2023 FEDERAL TAX UPDATE

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

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These materials summarize important developments in the substantive federal income, estate and gift tax laws affecting individual taxpayers and small businesses from September, 2022, through October, 2023, with an occasional reference to some older items where relevant. The materials are organized roughly in order of significance. These materials generally do not discuss developments in the areas of deferred compensation or the taxation of business entities (except to a very limited extent).

I. INFLATION-ADJUSTED FEDERAL INCOME TAX BRACKETS FOR 2023 (Adapted from Rev. Proc. 2022-38)

<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="5">2.9%</td><td rowspan="5">0%</td></tr>
<tr><td>$11,000</td><td>$22,000</td><td rowspan="2">12%</td></tr>
<tr><td>$44,625</td><td>$89,250</td><td rowspan="6">15%</td></tr>
<tr><td>$44,725</td><td>$89,450</td><td>22%</td></tr>
<tr><td>$95,375</td><td>$190,750</td><td>24%</td></tr>
<tr><td>$182,100</td><td>AGI over $250,000</td><td rowspan="2">32%</td><td></td><td></td></tr>
<tr><td>AGI over $200,000</td><td>$364,200</td><td rowspan="4">3.8%</td><td rowspan="4">3.8%</td></tr>
<tr><td>$231,250</td><td>$462,500</td><td rowspan="2">35%</td></tr>
<tr><td>$492,300</td><td>$553,850</td><td rowspan="2">20%</td></tr>
<tr><td>$578,125</td><td>$693,750</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 2023
(Adapted from Rev. Proc. 2022-38)

<table>
<tr><th>Taxable Income Exceeding</th><th>Ordinary Income</th><th>Adjusted Net Cap Gain* & Qualified Dividends</th><th>Medicare Surtax on Net Investment Income</th></tr>
<tr><td>$0</td><td>10%</td><td rowspan="2">0%</td><td rowspan="5">0%</td></tr>
<tr><td>$2,900</td><td rowspan="2">24%</td></tr>
<tr><td>$3,000</td><td rowspan="3">15%</td></tr>
<tr><td>$10,550</td><td>35%</td></tr>
<tr><td>$14,450</td><td rowspan="2">37%</td></tr>
<tr><td>$14,650</td><td>20%</td><td>3.8%</td></tr>
</table>

* Other long-term capital gains could be taxed as high as 25% (building recapture) or 28% (collectibles and §1202 stock).

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

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		

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

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

A. Background

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

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

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

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

B. Analysis of the Ruling

The ruling uses this example to frame the discussion:

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

On these facts, the IRS concludes:

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

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

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

C. Lingering Questions

As the first significant ruling related to grantor trusts in over a decade, the IRS deserves credit for trying to provide helpful guidance. But *Revenue Ruling 2023-2* seems to raise more questions than it answers. For example, the ruling concludes that a defective grantor trust's basis in gifted property is "the same as the basis [in such property] immediately prior to A's death." But what is that basis? While the grantor was alive, of course, the trust was disregarded for federal income tax purposes thanks to *Revenue Ruling 85*-13, supra. That must mean the trust's basis in the gifted property was the same as the decedent's basis at the time of the gift. In that way, the result is akin to the transferred basis rule that generally applies to inter-vivos gifts under IRC §1015(a). But in the case of a transaction recognized as an inter-vivos gift under the federal income tax laws, the recipient of the gift may add to the gifted property's basis a portion of the federal gift tax paid by the donor in connection with the transfer. See IRC §1015(d). That leads to an important question: what if the decedent in the ruling had paid federal gift tax on this transfer? At what point, if ever, does the trust get basis credit under IRC §1015(d)? It cannot be before death, as the income tax—which continues to see the grantor as the owner of the gifted property—would say no gift happens until the grantor's death, when the trust becomes a separate taxable entity. Does that mean, then, that any basis adjustment for gift tax paid would come into effect at death? We still lack firm guidance on this point.

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

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

2002), at 154 – 155. Because the transfer from the grantor at death is effectively a part-bequest, part-sale (because the trust is paying for the property with a promissory note), they contend, the basis rules effectively award the trust a stepped-up basis.

But as discussed above, IRC §1014(b) identifies exactly ten instances in which property is considered to have been acquired from a decedent for purposes of IRC §1014(a), and property received by the new, nongrantor trust through a deemed transfer at the grantor's death does not clearly fall within any of them. Since the property transferred to the trust at death is not included in the grantor's gross estate (it was a defective grantor trust, remember), IRC §1014(b)(9)—the rule that confers a stepped-up basis to any asset included in a decedent's gross estate for estate tax purposes—does not apply. Nor does any of IRC §§1014(b)(2) (property held by a revocable living trust), 1014(b)(3) (property held by a trust in which the decedent retained a power to alter or amend enjoyment), 1014(b)(4) (property passing for less than full consideration by testamentary exercise of a general power of appointment), 1014(b)(5) (a now-defunct rule for certain stock in a foreign personal holding company), 1014(b)(6) (the surviving spouse's share of community property), 1014(b)(7) (a pre-1947 rule for community property), 1014(b)(8) (a pre-1954 rule for joint and survivor annuities), or 1014(b)(10) (property includible under IRC §2044 because of a marital deduction previously allowed).

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

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

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

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

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

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

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

Michael's estate filed an estate tax return that reported the value of Michael's stock at $3 million, and the estate paid federal estate tax on this amount. The valuation, remember, was determined by a private agreement, and the valuation did not factor in the value of the death benefit from the life insurance policy. On audit, the IRS determined that the estate should have had the stock appraised and that any such appraisal would have included 77 percent of the value of the death benefit. As a result, it determined that the value of Michael's stock was about $5.3 million, resulting in a $1 million deficiency that Michael's estate paid. The estate then brought this refund action, but a federal district court granted summary judgment to the IRS.

On this appeal to the Eighth Circuit, the estate advanced two alternative arguments. First, the estate claimed that the actual redemption transaction pursuant to the buy-sell agreement established the value of Michael's stock for federal estate tax purposes at $3 million. Although

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

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

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

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

> If we accept the estate's view and look to [the company's] value exclusive of the life insurance proceeds intended for redemption, then upon Michael's death, each share was worth $7,720 before redemption. ($3.86 million divided by 500 shares.) After redemption, Michael's interest is extinguished, but Thomas still has 114.1 shares giving him full control of [the company's] $3.86 million value. Those shares are now worth about $33,800 each. ($3.86 million divided by 114.1

> shares.) Overnight and without any material change to the company, Thomas's shares would have quadrupled in value. This view of the world contradicts the estate's position that the proceeds were offset dollar-by-dollar by a "liability." A true offset would leave the value of Thomas's shares undisturbed. … In sum, the brothers' arrangement had nothing to do with corporate liabilities. The proceeds were simply an asset that increased shareholders' equity. A fair market value of Michael's shares must account for that reality.

The court thus affirmed summary judgment for the IRS.

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

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

V. LEGISLATION SO NICE, THEY DID IT TWICE (SECURE ACT 2.0 of 2022, enacted December 29, 2022).

Congress passed the "SECURE 2.0 Act of 2022" as part of the Consolidated Appropriations Act, 2023, signed by the President on December 29, 2022. The Act contains a number of new rules impacting retirement savings. This section summarizes some of the more important provisions.

A. Automatic Enrollment in Retirement Plans

New Code §414A requires that, in plan years beginning after 2024, §401(k) and §403(b) plans must automatically enroll participants upon their becoming eligible, with employees given the option to opt out of participation. Under this new rule, the participant must contribute at least three percent but not more than ten percent of the participant's compensation, with the limits to gradually increase to a ten percent floor and a 15 percent cap. Existing plans, as well as governmental plans, church retirement plans, and plans for new or small businesses are not subject to this automatic enrollment requirement.

B. Saver's Match

Instead of receiving a nonrefundable credit for contributions to an individual retirement account, taxpayers with modified adjusted gross incomes under $20,500 ($41,000 for married couples filing jointly and $30,750 for heads of households) will receive a 50-percent matching contribution up to $2,000. The matching contribution is phased out, eliminated once the individual's modified adjusted gross income exceeds $35,500 ($71,000 for joint filers and $53,250 for heads of households). These dollar figures will be adjusted for inflation starting in 2028.

C. Increased Age for Required Minimum Distributions

While the SECURE Act of 2019 increased the age for required minimum distributions from age 70½ to age 72, the new Act increases the age to 73 for those who reach age 72 after 2022 and to age 75 for those who reach age 74 after 2032.

As an aside, in *Notice 2023-23*, 2023-13 I.R.B. 1 (March 7, 2023), the IRS announced that statements furnished by an IRA custodian to IRA owners turning 72 in 2023 will not be considered as improperly sent as long as the custodian notifies the account owners by April 28, 2023, that no minimum distribution is required. Under *Notice 2002-27*, 2002-1 C.B. 814, an IRA custodian must furnish by January 31 a statement to an IRA owner required to take a minimum distribution that the owner must do so before the applicable deadline. The IRS recognizes that since the SECURE 2.0 Act of 2022 was passed late in the year, some financial institutions may have sent statements to account owners turning 72 in 2023 indicating that a minimum distribution is required, though that is no longer the case. Accordingly, the new Notice provides that the IRS "will not consider [a required] statement provided to an IRA owner who will attain age 72 in 2023 to have been provided incorrectly if the IRA is notified by the financial institution no later than April 28, 2023, that no [minimum distribution] is actually required for 2023."

D. Catch-Up Contributions

The new rules are explained well on page 14 of the "Recent Developments – 2022" materials from the Heckerling Institute on Estate Planning (2023):

> Under current law, individuals aged 50 and older may make catch-up contributions in excess of otherwise applicable limits. The limit is $6,500 for 2022 and $7,500 for 2023 ($3,000 in 2022 and $3,500 in 2023 for SIMPLE plans). Beginning in 2025, the limit will be increased for individuals aged 60 to 63 to the greater of $10,000 or 150 percent of the 2024 amount. (The increased amounts are indexed for inflation after 2025.)

E. Emergency Withdrawals, Withdrawals in Domestic Abuse Cases, and Withdrawals by the Terminally Ill

An individual can 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." 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. In addition, a victim of domestic abuse may, as of 2024, withdraw up to $10,000 (of, if less, half of the value of the participant's account) from a retirement plan without penalty. This $10,000 cap will adjust for inflation starting in 2025. Finally, 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").

F. 529 Plan Rollovers to Roth IRAs

The beneficiary of a 529 plan may roll over up to $35,000 during the beneficiary's lifetime from the plan into a Roth IRA. The rollovers are subject to Roth IRA annual contribution limits, and the 529 account must have been open for more than 15 years. The new provision applies to distributions as of 2024.

G. Spouse Election to be Treated as Participant

Starting in 2024, a surviving spouse can elect to be treated as the plan participant for purposes of the required minimum distribution rules.

H. Special Needs Trust with Charitable Remainder Beneficiary Still Eligible for Lifetime Stretch-out

A special needs trust for a disabled beneficiary may name a charitable organization as the remainder beneficiary without jeopardizing the trust's ability to qualify as an eligible designated beneficiary.

I. Inflation Adjustments to Charitable Rollover Limits

The $100,000 limitation for qualified charitable distributions will be indexed for inflation starting in 2024. In addition, a participant may make a one-time transfer of up to $50,000 to a charitable remainder trust or an immediate charitable gift annuity.

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

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

A. Background

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

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

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

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

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

B. *Notice 2022-53*

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

C. *Notice 2023-54*

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

Notice 2023-54 also gave guidance related to the change in the required beginning date for RMDs made under the SECURE 2.0 Act of 2022. As noted *supra*, the SECURE 2.0 Act changed the required beginning date for RMDs from April 1 of the calendar year following the calendar year in which an individual turns 72 to April 1 of the calendar year following the calendar year in which an individual turns 73 or 75, depending on the individual's date of birth. Because it takes time to update automated payments, apparently, some individuals who reach age 72 in 2023 received (or will receive) distributions in 2023 that will be mischaracterized as RMDs, making them ineligible for rolling over into an eligible retirement plan. The Notice provides relief by announcing that any distribution made in the first seven months of 2023 to a participant born in 1951 (or to that participant's surviving spouse) that would have been an RMD under pre-SECURE 2.0 Act law will still qualify as an eligible rollover distribution. The Notice further extended the 60-day rollover deadline in all cases to September 30, 2023.

VII. THE WAR AGAINST SYNDICATED CONSERVATION EASEMENTS

A. Statutory Background

In 2004, Congress enacted a number of Code provisions designed to help the IRS in its enforcement efforts. Section 6707A(a) 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." IRC §6707A(c)(1). "Listed transactions" are a subset of reportable transactions; more precisely, they are reportable transactions which have been specifically identified by the IRS as a tax avoidance transaction. IRC §6707A(c)(2). The maximum penalty for listed transactions is significantly higher than the maximum penalty for other reportable transactions.

In addition, §6662A 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. IRC §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. IRC §6662A(b)(1)(A). Importantly, the penalty only applies to understatements attributable to: (1) any "listed transaction"; or (2) any "reportable transaction" with a significant purpose of tax avoidance or evasion. IRC §6662A(b)(2). Thus, for example, where an individual taxpayer claims on a 2023 federal income tax return a $1,500,000 deduction in connection with a listed transaction but the IRS concludes that the deduction amount should have been only $500,000, the taxpayer would owe a §6662A penalty of $74,000 (37 percent times the $1,000,000 understatement in taxable income, times a 20 percent penalty).

Section 6662A defers to §6707A for the definitions of "listed transactions" and "reportable transactions." A reportable transaction is one identified in regulations "as having a potential for

tax avoidance or evasion." IRC §6707A(c)(1). "Listed transactions" are a subset of reportable transactions; more precisely, they are reportable transactions which have been specifically identified by the IRS as a tax avoidance transaction. IRC §6707A(c)(2). In effect, then, the statute gives the IRS the authority to identify listed transactions.

B. Identifying Listed Transactions by Notice Proves Problematic

Historically, the IRS has identified listed transactions and other reportable transactions through a Notice. But in recent cases, courts have called the IRS on the carpet for this practice, finding that this process violates the Administrative Procedure Act ("APA") since notices are not first issued in proposed form.

