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 federal income, estate and gift tax laws affecting individual taxpayers and small businesses from July, 2023, through August, 2024, with occasional references to older items where relevant. The materials are organized roughly in order of significance. These materials generally do not discuss developments in 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 > $250,000</td><td rowspan="2">32%</td></tr>
<tr><td>AGI > $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>
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</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. THE SUPREME COURT HAD ANOTHER BUSY YEAR

It is unusual for the Supreme Court of the United States to consider a federal tax matter, and yet the October 2023 term featured an estate tax case, an income tax case, and two other cases that will have a seismic impact on federal agencies like the IRS.

A. Corporate-Owned Life Insurance Increases Estate Tax Value of Stock (*Connelly v. United States*, U.S.S.Ct., June 6, 2024)

In a unanimous decision, the Supreme Court affirmed a decision of the Eighth Circuit Court of Appeals holding that corporate-owned life insurance on the life of a deceased shareholder acquired for the purpose of redeeming the deceased shareholder's stock increased the estate tax value of that stock.

1. Facts

The decedent, Michael Connelly, and his brother, Thomas Connelly, were the only shareholders of a building materials corporation based in St. Louis. Michael owned 77.18 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 77.18-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 an "amicable and expeditious" 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 77.18 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 $890,000 deficiency that Michael's estate paid. The estate then brought this refund action, but a federal district court granted summary judgment to the IRS.

2. The Eighth Circuit's Decision

On 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 §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 found 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.

3. Supreme Court Affirms

Before the Supreme Court, the estate clung to the argument that the corporation's obligation to redeem Michael's shares offset the value of the death benefit received from the policy on Michael's life. But the Supreme Court unanimously rejected that argument, swiftly affirming the Eight's Circuit's holding. Writing for the Court, Justice Thomas observed that:

> Economically, the redemption would have no impact on either shareholder. The value of the shareholder's interests after the redemption … would be equal to the value of their respective interests in the corporation before the redemption. Thus, a corporation's contractual obligation to redeem shares at fair market value does not reduce the value of those shares in and of itself.
>
> Because a fair-market value redemption has no effect on any shareholder's economic interest, no willing buyer purchasing Michael's shares would have treated [the corporation's] obligation to redeem Michael's shares at fair market value as a factor that reduced the value of those shares.

The estate also argued that the insurance proceeds should be ignored in valuing the company because "they would leave the company as soon as they arrived to complete the redemption." But the Court observed that this argument assumes that valuation should be based on what a willing buyer would pay for the shares after the redemption, when the relevant inquiry is the value at the date of Michael's death, which necessarily is before the redemption. As Justice Thomas writes:

> In Thomas's view, [the company's] redemption of Michael's shares left Thomas with a larger ownership stake in a company with the *same* value as before the redemption. Thomas argues that [the company] was worth only $3.86 million before the redemption, and thus that Michael's shares were worth approximately $3 million ($3.86 million x 0.7718). But, he also argues that Crown was worth $3.86 million *after* Michael's shares were redeemed. That cannot be right: A corporation that pays out $3 million to redeem shares should be worth *less* than before the redemption. Thomas's argument thus cannot be reconciled with an elementary understanding of a stock redemption.

(Emphasis in original.)

4. Observations

The estate claimed that the Eighth Circuit's approach will make closely-held business succession planning more difficult, but the Court noted that the brothers could have structured their agreement as a cross-purchase agreement, under which each brother would acquire an insurance policy on the life of the other to fund the purchase of shares. That doesn't completely solve the problem, though. If, for example, Michael had purchased a policy on Thomas's life, Michael's gross estate would still include the value of that policy, though obviously that amount would be less than the amount of the death benefit. In any event, the Court's decision here effectively overrules the Eleventh Circuit's ruling in *Estate of Blount*.

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 §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.

B. Court Upholds Mandatory Repatriation Tax and Sends Signals About Realization and a Wealth Tax (*Moore v. United States*, U.S.S.Ct., June 20, 2024)

The Supreme Court held (7-2) that the "mandatory repatriation tax" ("MRT") imposed by §965 is a valid exercise of the power of Congress to collect income tax under the Sixteenth Amendment, upholding the decision of the Ninth Circuit in *Moore v. United States*, 36 F.4th 930 (9th Cir. 2022), *reh'g denied*, 53 F.4th 507 (9th Cir. 2022). While many expected the Court to announce whether realization was a constitutional requirement to income, the majority instead affirmed on a narrower ground, leaving one to speculate exactly where the Court stands on the realization issue.

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. The case, then, was not really about the trifle amount of revenue generated by the MRT. Instead, the case was important as a barometer for the Court's current thoughts on the concept of realization and the constitutionality of a proposed wealth tax.

1. Factual Background and Lower Court Analysis

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 Moores never received a distribution from the company. Still, by virtue of owning more than 10 percent of the CFC's stock, in 2017 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 and thus would never have 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 would become the focus of their appeal to the Supreme Court: they claimed the MRT violated 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* claimed the MRT was 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 claimed the MRT is not an income tax because it taxed them on amounts they have not yet received as income. They based this argument on the one-two punch of two Supreme Court cases nearly 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, the Ninth Circuit held, and within the scope of the Sixteenth Amendment.

2. Early Concerns

That the Supreme Court granted the taxpayers' certiorari petition took many by surprise. 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 provoked speculation the case was not so much about the MRT as it was about testing the constitutionality of a proposed 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, as with the MRT, 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, persisted, leading to significant hand-wringing as to how the Court might rule.

3. Much Ado About Nothing, Says the Majority

The Supreme Court affirmed the Ninth Circuit, though it framed the issue much more narrowly. Writing for the majority, Justice Kavanaugh observed that the case was really about income attribution and not whether the MRT was an income tax. Contrary to the Moores contention that the MRT taxes unrealized income:

> the MRT *does* tax realized income – namely, income realized by the corporation, KisanKraft. The MRT attributes the income of the corporation to the shareholders, and then taxes the shareholders (including the Moores) on their share of that undistributed corporate income.
>
> So the precise and narrow question that the Court addresses today is whether Congress may attribute an entity's realized and undistributed income to the entity's shareholders or partners, and then tax the shareholders or partners on their portions of that income.

(Emphasis in original.) Justice Kavanaugh then cites a long line of cases confirming that "Congress can attribute the undistributed income of an entity to the entity's shareholders or partners, and tax the shareholders or partners on their pro rata share of the entity's undistributed income." Viewed as a question of attribution, then, the case for affirming the Ninth Circuit is easy.

In two footnotes, Justice Kavanaugh is quick to remind the reader that the decision rests on narrow grounds. In footnote 2 he observes that:

> our analysis today does not address the distinct issue that would be raised by (i) an attempt by Congress to tax both the entity and the shareholders or partners on the entity's undistributed income; (ii) taxes on holdings, wealth, or net worth; or (iii) taxes on appreciation.

Then, in footnote 3, he writes:

> Because the MRT taxes realized income – namely, income realized by the corporation and attributed to the shareholders – we do not address the Government's argument that a gain need not be realized to constitute income under the Constitution.

Consequently, we do not know whether and to what extent the current Court sees realization as a constitutional prerequisite to income. As Justice Kavanaugh concludes:

> The Moores argue that realization is a constitutional requirement; the Government argues that it is not. To decide this case, we need not resolve that disagreement over realization.

4. Other Opinions Tackle Realization Directly

But we do know the views of at least five Justices when it comes to realization, thanks to concurring opinions from Justice Jackson and Justice Barrett, the latter of which Justice Alito joined, and the dissenting opinion of Justice Thomas that Justice Gorsuch joined.

In her concurring opinion, Justice Jackson makes clear her view that the realization requirement springs not from the Sixteenth Amendment but from *Macomber*, and that *Bruun* neutered *Macomber*'s stance on realization. "Any litigant seeking to sustain her case on the basis of *Macomber* would have to bring back from the dead its Court-created limit on Congress's power," she writes.

Justice Barrett concurs in the result but feels "the issue is more complex than the Court lets on." She doesn't hide the ball, writing:

> The question on which we granted review is "[w]hether the Sixteenth Amendment authorizes Congress to tax unrealized sums without apportionment among the states." … The answer is straightforward: No.

There is no doubt she and Justice Alito see realization as a constitutional requirement. She cites a string of cases in which the Court and lower courts have used "realized" and "derived" (a word that *does* appear in the Sixteenth Amendment) interchangeably. Indeed, she even questions whether subpart F, the provisions that tax United States shareholders on their shares of some of the income from controlled foreign corporations, is constitutional. She concludes:

> Congress's power to attribute the income of closely held corporations to their shareholders is a difficult question—and unfortunately, the parties barely addressed it. Without focused briefing on the attribution question, I would not resolve it. <u>Subpart F and the MRT may or may not be constitutional</u>, nonarbitrary attributions of closely held foreign corporations' income to their shareholders. In this litigation, however, the Moores have conceded that subpart F is constitutional. And I agree with the Court that subpart F is not meaningfully different from the MRT in how it attributes corporate income to shareholders. Taxpayers generally bear the burden to show they are entitled to a refund. Given the Moores' concession, they have not met that burden here. For that reason, I concur in the Court's judgment affirming the judgment below.

(Emphasis added, citations omitted.)

In his dissent, Justice Thomas agrees in large part with Justice Barrett. He writes:

> Sixteenth Amendment "incomes" include only income realized by the taxpayer. The text and history of the Amendment make clear that it requires a distinction

> between "income" and the "source" from which that income is "derived." And, the only way to draw such a distinction is with a realization requirement. Our precedent says as much. In *Eisner v. Macomber*, 252 U. S. 189 (1920), the Court explained that "the characteristic and distinguishing attribute of income," as the term is used in the Sixteenth Amendment, is that it is "*received* or *drawn* by the recipient (the taxpayer) for his *separate* use, benefit and disposal." Id., at 207. Because the Moores never actually received any of their investment gains, those unrealized gains could not be taxed as "income" under the Sixteenth Amendment.

(Emphasis in original.) He agrees with Justice Barrett that the majority dodged the question on which it granted review by framing the case as one of income attribution instead of realization. Unlike Justice Barrett, though, Justice Thomas rejects the majority's reliance on an "attribution doctrine" to sustain the MRT:

> The majority's Sixteenth Amendment "attribution" doctrine is a new invention. The majority justifies its creation by plucking superficially supportive phrases from an eclectic selection of tax cases. But, none of the cases supports the proposition that the Sixteenth Amendment empowers Congress to freely attribute income to any taxpayer it reasonably chooses.

Justice Thomas also rejects the argument that the MRT is like other pass-through taxes applicable to partnerships, S corporations, and CFCs. Those regimes all tax owners on a business entity's income currently, while:

> the MRT "tags a shareholder with taxable 'income' even if" he purchased shares "long after the corporation earned the sums being taxed," and it imposes no liability on taxpayers who owned shares for years of retained earnings but sold them before the MRT's trigger date. Brief for Petitioners 45. Subpart F includes some minimal requirements to ensure that taxable "income" belongs to the shareholder in some way; the MRT abandons that effort entirely.

5. Observations

The MRT survived constitutional scrutiny, but it is doubtful that a wealth tax would. Indeed, based on the opinions of Justices Barrett and Thomas joined by Justices Alito and Gorsuch, respectively, there are clearly four votes against a wealth tax. While neither of the Court's other two conservative members, Justice Kavanaugh and Chief Justice Roberts, tipped his hand, one suspects a case presenting the realization question more squarely might find one or both of them joining their colleagues.

Should the Court later decide that realization is a constitutional requirement, it will need to grapple with other Code provisions that impose income taxation absent the actual receipt of some benefit. These provisions might include, for example, §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 §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).

Justice Thomas endorsed the view of the Moores that the MRT "tagged" a CFC shareholder with income even if he or she purchased the shares in 2017, long 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 persuaded more than only Justices Thomas and Gorsuch.

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.

C. So Long, *Chevron* Deference (*Loper Bright Enterprises v. Raimondo*, U.S.S.Ct., June 28, 2024)

The Supreme Court voted 6-3 to overrule its decision in *Chevron USA v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), deferring to federal agency interpretation of ambiguous statutes. The decision simultaneously broadens the powers of federal courts and curbs the authority of federal agencies, which could have a significant effect on the IRS and the interpretation of the Internal Revenue Code.

The Court consolidated two similar cases, one from the Federal Circuit and the other from the First Circuit. Both cases involved challenges to a rule promulgated by the National Marine Fisheries Service ("NMFS") that sometimes required Atlantic herring fishers to pay the costs of statutorily-required "observers" to be onboard during fishing trips for the purpose of collecting data necessary for conservation and management purposes. The fishers argued that the statute required only three specific groups to pay for observers, and since herring fishers were not among those three groups, the NMFS rule requiring them to pay the costs on some occasions was invalid. Both the Federal Circuit and the First Circuit, however, rejected these challenges, finding that the NMFS rule was entitled to so-called "*Chevron* deference."

In simplest terms, *Chevron* deference requires that a court defer to an agency's interpretation of a statute that is either silent or ambiguous as to a particular matter as long as that interpretation "is based on a permissible construction of the statute." In other words, a court may not second-guess or substitute its own, "better" interpretation of a statute as long as the agency's interpretation is a reasonable one. The case was decided in the heyday of the

Reagan Administration's deregulation campaign. At the time, it was viewed as a modest victory for conservatives who controlled federal agencies focused on implementing rules that reduced government oversight.

But *Chevron* proved to be a landmark case, having been cited by federal courts more than 18,000 times in its 40-year lifespan. Despite its status, the case has always attracted criticism, primarily on the grounds that it undermines the separation of powers. Critics say that only courts should interpret statutes, not executive branch agencies. By deferring to agency interpretations, courts elevate agencies to the status of quasi-courts. Defenders of *Chevron* deference, on the other hand, claim the doctrine is key to allowing agencies to administer the statutes they are charged with enforcing. They claim agencies have the requisite subject matter expertise to administer congressional acts and that federal judges, as human beings, cannot be expected to have the same level of competence in all fields.

1. The Majority Opinion

Writing for the majority, Chief Justice Roberts cites The Federalist Papers and *Marbury v. Madison*, 1 Cranch 137 (1803), for the notion that interpretation of laws belongs to the judiciary and to no other branch of government. He traces the history of judicial review of agency interpretations through the early twentieth century, concluding that "Nothing in the New Deal era or before it thus resembled the deference rule the Court would begin applying decades later to all varieties of agency interpretations of statutes."

He then observes that the Administrative Procedure Act, 5 U.S.C. §551 et seq. (the "APA"), was enacted in 1946 as a check on administrative zeal, and that it confirms "the unremarkable, yet elemental proposition reflected by judicial practice dating back to *Marbury*: that courts decide legal questions by applying their own judgment." The APA, he notes, does not distinguish between ambiguous and unambiguous laws. Instead, it gives deference only to agency factfinding and policymaking. The APA says nothing about deference to agency rulemaking.

Chief Justice Roberts then makes the case for why *Chevron* deference is inconsistent with the APA and therefore must be overturned. Noting it was decided "by a bare quorum of six Justices," he observes that the case made no mention of the APA. Indeed, "It requires a court to *ignore*, not follow, 'the reading the court would have reached' had it exercised its independent judgment as required by the APA." (Emphasis in original.) But more importantly, says Chief Justice Roberts, *Chevron* deference upsets the separation of powers:

> Perhaps most fundamentally, *Chevron*'s presumption is misguided because agencies have no special competence in resolving statutory ambiguities. Courts do. The Framers, as noted, anticipated that courts would often confront statutory ambiguities and expected that courts would resolve them by exercising independent legal judgment. And even *Chevron* itself reaffirmed that "[t]he judiciary is the final authority on issues of statutory construction" and recognized

> that "in the absence of an administrative interpretation," it is "necessary" for a court to "impose its own construction on the statute." *Chevron* gravely erred, though, in concluding that the inquiry is fundamentally different just because an administrative interpretation is in play. The very point of the traditional tools of statutory construction—the tools courts use every day—is to resolve statutory ambiguities. That is no less true when the ambiguity is about the scope of an agency's own power—perhaps the occasion on which abdication in favor of the agency is *least* appropriate.

Loper Bright at 23 (emphasis in original). He challenges the government's position that agencies should resolve statutory ambiguities because they have subject matter expertise, claiming that *Chevron* required deference to agency interpretations of "ambiguities of all stripes," no matter whether the ambiguities relate to the agency's technical subject matter expertise. "The better presumption," he says, "is therefore that Congress expects courts to do their ordinary job of interpreting statutes, with due respect for the views of the Executive Branch."

Chief Justice Roberts also rejects the claim that agency deference leads to greater consistency in statutory interpretation, noting "there is little value in imposing a uniform interpretation of a statute if that interpretation is wrong." Finally, he catalogues "the many refinements" made to the doctrine over the years as proof that "*Chevron*'s fictional presumption of congressional intent was always unmoored from the APA's demand that courts exercise independent judgment in construing statutes administered by agencies."

Dismissing *Chevron* as "fundamentally misguided," "unworkable," and "an impediment, rather than an aid" in statutory interpretation, Chief Justice Roberts concludes that the case is not worthy of *stare decisis*:

> *Chevron* was a judicial invention that required judges to disregard their statutory duties. And the only way to "ensure that the law will not merely change erratically, but will develop in a principled and intelligible fashion," *Vasquez v. Hillery*, 474 U. S. 254, 265 (1986), is for us to leave *Chevron* behind.

