRC §183(b)(2) deduction is listed in neither IRC §62(a) nor IRC §67(b). Accordingly, as a matter of simple statutory interpretation, the deduction is a miscellaneous itemized deduction. But the taxpayers made a number of arguments as to why the deduction should be above the line, two of which got considerable attention from the court.

The first argument from the taxpayers was that because IRC §183(b)(2) assumes the hobby is operated for profit, that assumption should carry over to the determination of whether the deduction qualifies to be taken above the line. But the Eleventh Circuit correctly observed that IRC §183(b)(2) grants "a deduction equal to the *amount* of the deductions" that would be allowable if the activity was engaged in for profit (emphasis added). As the court states, "in no other respect does Section 183(b)(2) instruct us to treat tat deduction the same as a business expense. *Amount* is not *kind*." (Emphasis in original.) In effect, IRC §183(b)(2) identifies the amount of the deduction but it does not reclassify a hobby expense as a business expense.

The taxpayers then argued that because IRC §183(b)(2) limits a deduction to the hobby's gross income, the deduction is supposed to reduce the taxpayer's "gross income" and not "adjusted gross income." As the Eleventh Circuit observed, however, gross income from a hobby and the taxpayer's gross income "are two very different things." The reference in IRC §183(b)(2) to "gross income" is there to cap the amount of the deduction; "it is not a command to apply hobby loss deductions against a taxpayer's total gross income."

A concurring opinion reaches the same conclusion through a different route. The concurring opinion finds the statutory framework set forth above to be ambiguous, and thus

uses the legislative history to the enactment of IRC §183 to determine congressional intent. It is hard to see the ambiguity, however. Section 62(a) specifically lists all of the above the line deductions, and it contains no reference to IRC §183. Likewise, IRC §67(b) specifically lists all of the regular itemized deductions, indicating that all other itemized deductions are miscellaneous. Here too, IRC §183 is not listed among the regular itemized deductions. How these statutes are ambiguous is, well, ambiguous.

XLV. PAST-DUE CHILD SUPPORT PAYMENT TAXABLE AS INTEREST INCOME (*Rodgers v. Commissioner*, T.C. Memo. 2023-56, May 9, 2023)

In the good old days (meaning before 2018), §71 generally required a recipient of "alimony" payments to include such payments in gross income and §215 generally allowed the payor of "alimony" to deduct such payments in the computation of adjusted gross income. The 2017 Tax Cuts and Jobs Act repealed these rules, generally effective for divorce and separation agreements entered into in or after 2018. But cases involving agreements entered into before 2018 continue to crop up in the courts, as here.

This case involves payments received by a taxpayer under a state court judgment awarding the taxpayer past-due child support. Prior to 2019, alimony and separate maintenance payments received by a taxpayer were generally includible in the taxpayer's gross income, and such payments were generally deductible by the payor. IRC §§71(a); 215. Amounts fixed as "child support" by a divorce or separation instrument, however, were not includible in the recipient's gross income and were not deductible by the payor. IRC §71(c). But interest paid on past-due child support is includible in the recipient's gross income, as it represents interest and not child support. *Fankhanel v. Commissioner*, T.C. Memo. 1998-403; *Aames v. Commissioner*, 94 T.C. 189 (1990). In determining what portion of a past-due child support payment represents interest, if any, a court will consider the taxpayer's own admissions, state court records, and any court orders directing the payment of interest.

In this case, the taxpayer was awarded a judgment in 2012 against her ex-spouse in the amount of $16,044. Of that amount, $5,362 represented the unpaid child support and the rest represented interest. The deadbeat ex-spouse was required to make payments to the State of Alabama for payment to the taxpayer. Starting later that year, the taxpayer received payments totaling $5,362 from the state's Child Support Enforcement Division, each marked with the code "CS NA AR." Then, the taxpayer received additional payments coded "CP INT." In 2015, those payments totaled $7,859. The State of Alabama filed a Form 1099-INT for 2015 reflecting interest paid to the taxpayer in the amount of $7,824 (there is no explanation for the missing $35 in the record). The taxpayer acknowledged that she received the form but she did not include this amount in her 2015 gross income because she believed the payment related to child support.

The Tax Court agreed with the IRS that the payments received in 2015 were taxable as interest income. For one thing, the taxpayer acknowledged receipt of the Form 1099-INT. In addition, the court order specified the amount of past-due child support and the amount of

interest. The payment records track the amounts set forth in the court order. The taxpayer argued that the payment should be treated as additional child support because she claimed the amount past due was in fact larger than the amount awarded by the court, but the court reasoned that if this was so, "any increase in the principal would have served only to increase the amount of interest due to petitioner." There was no evidence that the court had increased the original amount of child support awarded in the 2012 judgment. Accordingly, the Tax Court upheld the deficiency against the taxpayer.

The 2017 Tax Cuts and Jobs Act repealed IRC §§71 and 215, effective at the end of 2018. Repeal of these rules essentially renders all alimony and separate maintenance payments nontaxable to the recipient and nondeductible by the payor as of 2019. But to the extent a past-due payment paid and received after 2018 represents interest, that portion would remain includible in the recipient's gross income as interest. See IRC §61(a)(4). The payment of interest on a past-due child support award would likely not be deductible by the payor, as the payment would represent nondeductible personal interest. See IRC §163(h).