It all started in 2022 with the Sixth Circuit's decision in *Mann Construction, Inc. v. United States*, 27 F.4th 1138 (6th Cir. 2022). In that case, the court held that *Notice 2007-83*, 2007-2 C.B. 960 (2017), was issued in violation of the notice-and-comment procedures for legislative rules under the APA and was therefore invalid. In the Notice, the IRS designated certain employee-benefit plans featuring cash-value life insurance policies as a listed transaction. When the taxpayer and its shareholders were forced to pay penalties in 2019 for failing to disclose a deferred compensation arrangement within the scope of the Notice, the taxpayer claimed in a refund suit that the Notice was invalid because the IRS did not first publish the Notice in proposed form. The IRS argued a proposed Notice was not required, first because the Notice was an "interpretive rule" and not a "legislative rule." A legislative rule makes new law, and thus must undergo the notice-and-comment process described above. But an interpretive rule merely proffers the agency's reading of an existing law, and the APA exempts interpretive rules from the notice-and-comment procedures. But the Sixth Circuit held that *Notice 2007-83* was a legislative rule. "The Notice has the force and effect of law. It defines a set of transactions that taxpayers must report, and that duty did not arise from a statute or a notice-and-comment rule. It springs from the IRS's own Notice." Moreover, said the court, the IRS's authority to issue the Notice stems from an express and binding delegation of rulemaking power: §6707A(c) specifically gives the IRS authority to determine which transactions have a potential for tax avoidance or evasion. By exercising this delegated power to make law, then, the Notice is a legislative rule.

The IRS than argued that even if the Notice was a legislative rule, Congress exempted the IRS from the APA's requirements with respect to the rules for disclosing listed transactions. Congress can do this, and it has in other arenas. But, the court observed, Congress did not do so here. Nothing in §6707A itself exempts the IRS from compliance with the APA. "Congress did not change the background procedural requirements of the APA or otherwise indicate an exemption from those requirements in a 'clear' or 'plain' way that would make the APA's procedures inapplicable to the IRS." The IRS argued that Congress has effectively blessed the IRS's nonconformance with the APA by taking no corrective action. But the court rejected this argument, finding that inaction "rarely suffices to show express modification of the APA's bedrock procedural guarantees given the raft of potential explanations for inaction on Capitol Hill."

Mann Construction set a dangerous precedent. If the Sixth Circuit is right, it means that any such Notice, not just the one at issue in the case, is invalid and, thus, not binding on taxpayers. That's what came to pass later with respect to syndicated conservation easements.

C. Syndicated Conservation Easements as Listed Transactions

In *Notice 2017-10*, 2017-4 I.R.B. 544 (December 23, 2016), 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). 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."

D. *Green Valley Investors, LLC v. Commissioner*, 159 T.C. No. 5 (November 9, 2022)

In a 15-2 decision, the Tax Court has held that *Notice 2017-10*, *supra*, was issued in violation of the notice-and-comment procedures for legislative rules under the APA and is therefore invalid. The court's holding is consistent with *Mann Construction,* even though an appeal in this case would be heard by the Fourth Circuit. The case appears to be another nail in the coffin for notices and other forms of regulatory guidance that are not originally issued in proposed form.

Green Valley Investors, LLC, is one of four taxpayers in these consolidated cases. In each case, the taxpayer, a limited liability company, purchased land and then donated a conservation easement to the Triangle Land Conservancy in either 2014 or 2015. Each LLC claimed a charitable contribution deduction of about $22,500,000. The IRS disallowed the deduction on the grounds that the donated easements violated the statutory requirement that they be given in perpetuity. Because the disallowed deductions resulted in understatements, the IRS asserted penalties, and because the donations in these cases were all syndicated conservation easement transactions, the IRS asserted §6662A penalties.

After consolidation, both parties filed motions for partial summary judgment as to the imposition of penalties. The taxpayer argued that the §6662A penalties could not apply because their donations in 2014 and 2015 preceded the 2017 notice identifying them as listed transactions. The taxpayer also argued that *Notice 2017-10* was invalid for failing to comply with the APA, akin to the holding of the Sixth Circuit in *Mann Construction*, *supra*, that a notice identifying a listed transaction was invalid for failure to undergo the APA's notice-and-comment procedure.

The Tax Court had little interest in the taxpayer's first argument, that the IRS could not penalize a transaction completed before it has been identified as a listed transaction. "We have previously upheld the retroactive application of penalties, even though the taxpayers became subject to the penalties after they had entered into the transactions or after their tax returns had been filed." *Green Valley Investors, LLC* at 7. On this point, even the dissenters agree. So while the court formally refrained from ruling on this argument because of its findings in connection with whether the IRS complied with the APA in promulgating the notice, it is clear the court would likely reject it.

The focus of all five opinions, including the majority opinion of Judge Weiler, is on whether the IRS complied with the APA in promulgating *Notice 2017-10*. The majority rejected the IRS's argument that the notice was a mere interpretive rule:

> The act of identifying a transaction as a listed transaction by the IRS, by its very nature, is the creation of a substantive (i.e., legislative) rule and not merely an interpretive rule." … [I]dentifying a transaction as a listed transaction imposes new duties in the form of reporting obligations and recordkeeping requirements on both taxpayers and their advisors. Notice 2017-10 exposes these individuals to additional reporting obligations and penalties to which they would not otherwise be exposed but for the notice. Creating new substantive duties and exposing taxpayers to penalties for noncompliance "are hallmarks of a legislative, not an interpretive rule."

Id. at 9 – 10, quoting *Mann Construction*, *supra*. Here too it appears there is unanimity among the Tax Court judges, as even the dissenters agree that the notice is a legislative rule. Where the judges part company is with respect to the IRS's argument that it is excused from the APA's notice-and-comment procedures when identifying listed transactions.

The majority observed that nothing in §6707A expressly exempts the IRS from the notice-and-comment procedure. The IRS argued that before the enactment of §6707A, existing regulations defined "listed transactions" as those "identified by notice, regulation, or other forms of published guidance." Treas. Reg. §1.6011-4(b)(2). According to the IRS, this language put Congress on notice that it would issue future notices without notice and comment. So when Congress referred to the regulation in defining reportable transactions and listed transactions in §6707A(c)(1), says the IRS, it indirectly excused the agency from the APA's notice and comment procedures.

The majority rejected this argument. It read the reference to the regulation merely as incorporating the various reportable transactions identified in the regulation as being within the statutory definition of a reportable transaction. The reference to the regulation did not endorse the IRS's decision to issue guidance without notice and comment. "In other words," said the majority, "we conclude that section 6707A(c) addresses a 'which transactions' question, not a 'what process' question." It thus granted the taxpayer's motion, invalidating both *Notice 2017-10* and the imposition of §6662A penalties in connection with reportable transactions.

In a concurring opinion, Judge Pugh observed that the procedure for identifying reportable transactions set forth in §6707A "can, by its terms, be reconciled with the APA; nothing in it directly conflicts with the APA like the 'sole and exclusive' or 'interim final rule, pursuant to which public comment will be sought' procedures at issue" in other cases where court have found congressional exception to APA requirements. In other words, nothing in the statute's reference to "identifi[cation] by notice, regulation, or other form of published guidance" is so clearly different from the APA's requirements that one must conclude that Congress intended a different procedure to apply.

Concurring separately, Judge Toro noted that while the IRS's 2003 regulation defines a listed transaction as one "that the IRS has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance," §6707A(c)(2), enacted in 2004, defined a listed transaction as one "specifically identified by the Secretary as a tax avoidance transaction." To Judge Toro, it matters greatly that the statute omits "by notice, regulation, or other form of published guidance:"

> [I]f Congress has intended to adopt a specific process for the Secretary to use in identifying listed transactions, Treasury Regulation §1.6011-4(b)(2) provided a ready model. Yet, despite apparently incorporating other words from the regulation into the statutory definition, Congress did not incorporate the nine procedural words.

Judge Gale, one of two dissenting judges, believes that "identification of a listed transaction 'by notice' cannot be reconciled with APA notice-and-comment procedures." As Judge Gale puts it:

> I find it very unlikely that, in cross-referencing the extant identification procedures in the section 6011 regulations, Congress intended as significant a modification to them as APA notice and comment would require without any mention in the accompanying committee reports. The 'necessary,' 'clear,' or 'fair implication.' … of Congress' action in incorporating the section 6011 regulations into the statute is that Congress intended to displace the otherwise applicable notice-and-comment requirements of the APA.

Judge Gale was likewise unpersuaded by Judge Toro's reference to the different wording used in the statute, finding support in the legislative history to §6707A that identification of listed transactions by notice, regulation, or otherwise was sufficient.

In a separate dissent, Judge Nega reasoned that Congress could not have intended penalties for tax avoidance to undergo the time-consuming notice and comment procedures. "I cannot agree," he wrote, "that Congress added a penalty regime to enforce the existing IRS rulemaking without addressing an obvious APA vulnerability, at least, to the then-listed transactions."

A 15-2 decision from the Tax Court is a strong blow to the IRS. If this decision and those in *Mann Construction* and *CIC Services* are correct, then no notice identifying a listed transaction or a reportable transaction is valid. This effectively neuters §§6707A and 6662A.

But who's to say the scope of this holding is limited to listed transactions and reportable transactions? Its logic would apply to any IRS notice or other guidance that identifies a transaction or a party as subject to a reporting requirement, a penalty, or a tax. In effect, any notice *ever issued* by the IRS that announced a new rule, regardless of the statutory provision or regulation at issue, is void unless it first underwent APA notice-and-comment procedures. Thus far, the IRS has yet to find a court that will hold otherwise.

E. *GBX Associates LLC v. United States* (N.D. Ohio, November 14, 2022)

A federal district court has held that while *Notice 2017-10*, 2017-4 I.R.B. 544 (December 23, 2016), is invalid under the controlling authority of *Mann Construction*, *supra*, the notice is only void as to the petitioning taxpayer and that the IRS may argue for a different result outside of the Sixth Circuit. The court's decision is noteworthy as it seemingly goes against decisions from three federal circuit courts of appeals that unlawful agency actions are invalid as a whole.

The court describes the taxpayer, GBX Associates LLC (GBX), as "a real estate investment and development firm that focuses on the acquisition, preservation, and rehabilitation of historic buildings in urban centers." GBX recruits investors to contribute funds so GBX can purchase parcels of real estate on which it will transfer conservation easements to charitable organizations. These transactions are "listed transactions" pursuant to *Notice 2017-10*, 2017-4 I.R.B. 544 (2016), and since GBX is a "material advisor" with respect to these transactions, it is subject to significant recordkeeping and reporting requirements.

GBX filed the present lawsuit seeking an injunction and a declaration that *Notice 2017-10* was void because it was issued by the IRS without first providing notice and an opportunity for public comment, in violation of the Administrative Procedure Act (APA). The IRS conceded that because an appeal in this case would go to the Sixth Circuit, *Notice 2017-10* is invalid under the controlling precedent of *Mann Construction*. Although *Mann Construction* involved a different notice, the IRS admitted that the analysis in that decision would apply with equal force to the notice at issue in this case. So the parties agree the notice is unlawful. The parties disagree, however, as to the scope of the relief the court should grant in light of the notice's invalidity.

The APA provides that where an agency violates applicable procedural requirements, a reviewing court shall "hold unlawful and set aside" the agency's action. 5 U.S.C. §706(2). GBX argues that the notice should "vacated in whole," meaning it should be declared unenforceable against all taxpayers and not just GBX. But the IRS argues that because GBX seeks an injunction and declaratory relief, the court should respect traditional limits on a court's application of equitable remedies and limit relief only to the requesting party (here, GBX). The IRS also argued that GBX lacked standing to seek relief as to all taxpayers because its "injury" (compliance with recordkeeping and notice requirements) can be remedied by a judgment that voids the notice as to GBX only.

The district court held that GBX has standing to pursue relief for all taxpayers, citing decisions from several other courts that rejected the argument that a party lacks standing to seek a remedy under §706(2) of the APA for the benefit of non-parties. As the court observed, the case is about "the nature and breadth of the relief to which GBX is entitled under §706(2). This is an important legal issue, but the Court is not persuaded that it is a standing issue."

The court then turned to what it considered the central issue in the case, what it called "an issue of statutory construction that requires this Court to determine what Congress meant when it authorized courts to 'set aside' unlawful agency action under the statute." After observing that APA itself does not directly answer the question, it then considered decisions from three circuit courts of appeals: *National Mining Association v. U.S. Army Corps of Engineers*, 145 F.3d 1399 (D.C. Cir. 1998), *East Bay Sanctuary Covenant v. Garland*, 994 F.3d 962 (9th Cir. 2021), and *Pennsylvania v. President United States*, 930 F.3d 543 (3d Cir. 2019). In each case, the court held that where a reviewing court determines an agency action is unlawful, the ordinary result is that the action is vacated as a whole and not solely as to the requesting party. The court then sites several lower court cases following this trend.

But then the court looked elsewhere within the Sixth Circuit and found a split among the district courts. In one case, the court declined a request to vacate an invalid agency action as a whole. *Skyworks, Ltd. v. CDC*, 542 F. Supp. 3d 719 (N.D. Ohio 2021). But in *CIC Services, LLC v. IRS*, *supra*, another court granted the taxpayer's request to vacate another IRS notice in its entirety. So the court it is unclear whether the Sixth Circuit would follow the decisions from the other circuits and invalidate *Notice 2017-10* as a whole. At this point, then, the court takes a sudden turn:

> This Court, however, need not decide this thorny legal question. Even assuming *arguendo* that federal courts have the authority to order universal vacatur under §706(2), the Court is not convinced that it is *required* to order such relief under the statute. And, for the reasons discussed in more detail below, the Court is not persuaded that the broad, universal relief requested by GBX herein is appropriate or necessary under the circumstances presented.

The court, quoting the Sixth Circuit that "there is value in having legal issues 'percolate' in the lower courts," reasons that if it set aside the notice in whole, its order "could potentially hamper the ability of other federal courts across the country…to reach these important issues." Giving universal relief would inhibit other courts from addressing the validity of the notice, and the court is thus wary to take such dramatic action.

GBX argued that if the ruling applies only to GBX, other participants in the syndicated conservation easement transactions would no longer have the necessary information to comply with the notice and would therefore face penalties, but the court rejected this claim, finding that under applicable regulations, a taxpayer who does not receive information from GBX is under no obligation to report the transaction. But GBX made another potentially viable argument, namely that universal relief is necessary because participants in GBX-promoted transactions are located outside the Sixth Circuit and thus do not enjoy the "safe harbor" of *Mann Construction*'s ruling. Unfortunately, noted the court, GBX only raised the issue in a status conference and did not make this argument in its summary judgment briefing. This means the argument was never officially made and the court could not consider it.

It is not surprising that the court sided with the *Skyworks* case in refraining from invalidating the notice as a whole, for *Skyworks* was likewise a decision from the Northern District of Ohio, albeit from a different judge. Still, it would seem there has been sufficient "percolation" of the issue in other courts that the court in the instant case did not need to shy away from deciding it. Even if the court had set aside the notice in whole, courts in other jurisdictions would not be bound by the decision, as the precedent to this point suggests.

