2022 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 December, 2021, though December, 2022. 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		

C. PROPOSED REGULATION LIMITS ANTI-CLAWBACK RULE TO ADJUSTED TAXABLE GIFTS (Prop. Reg. §20,2010-1(c)(3), April 26, 2022)

A proposed regulation provides that the so-called "anti-clawback rule" does not apply to taxable gifts that are included in a decedent's gross estate. If finalized, the new rule would apply to the estates of decedents dying after April 26, 2022.

1. Background on the Scheduled Reduction of the Basic Exclusion Amount and the Clawback Concept

As explained above in Part B, the basic exclusion amount for federal wealth transfer tax purposes is set to revert from $10 million (adjusted for post-2011 inflation) to $5 million (adjusted for post-2011 inflation) in 2026. If an individual makes a large taxable gift in 2022 that utilizes most of the individual's $12.06 million basic exclusion amount, and if Congress takes no other action, will that mean that the individual must pay gift tax in 2026 on the amount in excess of the reduced basic exclusion amount applicable that year? Alternatively, will the individual's estate have to pay estate tax on that excess amount if the individual dies in 2026? The answer to both of these questions has always been "no." More precisely, the answers should be "no," but some planners worried that the statute was not entirely clear on this point.

The relevant statute, IRC §2001(g)(1), states that:

> For purposes of applying subsection (b)(2) with respect to 1 or more gifts, the rates of tax under subsection (c) in effect at the decedent's death shall, in lieu of the rates of tax in effect at the time of such gifts, be used both to compute—
> (A) the tax imposed by chapter 12 with respect to such gifts, and
> (B) the credit allowed against such tax under section 2505, including in computing—
> (i) the applicable credit amount under section 2505(a)(1), and
> (ii) the sum of the amounts allowed as a credit for all preceding periods under section 2505(a)(2).

Note that the statute says to use the *rates* of tax in effect at death rather than the *rates* in effect at the time of the gift. It does not say to use the *exemption amounts* in effect at death.

That's what led some planners to conclude that there could be "clawback," the scary-sounding term for gift or estate tax attributable to a prior taxable gift. The 2017 Tax Cuts and Jobs Act addressed this concern by enacting IRC §2001(g)(2). It says:

> (2) MODIFICATIONS TO ESTATE TAX PAYABLE TO REFLECT DIFFERENT BASIC EXCLUSION AMOUNTS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out this section with respect to any difference between—
> (A) the basic exclusion amount under section 2010(c)(3) applicable at the time of the decedent's death, and
> (B) the basic exclusion amount under such section applicable with respect to any gifts made by the decedent.

Though perhaps cryptic in its language, the directive to Treasury was clear: issue regulations making clear that a large gift made today will not face gift or estate tax when the basic exclusion amount reverts to a smaller amount.

2. Anti-Clawback Regulations

On November 23, 2018, Treasury published proposed regulations implementing the Congressional mandate, and those regulations were finalized on November 26, 2019 in T.D. 9884. Known on the street as the "anti-clawback regulations," they provide a "special rule" that allows an estate to use the higher of the basic exclusion amount used for gifts made during life or the basic exclusion amount applicable on the date of death. The operation of the "special rule" can be illustrated through three simple examples.

EXAMPLE (1): D, an individual who never before made taxable gifts, makes a taxable gift of $12,060,000 in 2022. Because the amount of the taxable gift equals does not exceed the basic exclusion amount of $12,060,000 applicable in 2022, D pays no federal gift tax on the transfer. D dies in 2026, and the basic exclusion amount in effect at that time is $7 million. In computing estate tax liability, D's estate will use a basic exclusion amount of $12,060,000. So while D's estate will pay federal estate tax on every penny of D's taxable estate, there will be no estate tax liability attributable to the 2022 taxable gift.

EXAMPLE (2): Assume the same facts from Example (1) except that the amount of D's taxable gift in 2022 is $11 million. In computing estate tax liability, D's estate will use a basic exclusion amount of $11 million, since the basic exclusion amount used for lifetime taxable gifts ($11 million) exceeds the exclusion amount applicable at death ($7 million). Here too there will be no estate tax liability attributable to the 2022 taxable gift. But note that D's estate cannot claim the extra $1,060,000 of unused exclusion left on the table in 2022. This is why planners refer to the "special rule" as a "use it or lose it" proposition: if an individual fails to utilize the entire basic exclusion amount before it drops, only the basic exclusion amount at death will apply.

EXAMPLE (3): Assume the same facts from Example (1) except that the amount of D's taxable gift in 2022 is $5 million. In computing estate tax liability, D's estate will use a basic exclusion

amount of $7 million, since the basic exclusion amount applicable at death ($7 million) exceeds the basic exclusion amount used for lifetime taxable gifts ($5 million). Once again the estate cannot claim the extra exclusion that D could have used for taxable gifts in 2022 (here, $7,060,000).

3. The New Proposed Regulation

The new proposed regulation considers the application of the "special rule" in the case of gifts that are pulled back into a decedent's gross estate under any of the "re-inclusion" rules. Specifically, the proposed regulation provides that the "special rule" does not apply in these situations. As Treasury explains in the preamble to the proposed regulation:

> Given the plain language of the Code describing the computation of the estate tax and directing that certain transfers, including transfers made within three years of death that otherwise would have been includible in the gross estate, are treated as testamentary transfers and not as adjusted taxable gifts, it would be inappropriate to apply the special rule to includible gifts. This is particularly true where the inter vivos transfers are not true bona fide transfers in which the decedent "absolutely, unequivocally, irrevocably, and without possible reservations, parts with all of his title and all of his possession and all of his enjoyment of the transferred property." *Commissioner v. Church's Estate*, 335 U.S. 632, 645 (1949). To prevent this inappropriate result, these proposed regulations would create an exception to the special rule applicable to includible gifts.

87 F.R. 24918 at 24919-24920 (April 26, 2022). Specifically, the proposed regulation states that the anti-clawback rule does not apply to four types of transfers:

- those includible in the gross estate pursuant to IRC §§2035, 2036, 2037, 2038, or 2042, no matter whether all or any part of such transfers qualify for the marital or charitable deductions;

- those made by enforceable promise to the extent they remain unsatisfied as of the date of death;

- those described in Reg. §25.2701-5(a)(4) or Reg. §25.2702-6(a)(1); and

- those that would fall within any of the foregoing transfer types but for the transfer, relinquishment, or elimination of an interest, power, or property, made within 18 months of the decedent's death by the decedent or by any other person.

Prop. Reg. §20.2010-1(c)(3)(i). In each of the first three types of transfers, a taxable gift would be re-included in the decedent's gross estate. The last type is included to avoid an easy end-run

around this exception to the anti-clawback rule. Without the last category of transfers, for instance, a trust protector could revoke a decedent's rights or powers over a trust that would cause gross estate inclusion under IRC §2036, IRC §2038, or IRC §2042 on the eve of the decedent's death solely for the purpose of preserving application of the anti-clawback rule. There appears to be no statutory authority for this 18-month lookback period and it is not clear why Treasury draws the line at 18 months as opposed to 12 months or three years or some other period.

Note too that this new 18-month rule appears to apply to both gifts and sales of re-inclusion interests. For example, suppose a decedent creates an irrevocable trust but retains the right to income for life. Suppose further that the transfer results in a taxable gift of $10 million (the value of the remainder interest). If the decedent sells the retained income interest at its fair market value one year before death, no portion of the trust assets will not be included in the decedent's gross estate. See IRC §2035(d). But under the proposed regulation's 18-month rule, the anti-clawback rule would not apply. That means the decedent's estate would use only the basic exclusion amount in effect in the year of death. If that amount is less than $10 million, the estate will owe estate tax attributable to the lifetime taxable gift. This seems inconsistent with the general purpose of the anti-clawback rule.

Finally, planners should also note that the anti-clawback rule continues to apply to re-included transfers where the value of the taxable gift does not exceed five percent of the total value of the transferred property. Prop. Reg. §20.2010-1(c)(3)(ii)(A). In effect, then, this de minimis rule operates as an exception to the exception to the anti-clawback rule.

The operation of the proposed regulation's exception to the "special rule," and the exception to that exception, can be illustrated through three more examples:

EXAMPLE (4): In 2022, D, an individual who never before made taxable gifts, transfers $100 million to a five-year grantor retained annuity trust (GRAT), retaining a qualified annuity interest worth $88 million. D thus makes a taxable gift of $12 million in 2022. D dies in 2026, when the basic exclusion amount is $7 million. Because D dies during the term of the GRAT, the entire corpus of the GRAT is included in D's gross estate. In computing estate tax liability, D's estate will use a basic exclusion amount of $7 million. Although D makes a taxable gift of $12 million in 2022 that uses nearly all of D's $12,060,000 basic exclusion amount that year, the $12 million gift is not an "adjusted taxable gift" since the gifted property is pulled back into D's gross estate under IRC §2036. Accordingly, D's estate cannot use the anti-clawback rule.

EXAMPLE (5): Assume the same facts from Example (4) except that the GRAT had a three-year term. Because D survived the GRAT's expiration, no part of the GRAT is included in D's gross estate, so the exception to the anti-clawback rules does not apply. Accordingly, because the basic exclusion amount applied to lifetime taxable gifts ($12 million) exceeds the basic exclusion amount in effect at D's death ($7 million), D's estate will use a basic exclusion amount of $12 million. D's estate will pay federal estate tax on the entirety of D's taxable estate, but there will not be any estate tax liability attributable to the GRAT.

EXAMPLE (6): Assume the same facts from Example (4) except that D transfers $250 million to the GRAT and retains a qualified annuity interest worth $240 million, meaning D makes a taxable gift of $10 million in 2022. Because the value of the taxable gift does not exceed five percent of the value of the property transferred, the de minimis rule applies and thus the exception to the anti-clawback rules does not apply to the gift. Accordingly, because D uses $10 million of basic exclusion amount on the taxable gift, and that amount exceeds the $7 million basic exclusion amount in effect at D's death, D's estate will use a basic exclusion amount of $10 million.

4. Observations

When Treasury announced its intention to issue new guidance related to the anti-clawback rule, some observers feared Treasury would create a broad anti-abuse exception that would significantly narrow the scope of the rule. In fact, the proposed regulation is relatively modest. It logically denies the benefit of the anti-clawback rule to gifts that ultimately come back in to a decedent's estate. The whole premise of the re-inclusion rules is that the decedent did not in fact part with dominion and control over the gifted property; in such cases, the decedent never really made the wealth transfer until death. Under that assumption, the decedent never really utilized the basic exclusion amount in the year of the gift. Logically, then, the decedent's estate should not be able to claim the benefit of the higher exclusion available in the year of gift.

What is of greater concern is Treasury's new 18-month lookback rule which would preclude use of the anti-clawback rule upon certain sales of retained interests (as described above) or where someone other than the grantor terminates a grantor's interest in or power over a trust that would cause re-inclusion of the trust's assets in the grantor's gross estate. Prior to the proposed regulation, the use of a trust protector for this purpose would have been thought acceptable. If this portion of the proposed regulation is finalized, the effectiveness of a trust protector in eleventh-hour planning could be significantly diminished.

5. Application to Enforceable Gift Notes

Included among the proposed exceptions to the anti-clawback rule are "transfers made by enforceable promise to the extent they remain unsatisfied as of the date of death," Prop. Reg. §20.2010-1(c)(3)(i)(B), as well as transfers that would be an unsatisfied enforceable promise "but for the transfer, relinquishment, or elimination of an interest, power, or property, effectuated within 18 months of the date of the decedent's death by the decedent alone, by the decedent in conjunction with any other person, or by any other person." Prop. Reg. §20.2010-1(c)(3)(i)(D).

Treasury explains the application of the exception to enforceable promissory notes through three examples, all of which posit a basic exclusion amount of $11.4 million at the date of gift and a $6.8 million basic exclusion amount at the date of death. Prop. Reg. §20.2010-1(c)(3)(iii)(A) – (C). A review of these examples proves instructive.

Example (1) from the proposed regulation states:

> Individual A made a completed gift of A's promissory note in the amount of $9 million. The note remained unpaid as of the date of A's death. The assets that are to be used to satisfy the note are part of A's gross estate, with the result that the note is treated as includible in the gross estate for purposes of section 2001(b) and is not included in A's adjusted taxable gifts. Because the note is treated as includible in the gross estate and does not qualify for the 5 percent de minimis rule in paragraph (c)(3)(ii)(A) of this section, the exception to the special rule found in paragraph (c)(3) of this section applies to the gift of the note. The credit to be applied for purposes of computing A's estate tax is based on the $6.8 million basic exclusion amount as of A's date of death, subject to the limitation of section 2010(d). The result would be the same if A or a person empowered to act on A's behalf had paid the note within the 18 months prior to the date of A's death.

Prop. Reg. §20.2010-1(c)(3)(iii)(A). Consider first why A would make this gift. If A resides in a jurisdiction where A’s gifted note is an enforceable obligation, the assets used to satisfy the note after death would have an income tax basis equal to their fair market values at the date of A’s death. This means A’s estate would have little or no income tax consequence from using assets to pay off the note. But more importantly, if A’s $9 million note is enforceable as of the date of the gift, A pays no gift tax and uses up $9 million of A’s $11.4 million basic exclusion amount. If the anti-clawback rule applies to this strategy, A’s estate would get to use a $9 million basic exclusion amount without having to transfer any property until after death when the basic exclusion amount has dropped to $6.8 million. That’s too good to be true, and the proposed regulation confirms that the anti-clawback rule will not apply in this case.

Notice, however, that the proposed regulation would reach the same result even where A pays off the $9 million note within 18 months of A’s death. As explained above, the 18-month rule takes aim at transfers made on the eve of death solely for the purpose of preserving application of the anti-clawback rule. But unlike other transfers to which this new 18-month rule applies—like shutting off a retained right to income, possession, or enjoyment, for example—in this example A makes an irrevocable transfer of $9 million to pay off the note. Shutting off a retained right or power does not involve the same financial commitment as transferring $9 million worth of assets in satisfaction of a note, especially since such a transfer would give rise to federal income tax consequences. Application of the new 18-month rule to transfers in satisfaction of enforceable gift notes thus appears more problematic.