XLVI. ATTORNEY'S COSTS IN RACE CAR ACTIVITY NOT DEDUCTIBLE AS LAW FIRM ADVERTISING EXPENSES (*Avery v. Commissioner*, T.C. Memo. 2023-18, February 21, 2023).

The Tax Court has upheld the IRS's determination that a lawyer with a solo practice could not deduct some $355,000 in expenses incurred over a six-year period in connection with his race car hobby as "advertising expenses" even though the taxpayer claimed the racing activity promoted his law practice. For one thing, the taxpayer could not substantiate all of the costs claimed on his federal income tax returns. But even as to costs he could substantiate, the court agreed with the IRS that those costs were not "ordinary and necessary expenses" for a lawyer and, thus, not deductible under IRC §162(a).

Section 162(a) permits deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." An expense is "ordinary" if the transaction giving rise to it is "of common or frequent occurrence in the type of business involved." *Welch v. Helvering*, 290 U.S. 111, 113-14 (1933). An expense is "necessary" if it is "appropriate and helpful" in carrying on the taxpayer's business. *Id.* at 113. In deciding whether a particular expense is ordinary and necessary, courts look for a reasonably proximate relationship between the expense and the business. If a cost is primarily personal in nature, no deduction is allowed. *Henry v. Commissioner*, 36 T.C. 879, 884 (1961). Even where a cost qualifies as a business expense, the taxpayer must keep adequate records that substantiate the expense, and the failure to maintain and produce such records weighs heavily against a deduction. See, e.g., *Rogers v. Commissioner*, T.C. Memo. 2014-141.

The taxpayer, a lawyer with a solo litigation practice based in Denver, was heavily involved in car racing throughout the Midwest, purchasing a 2009 Dodge Viper for $102,500 that he drove in many races until his divorce, after which he "didn't have the funds to race." On the back tail of the race car was a decal for the "Avery Law Firm." The taxpayer also maintained

a website for his "Viper racing team" that was linked to his law firm's Facebook page. Before the Tax Court, the taxpayer testified that he hoped his racing activity would attract auto accident victims as potential clients. As the court explained:

> Petitioner believed that being involved in car racing might enable him to meet lawyers, doctors, and other professionals who could help his career. Car racing, he said, was a good "conversation starter" with these individuals. But he could identify only two instances in which his car-related activity actually intersected with his law practice. Through one racing connection he met a Pizza Hut franchisee who had a dispute with a vendor; petitioner subsequently "consult[ed]" with that franchisee. Several years previously he had met a surgeon who later served as an expert witness in a personal injury case he tried in Denver. But he met that doctor at an Indiana car show, not at a racing event.

On late and amended federal income tax returns for the years 2008 through 2013, the taxpayer claimed a total of $355,000 in "advertising expenses," all related to the car racing. At trial, though, the taxpayer could only substantiate $51,634 of this amount. The taxpayer tried to deduct the cost of the Dodge Viper and parts. The court noted that these costs were "potentially recoverable" as depreciation expenses, but even so, the costs would not be deductible as ordinary and necessary business expenses. As the court observed:

> We agree with respondent that petitioner's racing-related costs were not ordinary and necessary expenses of his business as an attorney. It is neither "necessary" nor "common" for attorneys to incur such costs. Petitioner greatly enjoyed car racing, which he found more exciting than his previous hobby of acquiring collector cars and participating in car shows. But we find that both activities were hobbies. No deduction is allowed for personal expenses of this kind. … [M]ost of his racing activity occurred during 2008 – 2010, when he lived in Indiana. He raced on tracks in Indiana, elsewhere in the Midwest, and on the East Coast. He did not convince us that racing at these venues had any synergy with his Denver-based litigation practice.

The court also found it troubling that the decal for his law firm "appeared in relatively small print on his Dodge Viper." Given the activity was one engaged in primarily for personal enjoyment and not to advertise his law firm, then, even the substantiated expenses were not deductible.

XLVII. INTERNATIONAL TRAVEL DID NOT AFFECT RECEIPT OF DEFICIENCY NOTICE, SO 90-DAY FILING DEADLINE APPLIES (*Evenhouse v. Commissioner*, T.C. Memo. 2023-113, September 7, 2023).

The Tax Court has held that a petition filed 148 days after the mailing of a notice of deficiency was after the 90-day deadline, thus leaving the court without jurisdiction to address the merits of the taxpayers' claim. The taxpayers argued for application of a 150-day filing

deadline because they were out of the country at the start of the day on which the deficiency notice was mailed. But they were back in the United States that same day, and that was sufficient for applying the 90-day deadline instead.

Section 6213(a) generally provides that a taxpayer seeking Tax Court review of a deficiency notice must file a petition within 90 days after the notice is mailed, except that if the 90th day falls on a weekend or legal holiday, the deadline is extended to the next day that is not a weekend or legal holiday. The 90-day deadline extends to 150 days "if the notice is addressed to a person outside the United States."

In this case, the IRS issued a notice of deficiency to William and Nelle Evenhouse regarding their 2019 joint return. The notice was mailed to their home address in Oakland, California, on May 23, 2022. The notice determined a deficiency of nearly $55,000 and a penalty of nearly $11,000. It also stated that the last day they could petition the Tax Court was August 22, 2022.