F. Proposed Regulation §1.6011-9 (December 6, 2022)

In the wake of the *Green Valley Investors* and *GBX Associates* cases, *supra*, Treasury responded with proposed guidance to ensure that syndicated conservation easement transactions would remain "listed transactions." The proposed regulation identifies a "syndicated conservation easement transaction" as a "listed transaction" for purposes of IRC §§6011, 6662A, and 6707A. Section 6011(a), recall, generally provides that taxpayers must include information identified in regulations when they file their federal income tax returns. Pursuant to this rule, Regulation §1.6011-4(a) provides that where a taxpayer participates in a "reportable transaction," the taxpayer must file a disclosure statement (currently Form 8886) with the taxpayer's federal income tax return. A copy of the Form 8886 must also be sent to the IRS's Office of Tax Shelter Analysis. Reportable transactions come in five forms: confidential transactions, transactions with contractual protection, loss transactions, transactions of interest, and, most importantly

for immediate purposes, “listed transactions.” A listed transaction is one that is the same or substantially similar to one that the IRS determines to be a tax avoidance transaction “identified by notice, regulation, or other form of published guidance.” Reg. §1.6011-4(b)(2).

A number of Code provisions police the reporting of (and participation in) reportable transactions, with stiffer sanctions often applicable to those reportable transactions that are listed transactions. As previously discussed, for example, §6707A imposes a penalty generally equal to 75 percent of the decrease in tax shown on the taxpayer’s return as a result of the reportable transaction for failing to disclose the transaction. In addition, §6662A imposes an additional 20 percent accuracy-related penalty on any understatement attributable to a reportable transaction; if the taxpayer did not properly disclose the transaction, the penalty increases to 30 percent of the understatement. Furthermore, §6111 and Regulation §301.6111-3(a) require a “material advisor” with respect to a reportable transaction must file a disclosure statement (currently Form 8918) with the Office of Tax Shelter Analysis, with §6707 imposing penalties on a material advisor that fails to file a timely disclosure or files an incomplete or false disclosure.

Historically, the IRS identifies listed transactions and other reportable transaction by publishing a notice in the Internal Revenue Bulletin. Notices traditionally do not undergo the “notice and comment” procedures required by the APA. Over the past year, as explained over the past several pages, this has proven to be problematic. If the decisions discussed in Part IV, *supra,* are correct, not one notice that identifies reportable transactions is valid, as none of the notices have undergone the APA’s notice and comment procedures. That in turn means that none of the statutory penalties applicable to participation in reportable transactions (or the failure to fully and timely disclose them) would apply to any taxpayer. Faced with such high stakes, the IRS decided to issue these proposed regulations in connection with syndicated conservation easement transactions. As Treasury states in the preamble to the proposed regulations:

> The Treasury Department and the IRS disagree with the Sixth Circuit's decision in *Mann Construction* and the Tax Court's decision in *Green Valley* and are continuing to defend the validity of *Notice 2017-10* and other notices identifying transactions as listed transactions in circuits other than the Sixth Circuit. At the same time, however, to eliminate any confusion and ensure consistent enforcement of the tax laws throughout the nation, the Treasury Department and the IRS are issuing these proposed regulations to identify certain syndicated conservation easement transactions as listed transactions for purposes of all relevant provisions of the Code and Treasury Regulations.

Proposed Regulation §1.6011-9(a) provides that “Transactions that are the same as, or substantially similar to, a transaction described in paragraph (b) of this section are identified as listed transactions….” Proposed Regulation §1.6011-9(b) then states that:

> The term "syndicated conservation easement transaction" means a transaction in which the following steps occur (regardless of the order in which they occur)—

> (1) A taxpayer **receives promotional materials** that offer investors in a **pass-through entity** the possibility of being allocated a charitable contribution deduction that equals or exceeds an amount that is **two and one-half times** the amount of the taxpayer's investment in the pass-through entity as determined under paragraph (d) of this section (2.5 times rule);
>
> (2) The taxpayer **acquires an interest** directly, or indirectly through one or more tiers of pass-through entities, **in the pass-through entity that owns real property** (that is, becomes an investor in the entity);
>
> (3) The **pass-through entity** that owns the real property **contributes an easement** on such real property, which it treats as a conservation easement within the meaning of paragraph (c)(2) of this section, to a qualified organization and allocates, directly or through one or more tiers of pass-through entities, a charitable contribution deduction to the taxpayer; and
>
> (4) The **taxpayer claims a charitable contribution deduction** with respect to the conservation easement on the taxpayer's Federal income tax return.

(emphasis added). Of these elements, the “2.5 times rule” in Proposed Regulation §1.6011-9(b)(1) merits elaboration. For purposes of the 2.5 times rule, “promotional materials” are any written or oral communications provided to investors, specifically including:

> marketing materials, appraisals (including preliminary appraisals, draft appraisals, and the appraisal that is attached to the taxpayer's return), websites, transactional documents such as the deed of conveyance, private placement memoranda, tax opinions, operating agreements, subscription agreements, statements of the anticipated value of the conservation easement, and statements of the anticipated amount of the charitable contribution deduction.

Prop. Reg. §1.6011-9(c)(4). In addition, if the promotional materials suggest or imply a range of potential charitable deduction amounts, the highest suggested or implied deduction amount will be used to determine if the 2.5 times rule is met. Prop. Reg. §1.6011-9(d)(1). In fact, the proposed regulations presume the 2.5 times rule is met where:

> [(1)] the pass-through entity donates a conservation easement within three years following taxpayer's investment in the pass-through entity, [(2)] the pass-through entity allocates a charitable contribution deduction to the taxpayer that equals or exceeds two and one-half times the amount of the taxpayer's investment, and [(3)] the taxpayer claims a charitable contribution deduction that equals or exceeds two and one-half times the amount of the taxpayer's investment.

Prop. Reg. §1.6011-9(d)(2). Anticipating that 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 contain an “anti-stuffing rule” under which only the investor’s contribution attributable to the portion of the real property on which the easement is placed is considered in determining whether the 2.5 times rule is met. Prop. Reg. §1.6011-9(d)(3).

To illustrate the anti-stuffing rule, suppose an investor acquires a ten-percent interest in the LLC that owns both real estate (worth $1 million) and marketable securities (also worth $1 million) by paying $200,000. In applying the 2.5 times rule, the investor’s contribution is $100,000 (that portion of the investment allocable to the land). Thus, a suggested deduction of $250,000 or more would satisfy the 2.5 times rule.

The IRS hoped to finalize the proposed regulations in 2023, with an effective date as of the date the final regulations are published in the Federal Register. But this may no longer be necessary, as we are about to see.

G. New §170(h)(7) and Related Amendments (enacted December 29, 2022)

Section 605 of the SECURE 2.0 Act of 2022 (itself part of the Consolidated Appropriations Act, 2023, signed by President Biden on December 29, 2022) enacted new §170(h)(7). Following is the text of the new Code provision with an annotated explanation:

§170(h)(7) – Limitation on deduction for qualified conservation contributions made by passthrough entities.

(A) In general. A contribution by a partnership (whether directly or as a distributive share of a contribution of another partnership) shall not be treated as a qualified conservation contribution for purposes of this section if the amount of such contribution exceeds 2.5 times the sum of each partner's relevant basis in such partnership.

(B) Relevant basis. For purposes of this paragraph --

(i) In general. The term "relevant basis" means, with respect to any partner, the portion of such partner's modified basis in the partnership which is allocable (under rules similar to the rules of section 755) to the portion of the real property with respect to which the contribution described in subparagraph (A) is made.

(ii) Modified basis. The term "modified basis" means, with respect to any partner, such partner's adjusted basis in the partnership as determined --

(I) immediately before the contribution described in subparagraph (A)

(II) without regard to section 752, and

(III) by the partnership after taking into account the adjustments described in subclauses (I) and (II) and such other adjustments as the Secretary may provide.

Subparagraph (A) sets forth the general rule, consistent with the proposed regulation, that denies a partner any conservation easement deduction where the amount of the deduction exceeds 2.5 times the applicable portion of the partner’s basis in the partnership. Subparagraph

(B) implements the “anti-stuffing rule” from the proposed regulation to avoid an easy evasion of the 2.5 times rule.

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

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

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

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

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

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

The exception in subparagraph (C) essentially narrows the scope of subparagraph (A) to deny a deduction only where the partnership makes the conservation easement contribution within three years of the partnership’s acquisition of the real property or the partner’s acquisition of the partnership interest.

(D) Exception for family partnerships.

(i) In general. Subparagraph (A) shall not apply with respect to any contribution made by any partnership if substantially all of the partnership interests in such partnership are held, directly or indirectly, by an individual and members of the family of such individual.

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

(I) the spouse of such individual, and

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

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

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

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

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

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

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

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

VIII. OTHER DEVELOPMENTS INVOLVING CONSERVATION EASEMENTS

A. Supreme Court Refuses to Address Circuit Split Over Validity of Proceeds Regulation

In decisions handed down in 2021 and 2022, two federal appellate courts reached different results concerning the validity of Regulation §1.170A-14(g)(6)(ii). This so-called "proceeds regulation" requires that upon judicial extinguishment and sale of property subject to a conservation easement, the charity "must be entitled to a portion of the proceeds at least equal to [the] proportionate value of the conservation restriction." A 2018 case from the Fifth Circuit Court of Appeals interpreted this language to mean that a charity's share upon extinguishment is that percentage determined by a fraction, the numerator of which is the value of the conservation easement on the date of the gift and the denominator of which is the value of the whole property on the date of the gift. *PBBM-Rose Hill, Ltd. V. Commissioner*, 900 F.3d 193 (5th Cir. 2018). Under this interpretation, the charity holding the easement benefits from post-transfer improvements to the property even though the charity may not be liable for a proportionate share of the costs. The Tax Court embraced this interpretation in *Oakbrook Land Holdings, LLC v. Commissioner*, 154 T.C. No. 10 (2020), and went on to hold both that the proceeds regulation was properly promulgated under the Administrative Procedure Act ("the APA") and that the IRS's interpretation of the statute was entitled to "*Chevron* deference."

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. The 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 prohibiting subtraction of the value of post-donation improvements in computing the amount payable to the charity upon judicial extinguishment of a conservation easement. 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.

The Eleventh Circuit 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 Sixth Circuit, in *Oakbrook Land Holdings, LLC v. Commissioner*, 28 F.4th 700 (6th Cir. 2022), found the proceeds regulation was enacted in compliance with the APA. The taxpayer in the case acquired a 143-acre parcel outside Chattanooga 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 deed granting the easement that if the easement is extinguished by judicial proceeding, 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 violates the proceeds regulation and thus reduces the taxpayer's deduction to zero.

The taxpayer argued that the proceeds regulation was invalid under the APA. In a reviewed opinion, the Tax Court, by a 16-1 vote, upheld the regulation's validity by a 16-1 vote, finding it was properly promulgated under the APA. *Oakbrook Land Holdings, LLC v. Commissioner*, 154 T.C. 180 (2020). On appeal, 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, 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 IRC §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, 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 IRC §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 gets no deduction for the irrevocable donation of the easement.

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

B. Observations

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 *Hewitt* 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.

C. Nevertheless, *Hewitt* Persists (*Glade Creek Partners LLC v. Commissioner*, T.C. Memo. 2023-82, June 29, 2023)

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

An investment entity acquired about 2,000 acres in Tennessee for just over $9 million in 2006. That entity transferred the property to Hawks Bluff Investment Group, Inc., an S corporation, in 2010. In 2012, Hawks Bluff contributed the land to the taxpayer in exchange for a 98-percent interest in the taxpayer. Shortly thereafter, the taxpayer granted an easement on the land to Atlantic Coast Conservancy, Inc., and claimed a charitable contribution deduction of $17.5 million on its 2012 income tax return. The IRS initially disallowed the deduction on the grounds that the deed violated the proceeds regulation because it provided that the charity would receive only a share of the *net* proceeds in the event of a judicial extinguishment and sale and not a share of the *gross* proceeds. The Tax Court agreed, consistent with its precedent. *Glade Creek Partners LLC v. Commissioner*, T.C. Memo. 2020-148. But in an unpublished opinion dated August 22, 2022, the Eleventh Circuit vacated the Tax Court's decision, holding the proceeds

regulation was invalid under *Hewitt*. It thus remanded the case back to the Tax Court for further determination as to the amount deductible.

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

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

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

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

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

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

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

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

D. Safe Harbor Deed Language Published

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

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

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

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

> *Pursuant to Notice 2023-30, Donor and Donee agree that, if a subsequent unexpected change in the conditions surrounding the property that is the subject of a donation of the perpetual conservation restriction renders impossible or impractical the continued use of the property for conservation purposes, the conservation purpose can nonetheless be treated as protected in perpetuity if (1) the restrictions are extinguished by judicial proceeding and (2) all of Donee's portion of the proceeds (as determined below) from a subsequent sale or exchange of the property are used by the Donee in a manner consistent with the conservation purposes of the original contribution.*
>
> <u>Determination of Proceeds</u>*. Donor and Donee agree that the donation of the perpetual conservation restriction gives rise to a property right, immediately vested in Donee, with a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction, at the time of the gift, bears to the fair market value of the property as a whole at that time. The proportionate value of Donee's property rights remains constant such that if a subsequent sale, exchange, or involuntary conversion of the subject property occurs, Donee is entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction, unless state law provides that the donor is entitled to the full proceeds from the conversion without regard to the terms of the prior perpetual conservation restriction.*

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

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

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

Notice 2023-30 was published on April 24, 2023. The ninetieth day following that was July 22, 2023, but because that was a Saturday, the deadline for amending conservation easement

deeds and have the new language take retroactive effect was Monday, July 24, 2023. Still, the language is helpful for future conservation easement deeds.

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

E. Taxpayer Prevails in Valuation Dispute (*Champions Retreat Golf Founders, LLC v. Commissioner*, October 17, 2022)

The Tax Court has held that the fair market value of a conservation easement donated to the North American Land Trust in 2010 was worth just over $7.8 million, a value much closer to the taxpayer's claimed value of $10.4 million than the IRS's asserted value of $20,000. The case serves as a helpful primer in the valuation of conservation easements.

It is well accepted that the value of a conservation easement is determined under a "before-and-after method," under which the value of an easement is the amount by which the value of the subject real property at its highest and best use exceeds the value of the subject property now that its use is limited in perpetuity to its existing use. See Treas. Reg. §1.170A-14(h)(3)(i). But in many valuation disputes, taxpayers and the IRS disagree both as to the value of the property at its highest and best use and the value of the property at its existing use.

This case is a classic valuation dispute involving a conservation easement granted to the North American Land Trust on 348 acres in Evans, Georgia, a community just north of Augusta, Georgia. The taxpayer owns and operates the subject property as a 27-hold luxury golf club, with courses designed by Jack Nicklaus, Arnold Palmer, and Gary Player. The taxpayer claimed the highest and best use of the land was as a residential subdivision. But now that it will be limited in perpetuity to use as a luxury golf club, the taxpayer claimed that the value of the easement is just over $10.42 million. By contrast, the IRS determined that use as a luxury golf club was in fact the highest and best of the property. Accordingly, it determined that the value of the easement granted to the charity was only $20,000. Given that the parties were a mere $10.4 million apart, litigation ensued.