Id. at 34. He summarizes the new regime as follows:

> *Chevron* is overruled. Courts must exercise their independent judgment in deciding whether an agency has acted within its statutory authority, as the APA requires. Careful attention to the judgment of the Executive Branch may help inform that inquiry. And when a particular statute delegates authority to an agency consistent with constitutional limits, courts must respect the delegation, while ensuring that the agency acts within it. But courts need not and under the APA may not defer to an agency interpretation of the law simply because a statute is ambiguous.

Id. at 35.

2. The Concurring Opinions

In his concurring opinion, Justice Thomas stressed how *Chevron* curbed judicial power while simultaneously expanding agency power beyond constitutional limits, largely quoting his own opinions in past cases where the doctrine applied. In effect, he argues that it is not enough simply to overrule *Chevron* because it conflicts with the APA. The case should be overturned, he says, because it violates the Constitution. As he concludes:

> Although the Court finally ends our 40-year misadventure with *Chevron* deference, its more profound problems should not be overlooked. Regardless of what a statute says, the type of deference required by *Chevron* violates the Constitution.

Justice Gorsuch issued a concurring opinion that elaborated on the *stare decisis* aspects of overruling *Chevron*. After offering a "quick sketch of traditional common-law understanding of the judge's role and the place of precedent in it," he explains that precedent should not be seen as an "inexorable command," especially where the precedent is mistaken. He notes that the Warren Court and the Burger Court overturned many more cases than the current Court, claiming "we have not approached the pace set by our predecessors, overruling an average of just one or two precedents each Term." In his signature staccato style, Justice Gorsuch then explains how this overview of *stare decisis* leads to the Court's decision to overrule *Chevron*:

> Turning now directly to the question what *stare decisis* effect *Chevron* deference warrants, each of these lessons seem to me to weigh firmly in favor of the course the Court charts today: Lesson 1, because *Chevron* deference contravenes the law Congress prescribed in the Administrative Procedure Act. Lesson 2, because *Chevron* deference runs against mainstream currents in our law regarding the separation of powers, due process, and centuries-old interpretive rules that fortify those constitutional commitments. And Lesson 3, because to hold otherwise would effectively require us to endow stray statements in *Chevron* with the authority of statutory language, all while ignoring more considered language in that same decision and the teachings of experience.

3. The Dissent

Justice Kagan penned the dissent, joined by Justice Sotomayor and, in part, by Justice Jackson. (Justice Jackson did not participate in the *Loper Bright* case from the D.C. Circuit but did participate in the case from the First Circuit.) Observing that *Chevron* "has become part of the warp and woof of modern government, supporting regulatory efforts of all kinds," she adds "the rule is right."

> Congress knows that it does not—in fact cannot—write perfectly complete regulatory statutes. It knows that those statutes will inevitably contain

> ambiguities that some other actor will have to resolve, and gaps that some other actor will have to fill. And it would usually prefer that actor to be the responsible agency, not a court. Some interpretive issues arising in the regulatory context involve scientific or technical subject matter. Agencies have expertise in those areas; courts do not. Some demand a detailed understanding of complex and interdependent regulatory programs. Agencies know those programs inside-out; again, courts do not. And some present policy choices, including trade-offs between competing goods. Agencies report to a President, who in turn answers to the public for his policy calls; courts have no such accountability and no proper basis for making policy. And of course Congress has conferred on that expert, experienced, and politically accountable agency the authority to administer—to make rules about and otherwise implement—the statute giving rise to the ambiguity or gap. Put all that together and deference to the agency is the almost obvious choice, based on an implicit congressional delegation of interpretive authority.

By overruling *Chevron*, Justice Kagan contends, "A rule of judicial humility gives way to a rule of judicial hubris." She says "the majority cannot destroy one doctrine of judicial humility without making a laughing-stock of a second. (If opinions had titles, a good candidate for today's would be Hubris Squared.)" She sees *Chevron* as "supercharged" precedent because "so many governmental and private actors have relied on it for so long" and because Congress never, in 40 years, took any action to overrule the decision. As she says, "A longstanding precedent at the crux of administrative governance thus falls victim to a bald assertion of judicial authority. The majority disdains restraint, and grasps for power."

4. Observations

The IRS will continue to promulgate regulations, but in light of the Court's decision, it is unclear to what extent courts will defer to those regulations. Before *Chevron*, in *National Muffler Dealers Association, Inc. v. United States*, 440 U.S. 472 (1979), the Court announced a multi-factor test to determine the validity of an IRS regulation:

> A regulation may have particular force if it is a **substantially contemporaneous construction** of the statute by those presumed to have been aware of congressional intent. If the regulation dates from a later period, the manner in which it evolved merits inquiry. Other relevant considerations are the **length of time the regulation has been in effect**, the **reliance** placed on it, the **consistency of the Commissioner's interpretation**, and the **degree of scrutiny Congress has devoted to the regulation** during subsequent reenactments of the statute.

Id., at 477 (emphasis added). This multi-factor test was widely used to assess the validity of regulations, even after *Chevron*, until *Mayo Foundation v. United States*, 562 U.S. 44 (2011), announced that *Chevron* supplanted *National Muffler*. Now that *Chevron* has been repealed, one can logically assume that the *National Muffler* test has been revived, though the Court did not speak to this issue directly.

Certainly one can expect to see more cases challenging the validity of IRS regulations now that *Chevron* deference no longer applies. Indeed, just two weeks after the Court's decision in *Loper Bright*, counsel for the taxpayer in a pending case before the Seventh Circuit, *Tribune Media Co. v. Commissioner*, argued to the court that Reg. §1.701-2, the partnership anti-abuse rule, was invalid as an "extraordinarily broad assertion of agency authority" no longer entitled to deference.

Even before *Chevron*'s repeal, federal courts in recent years have been striking down both temporary and permanent IRS regulations. See, e.g., *Liberty Global, Inc. v. United States*, 1:20-cv-03501-RBJ (D. Colo. 2022), *Hewitt v. Commissioner*, 21 F.4th 1336 (11th Cir. 2021). The decision in *Loper Bright* will give judges more confidence in deciding that regulations are contrary to their own, "better" interpretations of statutes.

D. Statute of Limitations on Challenging Regulations Starts at Injury, Not Promulgation (*Corner Post, Inc. v. Board of Governors of the Federal Reserve System*, July 1, 2024)

A divided Supreme Court of the United States (6-3) held that the six-year statute of limitations for suits against the United States brought under the Administrative Procedure Act (the "APA") starts "when the plaintiff is injured by final agency action." Thus, for example, a taxpayer challenging the validity of an IRS regulation has six years from the date the IRS determines a deficiency pursuant to that regulation, even if the regulation was promulgated decades earlier. This decision, no doubt, will spur many more challenges to regulations promulgated by federal agencies, and given the death of *Chevron* deference one week earlier in *Loper Bright*, *supra*, judges will get the chance to implement their "better" interpretations of statutes with nearly unchecked power.

The case involved a North Dakota truckstop that accepted debit cards from customers for payment. Frustrated at the high interchange fees charged by payment networks on each transaction, in 2021 it joined a lawsuit challenging a rule promulgated by the Federal Reserve Board in 2011 that set high caps for those fees. The lawsuit argued that the Fed's rule was contrary to the Durbin Amendment to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. A similar suit in 2014 failed before the D.C. Circuit, but the plaintiffs in the new suit filed in North Dakota (in the Eighth Circuit).

The district court dismissed the suit as barred by the six-year statute of limitations, and the Eighth Circuit affirmed. Agreeing with the Fourth, Fifth, Ninth, Federal and D.C. Circuits, both the lower and appellate court distinguished between "facial" challenges to a rule (like the one in this suit, arguing that the Fed's rule is facially invalid) and "as-applied" challenges to the application of a valid rule to a particular regulated party. These courts all agree that in the case of facial challenges, the statute of limitations starts to run when the federal agency publishes the rule at issue. Only the Sixth Circuit maintains that the statute of limitations starts to run when the plaintiff "first becomes aggrieved by a regulation that exceeds an agency's statutory authority." That's a 6-1 split among the circuits, leading the Supreme Court to grant review.

The majority, in an opinion by Justice Barrett, agrees with the Sixth Circuit. Justice Barrett reasons that because "a litigant cannot bring an APA claim unless and until she suffers an injury," it would not make sense that the statute of limitations would start to run upon promulgation. Further, the statute of limitations itself, 28 U.S.C. §2401(a), speaks of starting "after the right of action first accrues." Justice Barrett notes that this language parrots language from an earlier statute, where it was clear that an action "accrues" only "when the plaintiff has a complete and present cause of action." And, as stated, a plaintiff must first suffer injury before having a "complete and present" case and the accompanying standing to sue.

The majority rejects all of the reasons offered by the Fed for treating facial challenges differently from as-applied challenges. It argued that the standard practice in administrative law matters is for the statute of limitations to start when "any proper plaintiff" can challenge agency action. Justice Barrett notes that while this practice is authorized by many other federal statutes, the APA reads differently.

The Fed also argued that the statute tolls when a plaintiff is incapacitated, suggesting that the statute can "accrue" even when a plaintiff is unable to sue. "True enough," says Justice Barrett, but that observation is of no relevance. "The tolling exception applies when the plaintiff *had* a complete and present cause of action" (emphasis in original). She continues: "What matters for accrual is when the plaintiff had 'the *right* to apply to the court for relief,' not whether some external impediment prevented her from doing so" (emphasis in original).

The Fed next argued that two prior Court decisions interpreted the statute of limitations consistent with its position in this case, but the majority concluded that the Fed's reading of one case was "incomplete" and that the Fed "vastly overread—in fact, … misread" the other. Finally, the Fed argued that "agencies and regulated parties need the finality of a 6-year cutoff." Challenges that come perhaps decades after a rule's introduction threaten to upset reliance interests of agencies and parties that have long operated under that rule. But the majority notes that pleas of administrative convenience do not justify ignoring the clear text of a statute. Congress could have chosen a different statute of limitations for APA claims, but it did not. Besides, says Justice Barrett, the Fed and other agencies are likely overreacting:

> Moreover, the opportunity to challenge agency action does not mean that new plaintiffs will always win or that courts and agencies will need to expend significant resources to address each new suit. Given that major regulations are typically challenged immediately, courts entertaining later challenges often will be able to rely on binding Supreme Court or circuit precedent. If neither this Court nor the relevant court of appeals has weighed in, a court may be able to look to other circuits for persuasive authority. And if no other authority upholding the agency action is persuasive, the court may have more work to do,

> but there is all the more reason for it to consider the merits of the newcomer's challenge.

Despite the attempted reassurance, Justice Jackson, in a dissent joined by Justices Sotomayor and Kagan, fears something worse is more likely. She summarizes the dissenting viewpoint thusly:

> The flawed reasoning and far-reaching results of the Court's ruling in this case are staggering. First, the reasoning. The text and context of the relevant statutory provisions plainly reveal that, for facial challenges to agency regulations, the 6-year limitations period … starts running when the rule is published. The Court says otherwise today, holding that the broad statutory term "accrues" requires us to conclude that the limitations period for Administrative Procedure Act (APA) claims runs from the time of a plaintiff 's injury. Never mind that this Court's precedents tell us that the meaning of "accrues" is context specific. Never mind that, in the administrative-law context, limitations statutes uniformly run from the moment of agency action. Never mind that a plaintiff's injury is utterly irrelevant to a facial APA claim. According to the Court, we must ignore all of this because, for other kinds of claims, accrual begins at the time of a plaintiff's injury.
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> Next, the results. The Court's baseless conclusion means that there is effectively no longer any limitations period for lawsuits that challenge agency regulations on their face. Allowing every new commercial entity to bring fresh facial challenges to long-existing regulations is profoundly destabilizing for both Government and businesses. It also allows well-heeled litigants to game the system by creating new entities or finding new plaintiffs whenever they blow past the statutory deadline.

For purposes of completeness, it should be noted Justice Kavanagh chimed in with a concurrence, taking 18 pages to note that the plaintiff here is eligible for relief only because the APA authorizes "vacatur" of agency rules.

Justice Jackson's dissent concludes by predicting a "tsunami of lawsuits against agencies that the Court's holding in this case and *Loper Bright* have authorized" that could "devastate the functioning of the Federal Government." It is in stark contrast to Justice Barrett's prediction that agencies and courts will likely just keep on keeping on, as facial challenges to major regulations are often initiated shortly after promulgation. Facial challenges, however, have greater stakes than as-applied challenges. They affect all regulated parties, not just the plaintiff that brings the claim. There is no question that through these cases, the Court has hung a large "welcome" sign on courthouse doors to regulated parties seeking to overturn agency rulemaking actions.

IV. DISTRIBUTION OF QTIP TO SURVIVING SPOUSE DOES NOT TRIGGER DEEMED GIFT OF REMAINDER INTEREST (*Estate of Anenberg v. Commissioner*, 162 T.C. No. 9, May 20, 2024)

In a unanimous opinion, the Tax Court held that a surviving spouse did not make a gift under §2519 upon the termination of two marital trusts holding "qualified terminable interest property" ("QTIP") because the surviving spouse received all of the trust assets upon termination. The court also held that the surviving spouse's subsequent installment sale of the assets formerly held in the marital trusts likewise did not trigger a deemed gift under §2519.

A. A Brief Primer on QTIP Elections and the Deemed Gift Rule in §2519

Both the gift tax and the estate tax offer an unlimited marital deduction for transfers of property to a spouse or surviving spouse, respectively. See §§2523(a) and 2056(a). To qualify for the deduction, generally, the spouse must receive complete ownership of the transferred property. Where the spouse receives only a life estate or some other terminable interest in property, the marital deduction is generally unavailable. See §§2523(b) and 2056(b)(1). There are exceptions to this "terminable interest rule," and the one at play in this case is the exception for QTIP. See §§2523(f)(1) and 2056(b)(7)(A).

QTIP refers to property passing from the donor spouse (1) in which the donee spouse has a "qualifying income interest" for life; and (2) to which an election has been made to treat the property as QTIP. §§2523(f)(2); 2056(b)(7)(B)(i). Although the spouse has only a partial interest in QTIP that will expire at some point, whether due to lapse of time or the occurrence of some event or contingency (often, the spouse's death), Congress is willing to give the donor spouse or the estate of the donor spouse a marital deduction for the full value of the QTIP. This is because the donee spouse will be treated as the absolute owner of the QTIP, so the remaining value of the QTIP will be subject to estate tax upon the death of the donee spouse. §2044. In this way, the QTIP election defers the imposition of wealth transfer tax until the time the QTIP leaves the control of the couple.

As previously mentioned, the recipient spouse must have a "qualifying income interest" for life in the transferred property in order for it to qualify as QTIP. This requires, generally, that the spouse receive all of the income from the property payable at least annually and that the property may not be appointed to anyone other than the spouse during the duration of the spouse's ownership. §2056(b)(7)(B)(ii). See also §2523(f)(3). Most often, QTIP is parked in a trust for the benefit of the recipient spouse. Upon the spouse's death, the property passes to the beneficiaries selected by the transferor spouse.

If the recipient spouse disposes of all or part of the qualifying income interest, the spouse is deemed to have transferred all interests in the QTIP other than the qualifying income interest. §2519. So if, for instance, the recipient spouse gifts the qualifying income interest to anyone else, the recipient spouse gifts not only the qualifying income interest but all of the other interests in the QTIP as well. If the recipient spouse sells the qualifying income interest, there is likewise a deemed transfer of all of the other interests in the QTIP, resulting in a deemed gift in addition to whatever income tax consequences attach to the sale. The purpose of the rule is straightforward—since the recipient spouse can no longer be deemed to have full ownership of the QTIP, it is appropriate to treat the transfer of the qualifying income interest as the moment the underlying property has left the control of the couple.

B. Facts of the Case

In 1971, Alvin and Sally, a married couple, formed a closely-held corporation that owned gas stations throughout Los Angeles and in other California locations. The couple established a revocable living trust in 1987, to which they contributed all of their assets, including the closely-held stock. When Alvin died in 2008, his half of the trust assets passed to two sub-trusts earmarked as "marital trusts." Both marital trusts gave Sally a qualified income interest for life, and both marital trusts provided that only Sally could receive distributions of principal as needed for her support. The marital trusts further provided that, upon Sally's death, the remainder would pass to various other trusts created for the benefit of Alvin's two children from a prior marriage, Steven and Neil. Acting in his capacity as executor of Alvin's estate, Steven elected to treat the assets of both marital trusts as QTIP so that Alvin's estate could claim an estate tax marital deduction for the value of the assets passing to the marital trusts.

In 2011, Steven, acting as trustee of the marital trusts, petitioned a state court to terminate the marital trusts, claiming that he anticipated receiving consent to the termination from all of the current, vested, and contingent beneficiaries. The court issued its order approving the termination of the marital trusts early in 2012. At that time, the value of the assets in the marital trusts was $25.45 million and the value of Sally's income interest totaled about $2.6 million.

Later that year, Sally gifted about $1.6 million worth of the closely-held stock to the trusts established for Steven and Neil. The next month, she sold almost all of the remaining closely-held stock to various trusts for Alvin's kids and grandkids in exchange for nine-year installment notes with a face value equal to the value of the transferred stock. All notes bore annual interest equal to the applicable federal rate at that time (0.84 percent). On a timely-filed federal gift tax return for 2012, Sally reported the gifts of the stock made to the trusts for Steven and Neil. She also disclosed the sale transactions but took the position that those transfers were not gifts because the promissory notes were full and adequate consideration for the transferred shares.