But the couple did not file a petition until October 18, 2022, which is 148 days after the deficiency notice was mailed. They claimed that their petition was timely since they were "traveling outside of the United States" on May 23, 2022. More precisely, travel records showed that the couple left Istanbul, Turkey, on an afternoon flight on May 23, 2022, and arrived at San Francisco at 4:35pm that same day. The taxpayers did not leave the country again for another ten months.

The Tax Court granted the IRS's motion to dismiss for lack of jurisdiction. The court observed it lacks the discretion to extend the applicable deadline for filing a redetermination petition. While there is precedent for applying the 150-day deadline instead of the 90-day deadline where a taxpayer is only temporarily absent from the United States, that temporary absence must result in delayed receipt of the deficiency notice. In this case, the taxpayers landed back in the United States on the same afternoon the deficiency notice was mailed. Presumably, then, they would have received the notice in the ordinary course. But all that matters is that they were present in the United States on the date the notice was mailed, and they did not leave the country again until well after the 90-day period expired. They thus cannot use the 150-day period because their absence from the country did not delay their receipt of the deficiency notice.

Although the Tax Court lacks jurisdiction due to the late petition, the taxpayers still have some recourse if they are intent on challenging the deficiency. They can pursue administrative appeals with the IRS and, if that fails, they can pay the deficiency, make a claim for refund and, when the refund claim is denied, commence an action for refund in federal district court.

In determining whether the 150-day period applies to a taxpayer, the right question to ask is not "Was the taxpayer out of the country that day?," but rather "Was the taxpayer out of the country for good that day, thus delaying the ordinary receipt of the deficiency notice?" In

this case, the answer to the first question was "yes," but the answer to the second, relevant question was "no."

XLVIII. IRS EXPLAINS FEDERAL INCOME TAX TREATMENT OF RELIEF PAYMENTS MADE BY STATE GOVERNMENTS (*Notice 2023-56*, August 30, 2023).

The IRS has announced rules for determining the federal income tax treatment of refunds of state and local taxes and certain other payments made by state and local governments to individuals. The Notice comes on the heels of a News Release issued on February 10, 2023 (IR2023-23) that gave guidance applicable for the 2022 federal income tax filing season.

In response to the COVID-19 pandemic, many states implemented programs in 2022 that paid cash to certain resident individuals. When individuals and their advisors flooded the IRS with questions about whether and how to account for these payments, the IRS issued News Release IR-2023-23 to provide temporary guidance in time for the federal income tax filing season. That guidance identified programs in 17 states that made payments to resident individuals and announced that:

> [I]n the best interest of sound tax administration and given the fact that the pandemic emergency declaration is ending in May, 2023 making this an issue only for the 2022 tax year, if a taxpayer does not include the amount of one of these payments in its 2022 income for federal income tax purposes, the IRS will not challenge the treatment of the 2022 payment as excludable from income on an original or amended return.

Now that some states have made additional payments in 2023, the IRS determined it would be helpful to issue updated guidance.

The updated guidance covers the tax treatment for four different types of payments made to taxpayers. The first type is a payment in the form of a **state income tax refund**. Consistent with *Revenue Ruling 2019-11*, 2019-17 I.R.B. 1041, *Notice 2023-56* provides that a standard deduction taxpayer need not include a refund of state income tax on the taxpayer's federal income tax return. But a taxpayer that itemizes must include a state income tax refund in gross income to the extent the taxpayer received a benefit from the deduction of state income tax paid on the federal income tax return.

The second type is a payment in the form of a **state property tax refund**. Here, the same rule applies: a standard deduction taxpayer can exclude the refund from gross income, but a taxpayer that itemizes must include the refund in gross income to the extent the taxpayer received a benefit from the deduction of property tax paid on the federal income tax return.

The third type is a payment under **programs covered by the earlier News Release that were paid in early 2023**. Since such payments received in 2022 were excluded from gross

income pursuant to the News Release, the IRS announced that individuals who did not receive a payment during 2022 may exclude a state payment received in 2023 pursuant to an approved 2022 program from gross income.

The fourth type is a payment made for **promotion of the general welfare**. Prior rulings consistently recognize a "general welfare exception," under which amounts paid by a government under social benefit programs for the promotion of the general welfare are not includible in gross income. To qualify for this exclusion, state payments have to be paid from a governmental fund, they must be based on the need of the individual or family receiving them, and they must not represent compensation for services. Thus, for example, low-income families have been able to exclude home rehabilitation grants made to address substandard living conditions. See *Rev. Rul. 76-395*, 1976-2 C.B. 16. *Notice 2023-56* simply restates this rule so as to make it clear that the notice is not supplanting the general welfare exception. It gives as an example a state "Energy Relief Payment Program" to help low-income residents who might otherwise not be able to pay electric and gas bills.

The Notice concludes by asking for public comment on the rules it contains, giving a deadline of October 16, 2023, for written comments. One suspects this request for comments is an attempt to comply with the Administrative Procedure Act's (APA's) requirement that any new rule announced by a federal agency must first be issued in proposed form, and the agency must solicit and consider public comments before finalizing any such rule. Although the rules set forth in *Notice 2023-56* are not couched in the form of "proposed" rules but instead as a description of "the rules that the Internal Revenue Service applies in determining the Federal income tax consequences of refunds of State or local taxes and certain other payments," by asking for public comment the IRS may be anticipating an argument that the rules contained in the Notice are void for lack of notice and comment. But it is unclear whether a general request for public comment is sufficient for this purpose. Unless the rules are announced as merely "proposed," there might still be a problem with APA compliance.