So how did the Tax Court go about valuing the easement? First, the court determined the highest and best use of the subject property. After considering expert opinion from both sides, the court held that the highest and best use of the property was a partial residential development together with an 18-hole golf course. But what is the value of this highest and

best use? There are three methods commonly employed for this purpose. Under the **sales comparison method**, the court compares the subject property to similar properties that have been sold in transactions at arm's length on or around the same time as the donation. Under the **income method**, the subject property is measured by the present value of its anticipated cash flow. Finally, under a variation of the income method called the **subdivision development method**, the court treats the property as if it was subdivided, developed, and sold. In light of these methods, the court ultimately determined that the value of the property at its highest and best use is $10.76 million.

From this figure, the court subtracted the value of the property now that it will be used in perpetuity as a 27-hole golf course without residential development. The taxpayer's expert concluded this value was just over $1.4 million, while the IRS's expert concluded the value was $4.3 million. Both parties considered the fact that the golf club was sold to an outside buyer just four years after the donation for just over $4.5 million. That, ruled the court, was highly probative as to the value of the property at the time of the easement's donation. The Tax Court ultimately determined the value of the property now forever limited to its existing state was just over $3 million. This resulted in a deduction amount of $7.8 million ($10.76 million – roughly $3 million).

The case is helpful for its lucid descriptions of three methods used to determine a property's highest and best use. The case also underscores the importance of qualified appraisals in this arena. Without an expert opinion to support a claimed deduction, a taxpayer's attempted deduction might well find itself rolling up short of the hole.

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

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

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

1. Facts

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

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

2. Strange Bedfellows

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

3. The Majority Opinion

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

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

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

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

> Nowhere in these materials did the government announce its current theory that a single deficient or untimely report can give rise to multiple violations, that the number of nonwillful penalties may turn on the number of accounts, or that the $10,000 maximum penalty may be multiplied 272 times or more without respect to an individual's foreign holdings or net worth. … Here, the government has repeatedly issued guidance to the public at odds with the interpretation it now asks us to adopt.

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

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

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

4. The Dissent

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

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

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

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

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

5. Observation

That the Fifth and Ninth Circuits would split is hardly surprising. But what was surprising was the Fifth Circuit siding with the government as the Ninth Circuit sided with the account holder. Likewise, a split decision from the current Supreme Court is par for the course. Yet, as noted above, the composition of the majority and dissenting camps was, to say the least, unique. By

embracing the Ninth Circuit's view and rejecting that of the Fifth Circuit, the *Bittner* Court no doubt comforts those advising clients with foreign bank accounts.

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

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

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

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

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

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

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

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

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

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

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

The court also noted that Kelly received a letter from the bank in 2013 advising him of the need to disclose the account and file FBARs, establishing his actual knowledge of the reporting requirement. Even then he "did not reach out to any accountant, advisor, or other tax professional, or otherwise inquire about his federal reporting obligation." Finding Kelly had a

"blasé attitude about his federal reporting obligations," the court had no trouble upholding the applicable penalty, together with interest and an additional late payment penalty.

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

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

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

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

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

Decisions from Florida federal district courts say that the way to determine if a penalty is penal is by asking whether the legislature expressed a preference for labeling the penalty as remedial or penal, and then considering seven other specific factors. In this case, said the court, Congress clearly signaled that the penalty for willful failure to file FBARs was remedial, for it titled the enabling statute as a "civil penalty" and left enforcement to Treasury rather than the

Department of Justice. The other factors also pointed to the penalty being remedial, for money penalties are not traditionally seen as punishment, the penalty applies regardless of the defendant's state of mind, and there is a separate criminal penalty for willful failure to file, underscoring the intent that this penalty be remedial in nature. Finally, the court also noted that abating the penalty on account of death would grant "a windfall to estates of violators of FBAR requirements because the violator … pass[ed] away after the violation occurred and before the Government filed suit."

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

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

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

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

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

While an occasional private benefit to private interests that is incidental to an organization pursuing its exempt purpose is allowed, any such private benefit must be "clearly incidental to the overriding public interest." Rev. Rul. 76-206, 1976-1 C.B. 154. In *Revenue Ruling 70-186*, 1970-1 C.B. 128, for example, an organization formed to preserve a lake as a public recreational facility benefited both the general public and the private landowners owning lakefront property. The IRS ruled that the benefit to private interests was incidental because it would

have been impossible to accomplish the tax-exempt purpose without benefiting the lakefront property owners. The benefit to the landowners was both indirect and clearly incidental to the organization's overriding purpose of preservation.

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

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

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

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

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

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

XI. 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).

XII. QUALIFIED PERSONAL RESIDENCE TRUST LOSES CLAIM FOR STEPPED-UP BASIS OF HOUSE AT GRANTOR'S DEATH (*Palermo v. United States*, S.D. Florida, August 7, 2023)

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

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

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

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

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

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

Although the trust's refund claim failed on procedural grounds, it is worth considering the merits of the trust's suit. From the facts as presented by the court, it is uncertain whether the value of the home was included in Peter's gross estate for federal estate tax purposes. Presumably, it was not – the purpose of a qualified personal residence trust is to limit the wealth transfer taxation of the residence to the value of the remainder interest at the time of its transfer to the trust. Peter survived the trust term, and died holding only an expired

leasehold interest in the property. Assuming the lease arrangement was bona fide and not a sham by which Peter effectively retained the right to occupy the residence until his death, the date-of-death value of the home would not be subject to estate tax.

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

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

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

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

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

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

> If the estate tax imposed by chapter 11 is not paid when due, then the spouse, transferee, trustee…, surviving tenant, person in possession of the property by reason of the exercise, nonexercise, or release of a power of appointment, or beneficiary, *who receives, or has on the date of the decedent's death*, property

> included in the gross estate under sections 2034 to 2042, inclusive, to the extent of the value, at the time of the decedent's death, of such property, shall be personally liable for such tax.

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

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

The majority of the Ninth Circuit panel reversed, holding that transferee liability applies to those "who have or receive estate property, either on the date of the decedent's death or any at any time thereafter, subject to the applicable statute of limitations." *Paulson* at 16. The majority applied "the rule of the last antecedent," a canon of statutory interpretation that reads a limiting clause as modifying only the noun or phrase it immediately follows. Under this rule, the limiting phrase "on the date of the decedent's death" would modify only the verb "has" and not also the verb "receives." It rejected the argument of the beneficiaries that the "series-qualifier" canon of interpretation should apply. Under the series-qualifier rule, a modifier at the end of a list applies to the entire list. But the majority noted that this canon is better suited to statutes where the modifier is separated from all antecedents by a comma, and such is not the case in this particular statute.

The majority reasons that its interpretation leads to a logical result. There is no reason to limit transferee liability only to those individuals in possession of the assets included in the gross estate at the time of the decedent's death and those who have an ownership interest immediately as of the date of the decedent's death, like survivors in a joint tenancy. The

purpose of transferee liability is to make sure the government can collect estate tax from the assets giving rise to the tax. If the argument of the beneficiaries was correct, then the government could only collect tax from surviving joint tenants and those in physical possession of property included in the gross estate; it could never collect estate tax from assets held by the revocable living trust at death once the trust distributed those assets to the beneficiaries. This does not seem consistent with the intent of transferee liability.

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

As for the second argument, the majority observes that the statute sets estate tax liability based on date-of-death values. Just as post-death increases in value inure to the benefit of a beneficiary, post-death decreases in value are a risk borne by the beneficiary. It is on this last point that the panel’s dissenting judge takes the greatest exception. That a beneficiary could be liable for tax in an amount exceeding the value of what they have received from the estate, says the dissent, is “not logical.” The majority explains at great length why it is unlikely that a beneficiary would be forced to pay more than the value of the bounty they received from a decedent’s estate, but the dissent finds the explanations “unpersuasive, even on their own terms.” *Paulson* at 67.

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

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

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

XIV. CASES INVOLVING SUBSTANTIATION OF CHARITABLE CONTRIBUTIONS

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

A. *Schweizer v. Commissioner*, T.C. Memo. 2022-102 (October 6, 2022)

The Tax Court has ruled that a taxpayer was not entitled to deduct the value of expensive artwork donated to a museum because the taxpayer submitted a mostly incomplete Form 8283 to substantiate the claimed deduction and did not rely in good faith on the advice of a return preparer in doing so.

The taxpayer worked for Sotheby's during the year at issue (2011) as Director of African and Oceanic Art. From the time he was hired by Sotheby's 2006, the taxpayer donated works of African art to various museums. In 2011, he donated a Dogon sculpture he bought for $100,000 in 2003 to the Minneapolis Institute of Art. The taxpayer requested a "statement of value" from the IRS, to which the taxpayer attached a 1.5-page appraisal from a New York art dealer that valued the donated work at $600,000. This was the dealer's first-ever appraisal, and the dealer had no formal credentials as an appraiser.

By the time the 2011 return came due, the taxpayer had not received a reply to the request for the statement of value. So the taxpayer went forward and claimed a $600,000 deduction for the donation on his 2011 return. With this return, the taxpayer attached a Form 8323 that was missing most of the required information. Figures were reported in the wrong sections of the form, and the words "SEE ATTACHED" appeared on the line asking for a description of the donated property. Alas, there were no attachments to the form. The form contained no information as to when the property was acquired or its condition at the time of donation. The signature lines that were supposed to have been signed by the charity and the appraiser were blank. And no appraisal was attached even though the claimed deduction amount exceeded $500,000.

Ultimately, the IRS determined the sculpture was worth $250,000, so it issued a notice of deficiency. The IRS contended that the taxpayer was entitled to no deduction at all for lack of substantiation. In the alternative it claimed the amount of the deduction should be limited to $250,000. In an earlier decision, the Tax Court ruled the taxpayer failed to comply with the

substantiation requirements. Now the taxpayer argued that a deduction is nonetheless proper because there was reasonable cause for the failure to comply with the substantiation requirements. The taxpayer tried to throw his tax preparer under the bus, but the court said the taxpayer offered no evidence that the preparer gave "professional advice directed to the statutory and the regulatory reporting requirements." Yet even if the preparer had given such advice, said the court, there was no evidence the taxpayer had relied on it in good faith. The taxpayer had made three prior large donations of art in the years preceding the gift at issue, making him "clearly familiar with Form 8283 and the section 170(f)(11) reporting requirements." Finding the taxpayer's actions here "willful blindness," the court upheld the disallowance of the claimed deduction.

B. *Brooks v. Commissioner,* T.C. Memo. 2022-122, December 19, 2022

In *Brooks*, the Tax Court denied a conservation easement deduction and imposed penalties, with the taxpayers providing a roadmap of how not to get a deduction. Back in December of 2006, the taxpayers, a married couple, purchased 85 acres in Georgia for $1.35 million. One year later, after partitioning the property into two separate parcels, the taxpayers donated a conservation easement on one of the parcels to Liberty County, Georgia, reserving a number of rights, including rights:

> (1) to construct and use, with certain restrictions, two paddocks, a barn with up lighting and down lighting on its one-acre parcel, rail fencing, underground and overhead utilities, and five acres for agricultural activity; (2) to cut, burn, or remove certain plants and trees to protect or restore the natural state of the encumbered parcel; (3) to harvest timber to construct the paddocks; (4) to plant indigenous trees and shrubs; (5) to make certain modifications to encourage growth of certain native animal and insect species; (6) to maintain or replace existing road beds, paths and all other land features and structures; and (7) to use the encumbered parcel for personal enjoyment not adverse to the conservation values.

The deed required that the taxpayers would have to give the county notice before exercising any of these rights. On their federal income tax return, the taxpayers claimed a deduction of $5.1 million for the value of the donated conservation easement. The large deduction was taken over a total of six taxable years. In this case, the IRS contests the deductions claimed in the final three years, likely because these were the only years still open for assessment by the time the IRS conducted its examination.

In upholding the IRS's assessed deficiency, the Tax Court found three independent grounds for denying the taxpayers any deduction at all in connection with the conservation easement.

1. Lack of Contemporaneous Written Acknowledgment

Section 170(f)(8)(A) requires a taxpayer to substantiate a charitable contribution of $250 or more by a "contemporaneous written acknowledgment" from the charity that includes, among other things, a statement as to whether the charity provided any goods or services in consideration for the property. The taxpayers did not receive any documentation to this effect from the county, but they argue the deed itself can fulfill this requirement. In *French v. Commissioner*, T.C. Memo. 2016-53, the court held that a deed conveying property to a charity can serve as a contemporaneous written acknowledgment where the deed recites no consideration other than the preservation of the property and the deed contains a provision stating that the deed is the entire agreement of the parties. The latter provision—that the deed is the entire agreement of the parties—is often referred to as a "merger clause." As the Tax Court stated in *Averyt v. Commissioner*, T.C. Memo. 2012-198, where the deed "stipulates that the conservation deed constitutes the entire agreement between the parties with respect to the contribution of the conservation easement, … the conservation deed, taken as a whole, provides that no goods or services were received in exchange for the contribution" and thus satisfies the requirements of a contemporaneous written acknowledgment.

Here, the deed from the taxpayers states the conveyance was made "for and in consideration of the sum of ten dollars ($10.00) and other good and valuable consideration and in consideration of the covenants, mutual agreements, conditions and promises herein contained." Even the IRS agreed that this language was boilerplate that could be ignored. But the deed lacked a merger clause, which is problematic. The taxpayers argued that the lack of a merger clause should not matter, especially since the deed refers to the "donation" of the land and since there were, in fact, no additional negotiations or agreements regarding the terms or conditions of the donated easement. But the court held noted that "Proving the facts that should have been included in the [acknowledgment] cannot replace the strict substantiation requirements of section 170(f)(8). Therefore there was no contemporaneous written acknowledgement, causing the deduction to be lost.

2. Lack of Documentation Regarding Condition of the Property

Where, as in this case, the donor reserves rights that could impair the protected conservation interest, the donor must provide to the charity documentation sufficient to establish the condition of the property at the time of the gift. Treas. Reg. §1.170A-14(g)(5)(i). The taxpayers provided the county with a "Conservation Easement Baseline Documentation Report" that was attached as an exhibit to the deed. Although the document set forth some information about the property, it was not sufficient to enable the county (or the court) to determine how exercise of the reserved rights could affect the property. As the court observed:

> The deed allows for the harvesting of forests on the property but only for construction of two paddocks. The document does not describe the sizes or locations of the forests, so it would be at minimum difficult and at maximum impossible to gauge whether the amount harvested was reasonable for the

> construction of two paddocks. The deed prohibits petitioners' LLC from "[d]iking, draining, filling, dredging or removal of wetlands." The Baseline Report does not provide a map or sufficiently detailed descriptions to establish the wetlands' location, size, or limits at or near the time of the gift, so it would be difficult to impossible to identify any change. The property owners may maintain or replace existing roads, but without knowing the location of the access roads at the time of the donation, it is difficult or impossible to prove whether a new road replaces an old one. The requirement that the property owner alert Liberty County to any exercise of the reserved rights is insufficient; it relies on the property owner to police itself when it is precisely their actions which the baseline requirement is intended to police.