Example (2) from the proposed regulation states, in relevant part:

> Assume that the facts are the same as in ... Example 1 ... except that A's promissory note had a value of $2 million and, on the same date that A made the

> gift of the promissory note, A also made a gift of $9 million in cash. The cash gift was paid immediately, whereas the $2 million note remained unpaid as of the date of A's death. The assets that are to be used to satisfy the note are part of A's gross estate, with the result that the note is treated as includible in the gross estate for purposes of section 2001(b) and is not included in A's adjusted taxable gifts. Because the $2 million note is treated as includible in the gross estate and does not qualify for the 5 percent de minimis rule in paragraph (c)(3)(ii)(A) of this section, the exception to the special rule found in paragraph (c)(3) of this section applies to the gift of the note. On the other hand, the $9 million cash gift was paid immediately, and no portion of that gift is includible or treated as includible in the gross estate. Because the amount allowable as a credit in computing the gift tax payable on A's $9 million cash gift exceeds the credit based on the $6.8 million basic exclusion amount allowable on A's date of death, the special rule of paragraph (c) of this section applies to that gift. The credit to be applied for purposes of computing A's estate tax is based on a basic exclusion amount of $9 million, the amount used to determine the credit allowable in computing the gift tax payable on A's $9 million cash gift.

Prop. Reg. §20.2010-1(c)(3)(iii)(B). This example simply confirms that if a taxpayer makes a large gift of cash coupled with the gift of an enforceable note, the gift of cash can still qualify the taxpayer’s estate for use of the higher basic exclusion amount applicable at death. Nothing much to see here.

Example (3) from the proposed regulation states, in relevant part:

> Assume that the facts are the same as in ... Example 1 ... except that, prior to A's gift of the note, the executor of the estate of A's predeceased spouse elected, pursuant to § 20.2010-2, to allow A to take into account the predeceased spouse's $2 million DSUE amount. Assume further that A's promissory note had a value of $2 million on the date of the gift, and that A made a gift of $9 million in cash a few days later. The cash gift was paid immediately, whereas the $2 million note remained unpaid as of the date of A's death. The assets that are to be used to satisfy the note are part of A's gross estate, with the result that the note is treated as includible in the gross estate for purposes of section 2001(b) and is not included in A's adjusted taxable gifts. Because A's DSUE amount was sufficient to shield the gift of the note from gift tax, no basic exclusion amount was applicable to the $2 million gift pursuant to paragraph (c)(1)(ii)(A) of this section and the special rule of paragraph (c) of this section does not apply to that gift. On the other hand, the $9 million cash gift was paid immediately, and no portion of that gift is includible or treated as includible in the gross estate. Because the amount allowable as a credit in computing the gift tax payable on A's $9 million cash gift exceeds the credit based on the $6.8 million basic exclusion amount allowable on A's date of death, the special rule of paragraph (c) of this section applies to that gift. The credit to be applied for purposes of

computing A's estate tax is based on A's $11 million applicable exclusion amount, consisting of the $2 million DSUE amount plus the $9 million amount used to determine the credit allowable in computing the gift tax payable on A's $9 million cash gift.

Prop. Reg. §20.2010-1(c)(3)(iii)(C). This example reminds us that when a surviving spouse makes a taxable gift, the gift is applied first against any "deceased spousal unused exclusion amount" ("DSUE amount") that passed from the first deceased spouse to the surviving spouse under a valid portability election. Accordingly, the DSUE amount from A's last deceased spouse would be applied to A's first taxable gift (here, the gift of the enforceable note). Since the value of the gifted note matches the DSUE amount, the gifted note does not utilize any of A's basic exclusion amount. As a result, the anti-clawback rule would not apply to this gift, and the example confirms this conclusion.

But suppose A made the gifts in Example (3) in reverse order. That is, assume A first made the $9 million cash gift and then made the gift of the $2 million enforceable note. The DSUE amount would have been applied against the cash gift, not the note. A would then apply $7 million of A's $11.4 million basic exclusion amount to cover the balance of the cash gift, followed by $2 million of the remaining $4.4 million basic exclusion amount to cover the gift of the note. At A's death, then, the proposed regulation would presumably give A's estate a basic exclusion amount of $9 million. This consists of the $2 million DSUE amount and the $7 million of basic exclusion amount used on the cash gift; the $2 million of basic exclusion amount used on the gift of the note would be excepted from the anti-clawback rule.

The foregoing suggests that use of enforceable gift notes to take advantage of a potential decline in the basic exclusion amount will no longer be an effective strategy. Whether the final regulation will still apply the exception to the anti-clawback rule where an enforceable gift note is paid not more than 18 months before death remains to be seen, though there is a good argument that it should not.

D. IRS EXTENDS AMNESTY PERIOD FOR PORTABILITY-ONLY RETURNS TO FIVE YEARS (*Revenue Procedure 2022-32*, July 8, 2022)

The IRS has extended the time for making a portability election without having to obtain a private ruling from two years after death to five years after death. As with the two-year amnesty period previously in effect, the new five-year amnesty period only applies where the estate is not required to file an estate tax return but is doing so solely for the purpose of making a portability election (a so-called "portability-only return").

By way of background, a surviving spouse may add a deceased spouse's unused exclusion amount (the "DSUE amount") to the surviving spouse's own basic exclusion amount for federal estate and gift tax purposes if the deceased spouse's executor timely files a federal estate tax return. This is referred to as the "portability election." The statute does not offer any exceptions for portability elections made after the deadline for filing a federal estate tax return.

So if the return is not timely filed, the executor and the surviving spouse generally must seek §9100 relief, though that requires both a fee and a good excuse. That's a particular hardship where the decedent's gross estate does not exceed the basic exclusion amount because a federal estate tax return is not otherwise required. Prior to 2017, though, §9100 relief was the only option for fiduciaries and surviving spouses wanting late portability elections.

Inundated with requests for relief from the consequences of a late portability election, the IRS in 2017 announced a policy effective June 9, 2017. Under *Revenue Procedure 2017-34*, 2017-1 C.B. 1282, an estate seeking to file a portability-only return generally received an automatic extension of time until the second anniversary of the deceased spouse's death. An estate claiming the benefit of the two-year amnesty period had to print "FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY UNDER § 2010(c)(5)(A)" at the top of the estate tax return (yes, the guidance indicated it should be in ALL CAPS). *Revenue Procedure 2017-34* specifically stated that the two-year amnesty period did not serve to extend the statute of limitations for purposes of making a refund claim. But if the statute of limitations has not run, the executor of the surviving spouse's estate could make a protective claim for refund in anticipation of an estate tax return being filed under the two-year amnesty regime. *Revenue Procedure 2017-34* also made clear that where the two-year amnesty period had passed, the executor and surviving spouse could still seek §9100 relief for a late election.

In justifying the choice for a two-year amnesty period (as opposed to a period shorter or longer in duration), the IRS originally stated that a two-year period:

> should not unduly compromise the ability of the taxpayer or the Service to compute and verify the DSUE amount because the necessary records are likely to be available during that period. In addition, limiting the availability of this simplified method to that two-year period could be beneficial to the surviving spouse or the surviving spouse's estate in two ways. First, it increases the likelihood that the portability election will be made before the surviving spouse or the executor of the surviving spouse's estate is required to file a gift or estate tax return, thus eliminating the need to file such a return without claiming any DSUE amount and then, after the portability election has been made, having to either file a supplemental return or file a claim for a credit or refund. Second, if the allowance of the portability election made pursuant to this revenue procedure and the corresponding revised computation of the surviving spouse's applicable credit amount would result in a credit or refund of the surviving spouse's gift or estate tax, the availability of the simplified method during the two-year period may reduce the risk that the period under §6511 for filing a claim for that credit or refund (generally, extending three years from the date of filing or, if later, two years from the date of payment) would expire before the portability election could be made pursuant to this revenue procedure.

Revenue Procedure 2017-34, 2017-1 C.B. 1282.

It appears that even with a two-year automatic extension, the IRS continues to be flooded with §9100 relief requests from estates seeking to file a late portability-only return. As the IRS states in *Revenue Procedure 2022-32*, "[t]he IRS has observed that a significant percentage of these ruling requests have been from estates of decedents who died within five years preceding the date of the request. The number of these requests continues to place a significant burden on the available resources of the IRS." Accordingly, the new guidance supersedes *Revenue Procedure 2017-34* by extending the deadline for a timely portability-only return to the fifth anniversary of the decedent's death. An estate claiming the benefit of the five-year amnesty period must print "FILED PURSUANT TO REV. PROC. 2022-32 TO ELECT PORTABILITY UNDER § 2010(c)(5)(A)" at the top of the estate tax return (again, apparently, in ALL CAPS). In all other respects, the rules under the new guidance are the same as under the 2017 guidance.

An executor should file a portability-only return whenever there is a reasonable chance that the combined amount of the surviving spouse's gross estate and the amount of any adjusted taxable gifts made by the surviving spouse might exceed the surviving spouse's basic exclusion amount. Planners should keep in mind that the value of a surviving spouse's estate might outpace inflation, and current law contemplates a reduction in the basic exclusion amount comes 2026. The incremental cost of a portability-only return is usually not very significant given the executor will already be compiling an inventory of the estate's assets for purposes of filings under state and local laws, for purposes of making distributions, and for purposes of determining a beneficiary's basis in property acquired from the decedent.

III. CIRCUITS SPLIT ON VALIDITY OF CONSERVATION EASEMENT REGULATION PROHIBITING SUBTRACTION OF POST-DONATION IMPROVEMENTS IN COMPUTING CHARITY'S SHARE OF EXTINGUISHMENT PROCEEDS (*Hewitt v. Commissioner*, 11th Cir., December 29, 2021; *Oakbrook Land Holdings, LLC v. Commissioner*, 6th Cir., March 14, 2022).

Two federal appellate courts have reached different results concerning the validity of Regulation §1.170A-14(g)(6)(ii). The 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 regulation was properly promulgated under the Administrative Procedure Act ("the APA") and that the regulation's interpretation of the statute was entitled to "*Chevron* deference." While the Sixth Circuit Court of Appeals went on to affirm the Tax Court, the Eleventh Circuit held that the regulation violates the APA and is, therefore, invalid.

A. *Hewitt v. Commissioner*, 21 F.4th 1336 (11th Cir., December 29, 2021)

In this case, the taxpayers in 2012 conveyed to the Atlantic Coast Conservancy a conservation easement on a portion of farmland that has been in the 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). The deed later confirmed that "the ratio of the value of the Easement to the value of the Property unencumbered by the Easement shall remain constant."

The taxpayers claimed a charitable contribution deduction of nearly $2.8 million on their 2012 joint federal income tax return, which they carried over to 2013 and 2014. The IRS did not challenge the 2012 return but disallowed the carryover deductions on the 2013 and 2014 returns.

Before the Tax Court, the IRS argued that the easement granted to the Conservancy failed the regulatory requirement that the easement be "protected in perpetuity" because the deed granting the easement provides that upon judicial extinguishment of the easement and resulting sale of the property the Conservancy will only receive an amount of the sale proceeds based on the value of the easement at contribution. The taxpayers argued for an interpretation of the regulations that would support the taxpayer's claim that a charity need only be entitled to an amount based on the value of the easement at contribution, but the court quickly and easily dispensed with the argument, citing precedents including *Oakbrook Land Holdings*. *Hewitt v. Commissioner*, T.C. Memo. 2020-89 (2020).

The taxpayers tried to rely on a favorable private ruling from 2008 containing language eerily similar to that in the taxpayer's deed, but the court said the ruling "is neither persuasive nor relevant" because it did not expressly consider the validity of the easement deed language that subtracted the value of post-easement appreciation from extinguishment proceeds.

Valuation was also an issue in this case because it determined whether the taxpayers were liable for an accuracy-related penalty. The IRS's expert valued the easement on the basis of the highest and best use of the entire farmland and not just the highest and best use of the property subject to the easement. The court found this improper given the significant differences in the topography and public access between the portion encumbered by the easement and the unencumbered portion. The court instead preferred the analysis from the several experts hired by the taxpayers. Although the court did not determine the exact value of the easement (why bother, since the deduction is disallowed anyway), it did conclude that the value was at least sufficient to avoid application of the accuracy-related penalty.

On appeal, the taxpayers challenged the validity of the 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 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 regulation invalid.

B. *Oakbrook Land Holdings, LLC v. Commissioner* (6th Circuit, March 3, 2022)

In this case, the taxpayer 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 regulation and thus reduces the taxpayer's deduction to zero. The IRS also determined that the deed language reducing the amount payable to the charity by the value of post-contribution improvements made by the taxpayer violated the regulation.

In a Memorandum decision, the Tax Court agreed with the IRS, finding that it does not matter that the fixed value provided for in the deed would almost certainly be more than the percentage of proceeds to which the Conservancy would be entitled under the regulation. *Oakbrook Land Holdings, LLC v. Commissioner*, T.C. Memo. 2020-54 (May 12, 2020). Writing for the court, Judge Holmes held that the taxpayer's deed violated the regulation because it would give the charity a fixed dollar amount instead of a proportionate share of the sale proceeds and because the deed subtracts from the fixed dollar amount the amount of any post-contribution improvements to the land made by the taxpayer. But the court also held that the taxpayer was not liable for a substantial understatement penalty since the taxpayer's manager reasonably relied on language pulled from a favorable private ruling in crafting the deed.

The taxpayer argued that the regulation was invalid under the APA. Judge Holmes called on his colleagues to review this aspect of the case in a reviewed opinion. In *Oakbrook Land Holdings, LLC v. Commissioner*, 154 T.C. 180 (2020), issued on the same date as the Memoradum decision, the Tax Court (16-1) upheld the regulation's validity by a 16-1 vote, finding it was properly promulgated under the APA and that the regulation's interpretation of the statute was entitled to "*Chevron* deference." The majority (in an opinion by Judge Lauber) concluded that the regulation is a legislative rule because it imposes a requirement not expressly stated in the statute, namely that the charity and the donor agree to a proportionate division of proceeds following judicial extinguishment of an easement. The taxpayer argued that when Treasury issued the regulation in final form, it failed to provide a "concise general statement of [the] basis and purpose" for the new rule. But the majority observed that "No court has ever construed the APA to mandate that an agency explain the basis and purpose of each individual component of a regulation separately." The provision at issue here was one "of a regulation project consisting of 10 paragraphs, 23 subparagraphs, 30 subdivisions, and 21 examples." Since Treasury adequately stated the general purpose of the substantiation regulations for conservation easements, the regulation was properly enacted.

The majority of the Tax Court also concluded that Treasury's requirement of proportionate division of proceeds was not arbitrary, capricious, or manifestly contrary to the statute, the standard for invalidating agency interpretations adopted in *Chevron v. National Resources Defense Council*, 467 U.S. 837 (1984). "If the donee's share were (sic) limited to the easement's historical [value], its property right could be eviscerated in real dollar terms. … That outcome would be at odds with the regulation's central purpose: to ensure satisfaction of the statute's 'protected in perpetuity' requirement by supplying the donee with an asset that replaces, in real terms, the easement that has been lost."