XLIX. REVIEWING THE PIPE DREAM THAT IS THE ADMINISTRATION'S FISCAL YEAR 2025 REVENUE PROPOSALS (*General Explanations of the Administration's Fiscal Year 2025 Revenue Proposals*, March 11, 2024)

On March 11, 2024, the Treasury Department released its General Explanations of the Administration's Fiscal Year 2025 Revenue Proposals. The 248-page document reviews the tax reform proposals set forth in the President's Fiscal Year 2025 Budget. According to Treasury, the proposed reforms "would raise revenues, expand tax credits for workers and families, and improve tax administration and compliance."

The chances of any of these proposals becoming law in the short term are, to say the least, slim. In an election year, no one has incentive to push through significant tax reforms. Further, with a Republican majority in the House and Democratic control of the Senate, any tax legislation would very likely need to be watered down to have any chance of passage. As a

result, everyone recognizes that the Budget proposals are little more than a wish list of reforms the President and his supporters would like to see.

Readers of a certain age might recall the *Schoolhouse Rock!* tune, "I'm Just a Bill," wherein proposed Congressional legislation in anthropomorphized form explains in song the tortuous process by which it hopes to become enacted. The proposals set forth in the Budget would be lucky to one day to be "just a bill." Nonetheless, a look at the proposals can give planners an idea of possible tax reform in the coming years, and it is never too early to think through the ramifications should the proposals be enacted. Accordingly, this summary will highlight the proposals of greatest interest to estate planners and their clients.

A. Taxing High-Income Taxpayers

The Budget proposes **increasing the top marginal tax rate on ordinary income to 39.6%**, applying to taxable income over $400,000 for unmarried taxpayers, $425,000 for heads of household, $450,000 for married couple filing jointly, and $225,000 for married couples filing separately. For taxpayers with taxable incomes over $1 million, the **preferential rate for long-term capital gains and qualified dividends would disappear**, leaving such items to be taxed as ordinary income.

The Budget also proposes that **gifts and bequests totaling would be taxable**, even in the case of transfers to a defective grantor trust, though the first $5 million in aggregate gains would be excluded. Transfers to charity would not give rise to recognized gain, and the rule would likewise not apply to gifts of tangible personal property (except collectibles). If this rule is adopted, all property received by gift, bequest, devise, or inheritance would have a basis in the hands of the recipient equal to the property's fair market value at the time of the gift, bequest, devise, or inheritance. In addition, the Budget proposes a **deemed sale of property held in trust, a partnership, or some other non-corporate entity** if it has not been the subject of a recognition event within the past 90 years.

Interestingly, the Budget proposes a **25 minimum tax on total income for taxpayers with net wealth of more than $100 million**. This is the "wealth tax" that Democrats have introduced from time to time and which may well be the real subject of *Moore v. United States*, a case currently before the United States Supreme Court, as explained elsewhere in these materials.

B. Estate and Gift Tax Reform

The Budget contains a mixed bag of recommendations for modifying the federal wealth transfer tax regime. Planners would likely welcome the proposal to **increase the special use valuation cap.** Under current law, the maximum reduction in value for certain real property used in a family-owned business is limited to $750,000, adjusted for post-1997 inflation (for 2024, the maximum reduction in value is $1,390,000). The proposal would increase this limit to $14 million, effective upon enactment.

But the Budget also proposes that most **trusts administered in the United States would have to make annual reports** to the IRS that would include identifying information about grantors and trustees, as well as information about the nature and estimated value of the trust's assets. The reporting rule would not apply to trusts with no more than $300,000 in net assets as of the last day of the taxable year, provided the trust does not have more than $10,000 in gross income for the year.

The Budget also calls for the **effective repeal of "as finally determined for Federal transfer tax purposes" defined value formula clauses**. Many donors today use defined value formula clauses to prevent an unwanted taxable gift that could arise from a valuation error. For example, the owner of $50 million in closely-held stock with an applicable exclusion amount of $13.61 million might give "shares having a value of $13.61 million as finally determined for Federal transfer tax purposes" to a child, with "all remaining shares" passing to a charity. If the IRS successfully challenges the valuation used to compute the number of shares transferred to the child, the IRS collects no gift tax, as the formula clause provides that any excess passes instead to the charity (qualifying for the unlimited charitable deduction). The Budget proposes that any gift or bequest using a defined value formula clause be treated as transferring the entire amount reported on the gift or estate tax return. In the example above, that would mean the donor would be deemed to have given all $50 million of the stock to the child. Under this proposal, two defined value formula clauses would remain effective: (1) where the value is to be determined by something other than action by the IRS, like an appraisal to be obtained within a short period following the transfer; and (2) defined value formula clauses used to define the gift to a marital trust or credit shelter trust.

The Budget also would impose a **minimum value for the remainder interest in a charitable lead annuity trust** to be at least 10 percent of the value of the property used to fund the trust, effectively requiring that the creation of a charitable lead trust will result in a taxable gift. Under current law, the value of the remainder interest in a charitable lead trust can be "zeroed-out."