Because of these deficiencies, the court found that the taxpayers did not comply with the requirement to supply sufficient documentation, a separate ground for disallowing the deduction.

3. Error in Reporting Basis on Appraisal Summary

Because the taxpayers claimed a deduction of more than $5,000, they had to attach an appraisal summary to their return that included certain information, including the cost basis of the acquired property and its acquisition date. Recall, though, that the taxpayers partitioned the property into two parcels and donated an easement only on one of the parcels. Rather than report the basis in the one parcel to which the easement applies (the basis in 40 acres), the taxpayers reported their entire $1.35 million purchase price (the basis in the original 80 acres). The IRS argued that by reporting a cost basis of double the amount of the actual basis, the taxpayers defeat the purpose of the reporting requirement and thus should get no deduction at all.

The Tax Court agreed, finding "Congress specifically passed [the] heightened substantiation requirements to prevent the Commissioner from having to sleuth through the footnotes of millions of returns. We cannot find that, in reporting roughly twice the accurate cost basis, petitioners substantially complied with [the statute]. Accordingly, petitioners failed to meet the requirements of Treasury Regulation §1.170A-13(c)(2)(i), and this is also a basis on which the deduction must be disallowed."

4. Gross Valuation Misstatement Penalty Applies

But wait, there's more! A 40-percent understatement penalty applies where the value of a deduction claimed on a tax return is 200 percent or more of the correct value. Since the taxpayers claimed a deduction of $5.1 million, this means the penalty should apply if the value of the easement exceeds $2.55 million. At trial, the taxpayers claimed the value of the easement at the time of donation was $3.63 million, but the IRS argued it was only worth $470,000. The court found the reasoning of the IRS's expert to be correct and complete. It thus upheld the $470,000 valuation and the imposition of the penalty.

5. Lessons from the Case

This case offers a number of important lessons to prospective donors. First, do not rely on a deed or any other donor-prepared documentation to serve as the contemporaneous written acknowledgment; get the document from the charity. Second, when reserving rights over a donated conservation easement, make sure to provide all of the information set forth in the regulations regarding the condition of the property. Finally, don't get cute when it comes to reporting basis or any other number on an appraisal summary (or on a return, for that matter). Truthful transparency is the ticket to a deduction.

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

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

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

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

was clear to the court that the letter had been prepared by Meyer because of his drafting habit of inserting client-specific terms into form documents using bold print.

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

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

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

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

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

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

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

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

In order to deduct a donation of property worth more than $5,000, a taxpayer must obtain a qualified appraisal of the property, attached a completed "appraisal summary" to the taxpayer's federal income tax return, and maintain other records containing certain information about the donated property. See Reg. §1.170A-13(c)(2). In determining whether the value of donated property exceeds the $5,000 threshold, all "similar items of property" donated to one or more charities is treated as one property. IRC §170(f)(11)(F); Reg. §1.170A-13(c)(1)(i). Regulations define "similar items of property" as "property of the same generic category or type, such as … paintings, photographs, books, … clothing, jewelry, furniture, electronic equipment, household appliances, toys, [and] everyday kitchenware." Reg. §1.1.70A-13(c)(7)(iii). While the taxpayer in this case submitted two partially completed Forms 8283 (Noncash Charitable Contributions), he did not obtain an appraisal and did not attach appraisal summaries for the donated items to his 2017 tax return.

The taxpayer argued that because the donated items on any one receipt did not exceed $250 in value, no appraisal was required, but the court concluded that the donated clothing items were all "similar items of property" claimed to have an aggregate value of more than $20,000. Because there was no appraisal, the taxpayer was not entitled to a deduction for the clothing. The court did allow the taxpayer to deduct various nonclothing items donated to Goodwill and Salvation Army, however, because those items were not similar items of property and, thus, did not require an appraisal since none of them had a claimed value in excess of $5,000.

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

In *Murphy*, the Tax Court held that while the taxpayers failed to comply with applicable substantiation requirements in connection with their contribution of a conservation easement,

they were excused from compliance for reasonable cause. The court upheld the donations as "qualified conservation contributions" but determined that the value of the donations was less than the value claimed by the taxpayers on their income tax returns.

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

1. Conservation Purpose

The IRS argued that the easements were not used "exclusively for conservation purposes" and thus were not "qualified conservation contributions" as defined in the Code. See IRC §§170(f)(3); 170(h)(1)(C). The deed for one of the easements stated the intended conservation purpose of the donation was "Preservation of … a relatively natural habitat," and the deed for the other easement stated the intended purpose was "preservation … for outdoor recreation." The taxpayers claimed that other conservation purposes could also be considered by the court, but the court, citing precedent, determined that only those purposes set forth in the deed are considered in determining whether the easements are exclusively for conservation purposes.

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

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

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

2. Substantiation

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

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

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

But if the failure to comply with substantiation requirements was "due to reasonable cause and not willful neglect," a deduction may still be allowed. IRC §170(f)(11)(A)(ii)(II). Because the IRS did not raise the Form 8283 issue until after the deficiency notices were sent, the IRS bears the burden of proving that the failure of the taxpayers to report their basis in the subject lands on the Forms 8283 was not due to reasonable cause. The Tax Court held the IRS did not satisfy this burden. The evidence showed that the taxpayers relied on "a well-known CPA firm with a good reputation" to prepare the required returns and that the taxpayers supplied the firm with all of the information it requested in order to prepare and submit the returns on behalf of the taxpayers. The IRS argued the taxpayers declined to provide information about basis to the return preparers, but the court said "[t]he cited evidence does not make this showing." *Id.* at 36. As the court observed:

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

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

3. Valuation of the Easements

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

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

4. The Other Case

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

It appears the only reason *Murfam Enterprises* was not consolidated with the *Murphy* case was because of the different result with respect to the penalty. In both cases, the taxpayer got lucky that the IRS did not challenge the validity of the deduction before issuing the notice of

deficiency. Had the burden of proof been on the taxpayers, precedent suggests their deductions very likely would have been disallowed.

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

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

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

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

1. Consideration Received in a Bargain Sale

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

2. Contemporaneous Written Acknowledgment

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

3. Substantial Valuation Misstatement Penalty

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

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

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

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

The taxpayer lost his job in 2017. That year, he withdrew $19,365 from his 401(k) account. The taxpayer reported the distribution on his 2017 federal income tax return but included no portion of the distribution in his gross income. The distribution was fully includible in gross income. What's worse, because the taxpayer had not yet attained age 59-1/2, this taxable distribution was subject to a ten-percent penalty tax under §72(t). The taxpayer timely petitioned to challenge the IRS's assessed deficiency.

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

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

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

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

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

> Anne and I have agreed that we want to put 3.5MM in the fund, but I would rather wait as long as possible to pull the trigger. If we do it and the sale does

> not go through, I guess my brothers could own more stock than I and I am not sure if it can be reversed.

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

A signed letter of understanding in connection with a proposed donation of shares was provided to Fidelity on June 1, 2015, but it did not indicate the number of shares that would be transferred to the donor advised fund. The letter specifically provided that "No contribution is complete until formally accepted by Fidelity Charitable." In an email to his estate planning attorney the same day, Scott asked that a corporate consent resolution authorizing the transfer be prepared but that "I do not want to transfer the stock until we are 99% sure we are closing." The consent resolution was approved and signed on June 11, 2015, but the resolution left the specific number of shares to be donated blank.

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

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

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

A. When Did the Gift Happen?

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

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

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

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

B. Assignment of Income

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

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

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

> We echo prior decisions in recognizing that our holding does not specify a bright line for donors to stop short of in structuring charitable contributions of appreciated stock before a sale. … However, as petitioners’ tax counsel seems to have recognized in her advice to petitioner, “any tax lawyer worth [her] fees would not have recommended that a donor make a gift of appreciated stock” so close to the closing of a sale. … By July 13, 2015, the transaction … had simply “proceeded too far down the road to enable petitioners to escape taxation on the gain attributable to the donated shares.”

C. Problems with the Charitable Contribution Deduction

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

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

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

But the court agreed with the IRS that the appraisal obtained by the taxpayers was not a qualified appraisal. The IRS pointed to no less than eight flaws in the valuation report, including the use of an incorrect date of contribution, an insufficient description of the valuation methods used, a failure to state the appraiser’s qualifications, and a failure to describe the property in sufficient detail. Conceding that the appraisal had some defects, the taxpayers argued that the appraisal should be accepted under the doctrine of substantial compliance. But that doctrine does not excuse the failure to meet substantive requirements in the

substantiation regulations or the omission of entire categories of required information. In this case, said the court, the appraiser was the investment banker that helped the brothers find their buyer. While he is familiar with the type of property being valued, that does not make him a qualified appraiser. Even if he had the requisite expertise, the appraisal provided no information about his valuation experience. By omitting this information, the IRS lacked the ability to evaluate whether the appraisal was reliable.

Finally, the appraisal used a June 11, 2015, valuation date. While this is consistent with the taxpayer's claim that the gift occurred on June 11, the court observed that the period between June 11 and July 13 saw over $6 million in cash distributions and the virtual certainty of the acquisition. These events would significantly affect the value of the gifted shares, making the appraisal unhelpful in determining the value of the stock as of July 13. Thus, the appraisal could not be saved on the grounds of substantial compliance with the substantiation requirements.

D. Lessons from the Case

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

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

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

XVII. ANNUITY PAYMENTS FROM CHARITABLE REMAINDER TRUSTS ARE TAXABLE

Charitable remainder trusts are a popular strategy for deferring federal income tax on appreciated property that simultaneously yields an immediate income tax deduction for a future gift to charity. In the typical arrangement, a donor transfers appreciated property to the

trustee, and the trustee then pays either a fixed dollar amount (a so-called "charitable remainder annuity trust" or "CRAT") or a fixed percentage of the net fair market value of the trust's assets (a so-called "charitable remainder unitrust" or "CRUT") back to the donor, typically for a term of years. Upon expiration of the donor's lead interest, the remainder of the trust is paid to one or more charitable organizations, usually chosen in advance by the donor. More often than not, the trustee of a CRAT or CRUT will sell the donated property shortly after receipt in order to fund the obligation to pay the donor's retained annuity or unitrust interest. The trust itself is tax-exempt, so the sale does not immediately give rise to liability for federal income tax. Instead, recognition is deferred over the term of the retained interest, as each payment made to the donor is deemed to consist of the gain from the sale of the donated property. This deferral of income tax is an attractive feature of the charitable remainder trust, but an added benefit comes in the form of an income tax deduction for the value of the charity's remainder interest, provided certain requirements are met.

In two cases, the Tax Court has reminded taxpayers that while charitable remainder trusts may be effective in *deferring* gains for federal income tax purposes, they cannot be used to *eliminate* those gains altogether. Interestingly, the taxpayers in both cases had the same advisor, suggesting (hopefully) that this scheme has not been followed widely.

A. *Furrer v. Commissioner*, T.C. Memo. 2022-100 (September 28, 2022)

The taxpayers in this case, a married couple, are active farmers that grow corn and soybeans. In 2015, they created a CRAT under which they retained the right to payments for their joint lives. At the death of the surviving spouse, the trust assets would be split among three charities. To fund the trust, the taxpayers transferred 100,000 bushels of corn and 10,000 bushels of soybeans that they raised. Within a month, the trustee sold the crops for just over $469,000. The trustee used about 90 percent of the sale proceeds to purchase a single-premium annuity that paid about $84,000 annually to the taxpayers.

The transaction worked so well, the taxpayers formed a second CRAT in 2016, to which they sold over 111,000 bushels of corn and over 31,000 bushels of soybeans. The trustee sold these crops for about $692,000, with 90 percent of the proceeds used to purchase another annuity contract, this one paying nearly $125,000 to the taxpayers annually.

The taxpayers did not include the annuity payments in gross income, concluding that the payments represented a nontaxable return of corpus. But they also did not claim a deduction for the contribution of the crops to the CRATs. When the IRS determined that the annuity payments were taxable, the taxpayers took the position that the donations to the CRATs should have been deducted as charitable contributions. But the taxpayers never secured an appraisal of the crops, and nothing was attached to any of their returns to substantiate the charitable gifts. For lack of adequate substantiation, then, the claim for the income tax deduction was denied.

The Tax Court went on to observe that even if the taxpayers had substantiated their contributions, their deductions would be limited to basis (zero) since they transferred ordinary income property to the trusts. The crops are inventory to the farmer-taxpayers, and §170(e)(1) limits the charitable deduction for inventory to basis. Since their basis in the crops was zero (they had expensed all of the costs of growing the crops), the deduction was likewise limited to zero.

This conclusion likewise impacts the taxation of the payments received by the taxpayers from the trustee. The trust had a zero basis in those crops as well, so the payments received by the trustee would be fully taxable as ordinary income when paid to the taxpayers. The taxpayers argued that they "sold" the crops to the trusts, but the Tax Court didn't buy it. They also argued that because each CRAT was tax-exempt, the distributions from each CRAT were also tax-exempt. As the court noted, "Petitioners cite no legal authority to support their position, and there is none." The taxpayers made a final argument that results would be different under the annuity rules of §72, but the court summarily rejected the claim, noting that even under §72 the crops would have a zero basis making all payments to the taxpayers fully taxable.

B. *Gerhardt v. Commissioner*, 160 T.C. No. 9 (April 20, 2023)

This case was a consolidation of four separate cases involving related taxpayers. While the exact numbers varied in each case, they all contained very similar fact patterns. In each case, the individual taxpayer or a married couple contributed one or more appreciated assets to a newly-formed charitable remainder annuity trust created by the individual or couple. The trust immediately sold the assets and used the proceeds to purchase annuity contracts, designating the grantor as the beneficiary. In each case, the taxpayer took the position that the payments received under the annuity contracts were exempt from federal income tax. Consistent with *Furrer*, however, the Tax Court rejected this argument, finding the payments were fully taxable and upholding assessed penalties after concluding the taxpayers lacked reasonable cause for their reporting positions.

In these cases, the CRATs created by the donors late in 2015 sold the contributed properties shortly following receipt. Each sale resulted in a realized gain that, due to depreciation recapture under IRC §1245, had the character of ordinary income. For the taxable years at issue in the case (2016 and 2017), the trustee made the required annuity payments but the taxpayers did not include them in gross income. In their brief to the Tax Court, they argued that any gains realized by a charitable trust from the sale of donated property "disappear and the full amount of the proceeds [is] converted to principal to be invested by the CRAT." But the Tax Court rejected this position: "The gain disappearing act the Gerhardts attribute to the CRATs is worthy of a Penn and Teller magic show. But it finds no support in the Code, regulations, or otherwise."

The court found the facts of this case eerily similar to those of *Furrer.* The court invited the taxpayers to distinguish their case from *Furrer*. "But, tellingly, their briefs fail to mention the case at all. Their silence confirms our view that the reasoning in *Furrer* applies with equal force here." Accordingly, the court had little trouble finding for the IRS in this case too.