Interestingly, the lone dissenter was Judge Holmes, the judge who tried the case and issued the Memorandum decision described above. Judge Holmes said that the majority's decision means "the Treasury Department can get by with the administrative-state equivalent of a quiet shrug, a knowing wink, and a silent fleeting glance from across a crowded room." Judge Holmes observed that a number of commentators expressed concern with the regulation related to the perpetuity requirement and judicial extinguishments in its proposed form, but neither the final

regulation nor its preamble addressed these concerns. "What we hear is the chirping of crickets." Judge Holmes found the IRS's statement in the preamble to the final regulation ("After consideration of all the comments, the proposed regulations are adopted as amended") to be insufficient. This, said Judge Holmes, is simply form language that cannot be used to excuse oversight of significant issues raised during the notice-and-comment phase of rulemaking.

On appeal to the Sixth Circuit, the taxpayer argued that the IRS wrongfully deviated from the APA's notice-and-comment procedures in two important ways, either of which justifies rejection of the final 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 regulation requiring 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 I.R.C. §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, 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 regulation at issue in this case. The taxpayer pointed to four 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 I.R.C. §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 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 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.

C. 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 regulation at issue in these cases applies only upon a judicial extinguishment of a conservation easement. 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.

In any event, now that there is a split among the circuits, we can be sure these cases are not the last we will see on the validity of the regulation prohibiting the subtraction of the value of post-donation improvements to property subject to a conservation easement in computing the extinguishment proceeds allocated to the charity. At some point a party will petition the United States Supreme Court for review, and one suspects the current Court would be receptive to the argument that the IRS failed to comply with the APA's notice-and-comment requirements when it comes to the regulation regarding extinguishment sales. In the meantime, of course, practitioners advising clients contemplating the donation of a conservation easement should continue to make sure the deed's language comports with the regulation.

D. Nevertheless, *Hewitt* Persists

Two cases decided a week apart, the first from the Eleventh Circuit and the second from the Tax Court, confirm that the Eleventh Circuit's decision in *Hewitt v. Commissioner* is binding precedent in that jurisdiction. At the same time, both cases left open the possible application of penalties against the taxpayers for valuation misstatements.

1. *Glade Creek Partners LLC v. Commissioner* (11th Cir., August 22, 2022)

In an unpublished opinion, the Eleventh Circuit vacated the decision of the Tax Court denying a claimed deduction for the value of a conservation easement for violating the proceeds

regulation. The taxpayer's predecessor in interest acquired about 2,000 acres in Tennessee for just over $9 million in 2006. In 2012, 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 deed conveying the easement contained a carve-out in the event of judicial extinguishment and sale, so the IRS determined that the entire deduction should be disallowed. The Tax Court agreed, for the matter was decided before the decision in *Hewitt*. In light of *Hewitt*, then, the Eleventh Circuit vacated the Tax Court's decision on this issue and remanded the case for further determination as to the amount deductible.

That brings us to the issue of valuation. 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 claimed this resulted in a value of $17.5 million, but the Tax Court 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 held 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 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. So while the taxpayer will be entitled to an income tax deduction of about $8.9 million, much of the benefit will be offset by the application of penalties.

2. ***Sparta Pink Property, LLC v. Commissioner*, T.C. Memo. 2022-88 (August 29, 2022)**

In this case, the taxpayer owned over 280 acres of land in Georgia. Late in 2016, the taxpayer granted a conservation easement over the land to the Southern Conservation Trust. On its 2016 income tax return, the taxpayer claimed a charitable contribution deduction of over $15.6 million for this donation. The IRS initially took the position that the value of the gift was only about $45,000, but the IRS sought summary judgment from the Tax Court disallowing the deduction altogether because the deed reserved to the taxpayer rights to repair, improve, and replace existing improvements on the property, and the deed further provided that the value of any such improvements made after the easement's donation would be subtracted from any sale proceeds to which the Southern Conservation Trust would be entitled upon extinguishment of the easement and sale of the property. This, argued the IRS, violates the proceeds regulation.

But an appeal in this case would lie in the Eleventh Circuit Court of Appeals, where *Hewitt* reigns supreme. Under the so-called "*Golsen* rule," the Tax Court must apply the law of the jurisdiction to which an appeal lies. *Golsen v. Commissioner*, 54 T.C. 742, 756-57 (1970), *aff'd*,

445 F.2d 985 (10th Cir. 1971). Accordingly, since the Eleventh Circuit rejects the application of the regulation to post-donation carve-outs, the Tax Court had no choice but to disallow the IRS's motion for summary judgment on this issue.

The Tax Court's work was not done, however. The IRS also imposed gross valuation misstatement penalties on the taxpayer, but the taxpayer argued that the IRS's compliance with the requirement to obtain timely supervisory approval of the penalties should be established at trial. On this issue, the IRS successfully obtained summary judgment, to the surprise of no one.

Section 6751(b)(1) states that a penalty cannot be imposed unless the initial determination of a penalty by a revenue agent is "personally approved (in writing) by the immediate supervisor of the individual making such determination." In addition, case law provides that this personal approval must be obtained before the penalty is formally communicated to the taxpayer. Here, revenue agent's written recommendation for a penalty was filed on January 27, 2020, and approved by the group manager on February 10, 2020. Formal notice of the penalty was not sent to the taxpayer until February 24, 2020. Therefore, there was timely approval. Nevertheless, the taxpayer argued that the IRS should be forced to authenticate these documents at trial.

But, as it has done repeatedly, the Tax Court rejected this argument, holding once again that a group manager's signature on the applicable civil penalty approval form is sufficient to satisfy the requirements of the statute and case law. The court observed that it has regularly "rejected the notion that examining agents and their supervisors must be subjected to cross-examination." Although the taxpayer had evidence that the revenue agent never got the appraisal until after penalties had been approved by the supervisor, the court concluded that the statute only requires written approval. "We have repeatedly rejected any suggestion that a penalty approval form or similar document must 'demonstrate the depth or comprehensiveness of the supervisor's review.'" The court thus granted the IRS's motion for summary judgment on the issue of its compliance with the requirement to obtain written supervisory approval.

IV. COURTS INVALIDATE SEVERAL NOTICES FOR FAILING TO COMPLY WITH THE ADMINISTRATIVE PROCEDURE ACT (DO YOU SEE A TREND HERE?)

It wasn't just the proceeds regulation that came under fire in 2022. The IRS lost in other cases involving Notices issued without notice and comment, establishing a trend of considerable importance.

A. *Mann Construction, Inc. v. United States* (6th Circuit, March 3, 2022)

The Sixth Circuit Court of Appeals has held that *Notice 2007-83*, 2007-2 C.B. 960 (October 17, 2017), was issued in violation of the notice-and-comment procedures for legislative rules under the Administrative Procedure Act ("the APA") and is therefore invalid.

The taxpayer in the case provides general contracting, construction management, and similar services. Two individuals own the taxpayer's stock. During the years at issue, the taxpayer established an employee-benefit trust that paid the premiums on insurance policies covering the lives of the two owners. The taxpayer deducted the payments and the owners reported the increase in the cash values of the policies as gross income. But neither the taxpayer nor the owners reported the arrangement as a "listed transaction," and that's what got them in trouble with the IRS.

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." I.R.C. §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. I.R.C. §6707A(c)(2). The maximum penalty for listed transactions is significantly higher than the maximum penalty for other reportable transactions.

In *Notice 2007-83*, the IRS designated certain employee-benefit plans featuring cash-value life insurance policies as a listed transaction. In 2019, the IRS determined that the taxpayer's arrangement fit the description set forth in the 2007 Notice and imposed a $10,000 penalty on the taxpayer together with penalties totaling over $16,000 on the owners. The taxpayer and the owners paid these penalties and then sued for refund. The federal district court upheld the penalties, bringing the parties to this appeal.

The taxpayer and the owners were prepared to argue that their arrangement did not come within the scope of the Notice, but the Sixth Circuit bought their leadoff argument that the Notice was invalid because the IRS did not comply with the APA. The APA generally requires a federal agency to publish a notice about a proposed rule, allow for public comment, consider submitted comments, make appropriate revisions, and provide a concise general statement of the basis and purpose of the final rule adopted. The IRS did none of that here, but offered two explanations for why that is not fatal to the validity of the Notice.

First, argued the IRS, the Notice is 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* is 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.

Second, the IRS claimed, even if the Notice is a legislative rule, Congress made the IRS exempt 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 has not done 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."

This case should be of considerable concern to the IRS, as few (if any) of the Notices issued under §6707A have undergone notice-and-comment procedures. If the Sixth Circuit is right, then, this means that any such Notice, not just the one at issue in the case, is invalid and, thus, not binding on taxpayers.

B. *CIC Services, LLC v. Internal Revenue Service* (E.D. Tenn., March 21, 2022)

Just 18 days after the Sixth Circuit's opinion, in fact, a federal district court for the Eastern District of Tennessee (located in the Sixth Circuit) relied on *Mann Construction* in striking down *Notice 2016*-66, which named micro-captive insurance arrangements as listed transactions. The case is another successful attack against the enforceability of IRS guidance based on the failure to follow the APA. While such arguments from taxpayers used to get short shrift from the courts, it appears courts today are more willing to consider them.

C. *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*, 2017-4 I.R.B. 544 (December 23, 2016), was issued in violation of the notice-and-comment procedures for legislative rules under the Administrative Procedure Act ("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.

Enacted in 2004, §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 2022 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 $370,000 (37 percent times the $1,000,000 understatement in taxable income).

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.

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."

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.

Green Valley Investors, LLC, supra at 40.

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.

Id. at 43 – 44. 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.

D. *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.

V. FIRST TREASURY, THEN CONGRESS RESPONDS TO ENSURE ENFORCEMENT AGAINST SYNDICATED CONSERVATION EASEMENTS

In the wake of the *Green Valley Investors* and *GBX Associates* cases, *supra*, both Treasury and Congress responded with proposed guidance and legislation, respectively, to ensure that syndicated conservation easement transactions would remain "listed transactions."

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

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.

B. 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.

In addition to this new Code provision, §605(d)(1) of the SECURE 2.0 Act of 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).

VI. 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.

1. 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.

2. 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.

3. 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.

4. 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.)

5. 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").

6. 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.

7. 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.

8. 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.

9. 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.

VII. PROPOSED REGULATIONS CLARIFY APPLICATION OF SECURE ACT CHANGES TO REQUIRED MINIMUM DISTRIBUTION RULES (Proposed Regulation §1.401(a)(9)-4, February 24, 2022).

In a notice of proposed rulemaking published in the Federal Register on February 24, 2022, Treasury has issued proposed regulations relating to required minimum distributions from qualified plans, §403(b) plans, individual retirement accounts, custodial accounts, and §457 plans. The proposed regulations reflect amendments made to §401(a)(9) by the Setting Every Community Up for Retirement Enhancement Act of 2019 (the SECURE Act) and generally update existing regulations last comprehensively updated in 2004. Coming in at 275 pages, the proposed regulations represent a significant revision and cleanup of the required minimum distribution rules. These materials focus on the rules set forth in Proposed Regulation §1.401(a)(9)-4, the determination of an employee or account holder's "designated beneficiary."

Although other aspects of the proposed regulations are certainly important reading for plan administrators, financial advisors, and retirement planning specialists, the rules related to the determination of a designated beneficiary are particularly relevant to estate planning professionals.

A. Background

The 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. I.R.C. §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. I.R.C. §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. I.R.C. §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.

B. Eligible Designated Beneficiaries Under the Proposed Regulations

The proposed regulations modify the method for determining whether an employee's child has reached the age of majority. The current regulations do not specify a particular age as the age of majority; instead, they provide that a child may be treated as not having reached the age of majority if the child has not completed a specified course of education and has not yet attained the age of 26. Treas. Reg. §1.401(a)(9)-6, Q&A 15. In the preamble to the proposed regulations, Treasury notes that this definition allows different plans to have different definitions of the age of majority, making it especially difficult planning for employees with multiple accounts. Accordingly, the proposed regulations provide that a child reaches the age of majority on the child's 21st birthday. Prop. Reg. §1.401(a)(9)-4(e)(3). Thus, where a deceased employee named a minor child as an eligible designated beneficiary, the employee's account balance must be withdrawn and paid to the child no later than the child's 31st birthday.

The proposed regulations also simplify the determination of whether an individual is "disabled" under §401(a)(9). The statute refers to the definition in §72(m)(7), which asks whether an individual is unable to engage in substantial gainful activity. As Treasury observes in the preamble to the proposed regulations, this standard is awkward to apply in the context of a minor. So the proposed regulations employ a different standard for minors: if, as of the date of the employee's death, the minor has a medically determinable physical or mental impairment that results in marked and severe functional limitations that can be expected to result in death or be of long-term and indefinite duration, the minor will be considered disabled. Prop. Reg. §1.401(a)(9)-4(e)(4). In addition, the proposed regulations introduce a safe harbor under which a beneficiary will be deemed disabled for purposes of §401(a)(9) if, at the employee's death, the beneficiary is disabled under 42 U.S.C. §1382c(a)(3).

Importantly, the proposed regulations provide that where an employee has more than one designated beneficiary and any one of them is not an eligible designated beneficiary then, for purposes of applying the minimum distribution rules, the employee will be deemed as having no eligible designated beneficiary. Prop. Reg. §1.401(a)(9)-4(e)(2). In other words, in the case of multiple beneficiaries, either all of them are eligible designated beneficiaries or none of them is an eligible designated beneficiary. That becomes an issue where an employee names a trust as a designated beneficiary.

C. Trusts as Beneficiaries Under the Proposed Regulations

The proposed regulations retain the "see-through" concept from existing regulations. Prop. Reg. §1.401(a)(9)-4(f)(1). Under this approach, the beneficiaries of a trust will be treated as the beneficiaries of the plan (rather than the trust itself) where the trust: (i) is valid under state law; (ii) is irrevocable at the date of the employee's death; (iii) has identifiable beneficiaries; and (iv) meets certain documentation requirements. A trust created exclusively for the benefit of eligible designated beneficiaries, therefore, will be treated as an eligible designated beneficiary. But if the trust has one or more beneficiaries that are not eligible designated beneficiaries, then the trust will be treated as having no eligible designated beneficiaries. While the existing regulations offer some examples of situations where the see-through concept applies, the proposed regulations helpfully offer more examples, many in response to recurring fact patterns posed in private ruling requests. Prop. Reg. §1.401(a)(9)-4(f)(6).