Sally died in 2016. In 2020, the IRS determined that Sally made a taxable gift of $22.85 million in 2012 under §2519. This amount represents the difference between the value of the marital trust assets distributed to Sally and the value of her income interests in the marital trusts. When that determination generated a gift tax deficiency of more than $9 million and an accuracy-related penalty of over $1.8 million, the estate timely petitioned the Tax Court for a redetermination.

The IRS based its determination on the theory that Sally made a deemed gift under §2519 in 2012, either upon termination of the marital trusts or upon Sally's subsequent installment sales of the closely-held stock. But in a unanimous (13-0) decision, the Tax Court held that Sally made no deemed gift at either point.

C. No Deemed Gift Upon Termination of Marital Trusts

The estate challenged the IRS's position that the termination of the marital trusts was a "disposition" of Sally's income interests under §2519, but the Tax Court concluded that whether the termination was a disposition within the meaning of §2519 did not matter because, even if it was a disposition, it was not a "gift:"

> [A]fter the transaction, Sally has full ownership of the … shares. As a result of the Superior Court's order, she received free and clear the underlying property that section 2056(b)(7) deemed her to have received from Alvin to start with and with respect to which (we assume) section 2519(a) deemed her to have transferred remainder interests upon the termination of the Marital Trusts.

In other words, Sally was already the deemed owner of the assets of the marital trusts for estate and gift tax purposes, so when she received those assets outright following termination of the marital trusts, she was no poorer after the transaction. There was, thus, no transfer by gift to someone other than Sally.

D. No Deemed Gift on Subsequent Sale

Likewise, the court concluded, Sally did not make a deemed gift under §2519 when she sold the stock in exchange for the promissory notes. By the time of the sale transactions, Sally no longer held a qualifying income interest in the marital trust assets—she had absolute ownership of those assets. If she had no qualifying income interest, §2519, which requires a disposition of a qualifying income interest in order to effect a deemed gift, logically could not apply. As the court put it:

> When the Superior Court terminated the Marital Trusts, the property interest Sally received was outright ownership of the … shares, not an income interest. And because the Marital Trusts terminated, the property interest Sally received was unencumbered by any restrictions that were placed on it while it was in the Trusts, including restrictions that would have limited distributions to individuals other than Sally. For these reasons, Sally no longer held a qualifying income interest for life as defined by section 2056(b)(7)(B)(ii), Consequently, her sale of the … shares for promissory notes could not trigger section 2519.

E. The IRS Misapplies Rules and Precedent

The IRS balked, claiming that §2519 had to apply, for otherwise Sally could escape federal wealth transfer taxation on the assets for which Alvin got a marital deduction. In its argument to the Tax Court, the IRS contended that "once the estate of the first spouse to die irrevocably 'checks-in' to the QTIP regime, there is no method to 'check-out' absent paying the deferred tax." But as the court observed, this argument ignores the fact that a distribution of QTIP to the surviving spouse does not trigger liability for transfer tax, even if the surviving spouse consumes or transfers away the distributed property. If the exercise of a power to appoint QTIP to the surviving spouse is not a deemed disposition under §2519, see Reg. §25.2519-1(e), even where the surviving spouse later disposes of such property, then a transfer of assets to a surviving spouse pursuant to a court-ordered termination likewise cannot be a deemed disposition under §2519.

The IRS also insisted that the court's prior decision in *Estate of Kite v. Commissioner*, T.C. Memo. 2013-43, required application of §2519 on these facts. In *Kite*, the Tax Court held that a termination of a marital trust and subsequent sale of trust assets in exchange for self-canceling private annuities triggered a deemed gift under §2519 because the private annuities were structured in a way that made it likely the decedent would escape estate tax. But the Tax Court here distinguished *Kite*:

> The case before us differs in material respects from *Estate of Kite*. To begin, the Commissioner has not asked that we apply the substance over form doctrine. Moreover, … *Estate of Kite* involved an apparent attempt to prevent estate or gift tax from ever being imposed on the residual value of the QTIP for which a marital deduction had been taken. Neither circumstance is present here.

Finally, the IRS argued that regulations under §2519 supported its position, but the Tax Court likewise rejected this position, noting again that, at most, §2519 deemed that Sally made a transfer of the marital trust assets. Not all transfers are gifts, and on these facts neither the termination of the marital trusts nor the subsequent sale of the trust assets were gift transfers.

F. What About the Remainder Beneficiaries?

In a footnote, the court stated that "We express no view on whether the other beneficiaries of the Marital Trust could be treated as making a gift to Sally for gift tax purposes" when they consented to the termination of the marital trusts and, thus, to Sally's absolute ownership of the trust assets. If this was not pursuant to a pre-arranged understanding that the sale transactions would later follow, the beneficiaries had no assurance they would continue to have a beneficial interest in the trust assets. At the very least, that bears the indicia of a gift transfer. Had the court been presented with that question, it is hardly certain the result would still be favorable to Steven, Neil, and the other heirs.

Indeed, in *Chief Counsel Advice 202118008* (May 7, 2021), the IRS concluded that the commutation of a QTIP trust—where the trust is terminated, the spouse receives an amount of assets equal to the present value of the qualifying income interest, and the remainder beneficiaries receive assets equal to the value of their remainder interests—resulted in taxable gifts by the surviving spouse and the remainder beneficiaries. It is somewhat surprising, then, that the IRS did not claim that Steven and Neil had made gifts of their remainder interests to Sally when they consented to the termination of the marital trusts.

V. NEW REQUIRED MINIMUM DISTRIBUTION REGULATIONS CLARIFY SECURE ACT AND SECURE 2.0 ACT CHANGES (T.D. 10001, July 19, 2024)

The IRS has finalized proposed regulations relating to required minimum distributions ("RMDs") from certain deferred compensation arrangements, including qualified plans and individual retirement accounts ("IRAs"). The final regulations, which reflect changes made under the Setting Every Community Up for Retirement Enhancement Act of 2019 (the "SECURE Act") and the SECURE 2.0 Act of 2022 ("SECURE 2.0"), take effect on January 1, 2025.

These regulations were first proposed in February, 2022, before the enactment of SECURE 2.0. Accordingly, the final regulations are accompanied by a new set of proposed regulations that reflect provisions of SECURE 2.0 that were not covered in the 2022 proposed regulations. The regulations clock in at 260 pages, making a comprehensive summary well beyond the scope of the Tax Report. Instead, this summary will focus on one of the matters of greatest interest to estate planning professionals—the application of the new "10-year rule" in cases where the participant dies after the required beginning date ("RBD") for distributions—along with the proposed regulations.

A. Application of the 10-Year Rule for Designated Beneficiaries

Among other things, the SECURE Act created a 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. §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. §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. Planners have come to call this the "10-year rule."

The conventional wisdom was that the 10-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.

But in the 2022 proposed regulations, the IRS announced that where: (1) the 10-year rule applies to an IRA or a qualified plan; and (2) the participant had started taking annual RMDs prior to death, RMDs must likewise 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 after starting RMDs 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 25 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 10-year rule contained in the proposed regulations, the IRS provide transition relief.

Thus began a series of Notices issued as the IRS continued to tweak the proposed regulations. In explaining the final rule in the preamble, the IRS reminds the reader of the guidance issued since the unveiling of the proposed regulations:

> While the final regulations do not eliminate the annual distribution requirement in cases in which annual life expectancy payments have begun, the Treasury Department and the IRS issued *Notice 2022-53*, 2022-45 IRB 437, *Notice 2023-54*, 2023-31 IRB 382, and *Notice 2024-35*, 2024-19 IRB 1051, in response to comments requesting transition relief for this requirement. Under those notices, if a distribution would have been required to be made to certain beneficiaries under these regulations had they applied before January 1, 2025, then: (1) a plan will not fail to be qualified for failing to make that distribution in 2021, 2022, 2023, or 2024; and (2) the taxpayer who failed to take the distribution will not be assessed an excise tax for failing to do so. This relief applies with respect to a beneficiary who is a designated beneficiary of an employee who died in 2020, 2021, 2022, or 2023, and after the employee's required beginning date, provided that the beneficiary was not an eligible designated beneficiary who used the lifetime or life expectancy payments exception under section 401(a)(9)(B)(iii).

> Those notices also provided comparable relief for the case in which an eligible designated beneficiary who was taking annual life expectancy payments died in 2020, 2021, 2022, or 2023, and that beneficiary's successor beneficiary failed to take a distribution in 2021, 2022, 2023, or 2024.

89 F.R. 58886, 58897 (July 19, 2024). While the preamble's text is silent as to the requirement for make-up distributions, the IRS offers good news in a footnote:

> This relief does not require taxpayers to make up missed required minimum distributions nor does it permit taxpayers to extend the 10-year deadline by which a full distribution is required to be made. For example, if an employee died in 2020, then in 2025, there are six years remaining in the 10-year period without regard to whether the designated beneficiary took distributions in 2021, 2022, 2023, or 2024. In 2030, the designated beneficiary must take a distribution of the remaining account balance.

Id. at note 11. Thus, the rule from the final regulations can be stated simply: if a participant was past the required beginning date ("RBD") for distributions at death, then the designated beneficiary is required to take annual distributions during the 10-year period based upon the designated beneficiary's life expectancy, and must drain whatever is left in the participant's account by December 31 of the tenth year following the year of death. There is no requirement for makeup distributions where RMDs should have been paid in 2021, 2022, 2023, or 2024. In explaining why the final regulations did not change the proposed rule despite several written comments decrying the rule's complexity, the IRS said this:

> Since it was first added to the Code, section 401(a)(9) has always included the concept of a required beginning date, under which, once required minimum distributions began to either an employee or designated beneficiary, they were required to continue until the employee's entire interest under the plan was fully distributed, and these regulations retain this requirement. There is little indication in … the SECURE Act to suggest that Congress intended to allow distributions of an employee's account to temporarily cease for up to 9 years once annual required minimum distributions have begun. Moreover, the requirement to continue annual distributions does not increase complexity (in that this requirement merely retains the rules that were in place before the addition of section 401(a)(9)(H), but subject to the full distribution requirement [at the end of the tenth year after the year of death]).

Id. at 58896-58897.

The following chart offers an overview of how post-death distributions work under the legislation and regulations. It is adapted from a slide presented by Steven Siegel at continuing education conferences.

Participant Dies	Named Beneficiary	Applicable Withdrawal Rule
Before RBD	None	Anytime within 5 years
Before RBD	Designated Beneficiary	Anytime within 10 years
After RBD	None	Over participant's "life expectancy"
After RBD	Designated Beneficiary	Annually over years 1-9 based on beneficiary's life expectancy, then balance in 10th year
Before or after RBD	Eligible Designated Beneficiary	Over beneficiary's life expectancy

B. Accompanying Proposed Regulations

On the same date the IRS issued the final regulations, it also unveiled new proposed regulations implementing some of the changes made to the RMD rules by SECURE 2.0. The proposed regulations contain guidance on, among other things, age determinations for employees born in 1959, annuity contracts purchased with a portion of an employee's individual account, distributions from designated Roth accounts, the impact of divorce after the purchase of a qualifying longevity annuity contract, and distributions to a beneficiary of a see-through trust. Two more changes made by the proposed regulations merit lengthier mention.

1. Surviving Spouse Election to be Treated as Participant

Under prior law, a surviving spouse generally had two options when named as the beneficiary of the deceased spouse's account: either roll the deceased spouse's account into the surviving spouse's account or simply remain as a beneficiary of the deceased spouse's account. But SECURE 2.0 created a third option: the surviving spouse can alternatively elect to be treated as the deceased spouse. This means the surviving spouse can postpone RMDs until the date that would have been the deceased spouse's RBD. It also means the surviving spouse can use the more favorable "Uniform Lifetime Table" instead of the "Single Lifetime Table" to calculate RMDs. There can also be advantages for subsequent beneficiaries where the surviving spouse dies before the deceased spouse's RBD.

In general, this third option primarily benefits a surviving spouse whose deceased spouse was younger, as it defers the triggering of RMDs, thus allowing the account more time to grow on a tax-deferred basis. Under Proposed Regulation §1.401(a)(9)-5(g)(3), if the employee spouse dies before the RBD and the surviving spouse is the sole beneficiary, the surviving spouse will automatically be treated as making the election to be treated as the employee spouse. But if the employee spouse dies on or after the RBD, then the surviving spouse will not be deemed to have made the election automatically. At the same time, though, the proposed regulation would provide that the election may be the default election under the terms of a plan, meaning the surviving spouse would not have to make the election even where the employee spouse dies on or after the RBD, as it would apply by default under the terms of the plan.

2. Corrective Distributions to Reduce Penalty

Under §4974(e), as added by SECURE 2.0, those who do not take a timely RMD generally pay a 10 percent penalty instead of the normal 25 percent penalty if a "corrective distribution" is made within two years. Proposed Regulation §1.401(a)(9)-5(g)(2)(iv) makes clear that a corrective distribution in a later taxable year does not count as an RMD in the year of the corrective distribution. As the preamble explains, "under the proposed regulations, if a missed required minimum distribution is corrected by a distribution made in a subsequent calendar year, the required minimum distribution for that subsequent year must be made in addition to the corrective distribution." Apparently the IRS felt compelled to declare formally this seemingly intuitive rule.

VI. IRS EXPLAINS HOW TO CLAIM EARLY WITHDRAWAL PENALTY EXCEPTIONS FOR EMERGENCIES AND VICTIMS OF DOMESTIC ABUSE (*Notice 2024-55, June 21, 2024)*

The IRS has provided guidance in question-and-answer format related to two exceptions to the 10-percent penalty under §72(t)(1) for "emergency personal expense distributions" and "domestic abuse victim distributions." Both exceptions were introduced into the Code by the SECURE 2.0 Act of 2022.

The 10-percent penalty generally applies to any distribution from a qualified retirement plan unless the employee has attained the age of 59-1/2. But the SECURE 2.0 Act of 2022 provided that an individual who has not yet attained age 59-1/2 may withdraw up to $1,000 per year without penalty for any "emergency personal expense distribution," defined as a distribution made "for purposes of meeting unforeseeable or immediate financial needs relating to necessary personal or family emergency expenses." §72(t)(2)(I)(iv). This exception from the penalty for early withdrawal applies only once every three years unless a distribution is repaid within three years, in which case the participant may make emergency withdrawals every year. §72(t)(2)(I)(vii).

In addition, a victim of domestic abuse may, as of 2024, withdraw up to $10,000 (or, if less, half of the value of the participant's account) from a retirement plan without penalty. §72(t)(2)(K). This $10,000 cap will adjust for inflation starting in 2025. §72(t)(2)(K)(vii). The statute defines "domestic abuse" as:

> physical, psychological, sexual, emotional, or economic abuse, including efforts to control, isolate, humiliate, or intimidate the victim, or to undermine the victim's ability to reason independently, including by means of abuse of the victim's child or another family member living in the household.

§72(t)(2)(K)(iii)(II). In addition to inviting comments as to the implementation of these new rules, the IRS provides some preliminary guidance in question-and-answer format.

A. Guidance on Emergency Personal Expense Distributions

The Notice indicates that emergency personal expenses can include medical care (determined without regard to the adjusted gross income limitation applicable to the §213(a) deduction for medical expenses), accidents and casualty losses, imminent foreclosure or eviction from a primary residence, the need to pay funeral or burial expenses, auto repairs, and "any other necessary emergency personal expenses" as determined by an individual's relevant facts and circumstances. Q&A A-2. For this purpose, a plan administrator may rely on an employee's written certification that the employee is eligible for an emergency personal expense distribution. Q&A A-9.

The Notice also makes clear that an eligible retirement plan is not required to permit emergency personal expense distributions. Q&A A-8. But if the plan permits such distributions, the plan must also accept repayment of an emergency personal expense distribution from the employee Q&A A-12. If the plan does not permit such distributions, an employee can still treat a distribution as an emergency personal expense distribution if it would otherwise qualify, though this will require the employee to make a special statement on the Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts. Q&A A-15.

B. Guidance on Domestic Abuse Victim Distributions

The Notice clarifies that an individual may repay a domestic abuse victim distribution within three years. Q&A B-6. It does not, however, indicate whether an individual who repays a distribution could later qualify for another domestic abuse victim distribution. An individual who certifies (by checking a box) that a distribution qualifies for exception will be deemed to have met the requirements for the distribution, no questions asked. Q&A B-9.

Here too, the Notice provides that an eligible retirement plan is not required to permit domestic abuse victim distributions. Q&A B-7. Likewise, if the plan does not permit such distributions, an employee can still treat a distribution as a domestic abuse victim distribution if it would otherwise qualify, though this too will require the employee to make a special statement on the Form 5329. Q&A B-14.

C. Observations

When the SECURE 2.0 Act unveiled these exceptions, some practitioners wondered how they would be administered, particular the exception for domestic abuse victim distributions. They worried that an individual invoking the exception could face further abuse if their abuser learned of the distribution. By relying on individual certifications of eligibility instead of making employees prove their abuse, the Notice helpfully errs on the side of safety.

The SECURE 2.0 Act also provided that a terminally ill person may withdraw amounts from a retirement plan as of December 29, 2022, without any penalty and without limitation. For this purpose, a person is terminally ill if the person is expected to die within seven years (not the usual two-year period used for other definitions of "terminally ill"). Although the IRS also solicited comments on the operation of this rule in anticipation of issuing proposed regulations, one hopes that guidance on terminal illness distributions will soon be forthcoming.

VII. 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 §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 §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.

VIII. 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 §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 §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.