One of the couples in this case challenged the assessment of a penalty, claiming they had reasonable cause to rely on the advice of their return preparers. They claimed the penalty should not apply because they lacked relevant legal training. The court noted that reliance on a tax professional is reasonable where (1) the professional is competent and has sufficient expertise to justify reliance, (2) the taxpayer provided necessary and accurate information to the professional, and (3) the taxpayer actually relied on the professional's judgment in good faith. Importantly, the taxpayer has the burden to prove these matters. Because the record had no information about the qualifications of their tax advisors, the nature of the taxpayers' communication with those advisors, or the quality of the advice they received, the taxpayers in this case failed to meet their burden of proof, so the reasonable cause exception to the penalty could not apply.

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

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

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

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

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

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

The IRS has ruled that taxpayers claiming charitable contribution deductions of more than $5,000 from donations of cryptocurrency must obtain qualified appraisals in order to qualify for the deductions. The IRS further ruled that a taxpayer may not rely on the value reported by a cryptocurrency exchange on which the cryptocurrency is traded in lieu of obtaining a qualified appraisal, concluding this approach would not qualify for the "reasonable cause" exception to the qualified appraisal requirement under IRC §170(f)(11)(A)(ii)(II).

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

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

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

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

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

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

> The reasonable cause exception was not intended to provide taxpayers with the choice of whether to obtain a qualified appraisal, but to provide relief where an unsuccessful attempt was made in good faith to comply with the requirements of section 170. [citations omitted] As such, claims that [the donated units had] a readily ascertainable value because it is listed on a cryptocurrency exchange does [sic] not establish reasonable cause for failing to obtain, or attempting to obtain, a qualified appraisal.

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

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

XX. ESTATE CAN MAKE SPECIAL USE VALUATION ELECTION ON LATE ESTATE TAX RETURN, AS LONG AS IT'S THE FIRST ESTATE TAX RETURN (*United States v. Parks*, E.D. Mich., November 18, 2022)

A federal district court held that an estate may make a special use valuation election under IRC §2032A on an initial federal estate tax return filed more than five years after the extended deadline.

Merle Parks's will devised almost all of his estate—including the residue—to his nephew, Ronald, with all estate taxes payable from the residue of the estate. Six weeks before his death in 2003, Merle and Ronald formed a limited liability company to which Merle contributed three parcels of Michigan farmland. Following Merle's death, Ronald, as Merle's executor, obtained an extension until December, 2004, to file an estate tax return. Although the estate made a prepayment of estate taxes to the tune of nearly $334,000, the estate failed to file an estate tax return until February, 2010, more than five years after the extended deadline. That very late return made a special use valuation election under IRC §2032A in connection with the farmland owned at Merle's death by the LLC, but the IRS rejected the election because the estate tax return was not timely filed. The IRS thus send a deficiency notice to the estate in 2012 that included a late filing penalty. Having been unable to collect on the deficiency, the United States commenced this action against the estate and Ronald.

Both parties filed motions for summary judgment raising the same issue; namely, whether a special use valuation election under IRC §2032A may be made for the first time on an estate tax return that is filed more than five years after the extended deadline.

Under IRC §2032A, an estate may elect to value real property used for farming or another trade or business for estate tax purposes at its "actual use" at the time of the decedent's death instead of the property's "highest and best use," provided the property passes to certain relatives who put the property to the same use for ten years following the decedent's death. IRC §2032A(d)(1) states that a special use valuation election shall be made on the federal estate tax return "in such manner as the Secretary shall by regulations prescribe." In enacting this provision regarding the method of making the election, the House Ways and Means Committee explained in its report that "the election is permitted to be made on a late return, if that return is the first estate tax return filed by the estate." H.R. Rep. No. 97-201, 171 (1981). Regulation §22.0(b), promulgated in 1981, reflects this intent, providing that "the election shall be valid even if the estate tax return is not timely filed." But in 1997, Treasury promulgated Regulation §301.9100-2(a)(1), which provides an automatic 12-month extension of time to make certain regulatory elections, including §2032A elections.

So how does the 1997 regulation affect the 1981 regulation? According to the government in its motion for summary judgment, the 1997 regulation supersedes the 1981 regulation, meaning the estate had to file its estate tax return making the IRC §2032A election no later than 12 months after the extended deadline. But in its own motion for summary judgment, the estate argues that Regulation §301.9100-2(a)(1) applies only when a first-filed estate tax return fails to make a special use valuation election, in which case the estate may still make such an election provided not more than 12 months have passed since the estate tax return's due date.

The court sided with the estate. It observed that nothing in the 1997 regulation or its preamble makes any reference to the 1981 regulation, while the 1997 regulation does specifically reference other regulations that are "removed" as a result of the 1997 regulation. The court also noted that the two regulations are not mutually exclusive, as the estate's argument makes clear.

The government argued in the alternative that the estate's interpretation renders the deadline essentially meaningless since an election could be made "many years or decades—even centuries—late." It argued that the court should not embrace an interpretation that would lead to such an "absurd result." But the court noted that two examples contained in the 1997 regulation expressly allow the taxpayer to make elections on late returns. Because the estate's interpretation adequately harmonizes the two regulations, ruled the court, the estate's interpretation prevails.

While one can sympathize with the IRS hoping to establish some final deadline for special use valuation elections, the court gets the decision right as a matter of regulatory interpretation. The court offers a helpful summary of how to approach the various authorities:

• Section 20.2032A-8(a)(3) first set the time, or "due date," for making an election under § 2032A, stating that the election "is made by attaching [the election] to a *timely filed* estate tax return" – which is nine months after decedent's death (or with a six-month extension). The parties agree on this.

• Section 22.0(b) next expressly modified § 20.2043A-8(a)(3) and amended that "due date" by stating that "the election shall be valid even if the estate tax return is not timely filed," thereby extending the "due date" for the election to the date the estate tax return is first filed, "even if" it is filed late.

. . .

• Section 301.9100-2 then separately provides that a taxpayer is automatically entitled to a 12-month *extension* of time to make a special use election under § 2032A(d)(1) "from the due date for making" that election "where the Internal Revenue Service (IRS) has not yet begun an examination of the *filed* return," which permits a taxpayer to take corrective action to make an election, within 12 months of the due date of a return, when he initially files a tax return without making an election.

(Emphasis in original.)

XXI. CASES INVOLVING LATE PETITIONS TO THE TAX COURT

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

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

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

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

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

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

The taxpayers did not qualify for the "timely mailing is timely filing" rule of IRC §7502(a) because their petition was not delivered by the United States Postal Service or any other approved delivery service. Thus the time of actual receipt determines the time of filing. The court justified this conclusion by noting, first, that the Tax Court's website states in bold print that "**The Court must receive your electronically filled Petition no later than 11:59 pm Eastern Time on the last date to file.**" In addition, this conclusion is consistent with Rule 6(a)(4) of the Federal Rules of Civil Procedure which provides that the deadline for electronic filing ends "at midnight in court's time zone." Finally, the court cited precedents from other federal courts that applied the same principle that electronic filing deadlines are governed by the court's local time zone.

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

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

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

The taxpayer received a notice of deficiency that stated the last day for filing a petition with the Tax Court was December 12, 2022. At 9:59 pm the evening of December 12, the taxpayer downloaded the PDF forms to his Android mobile phone, but he was unable to complete the

forms on his phone. Later, between 11:03 pm and 11:44 pm, the taxpayer made several attempts to upload the documents from his phone to the Tax Court's electronic filing system. He finally switched to his personal computer just before midnight, logging in at 11:57 pm. The filing system logs show that the taxpayer began uploading his petition nine seconds after midnight and that the filing was complete eleven seconds after midnight.

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

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

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

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

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

> Indeed, Congress reinforced the notion that section 6213(a) is jurisdictional in 2021 when it enacted section 7451(b), which extends the deadline for filing a petition when a filing location is inaccessible or otherwise unavailable to the general public. When adding this provision, Congress clearly viewed the *timely* filing of a petition as a prerequisite to the Court's jurisdiction, stating in the effective date provision: "The amendments made by this section shall apply to petitions *required* to be timely filed (determined without regard to the amendments made by this section) after the date of enactment of this Act." Infrastructure Investment and Jobs Act § 80503(c) (emphasis added). Notably,

> Congress made this provision applicable only to petitions, and not to documents that lack the jurisdictional significance of petitions.

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

C. But the Third Circuit Says Tax Court Can Still Consider Late Petitions (*Culp v. Commissioner,* 160 T.C. No. 16, June 20, 2023)

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

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

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

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

The taxpayers then argued that if the deadline in IRC §6213(a) is not jurisdictional, the 90-day time limit is presumptively subject to the doctrine of equitable tolling. This doctrine essentially

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

The court's opinion ends with a succinct summary:

> Missing a statutory filing deadline is never ideal for the filer. But the specific consequence for doing so depends on the legislature's intent. If the statute clearly expresses the deadline is jurisdictional, the filer's tardiness deprives a court of the power to hear the case. Without a clear statement, courts will treat a filing period to be a claims-processing rule that is presumptively subject to equitable tolling. Because we discern no clear statement that §6213(a)'s deadline is jurisdictional, we hold it is not. And because the presumption that nonjurisdictional time limits are subject to equitable tolling has not been rebutted here, we hold it may be tolled. We thus reverse the Tax Court's dismissal for lack of jurisdiction and remand for that Court to determine whether the Culps are entitled to equitable tolling.

D. Observations

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

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

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

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

The taxpayers originally reported their pension and IRA distributions as gross income on their 2017 joint federal income tax return. In 2020, they filed an amended return in which they claimed a deduction for the amounts paid to Anderson as "fictious invoices, fake attorneys' fees, and other fraudulent mechanisms." When the IRS rejected the amended return, the taxpayers brought this refund action. But the court granted summary judgment to the IRS. Although the facts give rise to a theft loss, it is well accepted that a theft loss occurs in the year the theft is discovered. In this case, discovery was in 2019, which is most unfortunate. Under IRC §165(h)(5), the deduction for theft losses is suspended for the tax years 2018 – 2025. The taxpayers therefore cannot deduct the amounts paid to Anderson as a theft loss.

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

the taxpayers, and since they had control over these funds, they did enjoy the benefit of them, however briefly.

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

The court summarizes the case aptly:

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

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

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

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

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

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

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

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

regulations, then, the IRS hopes to validate its position that certain "captive" insurance arrangements are abusive.

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

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

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

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

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

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

In November of that year, the couple gave one share of Class A voting stock to their two children as tenants in common. On the same day, they transferred all of their Class B nonvoting shares to five trusts, one for each grandchild. The couple effectively split the gift among their grandchildren *per stirpes*, so the trusts for the three issue of their son each received a 15.57 percent interest while the trusts for the two issue of their daughter each received a 23.36 percent interest. On their federal gift tax returns, where they elected to split gifts, the couple

each reported total gifts of over $10.4 million. The IRS challenged the valuation and determined a combined deficiency of over $13 million, bringing us to the Tax Court for resolution.

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

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

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

The court also rejected the "guideline public company" valuation method used by the taxpayers' second expert since it only used one comparable. It likewise lacked confidence in that expert's use of the "capitalization of net cashflow" method as the expert used financial statements from the height of the Great Recession (including the statements from the one year in its 70-year history that the property generated a loss) without adjustment.

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

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

The court rejected the 2-percent "lack of voting control" discount claimed by the taxpayers' second expert since it relied on data that was too old and ignored the fact that the nonvoting

shares in fact had limited voting rights on some matters. Differences in the voting rights are already reflected in the minority interest discount.

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

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

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

> Now given that each side's experts … totally agree that tax affecting should be taken into account to valuer the subject stock, and experts on both sides agree on the specific method that we should employ to take that principle into account, we conclude that the circumstances of this case require our application of tax affecting.

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

Consider yourself on notice.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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 IRC §61(a)(11). But not all forms of COD income are taxed. Section 108 lists a number of ways in which some COD income can be excluded from gross income, including where the discharge arises in a bankruptcy proceeding or occurs while the taxpayer is insolvent. Though the tax treatment of debt is a fundamental concept, it continues to raise difficult issues, as illustrated in these cases.

A. RELIEF FROM NONRECOURSE DEBT UPON SALE OF PROPERTY IS NOT C.O.D. INCOME, IT'S PART OF THE AMOUNT REALIZED (*Parker v. Commissioner*, T.C. Memo. 2023-104, August 10, 2023)

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

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

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

It is well accepted—even if not entirely supported among commentators—that the amount of any debt, whether recourse or nonrecourse, is included in the amount realized from the sale or other disposition of property encumbered by the debt. *Commissioner v. Tufts*, 461 U.S. 300 (1983); *Crane v. Commissioner*, 331 U.S. 1 (1947). The debt relief is seen as part of the sale

proceeds, and not as COD income that is eligible for potential exclusion under IRC §108(a). As the court here noted: "If nonrecourse debt is conditioned upon a sale or exchange of property or is otherwise a part of that underlying sale or exchange, the amount of debt relief is properly included in the amount realized and is not COD income." Quite clearly, the loans in this case were either assumed by the buyers or terminated by the lender as part of the sale of the property.

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

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

B. DISREGARDED ENTITY'S C.O.D. INCOME IS REPORTABLE BY OWNER (*Jacobowitz v. Commissioner*, T.C. Memo. 2023-107, August 16, 2023)

The Tax Court has held that the COD income of a taxpayer's single-member limited liability company was gross income to the taxpayer, despite increasingly desperate arguments from the taxpayer to the contrary. The taxpayer was the sole member of a limited liability company created in 2003. In 2006, the entity obtained a line of credit with a local bank, secured by the entity's business assets. The entity drew on the account over the next few years. The entity last made a payment on the line of credit in 2010. In 2017, the bank sent the entity a Form 1099-C, Cancellation of Debt. The form indicated that, as of December 30, 2016, the bank had discharged the total principal balance owed, together with accrued interest. This amounted to nearly $35,000. The form also indicated that the reason for the discharge was "Statute of limitations or expiration of deficiency period." When the taxpayer did not include this amount in gross income, the IRS determined a deficiency.

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

so. Under the default rules, then, the entity is disregarded, meaning the entity's COD income is taxable to the taxpayer.

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

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

XXIX. TRUSTEE OF DECEDENT'S LIVING TRUST LACKS AUTHORITY TO ACT FOR DECEDENT IN DEFICIENCY PROCEEDINGS (*Sander v. Commissioner*, T.C. Memo. 2022-103, October 6, 2022)

The Tax Court has held that a co-trustee of a decedent's living trust did not have the authority to represent the decedent in connection with a federal income tax deficiency, though it did give the co-trustee six months to commence probate and seek appointment as the decedent's personal representative. If successful, the co-trustee would then have authority to act in the decedent's stead.