The proposed regulations clarify that certain beneficiaries of a see-through trust will be disregarded for purposes of determining whether all trust beneficiaries are eligible designated beneficiaries. For example, a beneficiary that could receive a distribution from the trust consisting of the employee's interest in the plan only after the death of a remainder beneficiary will not count because that beneficiary holds a "minimal or remote" interest. Even a remainder beneficiary will be disregarded where the terms of the trust require the complete distribution of the employee's account balance to an eligible designated beneficiary by the later of the calendar year after the year of the employee's death or the end of the tenth year after the year in which the eligible designated beneficiary attains the age of majority. The preamble to the proposed regulations offer a helpful example of this rule:

> [A]ssume an employee names a see-through trust as the sole beneficiary, the trust permits specified amounts to be paid to the employee's niece until the niece reaches age 31 (age of majority plus 10 years), and those specified amounts are not required to include the immediate payment of plan distributions made to the trust. The trust is scheduled to terminate with a full distribution of all trust assets to the niece when the niece reaches age 31, but if the niece dies before the scheduled termination, then the amounts remaining in the trust will be paid to the employee's sibling. In that case, the only beneficiary designated under the plan for purposes of section 401(a)(9) and these regulations is the employee's niece because the employee's sibling is disregarded…. However, if the see-through trust terms do not require a full distribution of amounts in the trust representing the employee's interest in the plan until the niece reaches age 35, then … both the employee's niece and sibling are treated as beneficiaries designated under the plan for purposes of section 401(a)(9) and these regulations.

D. Required Minimum Distributions Applicable to Ten-Year Payout, With Interim Relief Rule (*Notice 2022-53*, October 7, 2022)

The proposed regulations announced that where the ten-year payout period applies, annual required minimum distributions (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 prior 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 have been unsure whether they must take an RMD in 2022. This very much matters because §4974 imposes a penalty for failure to take an RMD. The penalty is 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.

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.

While the announcement that the IRS will not impose retroactive penalties is no doubt 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.

E. Effective Date

If finalized, the proposed regulations will generally apply for calendar years beginning no earlier than January 1, 2023. The proposed regulations state that for the 2021 distribution calendar year, taxpayers must apply the existing regulations and take into account a reasonable, good-faith interpretation of the SECURE Act amendments. Treasury indicates that compliance with the proposed regulations will satisfy this requirement for 2021 distributions.

VIII. PROPOSED REGULATIONS LIMIT ESTATE TAX DEDUCTION FOR LONG-TERM CLAIMS AND EXPENSES TO PRESENT VALUE (AND MAKE RELATED TWEAKS) (*Prop. Reg. §§ 20.2053-1(d)(6), 20.2053-3(d), 20.2053-4(b)(1)(iv), 20.2053-4(c)(1)(iv), and 20.2053-4(d)(5)*, June 28, 2022)

Treasury has published proposed regulations related to the estate tax deduction for estate administration expenses, claims against the estate, and interest expenses owed by the estate. Section 2053(a) authorizes a deduction for funeral expenses, administration expenses, claims against the estate, and unpaid mortgages on (or any debt in respect of) property included in the decedent's gross estate. In 2009, Treasury issued final regulations that generally limit the deduction for claims and expenses to amounts actually paid in satisfaction or settlement of those items, with exceptions for ascertainable amounts, claims against the estate, and debt. Those final regulations expressly reserved for future guidance the issue of applying present-value concepts in determining the deduction amount. The new proposed regulations tackle this issue and others. The proposed regulations would apply to estates of decedents dying on or after the date the regulations are finalized.

A. Guidance on Use of Present-Value Principles

If a decedent's estate will pay a $100 debt ten years after the decedent's death, it hardly makes sense to allow the estate to claim a $100 deduction on the federal estate tax return just nine months after the decedent's death. Just as the value of a vested remainder interest is reduced to present value for gift tax purposes, the value of a future expense item should likewise be reduced to its present value. As Treasury explains in the preamble to the proposed regulations, limiting the §2053(a) deduction to the present value of a payment to be made long after the decedent's death "will more accurately reflect the economic realities of the transaction, the

true economic cost of that expense or claim, and the amount not passing to the beneficiaries of the estate."

Treasury tried to implement this concept through proposed regulations in 2007. Those regulations required the computation of present value of future payment only for noncontingent recurring obligations (like annuity payments pursuant to a settlement agreement, for example). For other future obligations, the 2007 proposed regulations simply denied any deduction until such amounts were actually paid.

In the new guidance, Treasury seeks to apply present-value concepts in valuing all future expenses and claims, whether contingent or noncontingent. But Treasury recognizes that requiring all future expenses and claims to be reduced to present value could impose hardship. In light of the fact that "a significant percentage of estates pay most, if not all, of their ordinary estate administration expenses during the three-year period following the decedent's date of death," the proposed regulations require the application of present-value concepts to claims and expenses that will be paid **more than three years after the decedent's death**. Prop. Reg. §20.2053-1(d)(6)(i)(B). In computing the present value of these long-term expenses, the estate must use the applicable Federal rate of interest under §1274(d) for the month in which the decedent died. The expected date of payment will determine whether the estate should use the short-, mid-, or long-term interest rate. The proposed regulations also require a supporting statement be filed with the estate tax return to show all computations of present value. Prop. Reg. §20.2053-1(d)(6)(iv).

Where the existing regulations allow a current deduction for a future payment (like fiduciary and attorney fees that are not yet paid but reasonably ascertainable as to the amount or reasonably certain claims against the estate), the proposed regulations provide that present value should be calculated using the expected date or dates of payment based on a "fair and reasonable estimate" based on "all information reasonably available to the taxpayer." Prop. Reg. §20.2053-1(d)(6)(iii). The proposed regulations also provide that any present value computation is subject to adjustment if the actual date of payment differs from the estimate used in the computation. Prop. Reg. §20.2053-1(d)(6)(vi).

B. Guidance on Deductibility of Interest

Interest on unpaid taxes and penalties is deductible under §2053(a)(2) as an administration expense. But §2053(c)(1)(D) disallows a deduction for any interest on unpaid estate tax deferred under §6166. (This is justified by the fact that the interest rate on tax deferred under §6166 is more favorable than the interest rate normally applicable to unpaid taxes and penalties.) The proposed regulations confirm this rule and add that no deduction will be allowed for interest accruing on any §6166 installment payment. Prop. Reg. §20.2053-3(d)(1)(i).

The proposed regulations further provide that interest accruing on or after the decedent's death on any unpaid tax or penalty generally is actually and necessarily incurred in the administration of the estate and is therefore deductible under §2053(a)(2). Prop. Reg.

§20.2053-3(d)(1)(ii). But then the proposed regulations state that no deduction is available to the extent the interest is attributable to an executor's negligence, disregard of applicable rules or regulations, or fraud with the intent to evade tax. Prop. Reg. §20.2053-3(d)(1)(iii).

With respect to **interest accruing on loan obligations incurred by an estate**, the existing regulations provide that an estate tax deduction is available where: (1) the underlying loan and the interest expense are bona fide obligations and not a disguised donative transfer; and (2) the loan is necessary to estate administration and essential to proper settlement of the estate. Treas. Reg. §§20.2053-1(b)(2); 20.2053-3(a). A much-discussed technique for creating liquidity to pay estate tax is a so-called "*Graegin* loan," named for *Estate of Graegin v. Commissioner*, T.C. Memo. 1988-477. This typically involves a loan to the estate from the decedent's closely-held business or some other related entity made so the estate can avoid a forced sale of assets to pay estate tax. The *Graegin* case established that an estate may deduct the interest on the loan even though it has not yet been paid provided that the amount of interest is ascertainable with reasonable certainty and certain to be paid.

The proposed regulations restate the requirements of the existing regulations and provide that interest on a *Graegin* loan (or any other loan incurred by the estate) is deductible only if the underlying loan obligation constitutes indebtedness under applicable income tax regulations and general principles of Federal tax law. Prop. Reg. §20.2053-3(d)(2). The proposed regulations then proceed to list 11 nonexclusive factors to consider in determining whether the loan arrangement is bona fide and whether the loan is necessary to estate administration. These include the terms of the loan, the identity of the lender, how the lender reports the transaction for tax purposes, other available alternatives for enhancing the estate's liquidity, and whether the estate has a right of recovery of estate tax against the lender. Prop. Reg. §20.2053-3(d)(2)(i) – (xi). In applying these factors, the preamble explains that:

> if, taken in their entirety, the facts and circumstances indicate that either the need for the loan or any of the loan terms are contrived to generate, or increase the amount of, a deduction for the interest expense, the interest is not deductible. Thus, if the lender is a primary beneficiary of the estate (or an entity controlled by such beneficiary) who may have liability for payment of the estate tax or whose share of the estate may bear the burden of estate taxes and other liabilities, the facts indicate the loan is not necessarily incurred in the administration of the estate and, therefore, indicate that any interest accruing on the loan is not necessarily incurred in the administration of the estate. Further, if the loan obligation carries an extended loan term with a single balloon payment that does not correspond with the estate's ability to satisfy the loan, the facts indicate that the interest accruing on the loan is not necessarily incurred in the administration of the estate.

This rule would make *Graegin* loans a riskier proposition, to say the least.

C. Guidance on Substantiating the Value of a Deductible Claim

Current regulations provide that in order to deduct the amount of an unpaid claim, the value of the claim must be determined by a "qualified appraisal" performed by a "qualified appraiser." The proposed regulations replace this requirement with one that requires a "**written appraisal document**" that adequately reflects the value of the claim as of the time the estate tax return is completed. Prop. Reg. §§20.2053-4(b)(1)(iv); 20.2053-4(c)(1)(iv). Among other things, the document should take into account post-death events occurring prior to the time the deduction is claimed as well as events reasonably anticipated to occur before payment. In addition, the document must be prepared, signed, and dated by a person who is qualified to appraise the claim being valued, but who is not: (1) related to the decedent or a beneficiary of the decedent's estate or revocable trust; (2) related to a beneficiary; or (3) an employee or owner of any of any such related party. The document also must include a statement describing the basis for the person's qualification to appraise the claim being valued.

D. Guidance on Deductibility of Amounts Paid Under Decedent's Guarantee

Finally, the proposed regulations contain a provision specifically addressing the deductibility of **claims based on a decedent's personal guarantee** existing at the date of death. A decedent, for example, may have made a personal guarantee in connection with a loan made to the decedent's closely-held business. Proposed Regulation §20.2053-4(d)(5)(i) states that "[t]o be deductible, a claim founded on a promise must represent a personal obligation of the decedent existing at the time of the decedent's death, and the claim must be enforceable against the decedent's estate. In addition, ... the promise or agreement must have been bargained for at arm's length and the price must have been an adequate and full equivalent reducible to money value." For this purpose, the proposed regulations provide that:

> a decedent's agreement to guarantee a debt of an entity in which the decedent had an interest at the time the guarantee was given satisfies the requirement that the agreement be in exchange for adequate and full consideration in money or money's worth if, at the time the guarantee was given, the decedent had control (within the meaning of section 2701(b)(2)) of the entity. Alternatively, this requirement is satisfied to the extent the maximum liability of the decedent under the guarantee did not exceed, at the time the guarantee was given, the fair market value of the decedent's interest in the entity.

Prop. Reg. §20.2053-4(d)(5)(ii). The proposed regulations also state that any right of contribution or reimbursement held by the estate will serve to reduce the amount of the deduction. Id.

IX. 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.
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> • 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.
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> . . .
>
> • 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.)

X. INTERGENERATIONAL SPLIT-DOLLAR ARRANGEMENTS CAN WORK (*Estate of Levine v. Commissioner*, 158 T.C. No. 2, February 28, 2022)

The Tax Court has held that an intergenerational split-dollar life insurance arrangement was properly structured under the "loan regime" so that inclusion in the decedent's gross estate was limited to the value of the reimbursement right held by the decedent's living trust and did not include the full surrender values of the policies. The court also held that §2703 did not apply to the arrangement. The case is significant in its complete victory for the estate on all issues.

The decedent, Marion Levine, was a key figure in the founding and growth of a supermarket chain with 27 stores at the time of its sale to an outside buyer in 1981. Levine quintupled the proceeds from the sale through investments in stock, real estate, mobile home parks, two Renaissance fairs and loans. By the time she started serious estate planning in 2007 she had some $25 million in wealth.

At the advice of counsel, Levine established an irrevocable life insurance trust ("ILIT") settled under South Dakota. The ILIT was created to hold two life insurance policies, one on the life of her daughter and the other on the life of her son-in-law. South Dakota Trust was the named as the directed trustee, and the "investment committee" that directed the trustee consisted of one person: Bob Larson, Levine's "close personal friend" who understood the family dynamics.

In his capacity as the ILIT's "investment committee," Larson approved of a split-dollar arrangement under which Levine's revocable living trust paid the premiums on the life insurance policies owned by the ILIT through various loan transactions. Under these loans, Levine's revocable trust would be repaid from the insurance proceeds after the deaths of her daughter and son-in-law. Specifically, Levine's revocable trust was to receive the greater of the money loaned to the ILIT or the surrender value of the life insurance policies, payable at the earlier of the insured's deaths or the surrender of the policies.

But Levine died before her daughter and son-in-law, and neither policy had been surrendered. Thus, at her death, Levine's trust was still owed money from the ILIT. That brings us to the central issue of the case: how much to include in Levine's gross estate. The estate claimed the amount includible was the amount it was entitled to receive from the ILIT (about $2.3 million) but the IRS said the amount includible was the $6.1 million surrender value of the policies at the time of Levine's death.

The IRS based its argument on the application of three Code provisions. Specifically, the IRS claimed that: (i) inclusion under §2036 results because Levine retained the right to designate who would possess the income from the split-dollar arrangement; (ii) inclusion under §2038 results because Levine maintained a power to alter, amend, revoke, or terminate the split-dollar arrangement; and (iii) any restrictions on the split-dollar arrangement should be disregarded under §2703, thus causing the estate to include the full surrender value of the policies. The Tax Court rejected each of these contentions.

Regarding §2036, the Tax Court held observed that the policies were bought and owned by the ILIT, not Levine. More importantly, the arrangement's express terms gave only the ILIT's investment committee (Larson) a power to terminate the arrangement. "Without any contractual right to terminate the policies, we can't say that Levine had any sort of possession or rights to their cash-surrender values." *Id.* at 29. And since Larson held the termination power in a fiduciary capacity, he was not a mere puppet of Levine. On top of that, he owed fiduciary duties not just to Levine's daughter and son-in-law but also to their descendants. Thus, neither Levine nor her revocable trust retained any power to control the possession, enjoyment, or income from the policies held by the ILIT.