Finally, the Budget purports to "simplify" the gift tax annual exclusion by **replacing *Crummey* powers with a revamped annual exclusion amount**. Specifically, the Budget proposes to eliminate the "present interest" requirement to qualify for the annual exclusion and instead cap the maximum annual exclusion to $50,000 *per donor*. This limit would be in addition to the current $18,000 *per donee* limitation. Thus, for example, if a donor subject to this new regime made gifts of $18,000 cash to each of three donees, the donor would be making taxable gifts of $4,000, the amount by which the total gifts of $54,000 exceeds $50,000. Did we mention that the odds of this or any proposal being enacted are slim to none, with the needle leaning heavily toward "none?"

C. Grantor Trusts

The Budget takes dead aim on grantor trusts, providing first that **remainder interests in grantor retained annuity trusts have a minimum present value** at least equal to the greater of 25 percent of the assets transferred to the trustor or $500,000 (but not more than the value of the assets transferred), with **no reduction in the annuity** during the trust term. Further, a GRAT would have a **10-year minimum term**, with a maximum term of the grantor's life plus ten years.

Furthermore, the Budget proposes to **tax transactions between grantors and defective grantor trusts**. As if that's not enough of a nightmare, the Budget proposes that the **grantor's payment of a defective grantor trust's income tax would be a gift** to the trust as of December 31 of year in which the tax is paid unless the grantor is reimbursed by the trust within the same year.

D. Provisions for Workers and Families

Unsurprisingly, the Budget calls for extending the **enhanced child tax credit** from 2021, when the refundable credit was $3,600 for each child under age 6 and $3,000 for children ages 6 – 17. The Budget seeks to make the credit fully refundable, regardless of a taxpayer's earned income. The Budget also wants to make permanent the **exclusion from gross income for forgiven student debt**, which is scheduled to expire at the end of 2025. Finally, the Budget proposes a **credit for first-time homebuyers and home sellers** for 2024 and 2025. The credit for first-time buyers would be 10 percent of the home's purchase price, up to a maximum credit of $10,000, with phaseouts once a buyer's adjusted gross income exceeds $100,000. The credit would be taken over two years, half in the year of purchase and the rest in next year. The credit for sellers would be similar: a credit equal to 10 percent of the home's sale price, up to a maximum credit of $10,000, with phaseouts once a buyer's adjusted gross income exceeds $100,000. The entire credit would be taken in the year of sale.

E. Closing Loopholes

The Budget again calls for **taxing carried interests as ordinary income**. Venture capital firms and other investment entities have long taken advantage of two partnership tax chestnuts to achieve favorable treatment for compensation paid to managers. The first is the preferential tax treatment given to profits interests as opposed to capital interests. A manager receiving a capital interest in a partnership as compensation for services has gross income upon receipt. But the recipient of a profits interest only has the right to a share of future profits, and thus has no value upon receipt. But when the interest is later sold, any gain qualifies as capital gain because the profits interest is still a capital asset. The second chestnut provides that limited partners do not pay self-employment tax on their distributive shares of partnership profits. Thus, the holder of a limited profits interest can convert compensation (which would be ordinary income subject to self-employment taxes) into capital gains (taxed at preferential rates and not subject to self-employment taxes). The Budget calls for treating the distributive shares of profits interest holders with taxable incomes over $400,000 both as ordinary income and as

income from self-employment. This proposed reform is nothing new, having been a staple of in the budgets of Democratic presidents throughout this century.

The Budget would also **cap the deferral for like-kind exchanges of real property to $500,000** in any one year, starting in 2025. Also starting in 2025 would be a new rule requiring **complete recapture of real property depreciation**. Under IRC §1250, a taxpayer selling depreciable real property at a gain must recapture as ordinary income only that portion of depreciation in excess of what would be allowed under the straight-line method. The rule is practically a dinosaur, however, because the straight-line method has been the only available depreciation method since 1986. Because no one can use accelerated depreciation methods with respect to real property, recapture of depreciation in this context rarely occurs. But under the proposed Budget, all depreciation deductions would be subject to recapture, not just the portion in excess of what is allowed under the straight-line method.

Finally, the Budget would make explicit that **distributions from a private foundation to a donor advised fund would not count** as qualifying distributions unless the donor advised fund in turn makes a distribution by the end of the next succeeding taxable year. The Budget points out, fairly, that using a donor advised fund to hold private foundation monies subverts the purpose of the minimum distribution requirement.

L. PENDING CASE ON MANDATORY REPATRIATION TAX HAS ADVISORS CONCERNED (*Moore v. United States*, U.S. Supreme Ct. No. 22-800).

In the October 2023 term, the Supreme Court of the United States will decide *Moore v. United States*, 36 F.4th 930 (9th Cir. 2022), *reh'g denied*, 53 F.4th 507 (9th Cir. 2022), *cert. granted*, No. 22-800 (U.S. 2023). At issue in the case is the constitutionality of the "mandatory repatriation tax" ("MRT") imposed by IRC §965. The MRT, enacted as part of the 2017 Tax Cuts and Jobs Act's conversion to a "source-based" system of corporate taxation from a "worldwide" system, was a one-time tax on United States persons owning at least 10 percent of the stock of a controlled foreign corporation ("CFC") in 2017 on the CFC's undistributed post-1986 earnings and profits. While the MRT imposed a one-time tax on what could be a huge amount of undistributed earnings, it did so at favorable rates: cash earnings were taxed at 15.5 percent and other earnings were taxed at 8 percent. While one would not think the MRT would be front and center in the minds of estate planning professionals, some commentators believe the Court's decision in the case bears close watch because it could have a profound impact on the constitutionality of a proposed wealth tax.