Sandra Sander's revocable living trust named Sandra and her daughter, Leda, as co-trustees. Sandra died on America's 240th birthday, July 4, 2016. Eleven days later, the IRS mailed a deficiency notice to Sandra based on its examination of her federal income tax returns from 2013 and 2014. The deficiencies included accuracy-related penalties for both years. On October

17, 2016, Leda filed a petition for redetermination on Sandra's behalf in Tax Court, advising the court of Sandra's death. The following April, Leda moved to substitute parties such that Sandra's trust would be substituted as the petitioner in the case. The IRS responded five days later with a motion to dismiss, arguing the petition was not filed by Sandra's personal representative or some other fiduciary acting on Sandra's behalf.

The Tax Court reasoned that the case turns on whether Leda was authorized to file a petition on Sandra's behalf. The court observed that no personal representative has been appointed for Sandra's estate (in over six years!), and under applicable state law (Florida), a person only becomes personal representative pursuant to a court appointment. Since no personal representative has been appointed, no one—not even Leda—can serve as the new party in Sandra's stead.

Leda argued that a Florida statute gave her authority to act for her mother's estate in the subject litigation. The statute, Fla. Stat. §736.0816(23) authorizes a trustee to "Prosecute or defend, including appeals, an action, claim, or judicial proceeding in any jurisdiction to protect trust property or the trustee in the performance of the trustee's duties." But, as the court noted, "'trust property' is not directly involved in this case. This case involves the redetermination of the income tax deficiencies of Sandra. … To then collect [additional tax] from the Sandra E. Sander Lifetime Trust, the IRS would need to invoke transferee liability concepts and show that the … Trust is liable transferee of Sandra." But that only means the trust is secondarily liable, and that does not give the trustee of the trust any special power to stand in for the decedent.

Though the court determined that Leda's status as trustee of Sandra's living trust did not give her the proper status to act on Sandra's behalf in the income tax deficiency matter, it agreed to defer ruling on the IRS's motion to dismiss for six months. If Leda can commence a probate action and get appointed as Sandra's personal representative, she will then have the power to act on Sandra's behalf.

The facts giving rise to the case arose in 2016 and 2017, yet the Tax Court only now, in 2022, decides the merits of the IRS's motion to dismiss. The wheels of justice turn slowly, so much so that describing the court's delay as slothful insults sloths.

XXX. REFUND CLAIM BELONGS TO LLC, NOT TO TRUST THAT OWNS MOST OF THE LLC (*Richard J. O'Neill Trust v. Commissioner*, T.C. Memo. 2022-108, October 27, 2022)

The Tax Court has held that a trust was not entitled to a refund of federal income tax attributable to its reported share of income from a so-called "*Graegin* loan" transaction between the settlor's estate and an LLC in which the trust held a super-majority interest. The case is a helpful reminder that refund claims in connection with the income of an entity taxed as a partnership must be made by the partnership and not by one of its partners.

Because the case involves a *Graegin* loan, some background on the technique will provide context. Estates with illiquid assets need cash to pay estate taxes soon after death, but selling assets in a hurry may not bring top value. In some cases, executors use a *Graegin* loan under which the estate borrows money from the decedent's closely held business or other related party. This is often better than borrowing money from a bank, for the loans can be structured in a favorable way that serves to reduce estate tax liability by deducting the interest payments made over the term of the loan.

Section 2053 allows a deduction of expenses that are “actually and necessarily” incurred in the administration of the estate. In *Estate of Graegin v. Commissioner*, T.C. Memo. 1988-477, the Tax Court held that a loan is “actually and necessarily” incurred if a majority of the estate assets are illiquid and the borrowing is necessary to avoid a forced sale of those assets to pay estate tax. The estate even gets to deduct interest that has not yet been paid as long as the amount of interest is both ascertainable with reasonable certainty and certain to be paid. It is this deduction for unpaid future interest that wags the dog.

The Richard J. O’Neill Trust was formed as a revocable living trust in 1968. It became irrevocable upon the death of its settlor in 2009. At the time of the settlor’s death, the trust owned an 86-percent interest in a limited liability company. The settlors’ estate borrowed money from the LLC in the form of a *Graegin* loan under which the estate paid interest at the rate of nine percent. The trust reported its proportionate share of the interest paid by the estate to the LLC.

In 2015, the estate and the IRS reached a settlement with respect to federal estate taxes under which: (1) the value of the decedent’s interest in the LLC was increased by $10 million; and (2) the estate’s §2053 deduction for the interest payable to the LLC was limited to six percent instead of nine percent. On the basis of this settlement, the trust filed a claim for refund for federal income taxes paid in the 2014 taxable year based on the overpayment of income tax paid by the trust in 2009 and 2010. The trust based its refund claim on §1341, the mitigation provisions of the statute of limitations, and the doctrine of equitable recoupment.

Section 1341 allows a taxpayer the benefit of a deduction or credit in situations where the taxpayer previously included an item of income under a claim of right but it is later determined that the taxpayer did not in fact have an unrestricted right to that item. The trust argued that it previously included its share of the LLC’s interest income in 2009 and 2010 and, in 2015, it was established that the LLC was not entitled to as much interest income as it reported. Therefore, said the taxpayer, §1341 applies to give the trust either a deduction or a refund on its 2014 tax return.

The Tax Court held that §1341 did not apply in this case, for two reasons. First, the trust was not the appropriate party to make this claim. Instead, the LLC was the taxpayer eligible to make the claim, as the interest income belonged to the LLC. The trust paid tax on the trust’s share of the LLC’s income, but the income was still that of the partnership and not the trust. Importantly, the LLC never filed an amended return for 2009 or 2010, and it did not apply for §1341 relief. Second, and more important, the IRS’s determination limiting the amount of the

estate's deduction did not affect the LLC's right to the interest income reported for those two years. At all relevant times, the LLC has an unrestricted right to the interest income it received. Since there has not been a determination that the LLC was not entitled to the income, §1341 cannot apply.

The trust also argued that the mitigation provisions of §§ 1311 through 1314 entitled it to a refund for 2014. Sections 1311 – 1314 generally allow a taxpayer in limited circumstances to claim a refund with respect to a year that is now closed by the applicable statute of limitations. But the Tax Court rejected this argument to, noting that:

> As with the claim of right, the mitigation provisions require that the refund claim be filed with respect to a specific year. See §1314(b). Because the trust is claiming it overpaid for the 2009 and 2010 tax years, it should have filed a refund claim for those years. Instead its claim is for the 2014 tax year. As with the claim of right argument, this procedural defect is fatal to the trust's position.

Equitable recoupment is a common law remedy used "where the Government has taxed a single transaction, item, or taxable event under two inconsistent theories." *United States v. Dalm*, 494 U.S. 596, 605 n. 5 (1990). The Tax Court has previously explained that a claim for equitable recoupment requires proof that: (1) the taxpayer's refund claim is now barred by the statute of limitations; (2) the time-barred offset arises from the same transaction or event as the overpayment of deficiency at issue in the present case; (3) the same transaction or event has been inconsistently taxed twice; and (4) where the transaction or event involves more than one taxpayer, the multiple taxpayers have sufficient identity of interest that they should be treated as one. *Estate of Branson v. Commissioner*, 113 T.C. 6, 15 (1999).

The Tax Court held that the doctrine of equitable recoupment did not apply here because the deficiency upon which the trust bases its claim for recoupment arises from the estate's liability for estate taxes, not the trust's liability for income tax. Moreover, said the court, the denial of a refund under §1341 is not inconsistent with the trust's income tax liability for 2009 and 2010. As the court concludes, "The liabilities for 2009 and 2010 have no transactional connection with respondent's denial under the claim of right."

Because 2009 and 2010 were "closed years" by the time the settlors' estate reached a settlement with the IRS over estate taxes, the trust was limited in its options for pursuing a refund of the income tax paid on interest that, ultimately, the settlor's estate was not allowed to deduct. If the LLC is forced to reimburse the settlor's estate for the extra interest paid, the case for the trust could be more compelling. But in fact the LLC voluntarily renegotiated the terms of the note payable from the estate to reflect the reduced deduction amount allowed to the estate. That will affect the amount of income received by the LLC (and thus reportable by the trust) going forward, but it does not affect the LLC's right to the income it received in the earlier, closed years.

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

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

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

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

XXXII. 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 short-term capital gain of only $42,069. The IRS examined the return, and when the taxpayer did not supply records to prove how he computed the gain, the revenue agent used records received from the virtual currency exchanges to reconstruct the various sale transactions. That led to the determination that the taxpayer had the following net short-term gains and losses:

Year	Net Short-Term

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

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

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

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

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

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

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

The Tax Court has held that a gift made in 2007 was adequately disclosed on a 2006 federal gift tax return included as part of an Offshore Voluntary Disclosure Program (OVDP) packet, thus

precluding the IRS from assessing a deficiency because the applicable statute of limitations had expired.

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

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

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

The IRS also argued that the disclosure was inadequate since the offshore entity statement only mentioned a gift transfer to his mother and made no mention of his aunt or uncle as sharing in the gift made to the mother. But the Tax Court ruled there was substantial compliance with the requirement to identify all gift transfers since the disclosure did mention the gift of stock. The

identity and relationship of each donee, said the court, is “not essential to the overall purpose of the (disclosure) requirement, which was to provide the IRS with enough information to understand the nature of the transfer.” That the statement suggested a single gift to one recipient as opposed to a gift split between three recipients “does not make a meaningful difference in understanding the nature of the transfer.”

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

getting to the flashy stuff, so too must we first master the fundamentals of deferred compensation and the accrual method before looking at what happened in the case.

A. Background on the Matching Rule for Nonqualified Plans

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

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

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

Given all of the restrictions and limitations applicable to qualified plans, employers prefer nonqualified deferred compensation arrangements. To incentivize qualified plans, therefore, the Code imposes a "matching rule" under IRC §404(a). Under this rule, generally, contributions to a nonqualified plan are not deductible by the employer until the employee includes those amounts in gross income. In that way, the timing of the employer's deduction "matches" the timing of the employee's inclusion in gross income. By contrast, contributions to a qualified plan are deductible when paid to the trust, even though the employee will not have gross income until a later taxable year. The offer of an earlier deduction is the carrot given to the employer to create a qualified plan that will provide retirement savings for more employees.

B. Background on the Economic Performance Requirement

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

The statute sets forth several rules for determining when economic performance of a liability occurs and authorizes the IRS to issue regulations explaining when economic performance occurs in situations not expressly addressed in the statute. IRC §461(h)(2)(D). In the context of deferred compensation arrangements, regulations issued in 1992 provide that "the economic performance requirement is satisfied to the extent that any amount is otherwise deductible under section 404 (employer contributions to a plan of deferred compensation)." Reg. §1.461-4(d)(2)(iii)(A). This language indicates that "economic performance" of the liability to pay deferred compensation follows the matching rule of §404(a). In other words, an accrual method taxpayer does not deduct amounts contributed to a nonqualified plan until the employee includes them in gross income.

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

C. Facts of the Case

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

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

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

About a month after filing its return, however, Hoops filed an amended return in which it claimed a deduction for the $10.68 million present value of the deferred compensation liability.

Hoops based this deduction on another provision in the economic performance regulations. Regulation §1.461-4(d)(5)(i) states in relevant part:

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

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

D. The Tax Court Played Referee

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

Hoops argued the call, claiming that if it cannot claim a deduction on the 2012 return it will never get a deduction for the deferred compensation liability, leading to what Hoops called "the ridiculous result" of recognizing income with no corresponding deduction. But the Tax Court, citing the Ninth Circuit's decision in Albertson's, Inc. v. Commissioner, 42 F.3d 537 (9th Cir. 1994), found that "in the light of Congress' intent to deviate from the clear reflection of income principle and to ensure matching of income inclusion and deduction between employee and employer under nonqualified plans, we conclude that disallowing a deduction for the year of sale would not lead to a 'ridiculous result.' To the contrary, under the facts of this case, such a result comports with the purpose of section 404."

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

E. Upon Review, The Ruling Stands as Called

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Neither party comes out looking especially well in this case.

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

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

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

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

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

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

The taxpayer performs storm restoration work as an employee but spends most of his paychecks gambling at three casinos in Minnesota and Iowa. Casino records show he had net

losses of $22,375, $16,850, and $894 from the three casinos in 2019. But the taxpayer received 24 Forms W-2G for that year showing wins totaling over $110,000. Oddly, though, the taxpayer's 2019 federal income tax return, prepared with the assistance of a tax preparer, reported over $240,000 in winnings as Schedule C business profits. Against those profits, the taxpayer deducted an equal amount of expenses on the Schedule C to reduce the net profit from the gambling business to zero.

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

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

As for the losses, the only proof came from the casino records that tracked his overall losses on a monthly basis. So the court compared the Form W-2G winnings from each casino for any given month against the monthly loss shown on the casino's records to compute the minimum overall loss for that month. "For example," said the court, "his Form W-2G winnings at Mystic Lake for January totaled $8,162, but he had an overall net loss of $1,192, [so] he must have lost $9,354. … Thus, we conclude that [the taxpayer] lost at least that much at Mystic Lake in January." After adding all the monthly amounts from each of the three casinos, the court determined that the taxpayer incurred gambling losses of at least $191,756, so it allowed the taxpayer to deduct that amount against the $240,000 in reported winnings.

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

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

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

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

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

> Mr. Nath's evidence regarding the wire transfers from Cambodia was unreliable and often conflicting. He testified that he was borrowing money from [the company] and that the transfers represented advances of income from [the company]. At times, he referred to the advances as salary…. And at other times, he referred to the advances as part loan, part salary.
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> He offered various unreliable trial exhibits. Two exhibits purported to be loan agreements between Mr. Nath and [the company] for loans made in 2014 and 2016. Mr. Nath signed the agreements both on his own behalf as the borrower and on behalf of [the company] as the lender. Neither agreement is dated. They are identical except for the loan amounts and effective dates. … They require him to pay interest 'at a rate of 8% per annum' within 14 business days of receiving an annual invoice from [the company]. Mr. Nath testified that he made monthly (not annual) payments, but he did not provide any documents evidencing those payments.

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

XL. 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.

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

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

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

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

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

In the case at bar, Carl and Leila Gregory, a married couple, formed a Cayman Islands corporation to own and charter a yacht, the *Lady Leila*. For the taxable years at issue (2014 and 2015), the yacht activity generated some income but also a lot of expenses. The taxpayers deducted the expenses associated with the activity (to the extent of their income from the

activity) on Schedule C to their Forms 1040 for both years as above the line deductions. When the IRS determined that the deductions were allowable as miscellaneous itemized deductions, it resulted in a deficiency. That's because the taxpayers reported taxable income of $19.67 million in 2014 and $80.15 million for 2015. While the record does not reveal their adjusted gross incomes for those years, it is safe to conclude that two percent of adjusted gross income in each year would be so high that none of the hobby expenses would be deductible. The taxpayers ran to Tax Court, arguing their hobby deduction should be above the line, but the Tax Court ruled for the IRS. That brought this appeal to the Eleventh Circuit.