As to §2038, the Tax Court rejected the IRS's argument that Larson's power to terminate the arrangement would give Levine effective control over the surrender value of the policies. The court observed that this argument relies on the same premise as the rejected §2036 argument—that Larson was somehow in Levine's pocket. Having rejected the argument already, the court did not bother to spell out the same reasons here too.

Finally, the Tax Court held that §2703 does not apply on these facts to warrant full inclusion of the surrender value of the policies because the policies at all times were held by the ILIT and not by Levine or her revocable trust. "The property we have to value here is the property in Levine's estate, which is the split-dollar receivable she held at the time of her death. There were no restrictions on *that* property. She could do with the receivable what she wanted. … Section 2703 is not relevant to the valuation of the receivable because Levine had unrestricted control of it. Section 2703 therefore does not apply." *Id.* at 40.

XI. CHECKS UNPAID AT DEATH STILL INCLUDIBLE IN GROSS ESTATE, BUT IRS ERROR IN USING TERM OF ART WORKS IN ESTATE'S FAVOR (*Estate of DeMuth v. Commissioner*, T.C. Memo. 2022-72, July 12, 2022)

The Tax Court has held that while the value of ten checks written before but paid after the decedent's death would normally be includible in the gross estate, only the value of seven of the checks would be included in this case since the IRS stipulated, erroneously, that three of the checks had been paid by the drawee bank. The case confirms both the rule regarding the gross estate inclusion of uncashed checks and the need to be careful in using terms of art.

Back 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. 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. So 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) says 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.

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 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.

XII. FAILURE TO DISCLOSE BASIS IN APPRAISAL SUMMARY DOOMS CHARITABLE CONTRIBUTION DEDUCTION (*Hickory Equestrian, LLC v. Commissioner*, Docket No. 347-21, February 8, 2022)

The Tax Court granted partial summary judgment to the IRS in a case involving a claimed charitable contribution deduction for a conservation easement the taxpayer placed on a 300-acre tract of land in Dade County, Georgia. The court's order, served on February 8, 2022, rejected the IRS's contention that the conservation easement was not protected in perpetuity but upheld the IRS's determination that the taxpayer's failure to disclose the property's cost basis on the required appraisal summary form meant the taxpayer failed to comply (or even substantially comply) with applicable substantiation requirements.

The taxpayer was formed in November, 2011, when several individuals contributed their interests in the subject real property. The individual purchasers collectively paid $111,715 to acquire the land in 2002. One month after the taxpayer's formation, it granted a conservation

easement over most of the property to the North American Land Trust. On its 2011 partnership tax return, the taxpayer claimed a charitable contribution deduction of $6,366,711 representing the value of the easement. The return showed that the unencumbered value of the land was $6,718,111. Effectively, then, the taxpayer took the position that the easement reduced the value of the land to a mere $351,400. Along with the tax return, the taxpayer included a completed (well, mostly completed) Form 8323, Noncash Charitable Contributions, as well as a separate document titled "Noncash Charitable Contributions Attachment."

The IRS disallowed the deduction on two grounds: first, that the easement was not "protected in perpetuity," and, second, that the taxpayer did not substantiate the claimed value of the contribution.

A. Perpetuity Requirement

The donation of a conservation easement is deductible for federal income tax purposes where the conservation purpose is "protected in perpetuity." I.R.C. §170(h)(5)(A). The regulations provide that where a donor reserves rights on the land subject to the easement, the donor must provide the charity with certain documentation in advance of the contribution, the donor must give written notice to the charity before exercising any reserved right which might adversely impact the conservation purpose of the easement, and the deed of easement must permit the charity to enter the property at reasonable times to inspect the property. Treas. Reg. §1.170A-14(g)(5).

The deed of easement in this case prohibits commercial or residential development of the land but reserves to the taxpayer certain rights, including the rights to engage in recreational activities like hunting, fishing, and horseback riding. Consistent with these reserved rights, the deed also reserves to the taxpayer rights to construct and maintain hunting or observation stands, bird houses, trails, and signage. The deed does not require that the taxpayer obtain the charity's permission before exercising any of these rights, but it does require that the taxpayer must give written notice "before exercising any Reserved Right that may impair the conservation interests." Finally, the deed reserves other rights to the taxpayer, including rights to build fences and raised walkways, repair roads, restore wetlands, remove vegetation, and erect "facilities normally used in connection with supplying utilities," but the deed expressly requires that the taxpayer first obtain the charity's permission before exercising any of these rights. If the charity does not respond to written notice from the taxpayer requesting approval, however, the deed provides that the charity is deemed to have consented to the request.

The IRS argued that the deed violates the perpetuity requirement since some of the reserved rights could be exercised without permission from the charity, but the Tax Court ruled that whether the exercise of any of these rights could have an adverse effect on the conservation interest of the easement is a question of fact that cannot be answered in a motion for summary judgment.

The IRS also argued that the “deemed consent” provision (under which the taxpayer could exercise rights otherwise requiring the charity’s permission if the charity does not timely respond to the taxpayer’s request for approval) effectively renders the charity powerless to prevent the exercise of the taxpayer’s reserved rights that would impair the conservation purpose, thus violating the perpetuity requirement. But the Tax Court refused to hold that the deemed consent provision violates the regulations as a matter of law:

> NALT is deemed to have consented to exercise of certain rights, but only if it has failed to respond to two successive notices from Hickory over a period of several months. NALT’s internal procedures and past practices may shed light on whether this is likely to happen. In any event, the question whether exercise of the right to which consent is deemed given would impair any conservation purpose presents factual questions ill-suited to summary adjudication.

Notice the court does not hold that deemed consent provisions are valid. It merely concludes that whether a deemed consent provision violates the perpetuity requirement is a question of fact. Planners should not read this rejection of the IRS’s motion for summary judgment as green-lighting the use of deemed consent clauses in conservation easement deeds.

B. Substantiation Requirement

When a taxpayer donates property worth more than $5,000 to charity, the taxpayer must obtain a qualified appraisal of the property and attach to the return an “appraisal summary.” I.R.C. §170(f)(11)(C); Treas. Reg. §1.170A-13(c)(2). Form 8283, Noncash Charitable Contributions, is the prescribed document to be used as the “appraisal summary.” Among other things, the Form asks for information about how and when the taxpayer acquired the donated property, the value of the donated property, and the taxpayer’s “cost or adjusted basis” in the donated property. Failure to complete Form 8283 generally precludes a deduction. I.R.C. §170(f)(11)(A); *RERI Holdings I, LLC v. Commissioner*, 149 T.C. 1, 16-17 (2017).

The taxpayer in this case submitted a Form 8283 together with an attachment. In box 5(e) of the form, the one asking about how the taxpayer acquired the property,” the taxpayer wrote “See Attached.” The taxpayer left box 5(f), the one asking the taxpayer’s basis in the property, blank. The written attachment to the Form states that the “basis in the property is not included … because … the basis of the property (in this case a conservation easement) is not determinable.” The taxpayer did not disclose its basis in the underlying land because, it said in the attachment, the taxpayer “has a holding period in the donated property in excess of 12 months” and “such basis will not impact the amount of the claimed deduction.”

By not completing box 5(f), the taxpayer did not comply with the applicable reporting requirements. The IRS moved for summary judgment on that basis. The taxpayer argued it substantially complied with the reporting requirements, however, and there is authority for applying the doctrine of substantial compliance in this arena. *Hewitt v. Commissioner*, 109 T.C. 258, 265 n. 10 (1997). But there is also authority that failing to disclose the basis of contributed

property is fatal to a claim for deduction. *RERI Holdings I, LLC, supra*; *Oakhill Woods, LLC v. Commissioner*, T.C. Memo. 2020-24; *Belair Woods, LLC v. Commissioner*, T.C. Memo. 2018-159. And it doesn't help that the taxpayer here stands to gain from the omission of information about basis. As the Tax Court explains:

> Here, Hickory acquired the land in question from its partners in November 2011. The partners (or their predecessors) had purchased the land in 2002 for $111,715. In December 2011 Hickory granted an easement over this land to NALT, valuing the unencumbered Property at $6,718,111. Hickory thus took the position that the Property had appreciated by more than 5,000% during the 9-year period that included the Great Recession of 2008-2009. This is precisely the sort of information that Congress wished the IRS to have, and Hickory's refusal to supply it contravenes the "essential requirements of the governing statute."

The taxpayer argued that information about the property's basis was disclosed elsewhere in the partnership tax return in an "IRS Section 721 Disclosure" attached to the return, but the court rejected this argument, concluding that revenue agents should not have to "sift through hundreds of pages of complex returns looking for possible clues about what the taxpayer's cost basis might be." Concluding that "[t]his was not a case of inadvertent omission, but of a conscious election not to supply information," the court determined there was no substantial compliance with the reporting requirements. It thus granted the IRS's motion for summary judgment on this issue.

Finally, the taxpayer argued that the "reasonable cause" exception to the reporting requirements, which excuses the failure to comply when "due to reasonable cause and not to willful neglect," I.R.C. §170(f)(11)(A)(ii)(II), should apply. The Tax Court ruled that this was a question of fact, so the question of whether the taxpayer reasonably relied on the advice of professionals would be reserved for trial.

XIII. DONATION OF CROPS TO CHARITABLE REMAINDER TRUSTS GENERATE NO INCOME TAX DEDUCTION, AND PAYMENTS FROM THE TRUSTS ARE TAXABLE AS ORDINARY INCOME (*Furrer v. Commissioner*, T.C. Memo. 2022-100, September 28, 2022).

The Tax Court has held that the donation of crops to two charitable remainder annuity trusts (CRATs) did not give rise to an income tax deduction. The court further held that distributions made to the taxpayers were taxable in full as ordinary income.

The taxpayers, 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.

XIV. TAX CONSEQUENCES OF DONATION TO PI (FOUNDATION) ARE SQUARED (WITH THE CODE) (*Keefer v. United States*, N.D. Tex., July 6, 2022).

A federal district court has held that a taxpayer had gross income under the assignment of income doctrine through a transfer of the donor's rights to a portion of the proceeds from a pending sale. In the case, the taxpayer was a limited partner in a limited partnership that owned and operated a single hotel property. In April, 2015, the partnership exchanged a nonbinding letter of intent with an unrelated party for the purchase and sale of the hotel. In June, 2015, the taxpayer assigned a 4% limited partner interest to the Pi Foundation, a charitable organization, for the purpose of establishing a donor advised fund that the Pi Foundation would administer. In July, 2015, the partnership and the unrelated buyer signed a

$54 million contract for the purchase and sale of the hotel. The transaction closed in August, 2015.

The taxpayer's joint federal income tax return for 2015 claimed a charitable contribution deduction in the amount of $1,257,000. Given that four percent of $54 million is $2,160,000, one might wonder why the taxpayer did not claim a larger deduction. That's because an appraisal of the donated interest indicated the taxpayer and the charity had an agreement that the charity would only share in the net proceeds from the sale of the hotel. As part of that side deal, the parties agreed that the charity would not share in any other assets of the partnership that were not part of the sale. The value of the donation was also reduced to reflect what the appraisal estimated to be "5% probability of no sale."

To substantiate the contribution, the taxpayer attached a completed Form 8283, the appraisal, and two other documents. One was a 12-page packet sent to the taxpayer from the charity outlining the terms and conditions of the donor advised fund to be established through the donation. The second was an acknowledgment letter which read in full as follows:

> Thank you for your donation to The PI Foundation, Inc. of a 4.00% interest in [the partnership]. The Pi Foundation, Inc., is a 501(c)(3) nonprofit organization. Your contribution is tax-deductible to the extent allowed by law. No goods or services were provided in exchange for your generous financial donation. Please keep this page for your records.

The IRS disallowed the deduction because the taxpayer did not have from the charity a contemporaneous written acknowledgment showing that the donor advised fund "has exclusive legal control over the assets contributed" and because the appraisal lacked an identifying number for the appraiser. The taxpayer paid the resulting additional tax plus a penalty and then filed the instant action for refund.

A. Assignment of Income Doctrine Applies

The court first held that because the taxpayer only assigned the rights to the net proceeds from the sale of the hotel and not all of the rights associated with the 4% limited partner interest, the taxpayer had gross income under the assignment of income doctrine. Under that doctrine, where a taxpayer transfers only the right to income from property (the "fruit") and not the property itself (the "tree"), the taxpayer continues to be the party liable for the tax on the assigned income. In this case, said the court, the Pi Foundation was entitled only to a share of the net proceeds from the sale of the partnership's principal asset. Thus, the taxpayer did not assign the "tree" (all rights associated with the 4% limited partner interest), just the "fruit" (the right to 4% of the net proceeds from the sale of the hotel). As the court observed:

> After the assignment, Pi did not have the right that other partners had to share in the net proceeds of the Hotel sale. … Or, in the unlikely event the Hotel sale had not been completed as planned, Pi would not have shared equally with the

> other limited partners in the duty to contribute funds for renovation, should additional funds be required to fulfill the partnership's obligations under the loan or franchise agreements. … Accordingly, the [taxpayers] did not donate their full 4% partnership interest on June 18, 2015, but donated only a portion thereof. They did not transplant the *whole* tree.

As a result of this holding, then, the taxpayer has to pay federal income tax on the portion of the sale proceeds that belongs exclusively and irrevocably to the charity.

B. Substantiation Problems

Section 170(f)(18)(B) disallows a deduction for a contribution to a donor advised fund unless "the taxpayer obtains a contemporaneous written acknowledgment … from the sponsoring organization … of such donor advised fund that such organization has exclusive legal control over the assets contributed." Neither of documents the taxpayer received from the Pi Foundation contain a statement to this effect.

The court observed that while the exact words "exclusive legal control" are not required, the documents must prove the organization's exclusive control over the donated property. Here, though, neither document does this. While the 12-page packet states that the donor "hereby transfers an irrevocable gift" to the Pi Foundation, the actual assignment did not occur until ten days after the taxpayer received this packet. What's more, the cover letter to the packet says "It is our understanding that you *intend* to donate" the partnership interest and that if the taxpayer does not do so the taxpayer "will be responsible for paying our legal fees and costs associated with your *anticipated* donation" (emphasis added). Thus, concluded the court, the 12-page packet does not "acknowledge" a contribution.

Likewise, the acknowledgment letter, furnished after the donation, was insufficient. The letter does not even refer to the creation of a donor advised fund, much less broach the subject of whether the donor advised fund has exclusive legal control over the donated property. The court rejected the taxpayer's claim that the 12-page packet and the acknowledgement letter could be read together to constitute a sufficient written acknowledgement, noting the acknowledgment letter does not reference the 12-page packet at all.