Charles and Kathleen Moore, a married couple residing in Redmond, Washington, owned 11 percent of the stock in KisanKraft, a CFC that supplies tools to farmers in rural India. The company was profitable, but all profits were reinvested in the business. The Moore's never received a distribution from the company. Still, by virtue of owning more than 10 percent of the CFC's stock, they became liable for MRT on the company's post-1986 retained earnings. They paid a tax of $14,729 and commenced this refund claim, arguing that the MRT was a retroactive tax on past earnings and thus violative of the Due Process Clause of the Fifth Amendment.

The United States District Court for the Western District of Washington granted the IRS's motion to dismiss, holding that although the MRT was indeed retroactive, it did not violate the Due Process Clause. The taxpayers appealed to the Ninth Circuit, again claiming that the retroactive nature of the MRT violated their due process rights. But the Ninth Circuit had little problem affirming the district court, finding that the retroactive application of the MRT had a legitimate purpose, namely preventing a windfall to CFC shareholders who never got a distribution from never having to pay taxes on those profits now that the United States was moving from a worldwide system of tax to a source-based system of tax. The court's analysis on this point is persuasive. Indeed, in their appeal of the Supreme Court of the United States, the taxpayers dropped their claim that the MRT is unconstitutional because of its retroactivity.

But the taxpayers presented an alternative argument to the Ninth Circuit that has become the focus of their appeal to the Supreme Court: they claim the MRT violates the Apportionment Clause. Article I, Section 9, Clause 4 of the United States Constitution provides that "No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken." So any "direct tax" must be apportioned so that the amount of tax paid by each state is proportionate to its population. The taxpayers in *Moore* claim that the MRT is an unapportioned direct tax and, therefore, unconstitutional.

The federal income tax, of course, is likewise an unapportioned direct tax, but the Sixteenth Amendment authorizes Congress to collect tax on "incomes, from whatever source derived" without apportionment. If the MRT is an income tax, then, the Sixteenth Amendment protects it from attack based on the Apportionment Clause. But the taxpayers assert that the MRT is not an income tax because it taxed them on amounts they have not yet received as income. They base this argument on the one-two punch of two Supreme Court cases every beginning tax student reads: *Eisner v. Macomber*, 252 U.S. 189 (1920), and *Commissioner v. Glenshaw Glass*, 348 U.S. 426 (1955).

Macomber held that a proportionate stock dividend was not gross income to a shareholder because the distribution did not alter the interest of any shareholder and did not affect the overall value of a shareholder's investment. In reaching this conclusion, the Court observed that "Income may be defined as the gain from capital, or from labor, or from both combined." A stock dividend, said the Court, does not fall within this definition because a shareholder has received nothing for the shareholder's "separate use and benefit." From this language, some say, the Court was indicating that there was no income because no benefit had been "realized" by the shareholder.

In *Glenshaw Glass*, the Court explained that the *Macomber* definition was not intended to be the exclusive test for income. In holding that punitive damages were income even though they were a windfall and not a gain from labor or from capital, the Court noted that the taxpayers had "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." From this language, some say, the Court echoed the sentiment that a

benefit had to be “realized” before it could be labeled as “income” and thus subject to federal taxation without regard to apportionment among the states.

Citing *Macomber* and *Glenshaw Glass*, then, the taxpayers argued to the Ninth Circuit that because they had not yet “realized” the post-1986 undistributed earnings of the CFC—after all, they had not yet been distributed—those earnings could not be “income,” and thus a tax on such amounts could not, by definition, be an income tax. But the Ninth Circuit concluded that the MRT was an income tax after all. Noting that the taxpayers’ reliance on these cases was “misplaced,” the Ninth Circuit explained that neither case attempted to offer a single, comprehensive definition of income. And more importantly, the Supreme Court already noted in *Helvering v. Horst*, 311 U.S. 112 (1940), that “the rule that income is not taxable until realized … [is] founded on administrative convenience … and [is] not one of exemption from taxation where the enjoyment is consummated by some event other than the taxpayer’s personal receipt of money or property.” *Id.* at 116. The *Horst* Court held that a taxpayer had to pay tax on the income from detachable interest coupons on a corporate bond that were given to the taxpayer’s child even though the taxpayer did not personally receive the benefit of the interest. The case is famous for establishing that income from property is taxed to the person who controls the property and not necessarily the person who receives that income.

The Ninth Circuit also discussed the Court’s decision in *Helvering v. Bruun*, 309 U.S. 461 (1940), where the taxpayer, a landlord, was held to have gross income from the repossession of leased property where the lessee had made permanent improvements that increased the value of the taxpayer’s land. Here too, the taxpayer did not yet “realize” the benefit of the increased value in the land, but the Court nonetheless held that the taxpayer had gross income.

As if that’s not enough, the Ninth Circuit even observed that:

> there is no blanket constitutional ban on Congress disregarding the corporate form to facilitate taxation of shareholders’ income. In other words, there is no constitutional prohibition against Congress attributing a corporation’s income pro-rata to its shareholders.