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

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

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

A concurring opinion reaches the same conclusion through a different route. The concurring opinion finds the statutory framework set forth above to be ambiguous, and thus uses the legislative history to the enactment of IRC §183 to determine congressional intent. It is hard to see the ambiguity, however. Section 62(a) specifically lists all of the above the line deductions, and it contains no reference to IRC §183. Likewise, IRC §67(b) specifically lists all of the regular itemized deductions, indicating that all other itemized deductions are miscellaneous. Here too, IRC §183 is not listed among the regular itemized deductions. How these statutes are ambiguous is, well, ambiguous.

XLII. RETALIATION SETTLEMENT PROCEEDS INCLUDIBLE IN GROSS INCOME (*Tillman-Kelly v. Commissioner*, T.C. Memo. 2022-111, November 21, 2022)

The Tax Court has held that settlement proceeds from a lawsuit alleging retaliation by the taxpayer's employer do not qualify for the IRC §104(a)(2) exclusion from gross income, as there was no evidence that the proceeds were paid on account of physical injury or physical sickness.

Section 104(a)(2) excludes from gross income any damages received on account of physical injury or physical sickness. Section 104(a) expressly provides in flush language that "emotional distress shall not be treated as a physical injury or physical sickness." Congress included this wording to reverse a line of cases holding that the exclusion applied to all tort claims because the statute used to exclude damages received on account of "personal injury or sickness." By adding the word "physical" to the statute (twice) and including the flush language provision about emotional distress, Congress made clear that only damages attributable to the a physical injury or physical sickness are eligible for the exclusion.

The taxpayer was hired by Chicago State University in 2009 to work as project director for a federal grant received by the university. Shortly after starting his employment, the taxpayer became concerned that some of the grant funds were being misappropriated, so he reported his concerns both internally to the university's ethics office and externally to the United States Department of Education. Shortly thereafter, the taxpayer was fired.

The taxpayer sued the university claiming wrongful termination, claiming his termination was in retaliation for his squealing. In his complaint he claimed to have suffered "humiliation, isolation, harsher discipline and different and comparatively more negative terms and standards of employment, [than] other university employees, denial of benefits, demotions, and, ultimately, termination." He asked for damages for "emotional distress and humiliation and lost income and benefits," just as a reader of the complaint might seek damages for comma neglect.

The case settled in 2017 when the taxpayer received $230,671 in exchange for ending the lawsuit. The settlement agreement cryptically provides that the amount paid to the taxpayer was for "alleged non-wage injuries, as non-economic emotional distress damages." The taxpayer did not include the settlement in the 2017 federal income tax return he filed with his spouse, but the university reported the payment to the IRS on a Form 1099-MISC. The IRS determined a deficiency in the taxpayer's 2017 return, leading to this case before the Tax Court.

Because the taxpayer received damages under a settlement agreement, the Tax Court first observed that "the nature of the claim that was the actual basis for the settlement controls whether the damages are excludable," citing *United States v. Burke*, 504 U.S. 229, 237 (1992). The court then concluded that because the settlement agreement expressly provided that the payment was not "emotional distress damages" and not for any physical injury or physical sickness, the exclusion did not apply in this case.

The taxpayer alleged there was a “heated altercation” with his supervisor, “which resulted in physical injury from the slamming of a door.” But the settlement agreement did not reference any physical injury, undercutting this argument. In a deposition, the taxpayer mentioned a hospital visit in 2010 in response to panic attacks, but he also admitted that the hospital sent him home because “physically there was nothing wrong” with him. Finally, in response to an interrogatory asking the taxpayer to identify the basis for any damages claimed, no mention was made of any physical injury. In short, the court concluded, “the dominant reason for the payment was to compensate for emotional distress and was altogether unrelated to physical injury.”

If there is any silver lining here for the taxpayer, at least the legal fees paid in connection with the lawsuit are deductible in computing the taxpayer’s adjusted gross income under IRC §62(a)(21). Under current law, most legal fees paid in connection with tort claims are not deductible where the deduction for such fees is a “miscellaneous itemized deduction” IRC §67(g). Only attorney fees and other costs in connection with certain discrimination and whistleblower cases are currently deductible. See IRC §62(a)(20) – (21).

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

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

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

In this case, the taxpayer was awarded a judgment in 2012 against her ex-spouse in the amount of $16,044. Of that amount, $5,362 represented the unpaid child support and the rest represented interest. The deadbeat ex-spouse was required to make payments to the State of Alabama for payment to the taxpayer. Starting later that year, the taxpayer received payments totaling $5,362 from the state’s Child Support Enforcement Division, each marked with the

code “CS NA AR.” Then, the taxpayer received additional payments coded “CP INT.” In 2015, those payments totaled $7,859. The State of Alabama filed a Form 1099-INT for 2015 reflecting interest paid to the taxpayer in the amount of $7,824 (there is no explanation for the missing $35 in the record). The taxpayer acknowledged that she received the form but she did not include this amount in her 2015 gross income because she believed the payment related to child support.

The Tax Court agreed with the IRS that the payments received in 2015 were taxable as interest income. For one thing, the taxpayer acknowledged receipt of the Form 1099-INT. In addition, the court order specified the amount of past-due child support and the amount of interest. The payment records track the amounts set forth in the court order. The taxpayer argued that the payment should be treated as additional child support because she claimed the amount past due was in fact larger than the amount awarded by the court, but the court reasoned that if this was so, “any increase in the principal would have served only to increase the amount of interest due to petitioner.” There was no evidence that the court had increased the original amount of child support awarded in the 2012 judgment. Accordingly, the Tax Court upheld the deficiency against the taxpayer.

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

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

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

Section 162(a) permits deduction of “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.” An expense is “ordinary” if the transaction giving rise to it is “of common or frequent occurrence in the type of business involved.” *Welch v. Helvering*, 290 U.S. 111, 113-14 (1933). An expense is “necessary” if it is “appropriate and helpful” in carrying on the taxpayer’s business. *Id.* at 113. In deciding whether a particular expense is ordinary and necessary, courts look for a reasonably proximate

relationship between the expense and the business. If a cost is primarily personal in nature, no deduction is allowed. *Henry v. Commissioner*, 36 T.C. 879, 884 (1961). Even where a cost qualifies as a business expense, the taxpayer must keep adequate records that substantiate the expense, and the failure to maintain and produce such records weighs heavily against a deduction. See, e.g., *Rogers v. Commissioner*, T.C. Memo. 2014-141.

The taxpayer, a lawyer with a solo litigation practice based in Denver, was heavily involved in car racing throughout the Midwest, purchasing a 2009 Dodge Viper for $102,500 that he drove in many races until his divorce, after which he "didn't have the funds to race." On the back tail of the race car was a decal for the "Avery Law Firm." The taxpayer also maintained a website for his "Viper racing team" that was linked to his law firm's Facebook page. Before the Tax Court, the taxpayer testified that he hoped his racing activity would attract auto accident victims as potential clients. As the court explained:

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

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

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

The court also found it troubling that the decal for his law firm "appeared in relatively small print on his Dodge Viper." Given the activity was one engaged in primarily for personal

enjoyment and not to advertise his law firm, then, even the substantiated expenses were not deductible.

XLV. 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."

XLVI. 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 (IR-2023-23) 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.

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

In the October 2023 term, the Supreme Court of the United States will decide *Moore v. United States*, 36 F.4th 930 (9th Cir. 2022), *reh'g denied*, 53 F.4th 507 (9th Cir. 2022), *cert. granted*, No. 22-800 (U.S. 2023). At issue in the case is the constitutionality of the "mandatory repatriation tax" ("MRT") imposed by IRC §965. The MRT, enacted as part of the 2017 Tax Cuts and Jobs Act's conversion to a "source-based" system of corporate taxation from a "worldwide" system,

was a one-time tax on United States persons owning at least 10 percent of the stock of a controlled foreign corporation ("CFC") in 2017 on the CFC's undistributed post-1986 earnings and profits. While the MRT imposed a one-time tax on what could be a huge amount of undistributed earnings, it did so at favorable rates: cash earnings were taxed at 15.5 percent and other earnings were taxed at 8 percent. While one would not think the MRT would be front and center in the minds of estate planning professionals, some commentators believe the Court's decision in the case bears close watch because it could have a profound impact on the constitutionality of a proposed wealth tax.

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

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

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

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

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

In *Glenshaw Glass*, the Court explained that the *Macomber* definition was not intended to be the exclusive test for income. In holding that punitive damages were income even though they were a windfall and not a gain from labor or from capital, the Court noted that the taxpayers had "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." From this language, some say, the Court echoed the sentiment that a benefit had to be "realized" before it could be labeled as "income" and thus subject to federal taxation without regard to apportionment among the states.

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

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

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

> there is no blanket constitutional ban on Congress disregarding the corporate form to facilitate taxation of shareholders' income. In other words, there is no

constitutional prohibition against Congress attributing a corporation's income pro-rata to its shareholders.

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

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

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

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

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

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

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

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

The custodial agreement between UBS and Caan stated that UBS would hold Caan's interest in P&A Multi-Sector Fund, L.P., a hedge fund, in one of the two IRAs it managed on Caan's behalf, but Caan had to provide UBS with a statement of the partnership interest's fair market value as of the end of the year for each year the IRA held the interest. UBS wanted this information because IRC §408(i) directs IRA custodians to report the value of non-public securities at least annually, and Caan was in the best position to know this value.

Caan failed to furnish UBS with the partnership interest's fair market value for 2014, however. UBS repeatedly asked Caan for this information in 2015, and UBS even reached out to the hedge fund for information, but UBS never received any replies. Also in 2015, Caan's advisor at UBS left the firm to join Merrill Lynch. The advisor then coaxed Caan into transferring both IRAs to Merrill Lynch, but the partnership interest could not be transferred, so the advisor ordered the hedge fund to sell Caan's interest and transfer the cash proceeds to Merrill Lynch, though that liquidation and transfer did not happen until 2016. In the meantime, UBS sent a letter to Caan in 2015 explaining that it would no longer serve as custodian of the partnership interest due to Caan's failure to supply information about the value of the fund pursuant to their

agreement. UBS followed up with a Form 1099-R reporting a distribution of the hedge fund interest.

Caan reported the distribution on his 2015 federal income tax return, but he claimed the distribution was nontaxable, apparently taking the position that the interest was successfully rolled over to the new Merrill Lynch accounts. When the IRS assessed a deficiency and an accuracy-related penalty, Caan requested a private ruling from the IRS seeking a waiver of the 60-day period for rollover contributions and also petitioned the Tax Court for review. The IRS denied the ruling request, reasoning that even if it granted a waiver of the 60-day rollover period, there would still be a problem with Caan's attempted rollover because the asset in the old account (the hedge fund interest) was not the same as the asset being placed in the new account (cash proceeds from liquidation of the interest).

Before the Tax Court, Caan's estate argued that Caan never got the partnership interest from UBS, as indicated on the Form 1099-R, but the Tax Court found the evidence in support of the claim lacked credibility. Even if Caan never received the interest directly, he was in constructive receipt of it because the evidence showed that as of November, 2015, Caan could have instructed the hedge fund to re-register the partnership interest in his name without any further action from (or approval by) UBS. He was likewise free to roll over the interest into another IRA managed by a custodian that was willing to accept it. "The presence of these options," said the Tax Court, "means that Mr. Caan had unfettered control over the P&A interest and was therefore in constructive receipt of it."

Caan's estate then argued that he successfully rolled over the partnership interest into the Merrill Lynch account, but the Tax Court found this argument went *A Bridge Too Far.* The court noted that a taxpayer must roll over the same asset in order to avoid taxation. But in this case, Caan's advisor ordered the liquidation of hedge fund interest and the transfer of cash to the new Merrill Lynch account. Besides, that transfer happened more than 60 days after UBS distributed the partnership interest to Caan. And, as if that's not enough, the hedge fund made three different transfers to Merrill Lynch even though the Code allows for only one rollover contribution in any single year. So for multiple reasons the attempted rollover was ineffective.

Caan's estate challenged UBS's claim that the partnership interest was worth $1.9 million in 2014, for this was based on the year-end value of the interest at the end of 2013. The Tax Court agreed with the estate on this count, but the estate never followed through with its own evidence as to the value at the end of 2014. Instead, the IRS argued to use the $1.5 million valuation from 2015 as proof of the 2014 value, and since the taxpayer presented no evidence as to why this value was wrong, the Tax Court adopted the value determined by the IRS. This pyrrhic victory for the estate surely left it in *Misery*.

Finally, the estate argued that the IRS improperly denied Caan's private ruling request. After holding (for the first time, apparently) that it had jurisdiction to consider a denial of a private ruling request for abuse of discretion, the Tax Court held that the IRS did not abuse its discretion here, as forgiving the 60-day deadline would do nothing to cure the other problems

with the attempted rollover, namely the fact that the asset transferred to the new account was not the same property distributed from the old account.

All in all, it was no *Honeymoon in Vegas* for Caan's estate.

XLIX. LOANS TO A THIEF DON'T NECESSARILY GENERATE A THEFT LOSS (*Johnson v. United States*, D. S.C., September 18, 2023).

A federal district court has held that the taxpayers, a married couple, could not deduct loans made to the husband's long-time friend as a theft loss as there was no evidence that the friend had, in fact, stolen the funds. The case is a reminder that a loan is not "stolen" just because it is still outstanding.

The husband became friends with John Harrison when they were teens. Starting in 2001, the taxpayers invested in real estate ventures recommended by Harrison. Early returns were positive—the couple made money on two lakefront investments made with Harrison. Based on these successes, the taxpayers made two more unsecured loans to Harrison to finance other investments. The two loans totaled $840,000. In 2015, though, Harrison pled guilty to federal bank fraud. In 2018, the couple filed amended returns for 2015 claiming that the amounts advanced to Harrison were deductible as theft losses. When the IRS disallowed the resulting refund claims, the taxpayers brought the instant action.

The district court held that the loans were not thefts. The husband had negotiated the terms of the unsecured loans and even charged Harrison a higher interest to compensate for the additional risk. Further, while the court acknowledged that Harrison was involved in a mortgage fraud scheme, there was no evidence that Harrison had stolen the amounts loaned by the taxpayers or that those amounts were in any way related to Harrison's criminal activity. Importantly, there was no evidence that Harrison made false or misleading statements to the taxpayers when the loans were made or that there was any intent to defraud the taxpayers.

The taxpayers argued that Harrison's assertion of his Fifth Amendment privilege when asked whether he made false or misleading statements to the taxpayers was proof that he provided false financial documents, but the court was unwilling to draw such an inference based on Harrison's assertion of his privilege. Being unable to offer proof of a theft, then, the taxpayers were left without a deduction for the theft loss.

If the taxpayers could prove that their loans were used to purchase certain properties that have been sold at a loss, presumably the taxpayers would be able to deduct these losses as those from a transaction entered into for profit. IRC §165(c)(2). Otherwise, if the loans are not repaid, the taxpayers can, at best, hope for a bad debt deduct under IRC §166, though that deduction will be flavored as a short-term capital loss and not as an ordinary loss.