Finally, the taxpayer argued that there was substantial compliance with the substantiation requirements, but the court rejected this claim, noting precedent that the substantiation requirements require strict compliance. Thus, because the documentation submitted with the return did not meet the Code's substantiation requirements, the taxpayer was denied any deduction for the charitable contribution.

C. Observations

Because this was a refund case, the court simply denied the taxpayer's claim. It did not impose additional tax from the failure to include the charity's share of the net sale proceeds in the

taxpayer's gross income. In another context, though, this decision could be quite harsh. At the end of the day, the charity gets four percent of the sale proceeds but the donor still has to pay the federal income tax from the gain. What's worse, the taxpayer does not get an offsetting charitable contribution deduction.

There are two slightly better approaches for donors in a similar situation. First, the donor can transfer the entirety of the partnership interest and not just the rights to the sale proceeds. That would have been cumbersome in this particular case as there were pre-existing agreements among the partners as to their rights in various cash reserves that had been amassed over time. Second, the donor can receive the sale proceeds (triggering gain) and then donate a portion of the cash proceeds to the charity (assuring a deduction for the cash contribution assuming the charity furnishes a contemporaneous written acknowledgment). The tax result in this second situation is better only in that the deduction has a better chance for success.

It is also important to note that the donation happened only during the letter-of-intent phase and not after execution of the binding contract. Once a binding agreement for the sale is made it becomes too late to assign any portion of the rights to the income to a charity or any other person.

XV. DEED FAILS AS CONTEMPORANEOUS WRITTEN ACKNOWLEDGMENT, SO TAXPAYER LOSES CHARITABLE DEDUCTION (*Albrecht v. Commissioner*, T.C. Memo. 2022-53, May 25, 2022).

The Tax Court has held that a "Deed of Gift" memorializing the taxpayer's 2014 transfer of about 120 items of Native American jewelry and artifacts to a museum did not constitute a "contemporaneous written acknowledgment" from the museum sufficient to allow the taxpayer a charitable contribution deduction on her 2014 federal income tax return. Section 170(f)(8)(A) requires a taxpayer to obtain from the charitable organization a "contemporaneous written acknowledgment" where the taxpayer contributes $250 or more in cash or property. Section 170(f)(8)(B) provides that the acknowledgment must state three things: (i) the amount of cash and a description of any non-cash property contributed; (ii) whether the charity provided any goods or services in consideration of the donation; and (iii) a description and good faith estimate of the value of such goods or services provided in consideration of the donation. The taxpayer must receive this acknowledgment by the time the taxpayer files the federal income tax return claiming the deduction (or, if earlier, the due date for that return).

The only documentation the taxpayer in this case had by the time she timely filed her 2014 federal income tax return was a "Deed of Gift" signed by both the taxpayer and an authorized agent of the museum receiving the gift. The first page of the five-page deed said that the taxpayer "hereby donates the material described below … under the terms stated in the Conditions Governing Gifts…." The second page contained the "Conditions Governing Gifts," the relevant portion of which specified that "the donation is unconditional and irrevocable; that all rights, titles and interests held by the donor in the property are included in the donation, unless

otherwise stated in the Gift Agreement." In this case, however, there was no "Gift Agreement," at least not one that was included with or within the deed. The last three pages of the deed listed the various items conveyed to the museum by the taxpayer.

Ultimately, then, there was no statement from the museum indicating whether it provided any consideration for the donation (and, if so, a good faith estimate of the value of that consideration). Indeed, the reference in the deed to a "Gift Agreement" suggests there might be additional terms, including the museum's promise to provide goods or services in exchange. That means, said the Tax Court, the taxpayer never received an acknowledgment that contains the information required by the statute. In the court's words, "When looking exclusively at the deed and considering it as a whole, it leaves open a significant question about whether the parties had entered into a side agreement that included additional, superseding terms." Noting that the statute imposes "strict demands," the court concluded that taxpayer's good faith substantial compliance in this case was not enough to save the deduction.

XVI. ARGUMENTS IN DEFENSE OF FAILING TO DISCLOSE SWISS BANK ACCOUNTS SEEM TO BE FULL OF HOLES.

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, only to come up short most of the time. Consider the following cases.

A. Maximum Penalty for Failing to File FBAR Upheld Against Constitutional and Other Challenges (*United States v. Toth*, 1st Cir., April 29, 2022)

The First Circuit Court of Appeals has upheld the imposition of a penalty in excess of $2.17 million against an individual for failing to report information related to amounts held on deposit with a Swiss bank, rejecting the individual's various procedural and constitutional challenges as well as her argument that Treasury regulations imposed a $100,000 ceiling on the amount of the penalty.

Monica Toth, a United States citizen, opened an account with the Union bank of Switzerland in 1999. She filed her first FBAR in 2010, even though the account at all times from 1999 through 2009 had a balance of more than $10,000. This case focuses on the year 2007, when Toth's account had a balance of about $4.3 million. On her 2007 federal income tax return, Toth checked a box indicating she had no foreign bank accounts. The IRS concluded that her failure to file an FBAR for 2007 was willful, so it imposed a penalty of about $2.17 million (half the

balance of the account). Add in interest and late fees and you get a total claim of over $3 million, which the IRS sued to collect in this action.

A federal district court in Massachusetts granted summary judgment to the IRS. Toth noted that Treasury's regulations imposed a maximum penalty of $100,000, consistent with the original terms of the Bank Secrecy Act. When Congress changed the civil penalty for the willful failure to file an FBAR to 50 percent of the balance of the account in 2004, Treasury never amended its regulations to reflect the new maximum penalty amount. Toth argued that since the regulations still imposed a maximum $100,000 penalty, her penalty should not exceed that amount. But the district court, like many other courts have done before, held that Treasury's failure to amend the regulations did not create a lower ceiling on the amount of the penalty. It observed that Treasury lacks the power to impose a lower ceiling on the penalty amount. The court went on to conclude that Toth's failure to file was indeed willful and upheld the total penalty imposed.

On appeal, the First Circuit affirmed. It rejected her claim that the court lacked jurisdiction due to improper service because the facts showed she "made a deliberate effort to avoid service." It also rejected her claim that discovery sanctions imposed on her by the lower court were excessive. Toth repeated her argument that the lower penalty cap imposed by the regulations should apply, but the First Circuit rejected that claim too. The court held that:

> neither the amount of maximum penalty identified in the regulation, nor the statute authorizing the promulgation of the regulation, nor the means of its promulgation suggests that the Treasury intended the regulation to set a ceiling on the penalty that would apply even if the statute that set the maximum penalty at the time of the regulation's issuance was amended to raise it. Rather, the test of the regulation, the statute authorizing its promulgation, and the means of its promulgation each accords with an understanding that the Treasury intended the regulation merely to parrot the maximum amount for the penalty that Congress had set at the time that the regulation was promulgated.

Finally, Toth argued that the penalty violated the Excessive Fines Clause of the Eighth Amendment and the lower court's grant of summary judgment violated the Due Process Clause of the Fifth Amendment. The appellate court rejected both constitutional arguments. On the Eighth Amendment claim, the court observed that the Excessive Fines Clause only applies to monetary penalties that function as a "punishment for some offense." Here, Toth was not subject to criminal prosecution and the fine was not a "punishment" because it served a remedial purpose. The court cited precedent indicating that a tax penalty for failing to file can exceed the amount owed in taxes without constituting a "punishment." On the Due Process claim, the court had even less tolerance, quickly observing that Toth supported her claim with reference to a case that involved a penalty imposed by a jury and not one set by a statute. Thus, the entire penalty was upheld on appeal.

B. Third Circuit Upholds Large Penalty for Willful Failure to Disclose Foreign Bank Account (*Bedrosian v. United States*, 3d Cir. July 22, 2022)

The Third Circuit Court of Appeals has affirmed a district court decision imposing a penalty of $975,789.17 against a taxpayer for willfully filing an inaccurate FBAR. The taxpayer had two accounts with the United Bank of Switzerland, but never filed an FBAR until 2008 even though his accountant had told him for years that he was breaking the law by failing to disclose the accounts. What's more, the FBAR the taxpayer ultimately filed disclosed only one of the two accounts and intentionally undervalued the balance in the disclosed account.

After discovering the omissions, the IRS assessed a penalty of $975,789.17, half of the balance of the undisclosed account. This is the maximum penalty for willfully filing an inaccurate FBAR. When the taxpayer refused to pay, the United States filed the instant action. At first a federal district court held that the taxpayer's omission was merely "negligent" and not "willful." But the Third Circuit reversed, concluding that "willfulness includes not only knowing, but reckless, conduct." It remanded the case for a determination of whether the taxpayer's omissions were willful. As the appellate court framed the issue:

> In layman's language, if the Government could show Bedrosian (1) "clearly ought to have known" (2) "there was a grave risk" the FBAR filing requirement "was not being met," and if (3) he "was in a position to find out for certain very easily," it would satisfy the willfulness element.

The lower court concluded that under this more objective test for willfulness, the taxpayer had acted willfully by recklessly disregarding the risk that the FBAR was inaccurate. It therefore upheld the penalty. That led to a second appearance before the Third Circuit, this time at the appeal of the taxpayer.

The taxpayer claimed his conduct was not willful, but the Third Circuit disagreed. It found no clear error from the lower court's decision that the taxpayer ought to have known there was a grave risk that an accurate FBAR was not being filed and that he was in a position to find out for certain very easily. It did not help that the taxpayer sent two letters to the Swiss bank ordering that two accounts be closed shortly after filing the FBAR disclosing the existence of only one account. There was also evidence showing the taxpayer was aware of "the significant amount of money held in his foreign bank accounts."

The taxpayer also disputed the computation of the penalty amount, claiming the United States derived the balance of the undisclosed account from inadmissible evidence. Accordingly, he claimed, the government never proved the account balance used to compute the penalty. The Third Circuit confirmed that the only evidence submitted in support of the account balance was a one-page spreadsheet that "appears to be a record of some account." But, as the court observes, "There is no name on the page. No account number. Not even a bank mentioned. There are numbers on the page, but no listed currency." Because this spreadsheet could be anyone's account at any bank in any currency, then, "it is just a slip of paper with no relevance

in this case." The court thus held that this document was improperly considered by the lower court in computing the penalty amount.

But that doesn't mean the taxpayer prevails. Indeed, counsel for the United States pointed to four separate statements made by the taxpayer's counsel on brief and at trial that effectively admitted to the omitted account's balance. First, the taxpayer's reply brief to the government's motion for summary judgment admits that the account balance was $1,951,578.34. Second, the taxpayer's brief in support of his own motion for summary judgment states that "the maximum value of the account was $1,951,578.34." Third, the taxpayer's trial brief contains the same statement. Finally, at trial, the taxpayer's counsel said in the opening statement: "the government states and we concede that at the time there was about two million U.S. dollars in that account give or take." Combined, said the Third Circuit, these statements constitute a judicial admission of the account balance and can serve as the basis for computing the penalty amount. Finding no error in the computation, then, the Third Circuit affirmed the district court's decision.

C. Supreme Court to Decide Whether Penalty Applies on a Per-Form or Per-Account Basis (*Bittner v. United States*, cert granted, June 21, 2022)

As explained above, the Bank Secrecy Act of 1970 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. Suppose an individual taxpayer has two foreign bank accounts, each with a balance of more than $10,000, and the individual inadvertently fails to disclose them on an FBAR. Has the individual violated the Act once (by failing to file the form) or twice (by failing to disclose either of two accounts, though both would be on one form)? In other words, does the penalty apply on a "per-form" basis or a "per-account" basis? That's the issue the United States Supreme Court will decide in this case.

The taxpayer in this case is a naturalized citizen of the United States who resided in his native Romania from 1990 until late in 2011. A successful entrepreneur, he had dozens of bank accounts while in Romania but was unaware that, due to his dual citizenship, he was under a duty to file annual FBARs. It was not until he returned to the United States in 2011 that he learned of his obligation, and he retained an accountant to prepare and file those forms. The IRS determined that the taxpayer had not made timely filings for the years 2007 – 2011 and imposed a $2.72 million penalty based on 272(!) violations of the Act. A federal district court held that the maximum penalty amount should be $50,000; that is, one $10,000 penalty for each annual FBAR during the five years at issue.

The Fifth Circuit held that each foreign account not timely reported on an FBAR is a separate violation triggering its own $10,000 penalty. *Bittner v. United States,* 19 F.4th 734 (5th Cir. 2021). That ruling stands in contrast to that of *United States v. Boyd,* 991 F.3d 1077 (9th Cir. 2021), where the Ninth Circuit held that that the failure to file an FBAR is a single violation regardless

of the number of accounts required to be disclosed. No doubt this split among the circuit courts of appeal convinced the Supreme Court to hear and decide the case.

On August 16, 2022, the American College of Trust and Estate Counsel (ACTEC) filed an amicus brief in support of neither party. Hoping to help the Court understand the implications of this case in common estate planning situations involving that the brief calls “fiduciary parties” (principals and agents under a financial power of attorney; grantors, trustees, and beneficiaries of trusts; and executors and beneficiaries of estates), ACTEC summarized its argument as follows:

> The case below relates to one person’s violation, but, “person” as it relates to fiduciary parties is complex and may change. In order to assist the Court in its consideration of the construction of the statute, ACTEC’s brief discusses the evolution of the [Bank Secrecy Act] to include non-willful violations of the [Act]; the effect of the statute on fiduciary parties; the alternative statutory constructions; and the potential constitutional impact of the statute as construed.

Though formally not in support of any party in the case, the brief makes clear that the Fifth Circuit’s interpretation, when applied to fiduciary parties, can be devastating:

> Given the various roles and relationships with respect to trusts, a single foreign account owned by a trust can be the basis for a filing requirement by multiple persons, and the changes that occur over time as to the identity of beneficiaries and trustees may easily result in inadvertent, non-willful failures to report.
>
> For example, assume that Grantor, a U.S. person, creates a revocable trust to hold Grantor’s assets. Grantor names three U.S. citizens as trustees, requiring that all decisions be made by majority vote. The trustees have authority to make distributions during Grantor’s lifetime only to Grantor and Grantor’s spouse. Grantor transfers to the trust two foreign financial accounts in Country A, which Grantor established to facilitate the payment of expenses associated with real properties owned by the trust in Country A. In Years 1-6 each account balance is $10,000. Each of the trustees is obligated to file an FBAR reporting the foreign financial accounts. On a per account basis, the trustees’ non-willful failure to file a timely and correct FBAR could subject the trust or trustees to up to $360,000 of FBAR penalties – eighteen times the size of the account balances. The Grantor’s power to revoke the trust makes Grantor the owner of the trust under the grantor trust rules...and obligates Grantor to file an FBAR reporting the foreign financial accounts. Grantor’s non-willful failure to file an FBAR could, computed per account, also subject Grantor to $120,000 of additional penalties. If Grantor’s spouse receives more than 50 percent of the trust income, she also becomes obligated to file an FBAR and her non-willful

failure to file an FBAR could result in the imposition of another $120,000 of additional penalties. The aggregate penalties under the per account construction of the statute would thus be $600,000 – 30 times the aggregate balance of the accounts.