IX. 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. 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."

B. 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 §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 §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 §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 §6712.

C. "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 (see below for verification!). 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.

D. Ninth Circuit Confirms That Recklessness is Willful for FBAR Penalty Purposes (*United States v. Hughes*, 9th Cir., August 21, 2024)

The Ninth Circuit Court of Appeals has joined other circuits in holding that recklessness in failing to file required foreign bank account reports (FBARs) constitutes "willfulness" in failing to file, triggering the application of a higher penalty. The taxpayer pushed the court to adopt a rule by which only the subjective intent not to file would constitute a willful failure to file, but the court declined the invitation.

In this case, the taxpayer, a United States citizen residing in San Francisco, owns a New Zealand winery and wine bar. She has signatory authority over the business accounts at a New Zealand bank, and the balance in those account was such that FBARs are required. But she did not file FBARs for 2010, 2011, 2012, or 2013. The IRS determined that the failure was willful, so it assessed a penalty of nearly $679,000. The taxpayer paid the penalty and commenced a refund suit in federal district court.

The district court determined that the failure to file FBARs in 2010 and 2011 was merely negligent, as there was no evidence the taxpayer had notice of the requirement to file FBARs. But the court further determined that the failure to file in 2012 and 2013 was willful, as the evidence showed she checked a box on her 2012 federal income tax return indicating she was required to file. Although the Ninth Circuit had not then addressed whether a reckless failure to file rose to the level of a "willful" failure to file, the court found persuasive precedent from five other circuits so holding. For those keeping count, the five circuits are the Third, Fourth, Sixth, Eleventh, and Federal Circuits.

The Ninth Circuit upheld the district court's application of those cases, agreeing that equating recklessness with willfulness is consistent with the Supreme Court's decision in *Safeco Insurance Co. v. Burr*, 551 U.S. 47 (2007), where, for purposes of penalties under the Fair Credit Reporting Act, the Court held that reckless violations of a standard satisfy the "willfulness" condition for a civil penalty to apply. The court also observed that the Cout has let stand the decisions of the other circuits equating recklessness with willfulness, refusing to grant review in the three cases for which review was sought. Finally, the Ninth Circuit found the taxpayer offered "no persuasive reason to distinguish *Safeco* and buck the consensus of other Courts of Appeals." It thus upheld the imposition of a willful penalty for both 2012 and 2013.

X. 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).

XI. 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 (9^{th} 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.

XII. 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 §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." §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 §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 §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 §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?" §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.

XIII. CONSERVATION EASEMENT DEVELOPMENTS

While §170(f)(3)(A) generally disallows a charitable contribution deduction for the donation of "an interest in property which consists of less than the taxpayer's entire interest in such property," §170(f)(3)(B) allows a deduction for certain partial-interest transfers, including the donation of a "qualified conservation contribution." The rules for qualified conservation contributions, found in §170(h), require a taxpayer to donate a "qualified real property interest" to a charity exclusively for conservation purposes. To be a "qualified real property interest," the donated interest must include a perpetual restriction on the use which may be made of the real property. See §170(h)(2)(C).

Most qualified conservation contributions take the form of "conservation easements" in connection with large parcels of land. A conservation easement is, in essence, a covenant that typically restricts the use of the subject real property to its current use in perpetuity. The amount of the deduction for the donation of a conservation easement is measured as the difference between the value of the land at its highest and best use and the value of the land now that its use is forever limited to its existing use. That difference in value is often quite large; in fact, in many cases the tax savings from the deduction proves to be more than the cost to acquire the subject property. As a result, taxpayers seeking large deductions have found conservation easements quite attractive.

At first, the IRS limited its policing of conservation easement transactions to question of valuation. Instead of disallowing deductions altogether, the IRS would question the appraisals used to determine the amount of the deduction, often concluding that the donation amounts were quite smaller than those claimed by taxpayers. But over the past several years, the IRS found an Achilles heel in several conservation easement deeds that, according to the IRS, caused the donations to flunk the perpetuity requirement explained above. The IRS's position was based on Regulation §1.170A-14(g)(6)(ii), known on the streets as the "proceeds regulation." In short, the proceeds regulation provides that upon a judicial extinguishment of a conservation easement that has become impossible to fulfill and subsequent sale of the property, the perpetuity requirement will be met only if the charity is entitled to a certain share of the sale proceeds. Early conservation easement deeds provided that the charity would receive a share of the *net* sale proceeds (after reimbursing the donor for the costs of any improvements made to the property after the easement's donation), but the IRS successfully argued the proceeds regulation required that the charity had to receive a share of the *gross* sale proceeds.

Until 2021, the IRS was overwhelmingly successful in attacking conservation easement deductions based on this argument. But then, in *Hewitt v. Commissioner*, 21 F.4th 1336 (11th Cir. 2021), the Eleventh Circuit held that the proceeds regulation is invalid because the IRS did not comply with the Administrative Procedure Act in promulgating the regulation. If the regulation is invalid, then the IRS cannot disallow a conservation easement contribution deduction on the basis that it violates the regulation. In 2022, the Sixth Circuit concluded the regulation was valid. *Oakbrook Land Holdings, LLC v. Commissioner*, 28 F.4th 700 (6th Cir. 2022). Maddeningly, the Supreme Court refused to resolve the split among the circuit courts of appeal.

As the following developments show, conservation easement disputes continue to clog the courts and command the time and attention of the IRS.

A. Final Regulations Implement Ban on Certain Conservation Easements from Partnerships and S Corporations (T.D. 9999, June 24, 2024)

The IRS has finalized proposed regulations implementing §170(h)(7), a provision added as a revenue-raiser to the SECURE 2.0 Act of 2022, P.L. 117-328. Section 170(h)(7) takes direct aim at the so-called "syndicated conservation easement" by preventing an owner of a partnership interest or S corporation stock from claiming a share of the entity's qualified conservation contribution where the claimed amount of the charitable contribution deduction exceeds 2.5 times the owner's basis in the partnership interest or S corporation stock. §170(h)(7)(G) directs the IRS to issue interpretive guidance, and these final regulations fulfill that instruction.

§170(h)(7)(A) generally denies a partner or S corporation shareholder any conservation easement deduction where the amount of the entity's deduction exceeds 2.5 times the sum of each owner's "relevant basis" in the entity. §170(h)(7)(B)(i), in turn, defines an owner's "relevant basis" as the owner's "modified basis" allocable to the portion of the real property to which the conservation easement applies. Under §170(h)(7)(B)(ii), modified basis means the owner's adjusted basis immediately before the contribution, without regard to an owner's share of entity liabilities, and as determined "after taking into account … such other adjustments as the Secretary may provide." (Without this "anti-stuffing rule," investors could easily avoid the 2.5 times rule by contributing other investment assets to the pass-through entity in addition to the amounts used to purchase a share of the real property on which the conservation easement will be placed.)

The proposed regulations explained how an owner's modified basis should be computed for purposes of this rule. The final rule, Reg. §1.170A-14(l)(2), now provides for five 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 to reflect any **partnership interests acquired or disposed of** between the start of the entity's taxable year to the moment immediately prior to the qualified conservation contribution. For example, if the owner acquired additional interests in the partnership, the amount would be increased by the owner's basis in those additional interests.

- Third, 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.

- Fourth, 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 regulations include examples of these adjustments. Reg. §1.170A-14(l)(4). In response to comments that the computation of modified basis under the proposed regulations was too complex, the IRS fired back in the preamble to the final regulations:

> Each of the steps from the proposed regulations is necessary to carry out the statutory directive that a partner's modified basis is the partner's adjusted basis in its partnership interest immediately before the time of the qualified conservation contribution, as computed by the partnership, and without regard to section 752 liabilities. Instead of simply repeating the statutory mandate, the proposed regulations provided a clear, administrable, step-by-step approach for taxpayers to reach the result required by the statute. To assist with performing the computations required by this step-by-step approach, the proposed regulations included several illustrative examples.

89 F.R. 54284 at 54289.

The regulations recognize that similar adjustments would 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 regulations generally provide that only the first three adjustments apply in the case of an S corporation. See Reg. §1.170A-14(l)(3)(i).

The statute provides three exceptions from the application of the 2.5 times rule. The first exception covers contributions of property held at least three years. In the typical syndicated conservation easement scheme, the entity purchases the subject land and immediately places an easement on the property. But under §170(h)(7)(C), the 2.5 times rule will not apply where the entity donates the easement at least three years after the entity acquired the subject property (or, if later, three years after the date in which any owner acquired any interest in the entity). While the statute does not define the phrase "acquired any interest," the 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 proposed regulations explained 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. The final regulations made no change to this approach.

The second exception relates to "family partnerships." Under §170(h)(7)(D)(i), the disallowance rule in §170(h)(7)(A) does not apply where "substantially all of the … interests in [the entity] are held, directly or indirectly, by an individual and members of the family of such individual." 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 regulations fill this gap, stating that "substantially all" means at least 90-percent ownership. 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. Reg. §1.170A-14(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. Reg. §1.170A-14(n)(3)(ii)(B). The 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. Reg. §1.170A-14(n)(3)(iv)(A). This latter rule prevents a partnership from allocating most of the deduction to a non-family member.

The third exception covers contributions made to preserve any building that is a certified historic structure. On this point, the regulations merely remind taxpayers of the special reporting requirements applicable to donations of conservation easements related to certified historic structures.

B. 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 §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, §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

§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 §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.

C. Conservation Easement Deduction Denied on Two Grounds, and with Either of Two Penalties (*Oconee Landing Property, LLC v. Commissioner*, T.C. Memo. 2024-25, February 21, 2024, and *Oconee Landing Property, LLC v. Commissioner*, T.C. Memo. 2024-73, July 17, 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. The court went on to uphold a substantial understatement penalty. In the first decision (*Oconee I*), the court did not consider whether a negligence penalty also applies. But in the second case (*Oconee II*, logically enough), the court ruled that a negligence penalty could apply, although any single owner of the taxpayer would face liability for either negligence or the substantial understatement, not both.

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 *Oconee I* 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 §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 *Oconee I* 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 §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 §1221(a)(1). The taxpayer is a partnership for federal income tax purposes, and under §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 *Oconee I* 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 §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 *Oconee I* 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 *Oconee I* 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 substantial understatement penalty applies. While the IRS also argued that a negligence penalty would apply, the *Oconee I* court did not decide whether the taxpayer was negligent because of its interpretation of the so-called "no-stacking rule." The *Oconee I* court described the rule as follows:

> Only one accuracy-related penalty may be applied with respect to any given portion of an underpayment, even if that portion is penalizable on more than one of the grounds set forth in section 6662(b).

T.C. Memo. 2024-25 at 75, note 34. This is consistent with Regulation §1.6662-2(c). Although the *Oconee I* court declined to address the applicability of a negligence penalty given its imposition of a substantial understatement penalty, the IRS convinced the court to reconsider this approach and decide whether a negligence penalty should apply. The taxpayer objected to reconsideration, arguing that because there was no change in the law or the facts, there was no basis for reopening the matter to consider the application of an additional penalty.

But the *Oconee II* court disagreed:

> Our decision to forgo determination of the negligence penalty was premised on our understanding that the no-stacking rule prohibited the application of multiple penalties with respect to a given portion of Oconee's underpayment. But Treasury Regulation §1.6662-2(c) makes clear that the no-stacking rule relates to "the maximum accuracy-related penalty *imposed*." (Emphasis added.) This Court has jurisdiction to determine partnership items and the *applicability* of any penalty that relates to an adjustment to a partnership item. §§6221, 6226; United States v. Woods, 571 U.S. 31, 39–42 (2013). There is thus no limitation on our ability to determine the applicability of more than one accuracy-related penalty at the partnership level.

T. C. Memo. 2024-73 at 3. The *Oconee II* court rejected the taxpayer's claim that the IRS's motion was really a request to reverse a prior ruling on negligence, noting that the court made no ruling on the negligence penalty in the prior case. And while it is true that neither the law nor the facts had changed since the earlier decision, "those are not the only grounds for seeking reconsideration. Another ground is to correct 'substantial errors of law or fact,' and that is the ground respondent urges." *Id.* at 4.

The court agreed with the IRS that there was a substantial error, for the failure to determine the applicability of the negligence penalty at the partnership level would preclude the IRS from imposing that penalty, if appropriate, at the partner level. That could be bad, for an individual owner might not be liable for a substantial understatement penalty attributable to the taxpayer depending on that owner's other tax attributes. It was thus important for the court to make a decision on the application of a negligence penalty. The court then went on to explain how the taxpayer was negligent both in failing to prove its basis in the underlying property and its failure to obtain a qualified appraisal. So while the total penalty applicable to any one owner of the taxpayer would not increase as a result of *Oconee II*, a negligence penalty will apply if the substantial understatement penalty does not.

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, §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.

D. Tax Court Reverses Itself, Invalidates Proceeds Regulation for Conservation Easements (*Valley Park Ranch, LLC v. Commissioner*, 162 T.C. No. 6, March 28, 2024)

A divided Tax Court has held that Regulation §§1.170A-14(g)(6)(ii) is "procedurally invalid" under the Administrative Procedure Act (the "APA"), overruling its prior decision in *Oakbrook Land Holdings, LLC v. Commissioner*, 154 T.C. 180 (2020), *aff'd*., 28 F.4th 700 (6th Cir. 2022), that upheld the regulation. As a result, the regulation remains in effect only within the Sixth Circuit.

1. Background

While §170(f)(3)(A) generally disallows an income tax deduction for a charitable contribution of property that constitutes less than the donor's entire interest in the property, this rule does not apply to, among other things, a "qualified conservation contribution." §170(f)(3)(B)(iii). Section 170(h) lists the requirements for a qualified conservation contribution. In the case of a conservation easement, the Code requires that the restriction on the use of the subject property must be "granted in perpetuity," §170(h)(2)(C), and that the conservation purpose of the contribution must be "protected in perpetuity," §170(h)(5)(A).

The Code does not define or explain "perpetuity" for purposes of these rules, but regulations finalized in 1986 fill the gap. Of relevance here, the regulations explain how the perpetuity requirement works given that the conservation purpose could always, at some point, become impossible or impractical to achieve through the donated easement. Specifically, Regulation §1.170A-14(g)(6)(i) provides that if, because of an unexpected change in the conditions surrounding the property, the continued use of the property for conservation purposes has become impossible or impractical, the perpetuity requirement will still be treated as met "if the restrictions are extinguished by judicial proceeding and all of the donee's proceeds (determined under paragraph (g)(6)(ii) of this section) from a subsequent sale or exchange of the property are used by the donee organization in a manner consistent with the conservation purposes" of the original easement.

As the foregoing excerpt suggests, Regulation §1.170A-14(g)(6)(ii) sets forth the portion of the proceeds from a subsequent sale of the property payable to the charity. This rule is referred to as the "proceeds regulation." In relevant part, it provides that the amount payable to the charity must be equal to "the proportionate value that the perpetual conservation restriction at the time of the gift, bears to the value of the property as a whole at that time. … [T]hat proportionate value of the donee's property right shall remain constant."

To illustrate the proceeds regulation, suppose that a taxpayer donates a conservation easement on property worth $1 million at the time of contribution and that the fair market value of the easement at the time of the gift is $300,000. If a court later extinguishes the easement and the taxpayer sells the property for $4 million, the charity must receive $1.2 million of the proceeds (30 percent of $4 million, because the $300,000 value of the easement at the time of the gift is 30 percent of the $1 million value of the land) and it must use these funds in a manner consistent with its charitable purpose. The proceeds regulation says that the charity's share of the proceeds "shall remain constant," suggesting in this example that the charity's share of sale proceeds would be 30 percent regardless of any improvements made to the property by the taxpayer after donation.

Many early conservation easement deeds did not read the proceeds regulation that strictly. In many of those deeds, sale proceeds following extinguishment would be used first to reimburse the donor for the cost of any post-donation improvements made to the property. The charity's "proportionate share" would then apply to the remaining sale proceeds. At first the IRS did not police this provision very heavily. Then, as the IRS perceived greater abuse by what came to be called "syndicated conservation easement" transactions, the IRS starting using the proceeds regulation to disallow charitable contribution deductions in full. Remarkably, this effort was successful, as the IRS convinced even taxpayer-friendly jurisdictions that deeds giving charities a proportionate sale of the *net* sale proceeds violated the requirement of the proceeds regulation that the charity get a cut of the *gross* sale proceeds. *See PBBM-Rose Hill, Ltd. V. Commissioner*, 900 F.3d 193 (5th Cir. 2018). Confused as to why a charity holding a conservation easement should benefit from post-transfer improvements to the property even where the charity is not liable for a proportionate share of the improvement costs, taxpayers set about attacking the validity of the proceeds regulation.

2. Prior Cases Disagreed on Regulation's Validity

In *Oakbrook Land Holdings, LLC v. Commissioner*, 154 T.C. 180 (2020), *aff'd*, 28 F.4th 700 (6th Cir. 2022) (*Oakbrook I*), the Tax Court held in a 16 – 1 decision that the proceeds regulation was properly promulgated under the APA and that the IRS's interpretation of the statute's perpetuity requirement as reflected in the provision on extinguishment was entitled to "*Chevron* deference." The taxpayer in that case acquired a 143-acre parcel outside Chattanooga, Tennessee, in December, 2007, for $1.7 million. With the intent to develop the property, the taxpayer made some improvements to the land, including building a bridge, installing a sewer-pump station, and rezoning the property. After conveying 37 acres to various related entities in

December, 2008, the taxpayer then placed a conservation easement for the benefit of the Southeast Regional Land Conservancy on the remaining 106 acres. Based on an appraisal, the taxpayer claimed a $9.545 million charitable contribution deduction on its 2008 return.