In the Ninth Circuit’s view, then, the Supreme Court has been clear that while realized gains may be indicative of income, realization is not required in order for income to exist. The MRT is thus constitutional and within the scope of the Sixteenth Amendment.

That the Supreme Court granted the taxpayers’ certiorari petition was notable. It’s not like lower appellate court were split on the issue, and the Ninth Circuit even refused a rehearing request by the taxpayers. If they could not convince the Ninth Circuit to hear the case *en banc,* why would the Supreme Court have an interest in taking the case? That question has provoked considerable armchair commentary. Perhaps the Court will agree with the Ninth Circuit that the MRT is a tax on income, and an affirmance from the Court might deter other taxpayers from launching similar arguments going forward. But some have wondered whether the Court is

prepared to hold that realization is a constitutional requirement to income despite the *Horst* Court's insistence that realization is merely a rule of convenience.

If it takes this latter course, the Court's holding might transcend the MRT. Should the Court decide that realization is a firm prerequisite to income, other Code provisions that impose income taxation absent the actual receipt of some benefit could likewise be unconstitutional. These provisions might include, for example, subchapter K (taxing partnership income to partners even where the partners have not received that income), subchapter S (taxing the income from an S corporation to its shareholders even where the shareholders have received nothing from the corporation), IRC §7872 (treating certain below-market loans as deemed transfers between borrowers and lenders despite no actual transfers, the original issue discount rules (treating the holder of original issue discount as receiving deemed payments on the instrument despite receiving no actual payment, and IRC §475 (requiring certain dealers in securities to use the mark-to-market method of accounting despite not yet realizing the appreciation in value of those securities).

So why would the Court take this aggressive step, possibly invalidating wide swaths of the Internal Revenue Code? Some have speculated that it has nothing to do with the MRT or with any of the aforementioned Code provisions. Instead, it has everything to do with preventing implementation of a wealth tax. If Congress cannot impose a one-time tax on prior undistributed earnings of a CFC that will never face United States taxation going forward, then it probably cannot impose a wealth tax that would tax a high-net-worth individual on unrealized wealth. It seems far-fetched that the Court would agree to review a case about the MRT with the ulterior motive of preventing a tax that has only been introduced as legislation but never advanced out of the House Ways and Means Committee. And yet such speculation, normally the fodder of conspiracy theorists, persists, explaining why more than a few estate planning professionals will be interested in the upcoming oral argument as they try to predict how the Court might rule.

In its brief to the Supreme Court, the taxpayers do not seek an aggressive holding. They just want the Court to be clear that the MRT impermissibly taxed shareholders on a benefit they might never receive. As they argue in their brief, "the MRT tags a shareholder with taxable 'income' even if he or she purchased the [CFC] shares in 2017, long as after the corporation earned the sums being taxed." The claim has intuitive appeal, but it does not really apply to them: the Moores were shareholders at all times their CFC had earnings. If they were being taxed on earnings attributable to years in which they were not shareholders, this argument might have more appeal.

Yet, even then, the argument may not have legs. After all, a shareholder purchasing stock this year might receive a dividend attributable to earnings from last year or even five years ago; it is not a defense to gross income inclusion to argue that the shareholder acquired the stock long after the corporation generated its earnings. Likewise, subpart F has long taxed United States shareholders of a CFCs on their shares of the entity's subpart F income even where the shareholders have acquired their interests late in the taxable year. Thus, while the

strategy to seek a narrow holding makes sense, the argument the taxpayers use to get that narrow holding might not win the day.

LI. SONNY CORLEONE PAYS A TOLL ON BUNGLED IRA DISTRIBUTION AND ROLLOVER (*Estate of Caan v. Commissioner*, 161 T.C. No. 6, October 18, 2023).

The Tax Court has held that the Union Bank of Switzerland (UBS), the custodian of two IRAs owned by the late actor James Caan, made a taxable distribution of a partnership interest in a hedge fund to Caan in 2015 and that Caan did not successfully roll over that partnership interest to a new IRA within 60 days. Caan became famous for his portrayal of Sonny Corleone in the film, *The Godfather*, and, like the character he played in that film, the arguments made by Caan's estate ended up being full of holes.

The custodial agreement between UBS and Caan stated that UBS would hold Caan's interest in P&A Multi-Sector Fund, L.P., a hedge fund, in one of the two IRAs it managed on Caan's behalf, but Caan had to provide UBS with a statement of the partnership interest's fair market value as of the end of the year for each year the IRA held the interest. UBS wanted this information because IRC §408(i) directs IRA custodians to report the value of non-public securities at least annually, and Caan was in the best position to know this value.

Caan failed to furnish UBS with the partnership interest's fair market value for 2014, however. UBS repeatedly asked Caan for this information in 2015, and UBS even reached out to the hedge fund for information, but UBS never received any replies. Also in 2015, Caan's advisor at UBS left the firm to join Merrill Lynch. The advisor then coaxed Caan into transferring both IRAs to Merrill Lynch, but the partnership interest could not be transferred, so the advisor ordered the hedge fund to sell Caan's interest and transfer the cash proceeds to Merrill Lynch, though that liquidation and transfer did not happen until 2016. In the meantime, UBS sent a letter to Caan in 2015 explaining that it would no longer serve as custodian of the partnership interest due to Caan's failure to supply information about the value of the fund pursuant to their agreement. UBS followed up with a Form 1099-R reporting a distribution of the hedge fund interest.