The result would be the same if the trust were an irrevocable grantor trust. Assume the same facts as in the prior example, except that the trust is irrevocable. The trustees' power to distribute income to Grantor and Grantor's spouse makes the trust a grantor trust. Again, the three trustees, Grantor, and Grantor's spouse would each be required to file an FBAR and could be subjected to non-willful FBAR penalties which on a per account basis could total $600,000.

If the trust holds an interest in an entity which maintains foreign accounts, there are additional entity level reporting obligations and the potential for further upstream reporting requirements. For a trust that owns a controlling interest in a corporation which has foreign accounts, each of the persons described in the preceding example could be subject to a $10,000 penalty for each non-willful failure to file an FBAR for each account owned by the business.

XVII. NO CHARITABLE DEDUCTION FOR LACK OF REASONABLE CAUSE IN FAILING TO SUBSTANTIATE CONTRIBUTION (*Schweizer v. Commissioner*, 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.

XVIII. 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.

XIX. TAXPAYER PREVAILS IN VALUATION DISPUTE OVER CONSERVATION EASEMENT (*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.

XX. 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.

Richard J. O'Neill Trust v. Commissioner, T.C. Memo. 2022-108, at 6.

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.

XXI. UPDATED GUIDANCE FOR PERIODIC PAYMENTS MIGHT INCENTIVIZE EARLY RETIREMENT (*Notice 2022-06*, January 18, 2022).

The IRS has updated its guidance for determining whether a series of payments from an individual retirement account qualifies for the exception from the 10-percent early withdrawal penalty given to “substantially equal periodic payments.” In doing so, it made early retirement a viable option for more taxpayers.

Section 72(t) generally provides that where a taxpayer receives any amount from a qualified retirement plan (defined to include individual retirement accounts) before age 59½, an additional tax equal to 10 percent of the amount received will apply. Section 72(t)(2)(A)(iv) excepts distributions which are “part of a series of substantially equal periodic payments” made for the life (or life expectancy) of the account holder or the joint lives (or join life expectancies) of the account holder and the designated beneficiary from the application of this 10-percent penalty. Practitioners often refer to these penalty-free distributions by the acronym SEPP.

Two decades ago, in *Revenue Ruling 2002-62*, the IRS stated that distributions will be treated as SEPPs if made in accordance with one of three methods: (1) the required minimum distribution method; (2) the fixed amortization method; or (3) the fixed annuitization method. *Notice 2022-06* updates the mechanics of each method.

Under the required minimum distribution method, the annual payment for each year is determined by dividing the account balance for that year by the number from the chosen life expectancy table for that year. Under this method, the account balance, the number from the chosen life expectancy table and the resulting annual payments are redetermined for each year. *Notice 2022-06* retains this method but requires the use of either the new life expectancy tables issued in 2020 or an updated "uniform lifetime table" set forth in Appendix A to the Notice.

Under the fixed amortization method, the annual payment for each year is determined by amortizing the account balance over a specified number of years determined using the chosen life expectancy table and a chosen interest rate that cannot exceed 120 percent of the federal mid-term rate for either of the two months preceding the month in which the distribution begins. Under this method, the account balance, the number from the chosen life expectancy table and the resulting annual payment are determined once for the first distribution year and the annual payment is the same amount in each succeeding year.

This method has not been utilized much in the past decade because interest rates have been quite low. In January, 2022, for example, the federal midterm rate is only 1.6 percent. The lower the interest rate, the lower the amount distributed to the account holder. Low interest rates make it harder for a taxpayer to withdraw amounts from an IRA before age 591/2 without incurring the 10-percent penalty.

But *Notice 2022-26* changes the fixed amortization method to provide that the applicable interest rate is the greater of (i) five percent or (ii) 120 percent of the federal midterm rate for either of the two months preceding the month in which the distribution begins. Under this revised guidance, younger account holders can withdraw more from their IRAs without incurring the 10-percent penalty because they can use a five percent assumed interest rate instead of the lower federal mid-term rate that would otherwise apply.

Finally, under the fixed annuitization method, the annual payment for each year is determined by dividing the account balance by an annuity factor that is the present value of an annuity of $1 per year beginning at the taxpayer's age and continuing for the life of the taxpayer (or the joint lives of the taxpayer and the designated beneficiary). *Notice 2022-06* also retains this method but requires that the updated life expectancy tables be used for calculations, and the applicable interest rate here too is the greater of (i) five percent or (ii) 120 percent of the federal midterm rate for either of the two months preceding the month in which the distribution begins.

Notice 2022-06 applies to any series of payments starting on or after January 1, 2023, but a taxpayer can elect to use this guidance for any series of payments starting in 2022.

XXII. DEDUCTION FOR DONATION OF AIRCRAFT FLIES OUT THE WINDOW (*Izen v. Commissioner*, 5th Cir., June 29, 2022)

The Fifth Circuit has affirmed a 2017 reviewed opinion from the Tax Court denying an income tax charitable contribution deduction to a taxpayer for the donation of an undivided interest in an airplane. The case involved two men (Joe and Phillipe) who together purchased a used jet in 2007 for $42,000. Joe's 2010 tax return showed a lot of gross income. During an audit of the 2010 return, Joe claimed for the first time that he and Phillipe donated the jet to the Houston Aeronautical Heritage Society. In 2016, Joe filed an amended return for 2010 claiming the value of his share of the contribution to be just over $338,000.

The IRS denied the deduction on the grounds that Joe did not furnish adequate substantiation. Specifically, the IRS determined Joe failed to obtain contemporaneous written acknowledgment from the charity. There was a thank you letter, but it was addressed to Phillipe and not to Joe. There was a donation agreement signed by all parties, but that does not constitute an acknowledgment from the charity, in part because it does not indicate whether the charity furnished any goods or services in consideration of the contribution. No documents included Joe's social security number, and there was never any written statement from the charity indicating its intended use of the plane. For all of these reasons, the Tax Court had little trouble concluding the Service was right to disallow the deduction. *Izen v. Commissioner*, 148 T.C. 71 (2017).

The Fifth Circuit likewise had little trouble affirming the decision of the Tax Court. Joe argued that he substantially complied with the substantiation requirements, but as the Fifth Circuit observed:

> The doctrine of substantial compliance may support a taxpayer's claim where he or she acted in good faith and exercised due diligence but nevertheless failed to meet a *regulatory* requirement. We cannot accept the argument that substantial compliance satisfies *statutory* requirements. Congress specifically required the contemporaneous written acknowledgment include the taxpayer identification number, but that is lacking here.

(Emphasis in original.) Joe also tried to introduce a different letter from the charity that was addressed to him, but the appellate court would not consider it since the letter was not attached to Joe's amended return.

XXIII. CONSERVATION EASEMENT DEED SILENT AS TO EXTINGUISHMENT AND AMBIGUOUS AS TO CONDEMNATION SURVIVES SUMMARY JUDGMENT (*Morgan Run Partners, LLC v. Commissioner*, T.C. Memo. 2022-61 (June 14, 2022)

The Tax Court has denied the IRS's motion for summary judgment that a conservation easement deed failed to satisfy applicable regulatory requirements that the gift made to charity be "protected in perpetuity," as required by § 170(h)(5)(A). The court determined that more facts are needed to determine whether the contribution satisfied the regulatory requirements.

The case involved the taxpayer's 2016 donation of a conservation easement covering 232 acres of land in Jefferson County, Alabama, to the National Farmer's Trust. The taxpayer claimed a $26 million deduction for the donation of the easement. A subsequent IRS examination led to a deficiency notice and the imposition of penalties resulting from the disallowance of the claimed deduction. That brought the parties to the Tax Court, where the IRS asked for summary judgment on the grounds that the easement did not comply with the "perpetuity" requirement.

Regulation §1.170A-14(g)(6)(ii) 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." In this case, however, the deed conveying the easement does not expressly address the subject of judicial extinguishment. Instead, the deed simply states that that "no change in conditions … will at any time or in any event result in the extinguishment of the easement." The deed contemplates that the parties would agree to any appropriate amendments required by changed circumstances subject only to the condition that any such changes would not violate §170(h). From this language alone it is unclear whether the deed violates the regulatory requirement.

The deed does, however, address the possibility that the easement could terminate through an exercise of eminent domain. It provides that upon condemnation, the charity would receive its "Proportionate Share of the recovered proceeds." Yet while "Proportionate Share" is a capitalized term, it is not defined in the deed. As the Tax Court observes, "This creates an ambiguity that would need to be resolved under principles of Alabama law, which might include parol evidence." Thus there is a question of material fact as to whether the deed's provisions

comply with the regulation, making summary judgment for the IRS inappropriate. Of course, the court is not at this stage declaring the deed complies with the perpetuity requirement, but at least the taxpayer's claim has survived this initial test.

XXIV. SON-IN-LAW'S CLAIM THAT LOANS FROM FATHER-IN-LAW WERE REALLY GIFTS DISMISSED ON SUMMARY JUDGMENT (*Yost v. Carroll*, N.D. Illinois, January 20, 2022)

A federal district court dismissed without prejudice counterclaims and defenses asserted by a soon-to-be son-in-law against his soon-to-be father-in-law alleging that transfers of over $7 million in the form of loans were in fact gifts. In 2009, David Yost transferred $1.5 million to his daughter, Anne, and Anne's spouse, Morgan Carroll. The transfer took the form of a loan, evidenced by a promissory note payable to David signed by both Anne and Morgan "collectively and/or individually." The couple used the funds to help purchase their New York City home for $2.7 million. The note matured in April, 2014. When Anne and Morgan sold the home three months later in July, 2014, for $5.6 million, they did not pay off any portion of the note. Instead, David rolled the total amount due into a new, consolidated note for just over $2.53 million. Two years later, David transferred another $4.5 million to Anne and Morgan in exchange for a second promissory note.

When Anne filed for divorce from Morgan, David sought payment on the notes, together with all accrued interest, from Morgan. When Morgan refused, David filed this lawsuit. In response to David's complaint, Morgan alleged affirmative defenses and counterclaims based on promissory fraud, civil conspiracy, and illegality. The common theme to Morgan's claims and defenses is that David's transfers to the couple were really gifts and not loans. Morgan claimed David had the couple sign notes so that David would not incur liability for gift taxes on the transfers and that David never intended to collect on the notes when the funds were transferred.

In support of his claims, Morgan produced a 2003 letter handwritten from David to Anne on the heels of a transfer made to Anne before her marriage to Morgan. The letter arguably supports Morgan's assertion that David regularly makes disguised gifts in the form of loans:

> "Annie - attached is a very simple promissory note for you to sign so that the money provided for your apartment does not count as a gift, for which gift taxes have to be paid. If you could get your signature notarized it would be super. I Love You, Dad."

The letter is probative of something, but do these facts support the claims and defenses raised by Morgan in this lawsuit? The court held they do not, granting David's motion to dismiss Morgan's counterclaims and defenses, though without prejudice. As to promissory fraud, Morgan argued that David made two fraudulent misrepresentations: David said that the notes were executed solely for the purpose of avoiding gift taxes, and he said that he never intended to collect the purported amounts due. Morgan claims David and Anne "knew or believed that all the Misrepresentations were false when [David] made them to [Morgan]."

If Morgan stuck with that position, the fraud argument might have had traction. But Morgan also argued that David "would never have sought to enforce the notes had [Morgan] and Anne not gotten divorced" and that at the time the loans were made, "it was not the intention of any of the parties to enforce the purported 'notes.'" You can't have it both ways; when David transferred the funds he either intended to seek payment from Morgan or he did not so intend. As the court explains, to maintain a claim for promissory fraud, a party must show that "when the promise was made, the promisor had no intent to fulfill it; if the promisor simply later changed his mind, an action for fraud will not lie."

The court found that the evidence here indicates David changed his mind about not seeking repayment on account of Morgan and Anne's divorce. Indeed, many of Morgan's claims are based on the assertion that David had no intention of enforcing the notes when they were made, so Morgan himself acknowledges there was no misrepresentation of David's intentions at the time the representations were made. The court thus granted David's motion to dismiss the claims and defenses based on promissory fraud.

Morgan also tried to raise the defense of illegality, repeatedly and randomly calling David's actions "tax avoidance" and "tax evasion." The court observed that while tax evasion is illegal, tax avoidance is not. Morgan did not allege sufficient facts to support the allegation of tax evasion, so the illegality defense was likewise dismissed, at least for now. Remember, the court dismissed Morgan's claims and defenses without prejudice. As the court explained, "there is a good deal of smoke here, and Mr. Carroll should be allowed to adequately allege there is a fire." No doubt this lawsuit will continue for a good while.

Divorce can bring out the ugly side of people, even those who are not the spouses. David couldn't resist collecting (only) from Morgan, and as a result Morgan has perhaps exposed David to civil and criminal liability for disguising gifts as loans. Even if Morgan's allegations are entirely false, David has to live with the stigma of being labeled a tax cheat in a public forum. Is repayment of the loans worth all of this?

This case is a chilling reminder to donees asked to sign a promissory note as a "mere formality." As the lawsuit against Morgan indicates, after signing a note promising payment, the argument that "it was all supposed to be a ruse" can be difficult to sustain credibly. Morgan's position effectively casts him as an active participant in David's fraudulent scheme.

Neither party comes off looking good in this case. The court observed as much in a short epilogue to the opinion:

> "Mr. Yost claims that 'it is true chutzpah' for Mr. Carroll to have filed the Counterclaim he did in light of the latter's admitted involvement in the 'loan' transactions. But, it was Mr. Yost who brought the family's dirty laundry to federal court, and given the repeated allegations by Mr Carroll of an attempt by Mr. Yost to evade gift taxes--not to mention the fact that the taxpayera re, in

effect, subsidizing this case--the needle on the 'chutzpah' detector would seem to point to Mr. Yost perhaps as much as it does to Mr. Carroll--depending, of course, on the truthfulness of the allegations by Mr. Carroll."