The IRS disallowed the deduction, pointing to a provision in the easement deed that upon a sale following extinguishment, the Conservancy would receive "a portion of the proceeds equal to the fair market value of the Conservation Easement" reduced by the value of any improvements made by taxpayer after the date of the gift. The IRS concluded that since the deed in this case limits the charity's share to a fixed dollar amount (the value of the easement at contribution) and not a percentage of the extinguishment sale proceeds as required by the regulation, the deed violated the proceeds regulation and thus reduced the taxpayer's deduction to zero. The Tax Court agreed, and in response to the taxpayer's claim that the proceeds regulation was invalid, it concluded that the regulation was properly promulgated under the APA.

But the next year, in *Hewitt v. Commissioner*, 21 F.4th 1336 (11th Cir. 2021), the Eleventh Circuit held that the proceeds regulation was not promulgated in compliance with the APA and was therefore invalid. The *Hewitt* case involved the 2012 donation of a conservation easement on a portion of farmland that had been in the taxpayers' family for almost 60 years. Heeding the advice of a national land trust organization, the deed provided that the amount payable to the charity upon extinguishment of the easement would be "determined by multiplying the then fair market value of the Property unencumbered by the Easement (*minus any increase in value after the date of this grant attributable to improvements*) by the ratio of the value of the Easement at the time of this grant to the value of the Property, without deduction for the value of the Easement, at the time of this grant" (emphasis added). Both the IRS and the Tax Court disallowed the deduction because the deed language would give the charity only a share of the net proceeds from any sale of the property following extinguishment of the easement rather than a share of the gross proceeds from such sale.

In their appeal to the Eleventh Circuit, the taxpayers challenged the validity of the proceeds regulation's requirement that a charity receive a share of the gross sale proceeds instead of the net sale proceeds. They claimed the IRS failed to respond to comments about the requirement raised in the notice and comment period preceding finalization of the regulation. Because of this failure, said the taxpayers, the proceeds regulation is arbitrary and capricious.

At this point it's worth a scenic detour to discuss the APA's requirements. As any civics class will tell you, lawmaking belongs to the legislative branch, not the executive branch. And yet executive branch administrative agencies, because of their subject matter expertise and their general marching orders to enforce laws passed by Congress, are often in the best position to set regulations implementing federal legislation. The APA generally provides that an administrative agency can make valid laws provided it follows what is called a "notice-and-comment procedure" for rulemaking. Very generally, this procedure requires that an agency must first publish a proposed version of the rule in the Federal Register. It must then solicit and consider comments from the public. Only then may the agency adopt a final rule—also published in the Federal Register—but that final rule must be accompanied by an explanation of the comments received and the agency's rationale for adopting or refusing the suggestions made by commenters.

The IRS appeared to follow the APA in promulgating the broad set of charitable contribution regulations that included the proceeds regulation. Those regulations were proposed in 1983, and the IRS received over 700 comments on them. The final regulations, issued early in 1986, discussed several of the comments and the reasons for making or refusing changes based on these comments. But the Eleventh Circuit in *Hewitt* agreed with the taxpayers that the IRS did not follow the APA specifically in the adoption of the proceeds regulation. The court observed that: "(1) one commenter … made specific comments raising the improvements issue as it relates to extinguishment proceeds and recommended deletion of the provision; (2) six other organizations submitted comments criticizing or urging caution as to the regulation; and (3) Treasury failed to specifically respond to any of those comments, instead simply stating that it had considered 'all comments.'" It also noted that the one specific comment:

> raised the post-donation improvements issue … and warned that its exclusion in the regulatory scheme would discourage prospective donors from donating conservation easements. In other words, [that] comment was specific to, and casted doubt on, the reasonableness of the proceeds regulation in light of one of Congress's committee reports which, according to Treasury, was "reflected" in the final regulations.

Because the IRS failed to respond to this comment, held the court, the IRS violated the APA's rulemaking requirements, rendering the proceeds regulation invalid.

But the very next year, the Sixth Circuit affirmed the decision of the Tax Court in *Oakbrook Land Holdings, LLC v. Commissioner*, 28 F.4th 700 (6th Cir. 2022) (*Oakbrook II*), holding the proceeds regulation was enacted in compliance with the APA after all. In its appeal to the Sixth Circuit, the taxpayer argued that the IRS wrongfully deviated from the APA's notice-and-comment procedures in two important ways, either of which justified rejection of the proceeds regulation. First, said the taxpayer, the IRS did not give an adequate explanation of the rationale for the regulation in the preamble to the final regulations. The APA generally requires, among other things, that a federal agency provide "a concise general statement" of the basis and purpose for rules adopted as final regulations. The Treasury Department typically satisfies this requirement in the preamble accompanying final regulations, where it explains in general terms both the nature of the comments received on a proposed regulation and the degree to which the final regulations reflect those comments. But the taxpayer argued that the IRS did not specifically explain the policy rationale for the proceeds regulation, specifically the requirement that the charity receive a proportion of extinguishment sale proceeds instead of a fixed dollar amount of proceeds equal to the value of the conservation easement. The Sixth Circuit rejected this argument, however, observing that:

> the statutory text and the legislative history that Treasury contemplated in promulgating Treas. Reg. §1.170A-14(g)(6)(ii) illuminate the regulation's basis and purpose: to provide an administrable mechanism that would ensure that an easement's conservation purpose as per §170(h)(5)(A) continued to be protected should the interest be extinguished. That the regulation allots the proceeds in a manner more favorable to the donees than to donors merely demonstrates Treasury's acute awareness of Congress's decision to concern itself with the welfare of one entity over the other once the donation was made. Because we can discern this from the information that Treasury provided during the rulemaking, its concise statement suffices.

In other words, in the view of the Sixth Circuit, there is no requirement to discuss every single rule set forth in an expansive regulatory project. Because the IRS was careful to list the statutes and legislative history that led to the final regulation, the court felt there was a sufficient popcorn trail showing the path the agency took in reaching its ultimate rule.

Second and more important, said the taxpayer, the IRS failed to respond to comments specific to the proceeds regulation. The taxpayer pointed to specific comments on the proposed regulation to which the IRS did not respond in the final regulation or its preamble. One, from the New York Landmarks Conservancy ("NYLC"), claimed that the rule applicable to extinguishment sales was inequitable, that it would deter donors from contributing easements, and that it was "possible" the rule could conflict with the condemnation laws of some states. But the Sixth Circuit held that this comment "left Treasury to guess at the connection, if any, between [these] problems and the … regulation's basis and purpose. Treasury was not required to respond to the comment."

Another comment, from the Landmarks Preservation Council of Illinois, expressed concern that the regulation could force a donor to pay additional funds to the charity if a condemnation award did not cover the amount to which the charity is entitled under the regulation. But the Sixth Circuit observed that this concern was misplaced: "Because [the regulation] calculates proceeds by using a formula based on the proportionate value, not the fixed value, of the easement, the donor could never owe to the donee more than what the extinguishment proceeds are."

A third comment, from Trust for Public Land, suggested that the IRS simply expand the so-called "remote future event rule" elsewhere in the regulations and delete the rule specific to extinguishment sales. But the Sixth Circuit found that the suggestion gives no indication of how expanding the rule allowing deductions when the conservation purpose of an easement may be defeated an act or event whose occurrence is so remote as to be negligible would fulfill Congress's specific intent to limit deductions to instances where the conservation purpose can be protected forever. Thus, said the court, the IRS was not required to respond to this comment.

A final comment, from the Land Trust Exchange, claimed the regulation was unnecessary in light of the tax benefit rule, but the court observed that the tax benefit rule "bears no relation to the requirement under §170(h)(5)(A) that an easement's conservation purpose be protected in perpetuity." So this comment did not merit a specific response, either.

Having determined that none of the comments proffered from the taxpayer merited comment in the preamble to the final regulation, the Sixth Circuit concluded that the proceeds regulation was valid. In one last gasp of desperation, the taxpayer pointed to the Eleventh Circuit's holding in *Hewitt*, *supra.* Alas, the Sixth Circuit rejected this too, noting: "we find that decision's reasoning to be unpersuasive."

The taxpayer also lost in its arguments that the proceeds regulation was not entitled to "*Chevron* deference" and that the IRS acted in an arbitrary and capricious manner by providing no specific explanation for the extinguishment sale rule and by failing to consider alternative rules to achieve the same objective. Thus, the taxpayer got no deduction for the irrevocable donation of the easement.

On October 4, 2022, the taxpayer in *Oakbrook II* petitioned the United States Supreme Court for review of the decision, given the different decisions reached by the Eleventh Circuit in *Hewitt* and the Sixth Circuit in this case. But, on January 9, 2023, the Supreme Court denied the petition, leaving the circuit split unresolved.

3. The Tax Court's Change of Heart

In the face of this conflict, then, what is the Tax Court supposed to do? Obviously in cases where an appeal would lie in the Eleventh Circuit, the court would apply *Hewitt* and ignore the proceeds regulation, allowing taxpayers a deduction even where the easement deed gives the charity only a share of the net sale proceeds following a post-extinguishment sale. Likewise, where an appeal would lie in the Sixth Circuit, the court would apply *Oakbrook II* and, consistent with its decision in *Oakbrook I*, follow the proceeds regulation. But what about cases involving real property in other circuits? When a Tax Court's position is affirmed by one appellate court and reversed by another, the court can either stick to its guns or change its mind. In this case, it chose the latter, though for reasons not entirely clear or satisfactory.

In this case, an Oklahoma limited liability company donated a conservation easement on 45.76 acres of land to Compatible Land Foundation in December, 2016. The LLC acquired the property in 1998 for $91,610. On its 2016 federal income tax return, the LLC claimed the value of the donated easement was $14.8 million. Interestingly, with respect to extinguishment of the easement, the LLC's deed to the charity provides that the amount payable to the charity "shall be determined by the court" ordering the extinguishment. The IRS determined this violated the proceeds regulation and disallowed the claim deduction in full.

The taxpayer, citing *Hewitt*, alleged the proceeds regulation was procedurally invalid under the APA. As an appeal in this case would be heard in the Tenth Circuit, the Tax Court was not bound by *Hewitt*. Nevertheless, in a 9 – 4 decision, the court announced that the proceeds regulation is invalid under the APA and that, "[t]o the extent [*Oakbrook I*] holds otherwise, we will no longer follow it." After citing a number of examples where the Tax Court stuck to its guns after being reversed by a single appellate court, the majority nonetheless changes its position, because it now believes both that *Oakbrook I* did not have to reach the question of the regulation's validity in order to disallow the deduction and that the Eleventh Circuit has the better overall analysis.

The reasoning here is unclear. The majority simply states, without elaboration, that "we agree with Judge Guy[, the concurring judge in *Oakbrook II*,] … that resolution of *Oakbrook* did not require reaching the validity of the regulation." That is the entire analysis as to why *Oakbrook I* was overreaching in its initial holding that the regulation was procedurally valid.

The majority instead focuses on the fact that the IRS did not respond specifically to the comments submitted about the proceeds regulation, noting that the NYLC's comment was "significant and required a response by Treasury to satisfy the APA's procedural requirements." Conspicuously absent from this analysis is any discussion of the Sixth Circuit's conclusion that this and other comments "left Treasury to guess" at how the proceeds regulation would have the adverse effect claimed by NYLC and other commenters. The majority then proceeds to find that the deed in the case at bar satisfied the perpetuity requirement and thus entitled the taxpayer to a deduction.

4. Other Opinions

In a concurring opinion, Judge Buch (who had earlier voted with the majority in *Oakbrook I* and was now changing his vote) focused on the argument missing from the majority opinion—why *Oakbrook I* unnecessarily reached the question of the regulation's validity. He noted that the deed in that case preserved to the charity that portion of the sale proceeds as "shall be determined by the court," like the deed at issue here in *Valley Park Ranch*. In his view, that provides a sufficient safeguard to make sure the charity would get a cut of the gross sale proceeds and not just a share of the net sale proceeds.

In dissent, Chief Judge Kerrigan, joined by three other colleagues who likewise stuck by their earlier decision upholding the regulation, argues both that *Oakbrook I* was correctly decided and that the decision should be upheld on grounds of *stare decisis*. As an initial matter, she argues that it was inappropriate for the majority to grant the taxpayer's motion for summary judgment when the construction of the deed in the case at bar should be decided at trial. But more importantly, she notes, "In 21 cases between 2016 and 2021, this Court sustained the disallowance of charitable contribution deductions because the deeds of easement failed to comply with the proceeds regulation." She notes *Hewitt* "does not raise any new arguments that were not considered by this Court in *Oakbrook I*." Citing authorities ranging from the Supreme Court to Alexander Hamilton, she concludes:

> I am concerned that the Court's reversing a prior position taken only four years ago and without compelling new legal argument will result in instability of the law in the area of conservation easements. Additionally, the opinion of the Court

may result in challenges to regulations that have been relied upon for over 40 years.

5. Observations

In less than four years, the Tax Court went from a 16 – 1 decision in *Oakbrook I* upholding the proceeds regulation to a 9 – 4 decision in *Valley Park Ranch* striking it down. What caused such a substantial change of opinion? Part of the answer, certainly, relates to the composition of the court. Seven of the 17 judges in *Oakbrook I* are now on senior status and did not participate in *Valley Park Ranch*. (Of note, one of those seven judges is Judge Holmes, the lone dissenter in *Oakbrook I*.) Of the ten judges who heard both cases, four of them—the four dissenters in *Valley Park Ranch*—did not change their opinion. The four dissenters, it may be worth noting, were Obama appointees. That means six judges changed their minds, four of whom were appointed by President Trump and were quite junior when the court decided *Oakbrook I*. Whether the change is attributable to politics, to judges becoming more seasoned, some combination of the two, or something else altogether, is left to the reader.

Valley Park Ranch is clearly a setback for the IRS. Cases involving conservation easements used to hinge on valuation. The donor would claim a very large deduction based on a sometimes-fantastical assertion as to the value of the subject property at its "highest and best use," and the IRS would have to convince courts that the highest and best use of the property—and, accordingly, the value of the easement given to the charity—was worth much less. But the regulation gave the IRS a nuclear bomb: if the deed contained faulty language, the IRS could avoid the valuation dispute altogether and determine that the donor got no deduction at all.

Note that the proceeds regulation applies only upon a judicial extinguishment of a conservation easement and subsequent sale of the property. Such an event is very rare, as it requires a finding that continued use of the encumbered land for conservation purposes has become impossible or impractical. The chances that the problematic formula in the deed will ever be employed are quite small. Yet this regulation allows the IRS to argue that a taxpayer who has irrevocably gifted to charity the unilateral power to change the existing use of real property and, thus, suffered a genuine opportunity cost should get no deduction at all. While it's axiomatic that a taxpayer should not get a charitable contribution deduction when the donation violates the requirements for a deduction, it's a bit harsh for a taxpayer to lose a deduction entirely by using language that almost certainly will never have any real impact.

What's more, the deed in these and other cases borrowed heavily from language in a deed that garnered a favorable private ruling for another taxpayer, though that ruling did not specifically consider the validity of the language regarding the charity's share of sale proceeds following judicial extinguishment. While a taxpayer cannot rely on another taxpayer's private ruling as authority, one can sympathize with a taxpayer who concludes, quite reasonably, that the language from one successful conveyance would likewise make the taxpayer's conveyance successful, especially where a national organization promoting conservation easements encourages use of the same language.

E. Conservation Easement Deduction Allowed, But at Greatly Reduced Value (*Savannah Shoals, LLC v. Commissioner*, T.C. Memo. 2024-35, March 26, 2024)

The Tax Court has upheld a charitable contribution for the donation of a conservation easement that the IRS disallowed both because of alleged substantive and substantiation errors. But the case was not a complete victory for the taxpayer, as the Tax Court determined the value of the easement was $480,000, a wee bit less than the $23 million value claimed by the taxpayer on its federal income tax return. Given the claimed deduction was so far in excess of the easement's value, the court upheld the imposition of a 40-percent gross valuation misstatement penalty.

The case involved the donation of a conservation easement on 103 acres in rural northeast Georgia. The property had been contributed by its long-time owner to a newly-formed LLC on November 30, 2017. Everything stayed quiet until a whole series of events took place on December 28, 2017. That morning, a separate LLC formed by investors acquired a 92-percent stake in the LLC holding the land. By noon, the new controlling owners of the land LLC approved the creation of the easement, and the deed conveying the easement was recorded at 4:46 p.m.

Because the investment LLC acquired a controlling interest in the land LLC, there was a technical termination of the land LLC. (Consistent with the court's opinion, the terminated LLC will be referred to as "Old LLC" and the new LLC effectively created through the investment LLC's acquisition of the controlling interest will be referred to as "New LLC.") Old LLC filed its one and only federal income tax return for the taxable year beginning October 12 and ending December 28, 2017. Likewise, New LLC filed its first federal income tax return for the taxable year ending December 31, 2017. The first page of New LLC's tax return says that the short year started on December 29, but New LLC was the one that reported the December 28 donation of the conservation easement and supplied the documentation substantiating the contribution. New LLC's CPA originally prepared a return showing December 28 as the first day of the taxable year, but the IRS's electronic filing system rejected the return, perhaps because Old LLC had already filed a return showing December 28 as its last day. So, acting on the advice of the technicians that prepared the CPA's e-filing software, the CPA changed the date on the first page of New LLC's tax return to December 29. *Et voila*, that return was accepted.