Caan reported the distribution on his 2015 federal income tax return, but he claimed the distribution was nontaxable, apparently taking the position that the interest was successfully rolled over to the new Merrill Lynch accounts. When the IRS assessed a deficiency and an accuracy-related penalty, Caan requested a private ruling from the IRS seeking a waiver of the 60-day period for rollover contributions and also petitioned the Tax Court for review. The IRS denied the ruling request, reasoning that even if it granted a waiver of the 60-day rollover period, there would still be a problem with Caan's attempted rollover because the asset in the old account (the hedge fund interest) was not the same as the asset being placed in the new account (cash proceeds from liquidation of the interest).

Before the Tax Court, Caan's estate argued that Caan never got the partnership interest from UBS, as indicated on the Form 1099-R, but the Tax Court found the evidence in support of

the claim lacked credibility. Even if Caan never received the interest directly, he was in constructive receipt of it because the evidence showed that as of November, 2015, Caan could have instructed the hedge fund to re-register the partnership interest in his name without any further action from (or approval by) UBS. He was likewise free to roll over the interest into another IRA managed by a custodian that was willing to accept it. "The presence of these options," said the Tax Court, "means that Mr. Caan had unfettered control over the P&A interest and was therefore in constructive receipt of it."

Caan's estate then argued that he successfully rolled over the partnership interest into the Merrill Lynch account, but the Tax Court found this argument went *A Bridge Too Far.* The court noted that a taxpayer must roll over the same asset in order to avoid taxation. But in this case, Caan's advisor ordered the liquidation of hedge fund interest and the transfer of cash to the new Merrill Lynch account. Besides, that transfer happened more than 60 days after UBS distributed the partnership interest to Caan. And, as if that's not enough, the hedge fund made three different transfers to Merrill Lynch even though the Code allows for only one rollover contribution in any single year. So for multiple reasons the attempted rollover was ineffective.

Caan's estate challenged UBS's claim that the partnership interest was worth $1.9 million in 2014, for this was based on the year-end value of the interest at the end of 2013. The Tax Court agreed with the estate on this count, but the estate never followed through with its own evidence as to the value at the end of 2014. Instead, the IRS argued to use the $1.5 million valuation from 2015 as proof of the 2014 value, and since the taxpayer presented no evidence as to why this value was wrong, the Tax Court adopted the value determined by the IRS. This pyrrhic victory for the estate surely left it in *Misery*.

Finally, the estate argued that the IRS improperly denied Caan's private ruling request. After holding (for the first time, apparently) that it had jurisdiction to consider a denial of a private ruling request for abuse of discretion, the Tax Court held that the IRS did not abuse its discretion here, as forgiving the 60-day deadline would do nothing to cure the other problems with the attempted rollover, namely the fact that the asset transferred to the new account was not the same property distributed from the old account.

All in all, it was no *Honeymoon in Vegas* for Caan's estate.

LII. LOANS TO A THIEF DON'T NECESSARILY GENERATE A THEFT LOSS (*Johnson v. United States*, D. S.C., September 18, 2023).

A federal district court has held that the taxpayers, a married couple, could not deduct loans made to the husband's long-time friend as a theft loss as there was no evidence that the friend had, in fact, stolen the funds. The case is a reminder that a loan is not "stolen" just because it is still outstanding.

The husband became friends with John Harrison when they were teens. Starting in 2001, the taxpayers invested in real estate ventures recommended by Harrison. Early returns were

positive—the couple made money on two lakefront investments made with Harrison. Based on these successes, the taxpayers made two more unsecured loans to Harrison to finance other investments. The two loans totaled $840,000. In 2015, though, Harrison pled guilty to federal bank fraud. In 2018, the couple filed amended returns for 2015 claiming that the amounts advanced to Harrison were deductible as theft losses. When the IRS disallowed the resulting refund claims, the taxpayers brought the instant action.

The district court held that the loans were not thefts. The husband had negotiated the terms of the unsecured loans and even charged Harrison a higher interest to compensate for the additional risk. Further, while the court acknowledged that Harrison was involved in a mortgage fraud scheme, there was no evidence that Harrison had stolen the amounts loaned by the taxpayers or that those amounts were in any way related to Harrison's criminal activity. Importantly, there was no evidence that Harrison made false or misleading statements to the taxpayers when the loans were made or that there was any intent to defraud the taxpayers.

The taxpayers argued that Harrison's assertion of his Fifth Amendment privilege when asked whether he made false or misleading statements to the taxpayers was proof that he provided false financial documents, but the court was unwilling to draw such an inference based on Harrison's assertion of his privilege. Being unable to offer proof of a theft, then, the taxpayers were left without a deduction for the theft loss.

If the taxpayers could prove that their loans were used to purchase certain properties that have been sold at a loss, presumably the taxpayers would be able to deduct these losses as those from a transaction entered into for profit. IRC §165(c)(2). Otherwise, if the loans are not repaid, the taxpayers can, at best, hope for a bad debt deduct under IRC §166, though that deduction will be flavored as a short-term capital loss and not as an ordinary loss.