But this did not sit well with the IRS. It argued that New LLC's tax year could not begin until December 29, the day after the technical termination of Old LLC. If that's correct, then New LLC could not claim any resulting deduction from the donation of the easement; any such deduction would belong to Old LLC. The Tax Court rejected this argument, finding no authority for the IRS's view that the entity resulting from the technical termination of a partnership had to have its first day on the day after the prior partnership's termination. It matters that the new ownership in New LLC "began to conduct business on December 28. Its members voted to donate the easement on December 28, and the deed was executed and recorded that day." Because it conducted business on December 28, reasoned the court, its first day of existence for tax purposes had to be December 28. The fact that the first page of the return used a December 29 start date was not fatal to New LLC's deduction since, as explained, that date was chosen just to get the IRS's filing system to accept the return.

The IRS had alternative grounds for disallowing New LLC's deduction, claiming both that the appraisal attached to the return was not a qualified appraisal and that the Form 8323 appraisal summary contained inconsistent information. Here too the IRS lost. The Tax Court determined that while the appraisal did not strictly comply with all of the requirements for a qualified appraisal (among other things, it did not state a date of donation, it incorrectly stated there were no agreements related to the donated land, and it did not state all of the appraiser's credentials), the appraisal substantially complied with those requirements, and that was enough to give the IRS enough information to determine the credibility of the appraisal.

As for the appraisal summary, the IRS faulted New LLC for attaching two Forms 8323, one prepared by a law firm and the other prepared by New LLC's CPA. The CPA tried to use the law firm's form, but the return prep software would not recognize the PDF file the CPA attempted to upload. So the CPA created another form, but this one contained different information. For one thing, the law firm's form correctly stated that the original landowner's basis in the land was just over $1.5 million, while the CPA's form reported basis as just under $38,000. The law firm's form had been signed by officers of the donor and donee, but the CPA's form was unsigned. Both forms refer to an attachment, but only the law firm's form contained an attachment. On the basis of these inconsistencies, the IRS argued that no complete Form 8323 was ever provided. But the Tax Court reasoned that no matter which form the IRS used, there was enough information provided to alert the IRS that the taxpayer was taking a very aggressive deduction considering the property's low basis and recent acquisition date. Importantly, noted the court, no pertinent information was hidden. The CPA's form contained "careless clerical errors," but those errors were "harmless" in this case.

Having determined that the taxpayer was eligible for a deduction, it turned to the issue of valuation. The LLC's experts said the highest and best use of the property was for mining aggregate, but the court agreed with the IRS's expert that the property was not suitable for mining given relatively low demand in the area and the costs to commence such an operation. Instead, the court agreed with the IRS's expert that the highest and best use of the property was for low-density residential and agricultural purposes. Unsurprisingly, then, it came to a valuation much closer to that offered by the IRS's expert, ultimately determining that the fair market value of the easement was $480,000. Given New LLC claimed a deduction nearly 48 times that amount, the court has no trouble upholding a 40-percent substantial valuation understatement penalty against New LLC.

F. Tax Court Upholds Only Ten Percent of Taxpayer's Claimed Conservation Easement Deduction (*Buckelew Farm, LLC v. Commissioner*, T.C. Memo. 2024-52, April 25, 2024)

The Tax Court has held that while a taxpayer was entitled to a deduction for the donation of a conservation easement, the correct amount of the deduction was far less than the amount claimed on the taxpayer's return. It thus upheld the application of a substantial valuation misstatement penalty, though it rejected the IRS's attempt to impose an additional civil fraud penalty.

This case involves property located in the Eleventh Circuit, where the proceeds regulation is invalid under *Hewitt.* In 2013, the taxpayer granted a conservation easement on about 1,500 acres of land in Jones County, Georgia, to the Southeast Regional Land Conservancy. On its federal income tax return, the taxpayer claimed a charitable contribution deduction of about $47.5 million based on a reporting position that, while the value of the land at its highest and best use would be about $50.5 million, the value of the land is now only about $3 million because of the conservation easement's restriction on development. The IRS disallowed the deduction and asserted both an accuracy-related penalty and a civil fraud penalty against the taxpayer in connection with the claimed deduction.

Before the Tax Court, the IRS argued that the deduction should be disallowed under the proceeds regulation, but the court quickly rejected the argument given the controlling decision in *Hewitt* that the regulation is invalid. The IRS then argued that the taxpayer lacked donative intent because the contribution was made only to generate a large income tax deduction and that the deal was structured to assure the taxpayer's investors would receive tax savings far exceeding their investments. Consistent with its decisions in other cases, the court rejected this argument too, finding it sufficient that the easement was donated to a charitable organization. In this case, in particular, the taxpayer's investors voted in favor of a conservation easement over other options that included developing the property or holding it for long-term investment. The court also rejected arguments from the IRS that the taxpayer's appraisal was deficient and that the taxpayer's appraiser was not qualified.

But the court bought the IRS's argument that the value of the conservation easement was much less than the value claimed on the taxpayer's return. While the taxpayer's expert determined the highest and best use of the subject land was for development into a "hunting and conservation oriented residential community," the IRS's expert claimed the highest and best use for the land was for timber production and for recreational purposes like hunting and fishing. The evidence showed that the zoning variance that would be required in order to develop the property into a residential community likely would not be granted. In addition, the court found the 12 comparable property sales used by the IRS's expert to be more relevant than the five comparable property sales used by the taxpayer's expert, only two of which were in the same state as the subject land. Ultimately, the court agreed with the IRS's expert that the value of the land at its highest and best use was about $7.4 million, an amount much less than the $50.5 million claimed by the taxpayer on its return. And since both experts seemed to accept that the value of the land was now $2.8 million, the resulting deduction amount is about $4.6 million.

Given the correct deduction amount ($4.6 million) was less than one-tenth the amount claimed by the taxpayer ($47.5 million), it is no surprise the court upheld the IRS's determination of a 40-percent accuracy-related penalty under §6662 in light of the gross valuation misstatement. The IRS also wanted a civil fraud penalty under §6663, but the Tax Court declined to impose it. Had the IRS prevailed on that issue, the taxpayer would have faced a penalty of about $32 million (gulp!). But the Code requires that the IRS prove fraud by clear and convincing evidence, and this burden the IRS could not meet. As the court noted:

> This is not a case in which the donor intentionally deprived the Commissioner of an essential tool needed for the "efficient identification of overvalued property." In fact, the Partnership complied with the reporting requirements of section 170(f)(11) when it timely filed its 2013 Form 1065 and attached Form 8283, which expressly disclosed the Partnership's relatively low adjusted basis ($3,521,827) in the Subject Property and, by comparison, its substantially higher amount claimed as a charitable contribution deduction ($47,750,000, which is an approximately 1,300% increase in value over the Partnership's original adjusted basis in the Subject Property). Moreover, section 170(f)(11) functioned as Congress intended with respondent being alerted to the Partnership's basis in the Subject Property and the value of the claimed charitable contribution, which resulted in the Partnership's return being examined and an FPAA being issued. We find the Partnership's compliance with its reporting obligations to stand in stark contrast to an intentional act, on its part, to conceal the underlying transaction from respondent.

We can expect more decisions like this from the Tax Court in future conservation easement cases, where the dispute centers more around valuation instead of the application of the proceeds regulation. For one thing, the Tax Court recently announced that it would no longer follow its prior holding that the proceeds regulation is valid, citing *Hewitt* with approval. *Valley Park Ranch LLC v. Commissioner,* 162 T.C. No. 6 (2024). For another, the IRS issued sample deed language that complies with the proceeds regulation. *Notice 2023-30*, 2023-17 I.R.B. 766. Newer conservation easement deeds should use this sample language, even for property located in the Eleventh Circuit (where the proceeds regulation is invalid) because a later court could change its mind.

G. Donation of Conservation Easement Followed by Donation of Remaining Interest in Land is Really Just a Donation of the Land (*Excelsior Aggregates, LLC v. Commissioner*, T.C. Memo. 2024-60, May 30, 2024)

The Tax Court has upheld an IRS determination that a limited liability company made a deductible contribution of $693,000 to charity in 2014, about 4 percent of the $16.7 million deduction the LLC claimed on its federal income tax return. While the LLC claimed to have made two donations, a $12.525 million conservation easement on about 300 acres of land to the National Wild Turkey Federation Research Foundation (the "Foundation") followed by a $4.175 million gift of its remaining interest in the land to the American Upland Land Trust (a disregarded subsidiary of the Foundation), the IRS and the Tax Court treated the two donations as a single donation of a fee simple absolute interest in the land.

This is just one of 13 cases before the Tax Court involving charitable contributions of conservation easements and fee simple interests in over 4,600 acres of land in rural southwest Alabama. The key players in these cases acquired this land early in 2014 for a total purchase price of $9.5 million, which translates to about $2,062 per acre. This group then divided the property into 13 separate parcels, 12 of which found their way into the ownership of 12 separate LLCs created for the purpose of engaging in syndicated conservation easement transactions. Investors in each LLC were promised, among other things, that "For every $1 contributed … the new member would receive a charitable contribution deduction of approximately $4.39 … that should save the new member approximately $2 in taxes."

The LLC in this particular case, one of three "test cases" decided on the same date, followed a pattern like the other 12 entities. In September of 2014, the LLC acquired its parcel (about 300 of the 4,600 acres), and on December 15, 2014, it donated a conservation easement to the Foundation. One week later, it donated its remaining interest in the parcel—a fee simple subject to the conservation easement—to the Foundation's trust. In valuing the donations, the taxpayer's expert claimed that the highest and best use" of the parcel was the development of a commercial sand and gravel mining operation. That generated a value of $16.7 million for the parcel, $12.525 million of which was allocated to the easement and $4.175 million to the remaining interest in the land.

Although the LLC maintained that there were two separate donations, the Tax Court felt otherwise:

> A less nuanced analysis may be adopted here. … [The taxpayer] contributed to the same donee, during the same year, fee simple interests in the easement-encumbered parcels. [T]herefore, the donee received during the taxable year 100% of the real property interests within [the] parcel, which equates to the parcel's "before" value. The "before" value of the [parcel] thus determines the total allowable charitable contribution deduction.

The court then agreed with the IRS that the amount of the deduction was the parcel's "before" value of $693,000. It rejected the conclusions of the taxpayer's experts as to the highest and best use of the property. The court observed that:

> Where the asserted [highest and best use] of property is the extraction of minerals, the proponent must show the presence of minerals in commercially exploitable volumes and the existence of a market "that would justify [mineral] extraction in the reasonably foreseeable future." "There must be some objective

support for the future demand, including volume and duration. Mere physical adaptability to a use does not establish a market."

Here, said the court, the LLC's experts "make unreasonable assumptions about the recoverable volume of minerals, supply, demand, pricing, and the costs of extraction." *Id.* at 35 – 36. Instead, the court was persuaded by the IRS's expert that the highest and best use of the property would be "silviculture, recreation, and residential use, but with some [sand and gravel] reserves that could be mined for local consumption."

Had the LLC deferred its donation of the encumbered property until the following taxable year, there would have been a better argument for valuing the easement as a donation separate from the land. One would think the result could be even better if the recipients of the easement and the remaining ownership interest were unrelated. At least in those cases, it would be clear that the LLC was making two donations, each of which would have to be valued separately. By donating all interests in the property to the same charity in the same taxable year, it was easy for the IRS to convince the court to view the donations as a single transaction.

Remember that this case involves just one of the 13 parcels that were donated in a similar fashion. The total amount deducted by the partnerships involved in this scheme came to over $187.3 million, yet the entire 4,600-acre tract from which the donated parcels were carved had been purchased earlier in the year for a total price of $9.5 million. Property does not normally grow in value by more than 1,870 percent in just a few short months, and yet no one steering the ships in this deal seemed to think that the claimed deductions were excessive.

H. Eleventh Circuit Agrees That Notice Targeting Syndicated Conservation Easement Transactions is Invalid (*Green Rock LLC v. IRS*, 11th Cir., June 4, 2024)

The Eleventh Circuit Court of Appeals has held that *Notice 2017-10*, 2017-4 I.R.B. 544 (December 23, 2016), in which the IRS announced that a "syndicated conservation easement transaction" is a "listed transaction" for purposes of §6707A (and, thus, for purposes of the penalty in §6662A), is invalid under the Administrative Procedure Act (the "APA"). The court's ruling is consistent with decisions from the Tax Court, *Green Valley Investors, LLC v. Commissioner*, 159 T.C. No. 5 (November 9, 2022), and the Northern District of Ohio, *GBX Associates LLC v. United States*, ___ F. Supp. 3d ___ (N.D. Ohio, November 14, 2022).

1. Statutory Background

Section 6707A(a), introduced in 2004, imposes a penalty on any person who fails to provide required information with respect to a "reportable transaction" on a return. A reportable transaction is one identified in regulations "as having a potential for tax avoidance or evasion." §6707A(c)(1). "Listed transactions" are a subset of reportable transactions which have been specifically identified by the IRS as tax avoidance transactions. §6707A(c)(2). The maximum penalty for listed transactions is significantly higher than the maximum penalty for other reportable transactions.

In addition, §6662A, also introduced in 2004, imposes an accuracy-related penalty on understatements with respect to "reportable transactions." Specifically, a taxpayer must pay an additional tax equal to 20 percent of the taxpayer's "reportable transaction understatement" for any taxable year. §6662A(a). Generally, the reportable transaction understatement is the product of the highest tax rate imposed by §1 (or §11, in the case of a C corporation) and the amount by which the amount of taxable income shown on the return is less than the amount of taxable income that should have been shown on the return. §6662A(b)(1)(A). Section 6662A defers to §6707A for the definitions of "listed transactions" and "reportable transactions."

In effect, the statutes give the IRS the authority to identify reportable transactions and listed transactions. Over the years, the IRS has done so though notices rather than through proposed regulations. Recent case law finds that method of operation problematic under the APA. Among other things, the APA requires that, in order for an administrative agency's rule to be valid, the rule must undergo a "notice-and-comment" procedure. This typically involves the agency publishing a proposed rule, soliciting public comments on the rule, considering those comments, and then publishing a final rule together with a preamble that explains how the comments received did (or did not) affect the wording of the final rule. IRS notices do not undergo this notice-and-comment procedure, and that has proven to be an Achilles heel for the IRS.

2. Notice 2017-10

As mentioned, *Notice 2017-10* declared that a "syndicated conservation easement transaction" is a listed transaction. Section 2 of the notice defines a syndicated conservation easement transaction as one the same as or substantially similar to the following:

> An investor receives promotional materials that offer prospective investors in a pass-through entity the possibility of a charitable contribution deduction that equals or exceeds an amount that is two and one-half times the amount of the investor's investment. The promotional materials may be oral or written. … The investor purchases an interest, directly or indirectly (through one or more tiers of pass-through entities), in the pass-through entity that holds real property. The pass-through entity that holds the real property contributes a conservation easement encumbering the property to a tax-exempt entity and allocates, directly or through one or more tiers of pass-through entities, a charitable contribution deduction to the investor. Following that contribution, the investor reports on his or her federal income tax return a charitable contribution deduction with respect to the conservation easement.

The notice makes clear that taxpayers participating in a syndicated conservation easement transaction are required to disclose certain information about the transaction under Regulation §1.6011-4, and those who fail to do so will be subject to penalties under §6707A and to an extended statute of limitations under §6501(c)(10). The notice also provides that "the IRS may impose other penalties on persons involved in these transactions or substantially similar transactions, including the accuracy-related penalty under §6662 or §6662A, the §6694 penalty for understatements of a taxpayer's liability by a tax return preparer, and the §6695A penalty for certain valuation misstatements attributable to incorrect appraisals."

3. Eleventh Circuit Agrees the Notice is Invalid

The notice was not first issued in proposed form, presenting the problem addressed in this case. Green Rock, an investment entity based in Birmingham, Alabama, is a material advisor to transactions that clearly fall within the ambit of *Notice 2017-10*. It complied with the reporting requirements of the notice at all times. In 2021, it filed this lawsuit to have the notice set aside. The Northern District of Alabama ruled in favor of Green Rock, and here the Eleventh Circuit affirmed.

The court acknowledged that Congress can exempt an agency from compliance with the notice-and-comment procedure, but it must do so expressly. "No such express language appears in the statute before us." While the statutes do provide that the IRS gets to define listed transactions and reportable transactions, they do not make any reference to the APA or to any procedural requirements at all.

The IRS argued that because the statutes ratified pre-existing regulations that specified identification of listed transactions by notice, Congress signaled its approval of the notice-listing process by implication. But the court rejected the argument, observing that while the statutes did copy-and-paste much from pre-existing regulations, it did not include the language about identification by notice. And "an indirect series of cross-references hardly suffices as the 'express' indication necessary to supplant the baseline procedures of the Administrative Procedure Act."

Finally, the IRS asserted that an adverse ruling would mean that there are no listed transactions. But the court was not convinced this is necessarily the case:

> According to the Service, it would be absurd for Congress to "invalidate sub silentio each and every one of the listed transactions already identified" in the 2004 Act, which provided penalties to strengthen the listing regime. But our holding does not necessarily compel such a result.
>
> Other listed transactions were issued in a different regulatory context. As we have explained, the pre-2004 listed transactions—that is, 28 of the 34 existing listed transactions—were *not* backed by statutory penalties at the time of their issuance. And "penalties and criminal sanctions" are what render a listing notice a "legislative" rule subject to notice and comment to begin with. Indeed, the judges of the United States Tax Court have suggested that section 6707A might be read to ratify the *substance* of existing, pre-2004 listed transactions, without exempting the Service from *prospective* notice-and-comment procedures after

> statutory penalties were enacted. But to be clear, we do not purport to rule on the validity of any listed transaction not before us. Our decision is specific to Notice 2017-10. Because the notice was a legislative rule and Congress did not expressly exempt the Service from notice-and-comment rulemaking, Notice 2017-10 is not binding on Green Rock.

(Emphasis added, citations omitted.)

4. Waning Impact

As part of the 2022 Consolidated Appropriations Act, Congress amended §170(h) so as to limit the deduction from a syndicated conservation easement transaction to 2.5 times the sum of each investor's relevant basis in the investment entity. As a result of this rule, the classic syndicated conservation easement transaction targeted by *Notice 2017-10* is dead. Going forward, then, the notice is of no concern. But the amendment to §170(h) is not retroactive, so the court's holding is still of interest to those who engaged in syndicated conservation easement transactions before December 2022 can take comfort in knowing that the statutory penalties for failing to report information required under *Notice 2017-10* do not apply.

XIV. 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. 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 in this and other cases.

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 §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 §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 §6213(a) deadline as jurisdictional. But even more importantly, 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.

B. 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 §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 §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 §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.

C. 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, §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 §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 §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.

D. 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 §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 §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.

XV. 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 §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 §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 §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 §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 §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 §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 §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 §6015(e)(1)(A) more clearly links the jurisdictional grant to the filing deadline than did §6330(d)(1).

The amicus brief argued that the deadline in §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.

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 §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. §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. PROPOSED QDOT REGULATIONS UPDATE OBSOLETE REFERENCES (Prop. Reg. §§20.2056A-2, 20.2056A-4, 20.2056A-11, August 21, 2024)

Treasury has proposed amendments to Treas. Reg. §§20.2056A-2, 20.2056A-4, and 20.2056A-11 in order to remove outdated references and update certain procedures applicable to so-called "qualified domestic trusts" (QDOTs). If finalized, the proposed changes would apply to estates of decedents dying after the date on which the final regulations are published in the Federal Register.

A. Background on QDOTs

In general, the federal estate tax marital deduction is not available for property passing to a noncitizen spouse of a decedent. IRC §2056(d)(1). Property passing to a QDOT, however, does qualify for the marital deduction. IRC §2056(d)(2)(A). The requirements for a valid QDOT are contained in IRC §2056A. If a trust qualifies as a QDOT, property passing to the trust will qualify for the marital deduction, but a deferred estate tax will apply upon a distribution of principal from the QDOT during the surviving spouse's lifetime, with remaining principal subject to a deferred estate tax at the noncitizen spouse's death. The statute authorizes regulations to carry out the purposes of the QDOT rules. IRC §2056A(e).

B. Items to be Updated

Regulations first proposed in 1993 were largely finalized in 1995. The final regulations included a new temporary regulation, Treas. Reg. §20.2056A-2T(d). That temporary regulation was finalized in 1996, but references to the temporary regulation in other provisions of the QDOT regulations were not updated to reflect the fact that the temporary regulation had become permanent. So the new proposed regulations remove all of the outdated references to the temporary regulation and replace them with references to the current, final regulation.

The 1995 regulations also set forth certain procedures for electing QDOT status, which included mailing information to specific IRS offices and addresses. But thanks to internal reorganization over the years, those offices no longer exist. Accordingly, the proposed regulations correct the outdated procedures by providing correct offices and addresses.

In one place, the 1995 regulations refer to the fair market value of assets as "finally determined" for federal estate tax purposes, and the regulations define that concept with reference to the issuance of an estate tax closing letter. Treas. Reg. §20.2056A-2(d)(1)(iii). Since 2015, however, the IRS has not routinely issued estate tax closing letters. The proposed regulations thus provide that the fair market value of assets as finally determined for federal estate tax purposes is:

(1) the value reported on an estate tax return once the statute of limitations on assessment of estate tax has expired without objection by the IRS;

(2) the value determined by the IRS once the statute of limitations on assessment of estate tax has expired without objection by the executor;

(3) the value determined in a written agreement between the estate and the IRS; or

(4) the value determined by a court for the purpose of determining estate tax liability, once the determination can no longer be appealed.

Prop. Reg. §20.2056-2(d)(1)(iii).

C. Observation

In issuing the proposed regulations, Treasury explained that there may well be other outdated references in the QDOT regulations, "but these matters do not cause the current regulations to substantively inaccurate." Thus, these proposed regulations do not address those items. So where an example here or there uses an outdated exclusion amount but still accurately illustrates the application of a particular rule, the example is left unchanged. Apparently, Treasury can only update so much at any one time.

XVIII. LIFETIME LOAN TRANSFERS BECOME GIFTS WHEN CONVERTED TO ADVANCEMENTS (*Estate of Bolles v. Commissioner,* 9th Cir., April 1, 2024)

The Ninth Circuit has affirmed a decision of the Tax Court that certain inter-vivos loans made by the decedent to her son were later converted into advancements of the son's share of the decedent's estate, converting those loans into gift transfers.

Over many years, the decedent made cash transfers of varying amounts to her five children, each time recording the transfers as loans. It was her practice each year to forgive each child's outstanding debt to the extent of the federal gift tax annual exclusion. The total cash transfers to her oldest son, Peter, an architect with a struggling practice, were larger than those made to the other kids (the total amount transferred to him over a 20-year period exceeded $1 million). When the decedent created a revocable living trust in 1989, she expressly excluded Peter from any distributions upon her death. In 1995, the decedent executed a new revocable living trust that included Peter as an equal beneficiary with his siblings. In 1996, Peter signed an acknowledgment that the total outstanding debt owed to the decedent (totaling over $700,000 at the time) "shall be taken into account for purposes of any and all calculations to be made" in determining his share of the trust upon the decedent's death.

The issue in this case was whether the amounts paid to Peter were loans or gifts. The IRS determined that the amounts were gifts, while the estate maintained that the amounts were at all times loans. In *Estate of Bolles v. Commissioner,* T.C. Memo. 2020-171, the Tax Court took a middle ground, finding that the transfers made prior to the execution of the 1989 revocable trust were loans. Although there were no loan agreements or efforts to collect payments, the court concluded that the decedent expected Peter to repay the loans. But that changed by 1989 when her trust made no provision for Peter. At that time, "the 'loans' lost that characterization for tax purposes and became advances on Peter's inheritance. … [T]he advances to Peter were loans through 1989 but after that were gifts. We … find that [the decedent] did not forgive the loans but rather accepted that could not be repaid on the basis of Peter's financial distress." Indeed, the later acknowledgment Peter signed in 1996 confirms the conclusion that the amounts paid to Peter over the years were really advances on his inheritance.

The Tax Court's conclusion meant that the estate lost over $1 million of applicable exclusion amount through the lifetime taxable gifts. But it also meant the estate avoided gross estate inclusion of the value of the amount that would have been owed to the estate (plus interest) had the transfers been respected as loans. So while the IRS prevailed in its argument that there was a gift, one would think the estate might have been happy to lose this one.

Alas, such appears not to be the case, for the estate appealed the Tax Court's decision. In an unpublished opinion, the Ninth Circuit affirmed. It found no clear error in the Tax Court's finding that Mary's pre-1989 payments were loans, as Mary had made prior loans to Peter's practice when it was run by her husband (Peter's father), all of which had been repaid in full. She "was familiar with fluctuations in the financial fortunes of the practice," so the Tax Court's conclusion that she had a real expectation of repayment when she made the initial loans was supported by the evidence. The estate also sought to recover administrative and litigation costs, but the Ninth Circuit agreed with the Tax Court that the IRS's position in the matter was "substantially justified." As a result, the estate was not eligible to recover these costs.

XIX. 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 §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 §1014(a), property must be "acquired from a decedent," a term of art defined in §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.

XX. BARGAIN SALE WAS NO BARGAIN (*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.

A. 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.

B. 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.

C. 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, §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.

XXI. NONRESIDENT'S SALE OF DOMESTIC PARTNERSHIP INTEREST NOT SUBJECT TO UNITED STATES TAX, EVEN WHERE THE PARTNERSHIP HOLDS INVENTORY (*Rawat v. Commissioner*, D.C. Cir., July 23, 2024)

The District of Columbia Circuit Court of Appeals has reversed a decision of the Tax Court treating $6.5 million of the proceeds from the sale of a partnership interest by a nonresident alien individual attributable to inventory items of the partnership as United States-source income on which the individual would owe federal income tax. The appellate court determined that the inventory gain was sourced outside the United States, shielding the taxpayer from federal income tax on that portion of the gain from the sale of the partnership interest. 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 the Tax Court ruled a different result was required by IRC §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. *Rawat v. Commissioner*, T.C. Memo. 2023-14. The Tax Court took that to mean that the inventory gain must be treated as income from the sale of inventory, which could have a United States source.

But on appeal, the D.C. Circuit concluded that "§751(a) does not treat inventory gain as gain from the sale of inventory." Instead, it "merely establishes that inventory gain arising from the sale of a partnership interest is taxed as ordinary income rather than as a capital gain." At bottom, what is sold is a partnership interest, not inventory. Further, because the gain from sale of a partnership interest by a nonresident alien has a foreign source, the United States does not have jurisdiction to tax it.

Note that under current law, the taxpayer's inventory gain would have a United States source. Part of the 2017 Tax Cuts and Jobs Act provides that the sale of an interest in a United States partnership has a United States source. The sale in this case took place in 2008, well before the current sourcing rule took effect.

XXII. PROPOSED REGULATIONS EXPLAIN REPORTING REQUIREMENTS FOR (AND TAX CONSEQUENCES OF) FOREIGN TRUST LOANS AND LARGE FOREIGN GIFTS MADE TO UNITED STATES PERSONS (*Prop. Reg. §§1.673(i)-1 through 1.673(i)-5, 1.6039F-1, 1.6048-1 through 1.6048-7, and 1.6677-1*, May 7, 2024)

Treasury has proposed guidelines for reporting transactions with foreign trusts and receipts of large foreign gifts. The proposed regulations also explain rules regarding loans from foreign trusts and the use of property held by foreign trusts. In large part, these regulations codify prior guidance issued in the form of a Notice.

A. Background on Relevant Statutes

Throughout the 1980s and 1990s, United States persons would transfer substantial assets offshore through foreign trusts based in jurisdictions with bank secrecy laws. This made it difficult, if not impossible, for the IRS to know whether and to what extent United States persons were paying federal income tax on the income realized by these trusts. As part of the Small Business Job Protection Act of 1996, Congress made changes to the information reporting rules to curb what it perceived as "rampant tax avoidance" through the use of foreign trusts.

Specifically, §6048(a) requires the United States grantor of a foreign trust (or, where applicable, a "United States transferor" or the executor of a United States decedent) to report the creation of any foreign trust, the transfer of any money or property to a foreign trust that is not a sale for fair market value, and the death of any United States person treated as the owner of any portion of a foreign trust (or whose gross estate includes any portion of a foreign trust).

This is done on Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts.* In addition, §6677 imposes a penalty for failing to report the information required under §6048 absent reasonable cause. The penalty amount is equal to the greater of $10,000 or 35 percent of the gross amount reportable. If, after the IRS mails notification of the failure to report, the failure continues for more than 90 days, an additional $10,000 penalty is imposed, and successive $10,000 penalties continue every 30 days (or portion thereof) thereafter.

Furthermore, §643(i) generally provides that where a foreign trust loans cash or marketable securities to any nonexempt United States grantor or beneficiary of a foreign trust (or to any person related to such grantor or beneficiary), the amount of the loan is treated as a distribution to the grantor or beneficiary. It also treats any uncompensated use of foreign trust property by a United States grantor or beneficiary (or any person related to such grantor or beneficiary) as a distribution. The statute authorizes regulations identifying exceptions to this rule. Loans and use of trust property are likewise reported on Form 3520. And finally, §6039F requires United States persons who receive large gifts or bequests from foreign persons to report those receipts. The purpose of this requirement is to give the IRS a chance to determine whether the receipt is, in fact, a gift. Failure to report a foreign gift triggers a penalty of five percent of the amount of the gift for each month the failure to report continues, up to a maximum penalty of 25 percent of the amount of the gift.

In *Notice 97-34*, 1997-1 C.B. 422, the IRS issued preliminary guidance on the application of these Code provisions. The proposed regulations now attempt to codify much of what was set forth in that earlier guidance, and also reflect changes to the statutes made after 1997.

B. Loans from Foreign Trusts and Use of Foreign Trust Property by United States Persons

Proposed Regulation §1.643(i)-1 explains the requirements of §643(i) and sets forth procedural rules for implementing the statute. Unless an exception applies, the proposed regulation treats any loan of cash or marketable securities from a foreign trust, whether from corpus or income, made directly or indirectly to a United States grantor or beneficiary as a distribution as of the date on which the loan is made. An anti-abuse rule in the proposed regulation provides that a nonresident alien grantor or beneficiary who receives a loan from a foreign trust and then becomes a United States person within two years will be deemed to receive a distribution of the outstanding loan amount as of the date the grantor or beneficiary becomes a United States person. With respect to the use of foreign trust property, the proposed regulation clarifies that use by an agent or nominee of the grantor or beneficiary is treated as use by the grantor or beneficiary.

Proposed Regulation §1.643(i)-2 then lists four exceptions to the deemed distribution rule in Proposed Regulation §1.643(i)-1. First, there is no deed distribution in the case of any loan made in exchange for a "qualified obligation," defined generally as a written debt instrument with a term of not more than five years requiring all payments to be made in United

States dollars and with interest payable at a fixed rate. Further, all stated interest on the obligation must be "qualified stated interest" as defined in the rules related to original issue discount, and the yield to maturity on the obligation must not be less than the applicable federal rate of interest in effect on the day the debt instrument is issued, nor more than 130 percent of such applicable federal rate of interest. Second, there is no deemed distribution from a foreign corporation to a United States beneficiary where the total amount of all loans made to the beneficiary does not exceed the foreign corporation's undistributed earnings and profits that are or have been included in the beneficiary's gross income under subpart F.

Third, in the case of a use of foreign trust property, there is no deemed distribution where the foreign trust receives fair rental value for such use within a reasonable period. Fourth, no deemed distribution results from a *de minimis* use of trust property, defined as use by all United States grantors and beneficiaries totaling not more than 14 days during the taxable year.

Proposed Regulation §1.643(i)-3 provides rules for determining the amount of the deemed distribution, how the deemed distribution amount is allocated where the trust has multiple United States grantors and beneficiaries, and how to determine the tax consequences to the foreign trust of a deemed distribution. Proposed Regulation §1.643(i)-4 contains examples explaining the foregoing rules, and Proposed Regulation §1.643(i)-5 states that the proposed rules would become effective when finalized.

C. Reporting Rules for United States Recipients of Large Foreign Gifts

Proposed Regulation §1.6039F-1 generally requires a United States person to report an amount received from a foreign person as a foreign gift during the taxable year on Form 3520 by April 15 of the following year, though the deadline is extended in certain cases. The proposed regulation defines a "foreign gift" as any gift received from a foreign person except for qualified transfers under §2503(e)(2) (transfers directly to providers for education and medical expenses of the donee). The proposed regulation contains several exceptions to this reporting requirement, including exceptions for gifts to charities, gifts not more than $100,000 received from any one foreign individual or estate (or persons related to the foreign individual or estate), and gifts not more than $10,000 from a foreign corporation or partnership. For purposes of these rules, the value of a gift is to be determined using normal gift tax valuation rules, specifically including the special valuation rules in §§2701 through 2704.

D. Rules for Reporting Transactions with Foreign Trusts and Related Penalties

Proposed Regulation §1.6048-2 requires a "responsible party" (grantor, transferor, or executor, as appropriate) to provide notice of a "reportable event" (foreign trust creation, transfer to a foreign trust, or death of a United States owner of a foreign trust) that occurs during the taxable year with respect to a foreign trust on Form 3520. For responsible parties using the calendar year, the deadline for filing Form 3520 is generally April 15 of the following year. Proposed Regulation §1.6048-3 then provides rules to ensure a foreign trust provides certain information about the trust's activities and operations for the year both to the IRS and to any United States person treated as an owner of the trust or who receives a distribution from the trust. Further, Proposed Regulation §1.6048-4 provides rules for reporting the receipt of a distribution from a foreign trust.

Proposed Regulation §1.6048-5 provides exceptions to the reporting rules, including exceptions for transfers for fair market value, transfers to certain compensatory foreign trusts, and transfers to foreign charities. Proposed Regulation §1.6048-6 contains special rules related to dual resident taxpayers and dual status taxpayers who compute their United States income tax liability as nonresident aliens for at least a portion of the taxable year. Section 1.6048-7 generally provides that the proposed regulations under §6048 would be effective when finalized.

Proposed Regulation §1.6677-1 explains the application of civil penalties applicable for failing to comply with the rules of Proposed Regulations §§ 1.6048-2 through 1.6048-4. Notably, this proposed regulation takes the position that the §6677 penalty applies separately to each of the §6048 reporting requirements (the requirements to report transactions under Proposed Regulation §1.6048-2, to report certain trust activities and operations under Proposed Regulation §1.6048-3, and to report distributions from foreign trusts in accordance with Proposed Regulation §1.6048-4). In explaining the reasonable cause exception to the §6677 penalty, the proposed regulation states that the determination of whether a failure to file a complete Form 3520 is due to reasonable cause and not due to willful neglect will be made "on a case-by-case basis, taking into account all pertinent facts and circumstances." According to the proposed regulation, the fact that a foreign jurisdiction would impose a civil or criminal penalty for disclosing the required information is not reasonable cause, nor is a foreign trustee's refusal to provide information.

XXIII. 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 §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.

XXIV. DISPROPORTIONATE DISTRIBUTIONS DON'T TERMINATE S ELECTION (*Maggard v. Commissioner*, T.C. Memo. 2024-77, August 7, 2024)

The Tax Court has rejected the argument of an S corporation shareholder that disproportionate distributions made to the other shareholders served to terminate the corporation's S election. Accordingly, the taxpayer-shareholder still had to report his share of the corporation's pass-through income. The case is as much a lesson in being careful in choosing business partners as it is a lesson in the single class of stock requirement applicable to S corporations.

The taxpayer is a chemical engineer. In 2002, he and his business partner incorporated an engineering consulting partnership and elected to have the new corporation taxed under subchapter S. By making the S election, the corporation would not pay tax on its net income; instead, each corporate item of income, gain, loss, deduction, and credit would "pass through" to the two shareholders proportionate to their interest in the corporation's single class of stock. The shareholders would then include those corporate tax items on their personal income tax returns. The S election and the resulting pass-through regime were in place for the taxable years at issue: 2014 – 2016.

In 2003, the taxpayer's co-owner sold his interest in the company to the taxpayer, leaving the taxpayer as the sole shareholder. The taxpayer then sold a total 60 percent interest in the company to two new individuals. (The individuals are not named because, the Tax Court explains in a footnote, "allegations of their misconduct could seriously harm their reputations if believed, and the truth of the allegations turns out not to be important" in the case.) The two others were not engineers—they were involved as the company's CFO and COO—but they engineered to drain cash from the company at an alarming rate.

Almost immediately after joining the business, the two newbies started misappropriating funds through inflated expense accounts and making disproportionate distributions to themselves but not to the taxpayer. The CFO also stopped filing corporate income tax returns immediately upon his appointment.

The taxpayer finally caught on in 2012. Through an independent CPA, the taxpayer eventually learned that over $1 million had been siphoned out of the company's coffers. Most of that was during the taxable years at issue in this case. When the taxpayer confronted his "partners" about the unauthorized distributions, they flexed their 60-percent ownership to freeze the taxpayer out of all decisions, including later decisions to pay themselves higher salaries and nothing to the taxpayer.

Eventually, everyone in this story sued each other. In 2016, a court determined that the company had "underdistributed" to the taxpayer and "overdistributed" to the others. It ordered a corrective distribution to the taxpayer to the tune of $165,000. In haggling over this payment, the taxpayer finally decided to sell his 40-percent stake in the business to one of the other shareholders for $1,262,500 in 2018.

But what about the income tax owed on the company's profits from the years at issue? The taxpayer knew he needed to file tax returns reporting his share of the company's income, but since he was on the outs with his turncoat partners, he had to find a way to get the information. Enter the taxpayer's lawyer, who contacted the CFO for the requisite details. The CFO replied with the number "$300,000" *written on a napkin*. Seriously, a napkin. The taxpayer understood this amount to represent his proportionate share of the company's loss for 2014, so on his 2014 return he claimed a $300,000 on Schedule E. He used the same procedure to claim a $50,000 loss in 2015. He originally claimed no income or loss from the company for 2016, but K-1s filed in 2018 by the CFO reported the taxpayer's share of a net profit.

As the Tax Court observed, "Napkin accounting is bound to attract the Commissioner's attention." After an audit, the IRS determined that the taxpayer owed extra tax from the years at issue because the company was profitable, meaning the taxpayer should have been reporting net income and not net loss for each year.

Before the Tax Court, the taxpayer argued that the disproportionate distributions by his colleagues caused the company to lose its S election. If that happened, then he would not be taxed on any share of the company's income since the corporation would then be a separate taxpayer required to file its own federal income tax return as a C corporation.

The Tax Court rejected the argument. Although Congress requires that S corporation have only one class of stock, it does not follow that disproportionate distributions automatically terminate the S election. Indeed, Treas. Reg. §1.1361-1(l)(1) provides that the single class of stock requirement is met as long as all shares "confer identical rights to distribution and liquidation proceeds." The IRS argued that this language requires focusing on *rights* to distributions and not on actual distributions, and the Tax Court agreed. Though the court "cannot help by sympathize with a taxpayer caught in this situation," it cited two other cases in which disproportionate distributions were held to have no effect on the validity of an S election. As in those prior cases, the distributions here were never authorized by way of formal corporate action. In other words, the taxpayer still had *rights* to catchup distributions, so the company still had just one class of stock.

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. §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 §4973(a) is a penalty and not a tax. If it's a penalty, then under §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 §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, §4975, was likewise a "tax" and not a "penalty."

The taxpayer argued that where exactions "function as penalties," the supervisory approval process of §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 §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 §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. 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 §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 §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.

XXIX. 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 §1212(a)(1), individuals may only carry such losses forward. See §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.

XXX. 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 §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. §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 §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 §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."

XXXI. TIERED PARTNERSHIPS AND OPINION LETTERS COULD NOT DISGUISE THIS DISGUISED SALE (*PICCIRC, LLC v. Commissioner*, T.C. Memo. 2024-50, April 22, 2024)

The Tax Court has held that an alleged contribution to a limited liability company of distressed receivables followed within about six months by a cash distribution to the contributing partner constituted a disguised sale, resulting in a disallowed loss deduction of over $27 million and a gross valuation misstatement penalty. The transactions in this scheme involved multiple tiered entities, an investment management firm operating through several aliases, and an individual who looked to be shopping for some tax deductions on the cheap.

It all started with a Brazilian corporation that had a ton of accrued receivables owed from a customer on the cusp of bankruptcy. As one would expect, the receivables had a high basis but a very low fair market value. Enter Gramercy Advisors, LLC, a United States investment firm. Gramercy and the Brazilian corporation formed a Delaware LLC called XBOXT. (How apt that the firm's name resembles that of a *gaming* platform). The Brazilian company contributed the distressed receivables to XBOXT for a 99-percent member interest, while Gramercy made a cash investment for its one-percent stake. On the same day, XBOXT then dumped the receivables into PIMLICO, LLC, another new Delaware entity, in exchange for a 99-percent interest in that entity. The other one percent interest in PIMLICO was held by Tall Ships, LLC, an entity that—you guessed it—is affiliated with Gramercy.

Four months later, the next player, an individual named John Howard, joined the party. Howard acquired an 89-percent interest in PIMLICO from XBOXT in exchange for about $300,000 cash. Howard was introduced to the structure through BDO Seidman, to whom Howard paid a fee of $865,000 for an opinion letter that everything you're reading about would not result in the imposition of any penalties. Howard paid another $100,000 to a law firm for a separate opinion letter that all of the transactions involved in this scheme had economic substance and business purposes.

On the same day Howard acquired his interest in PIMLICO, PIMLICO contributed the receivables to yet another new Delaware entity, PICCIRC, LLC, for a 99-percent interest. (The other one-percent interest was held by Tall Ships.) Two weeks later, PICCIRC sold the receivables to Gramercy Financial Services LLC, another Gramercy affiliate, for about $360,000. PICCIRC claimed a loss of about $22.7 million from the sale, and ultimately 89 percent of this loss (some $20.4 million) flowed through to Howard. This gave him a substantial deduction for use on his individual tax return, a great return on his investment of about $300,000. Meanwhile, about a month after the sale, XBOXT distributed about $300,000 cash to the Brazilian corporation in redemption of its 9.9-percent member interest. Weird that the amount paid to the Brazilian corporation was about the same as the amount invested by Howard, huh?

If the law firm that gave Howard the opinion letter was correct, PICCIRC's loss from the sale was real and XBOXT's redemption of the Brazilian corporation's membership interest was without tax consequence since it was a cash distribution that did not exceed the Brazilian corporation's basis in its XBOXT membership interest. But the IRS determined that all of these transactions were, in substance, a disguised sale between the Brazilian corporation and Gramercy. That led the IRS to disallow PICCIRC's claimed deduction, which would, in turn, result in no deduction to Howard.

The Tax Court held that the taxpayers did not meet their burden to prove that the IRS's determination were erroneous. The court observed that while contributions to (and distributions from) partnerships are generally without tax consequence, §707 provides that nonrecognition does not apply when contributions and distributions are, in reality, a disguised sale of property. The court explained the framework for analysis as follows:

> A disguised sale occurs where a partner contributes property to a partnership and receives a related distribution that is, in effect, consideration for the contributed property. See §707(a)(2)(B); *Canal Corp. & Subs. v. Commissioner*,

> 135 T.C. 199, 210-11 (2010); Treas. Reg. §1.707-3. A transaction may be deemed a disguised sale if, on the basis of all the facts and circumstances, (1) the partnership's transfer of money or other consideration to the partner would not have been made but for the partner's transfer of property and (2) if the transfers were not made simultaneously, the subsequent transfer was not dependent on the entrepreneurial risks of partnership operations. Treas. Reg. §1.707-3(b)(1); see also *Route 231, LLC v. Commissioner*, 810 F.3d 247, 253 (4th Cir. 2016), *aff'g* T.C. Memo. 2014-30. The regulations provide that transfers between a partnership and a partner within a two-year period are presumed to be a sale of property to the partnership unless the facts and circumstances "clearly establish" otherwise. Treas. Reg. §1.707-3(c)(1); see *Superior Trading, LLC v. Commissioner*, 728 F.3d 676, 681 (7th Cir. 2013) (finding the presumption triggered where the partner received a substantial distribution 10 months after contributing distressed receivables), *aff'g* 137 T.C. 70 (2011).

Here, the time between the Brazilian corporation's contribution of the receivables to XBOXT and its receipt of a $300,000 cash distribution was less than six months. Moreover, the court found it not coincidental that the amount paid by Howard to acquire his interest more or less matched the amount ultimately paid to the Brazilian corporation. "The purpose of the redemption," observed the court, "was to trigger the section 704(c) loss allocation rule for the benefit of Mr. Howard. The dates and account activity of the partnerships match to such an extent that it becomes clear XBOXT was formed solely as a conduit to execute a disguised sale of the … receivables."

The Tax Court went on to hold that because there was no evidence corroborating the basis of the receivables except for a spreadsheet prepared by Gramercy, no loss could be sustained. Further, the court found the various LLCs were shams that could be disregarded under the anti-abuse rules in Regulation §1.701-2. Finally, the court upheld the imposition of a 40-percent gross valuation misstatement penalty, concluding that PICCIRC's basis in the receivables was, at most, the $300,000 paid by Howard, making the claimed basis of $23 million well-deserving of the penalty.

The case is a helpful reminder of the disguised sale rules. While the transactions here look like they may have been designed to obfuscate the purchase of a tax deduction, the disguised sale rules can apply even where taxpayers do not have a tax avoidance motive. Planners should hesitate anytime they see a partner receiving cash or property from a partnership within two years of contributing some other property to the partnership. Likewise, planners should hesitate when they see multiple tiers of partnerships with similar ownership structures that don't seem to have any business function or purpose apart from generating very large deductions.

XXXII. 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.

XXXIII. FLEDGLING WRITER-RESEARCHER CONDUCTS A HOBBY, NOT A BUSINESS (*Mazotti v. Commissioner*, T.C. Memo. 2024-75, July 25, 2024).

The Tax Court has held that a married couple could not deduct the claimed expenses from the wife's research and writing activity, finding the activity was a hobby that did not rise to the level of a business. It also upheld penalties for negligence and substantial understatement of tax. The case is a reminder both that an activity is not a business simply because the taxpayer deems it as such and that a taxpayer must be prepared to substantiate expenses related to an alleged profit-seeking activity.

Robert and Debra, a married couple, filed joint returns for 2018, 2019, and 2020. In each of those years, Debra claimed Schedule C net losses in excess of $60,000 from her purported business of research and writing. Debra claims to have published six books. Three of them were submitted as exhibits, each being between one and two pages in length (double-spaced, no less). She also claims to have written "numerous" newspaper and online articles, but the only evidence to support this claim was an article written ten years before the tax years at issue in this case. The couple's tax returns reported $30 of income from writing in 2018 and $15 of income in 2019, but at trial Debra could not identify the source of these receipts.

This busy workload required numerous research trips to California, Florida, and Hawaii. One trip to Disney World was expensed as research in connection with a family trivia game she planned to create.

The IRS determined that Debra did not have a profit motive in connection with her writing activity. It also determined that the claimed expenses had not been substantiated. Accordingly, the IRS disallowed the claimed losses from the activity and imposed penalties both for negligence and for substantial understatement of tax for 2018 and 2019.

The Tax Court, finding Debra's testimony "inconsistent" and "not a model of clarity," had little trouble upholding the IRS's determinations. In a six-page analysis (longer than the cumulative page count of Debra's published works), the court applied the nine factors set forth in Reg. §1.183-2(b) for determining whether an activity is conducted for profit rather than as a hobby. Eight of the factors weighed against or "heavily against" Debra's claim that she was engaged in a business. (The ninth factor, expected appreciation in the value of assets used in the activity, was neutral only because Debra uses no assets in her research and writing activity.)

The court found the couple negligent since Debra kept no formal books or records related to her activity and because the couple deducted personal expenses like family vacations, home improvements, and vehicle repair costs as expenses related to the activity. "A reasonable and prudent person would know that personal expenses may not be deducted under the guise of business expenses," the court observed.

XXXIV. 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."

XXXV. 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.

XXXVI. 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 §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.

XXXVII. 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 §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.

XXXVIII. 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. §165(c)(2). Otherwise, if the loans are not repaid, the taxpayers can, at best, hope for a bad debt deduct under §166, though that deduction will be flavored as a short-term capital loss and not as an ordinary loss.

XXXIX. SETTLEMENT PROCEEDS TAXABLE FOR LACK OF CONNECTION TO PHYSICAL INJURY (*Estate of Finnegan v. Commissioner*, T.C. Memo. 2024-42, April 10, 2024)

The Tax Court has held that $25 million in compensatory damages received in 2017 under a settlement agreement by four plaintiffs was includible in the plaintiffs' gross incomes, rejecting their claim that the damages were paid on account of personal physical injury or physical sickness and thus excludable under §104(a)(2). The case is a reminder to prospective plaintiffs seeking to exclude damage or settlement awards to get evidence of physical injury or physical sickness in the record early and often.

Roman and Lynette married in 2004. They raised Lynette's four children in their home. Late in 2005, one of the children died at the age of 14. After the child's death, the state police and state department of child services investigated accusations of the child's neglect and abuse by Roman and Lynette. Following the investigation, the state police arrested Roman and Lynette. Eventually, the criminal charges against them were dropped, but the department of child services proceeded to remove two other children from Roman and Lynette's care. The children were placed into foster care and eventually returned home sometime later.

In 2008, Roman, Lynette, and the three surviving children sued over two dozen state employees under 42 U.S.C. §1983, alleging violations of their civil rights under state law, federal law, and the First, Fourth, Sixth, and Fourteenth Amendments to the United States Constitution. In 2015, a jury returned a verdict in the favor to the tune of $31.35 million. In 2016, the federal district court judge upheld the jury verdict. As an appeal was pending before the Seventh Circuit Court of Appeals, the parties settled when the defendants agreed to pay a total of $25 million to the plaintiffs. Payment was received in 2017.

When the plaintiffs did not pay federal income tax on the award, the IRS assessed a deficiency. The plaintiffs took the position that the payment was entirely excludable under §104(a)(2) as damages received "on account of personal physical injuries or physical sickness." They claimed Roman suffered from post-traumatic stress disorder ("PTSD") due to the wrongful actions of state police and the state department of child services. Curiously, they offered no evidence of physical injury or physical sickness of any of the other plaintiffs, yet they claimed the entire award was excludable.

The Tax Court rejected their argument, observing first that because the damages were received under a settlement agreement, the nature of the claim giving rise to the settlement controls whether the damages are excludable under §104(a)(2). The settlement agreement's own terms state the payment is made in full settlement of the plaintiffs' claims for violations of their civil rights and both federal and state laws. It "makes no reference to PTSD specifically or to physical injury or physical sickness more generally; thus, on the basis of the terms of the Settlement Agreement, we cannot find in petitioners' favor."

The court went on to note that even if the court looked beyond the settlement agreement, the plaintiffs would still lose. Nothing in the original or amended complaints says anything about PTSD, physical injury, or physical sickness. Same goes for the jury instructions, the *voir dire* questions, the jury's allocated verdict. As the court concludes:

> With the vast ocean of evidence before us concerning the district court litigation, references to PTSD make barely a drop in the bucket. Rather, the image that overwhelmingly emerges is that the damages were paid not as compensation for PTSD but for violations of plaintiffs' constitutional rights stemming from defendants' conduct and the emotional pain caused therefrom.

Accordingly, the $25 million payment is includible in the plaintiffs' gross income.

Notice the court did not address whether PTSD can qualify as a physical injury or physical sickness. If PTSD is a form of emotional distress, as a matter of law the §104(a)(2) exclusion would not apply. That is because the flush language to §104(a) states that emotional distress, by itself, does not qualify as physical injury or physical sickness. But arguably, PTSD can qualify as a physical injury or physical sickness to the extent the condition results in "observable bodily harm." Instead of tackling this tricky question, the court took the easy course, basing its decision on the dearth of references to PTSD in the record.