XXV. LIECHTENSTEIN FOUNDATION PROPERLY CLASSIFIED AS FOREIGN TRUST, SO PENALTY FOR DELAY IN DISCLOSING TRANSFERS APPLIES (*Rost v. United States*, 5th Cir., August 11, 2022)

The Fifth Circuit Court of Appeals held that the estate of a United States person who created and funded a Stiftung under Liechtenstein law was liable for penalties from the late disclosure of amounts transferred to what United States law considers a "foreign trust." The case offers a helpful reminder of how to determine whether a foreign entity qualifies as a "trust" under United States tax laws.

In 2005, John Rebold, an engineer who worked overseas, formed the Enelre Foundation ("Enelre" is the backward spelling of John's wife, Erlene) as a "Stiftung." As explained by the Tax Court, "[a] stiftung is a creation of the laws of Liechtenstein…, resembling a trust, but not limited to specific lives in being. A stiftung can own property and is controlled by an administrator (known as a stiftungerat) whose powers and duties are comparable to a trustee." *Kraus v. Commissioner*, 59 T.C. 681, 685 (1973). After opening bank accounts for the new entity, Rebold transferred to $2 million to it in 2005 and an additional $1 million in 2007. Neither Rebold nor the entity filed the appropriate forms (Forms 3520 and 3520-A) disclosing creation of the entity or the cash transfers. Eventually, in 2013, Daphne Rost, Rebold's daughter, acting under a power of attorney, reported the transactions on her father's behalf. The IRS then assessed over $1.38 million in penalties for the failure to timely file the required forms, which Rebold paid before initiating this lawsuit. Rebold died before the case was heard, so Rost, his executor, became the new plaintiff.

A federal district court held that Enelre was a foreign trust, rejecting Rost's argument that there was no authority that a Stiftung formed under Liechtenstein law is a foreign trust for United States federal income tax purposes. Rost made the same argument on appeal, only to lose again before the Fifth Circuit. Just because United States tax law does not definitively classify a Stiftung as a trust does not mean the Stiftung at issue here cannot be a trust. Instead, the determination of whether any entity is a trust is one based on the facts and circumstances.

In this case, said the Fifth Circuit, the Stiftung is a trust. The appellate court observed that the entity's organizational documents explain its purpose is "to provide education, training, support, and maintenance for its beneficiaries. The documents prohibit 'commercial trade' and do not provide for allocation of profits. They refer to Enelre as a trust, and Enelre has trustees and pays trustee fees." As the court concluded, "Enelre's familial purpose, lack of business objective, and bar on commercial activity render it a trust." Moreover, noted the court, Rebold described himself as "settlor" and "beneficiary" of the entity, and his cash transfers to the entity strongly resembled the types of transfers a grantor would make in trust. Clearly, then,

Enelre was a trust. And the organizational documents are likewise clear that it's a foreign trust and not a domestic trust.

Rost also argued that the lack of clear authority on the United States tax treatment of a Stiftung violated the Administrative Procedure Act, public policy, and due process, but the Fifth Circuit rejected all of these claims. Since the determination of whether a particular entity is a trust is always dependent on the facts and circumstances, the court observed, there simply cannot be a blanket rule that a Stiftung is always (or is never) a trust. Thus the guidance Rost insists must be in place for penalties to apply simply cannot exist.

XXVI. DRUG DISTRIBUTION COMPANY SECURES FAVORABLE RULING ON "QUALIFIED TRADE OR BUSINESS" STATUS IN ADVANCE OF CONTEMPLATED SALE (*Private Letter Ruling 202221006*, May 27, 2022)

The IRS has ruled that a C corporation engaged in the retail sale of medication as a distributor was not engaged in the field of health and that the corporation's principal asset is not the reputation or skill of one or more of its employees. Accordingly, the C corporation is engaged in a "qualified trade or business," meaning a sale of the corporation's stock might qualify for the exclusion under §1202 for gain from the sale or exchange of "qualified small business stock."

Section 1202 allows a noncorporate shareholder to exclude all or a portion of the gain from the sale or exchange of "qualified small business stock." As originally enacted, 50 percent of such gain was excluded if the shareholder held the stock for more than five years. I.R.C. §1202(a)(1). This is still the default rule. But, generally, for stock acquired in 2009 and early 2010, 75 percent of such gain is excluded. I.R.C. §1202(a)(3). And for stock acquired after late 2010, all of the gain is excluded. I.R.C. §1202(a)(4).

The statute defines qualified small business stock as any stock in a domestic C corporation originally issued after August, 1993, that a shareholder acquires in exchange for money or stock for as compensation for services provided to the corporation. In addition, the corporation must be a "qualified small business" as of the date of the stock's issuance. I.R.C. §1202(c)(1). Generally, a qualified small business is a domestic C corporation with aggregate gross assets of no more than $50 million. I.R.C. §1202(d)(1).

The statute also requires that a qualified small business must meet the "active business requirements" during substantially all of the taxpayer's holding period for the stock. I.R.C. §1202(c)(2). This generally means that the corporation must devote at least 80 percent of its assets to the active conduct of one or more "qualified trades or businesses." I.R.C. §1202(e)(1)(A). Under § 1202(e)(3), most any trade or business will be a qualified trade or business; the only business activities excluded from being "qualified" are the following:

- A business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services;

- A business where the principal asset of the business is the reputation or skill of one or more of its employees;

- A banking, insurance, financing, leasing, investing, or similar business;

- A farming business;

- A business involving the production or extraction of products of a character with respect to which the percentage depletion deduction is allowable; and

- A business of operating a hotel, motel, restaurant, or similar business.

I.R.C. §1202(e)(3). In this private ruling, the C corporation does not manufacture drugs but is involved in the retail sale of them as a distributor. The corporation employs pharmacists to fill prescriptions and other employees to coordinate insurance coverage for prescription orders. Neither the pharmacists nor the employees working on insurance have any contact with physicians other than to receive prescriptions. No employee diagnoses any medical issue or recommends any drug treatment to patients; interactions with patients are limited to answering questions about particular prescriptions. The corporation makes no money from medical care of patients; all of its revenues come from the sale of drugs.

The IRS ruled that the corporation is not engaged in the performance of services in the field of health. No employee provides medical services to patients. Only the pharmacists are certified healthcare providers, but their interaction with patients about prescriptions "is merely incidental to ensuring receipt of their required prescriptions or answering a patient's question about them."

The IRS further ruled that the corporation's principal asset is its exclusive distribution rights with certain pharmaceutical manufacturers, not the reputation or skill of one or more of its employees. Accordingly, the corporation conducts a "qualified trade or business." If the other elements of § 1202 are met, the corporation's shareholders will qualify for the § 1202(a) exclusion.

The ruling itself is no surprise. Indeed, it is consistent with a prior ruling in which the development and manufacture of experimental drugs was ruled not to be the performance of health services. *Private Letter Ruling 201436001*. It is also consistent with another ruling in which the analysis and delivery of lab test results to healthcare providers was ruled not to be performance of health services. *Private Letter Ruling 201717010*.

The more noteworthy aspect of the ruling relates to its timing. When the corporation applied for this ruling, its shareholders were in the process of negotiating a stock sale to an unrelated buyer. Often the IRS will defer a ruling request until a transaction has been completed, as it does not want to respond to requests about hypothetical transactions. Perhaps the fact that

negotiations with a specific buyer were well underway gave the IRS enough confidence to issue the ruling.

XXVII. DIRECTION TO PAY INHERITANCE TAXES FROM RESIDUE FAILS FOR WANT OF RESIDUE (*Svobada v. Larson*, 311 Neb. 352, April 15, 2022)

The Nebraska Supreme Court has held that "where a will directs that the inheritance taxes should be paid out of the residuary estate, but there is no residuary estate or the residuary estate is insufficient to pay the inheritance taxes, the direction in the will fails. As such, the payment of inheritance taxes reverts to the default rule placing the burden on the individual beneficiaries receiving the property." 311 Neb. 352 at 362.

The case involved the estate of Blain Larson, who died in 2017. Blain's will named his girlfriend, Cindy Svobada, as personal representative. The will made specific gifts of livestock and Blain's pharmacy business to each of Svobada and Blain's son, Matthew. The will also contained additional specific gifts to Matthew and a gift of the residue to Svobada. Regarding the payment of debts and estate expenses, Blain's will provided:

> My Personal Representative shall pay from the residue of my estate all my debts, funeral expenses, administration expenses and all estate, inheritance, succession and transfer taxes imposed by the United States or any state, territory or possession which shall become payable by reason of my death. It shall not be necessary to file any claims therefor, not to have them allowed by any court.

311 Neb. 352 at 354-55. Nebraska law generally requires a personal representative to deduct and withhold inheritance taxes from property distributed to a beneficiary, but the decedent's will can, by "clear and unambiguous language," shift the tax burden to the estate. The Nebraska Supreme Court concluded that the quoted provision from Blain's will clearly reflected an intent that inheritance taxes be paid from the residue of the estate. Yet the residue was essentially depleted through the payment of administrative expenses, funeral expenses, and federal income tax. In that case, ruled the court, the direction in the will must fail and the beneficiaries must be liable for inheritance taxes as is the custom. The court observed that this conclusion is consistent with "the rule followed by a majority of states." 311 Neb. 352 at 362.

The court also considered (and rejected) a variety of other challenges made by Matthew against Svobada in her capacity as personal representative.

XXVIII. GAIN FROM SALE OF RESIDENCE RENTED FOR SIX YEARS PRIOR TO SALE TAXABLE DESPITE OWNER'S POOR HEALTH (*Webert v. Commissioner*, T.C. Memo. 2022-32, April 7, 2022)

The Tax Court has held that the sale of a home that the taxpayers, a married couple, rented for six years prior to its sale did not qualify for the exclusion under §121 for gain on the sale of a principal residence. Although one spouse insisted that it should matter that the sale was due to

the other spouse's health, the Tax Court implied that this fact would probably not help the taxpayers in this particular case because of their extended absence from the home.

Section 121 allows a married couple filing a joint return to exclude up to $500,000 in gain from the sale of a principal residence where: (1) either spouse owned the home during the five-year period prior to the sale for periods totaling at least two years (the "ownership requirement"); (2) both spouses used the home as a principal residence during the five-year period prior to the sale for periods totaling at least two years (the "use requirement"); and (3) neither spouse has claimed the benefit of the §121 exclusion in the two taxable years prior to the sale (the "prior exclusion requirement"). (Unmarried taxpayers meeting similar requirements can exclude up to $250,000 in gain from the sale of a principal residence.) But the statute provides that gain allocable to "periods of nonqualified use" is not eligible for the exclusion. For this purpose, however, "temporary absences" because of "health conditions," among other things, do not count as periods of nonqualified use.

Where a taxpayer fails any of the ownership requirement, the use requirement, or the prior exclusion requirement, the taxpayer may still be able to exclude all or a portion of the recognized gain from the sale of a principal residence where the sale is "by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances." The maximum amount that can be excluded under this rule, however, depends on the period of ownership and use (or the period since the last prior use of the §121 exclusion, if less). So if a taxpayer has not occupied a residence at all during the five-year period prior to the sale, this "reduced exclusion" benefit is unavailable.

In this case, Catherine Webert purchased a home in Mercer Island, Washington, in 2005. That same year, she was diagnosed with cancer. She took out a line of credit on the property to pay for medical expenses and insurance. In 2009, she vacated the home and moved to a house in Sammamish, Washington, owned by her husband, Steven. Catherine tried the sell home, but history buffs will remember that the financial and housing markets that year were awful. So she rented the home more or less constantly from 2009 through 2015. The home finally sold late in 2015 for $1.14 million, generating a long-term capital gain of about $195,000.

The couple excluded the gain from the sale of the house on their 2015 joint return, taking the position that the §121 exclusion applied. Just after filing their return, Catherine and Steven divorced. The IRS concluded that §121 did not apply since the couple rented the home for the six-year period prior to the sale and did not occupy the house at all during that time. Catherine did not oppose this conclusion, but Steven sure did. He claimed the couple continued to live in the Mercer Island home and the sale was because of Catherine's health.

The IRS moved for summary judgment, claiming there was no genuine dispute as to the facts that neither Catherine nor Steven used the Mercer Island home as a residence during the five years prior to the sale. The evidence in support of this conclusion included the couple's tax returns for 2010 through 2015, in which they reported rental income and claimed depreciation deductions on the property. This surely suggested the couple rented the property and did not

maintain it as their residence. On the other hand, Steven had no evidence to support his position that the couple lived in the home during these years. Because he lacked any such evidence, ruled the Tax Court, summary judgment for the IRS was proper.

The IRS also moved for summary judgment on the grounds that Steven did not show a causal connection between Catherine's health and their absence from the home or its ultimate sale. The Tax Court denied summary judgment here, finding a genuine dispute of fact as to whether Catherine's illness led to the couple vacating the Mercer Island home and, eventually, selling it. Since the IRS made the motion, the Tax Court said, fact inferences must favor the taxpayer, so "we assume that health reasons *were* the primary reason for the sale (emphasis in original)."

But that doesn't mean Steven has much of a fighting chance going forward. Steven likely raised the issue of Catherine's health for two reasons. First, he probably seeks to treat their absence from the Mercer Island home as something other than "nonqualified use" so as to avoid denial of the exclusion under §121(b)(5). Second, he seemingly wants to argue that the reduced exclusion in §121(c) should apply because the sale was due to Catherine's health. But Steven's arguments should not get very far.

Consider his first argument: that their absence was not a period of "nonqualified use." As the Tax Court explains, "one undertakes this allocation [under §121(b)(5)(A)] only in the case of taxpayers who have otherwise shown an entitlement to the exclusion under section 121(a) and (b)—i.e., to a taxpayer who has met the ownership *and use* requirements. It appears to us that the 'health conditions' provision of section 121(b)(5)(C)(ii)(III) (unlike the 'health' provision of section 121(c)(2)(B)) does not abrogate the use requirements, and neither party has argued that it does or does not. They seem instead to have assumed that it does, and it does not seem that that assumption is correct (emphasis in original)." This suggests that the court would still consider the couple's absence from the home a "nonqualified use" under §121(b)(5)(A), not boding well for an exclusion.

And then there is Steven's argument for the reduced exclusion under §121(c). Even if he makes the case that the sale was because of Catherine's health, the reduced exclusion still looks to the period of actual ownership and use by the taxpayers during the five-year period prior to the sale. And there is no genuine dispute that the couple failed to occupy the Mercer Island home at all during that time. That means the couple does not qualify for the reduced exclusion even if the sale was due to Catherine's health.

So while Steven avoided summary judgment on the issue of whether the primary reason for the sale of the Mercer Island home was Catherine's health, the Tax Court observed that "the parties have not yet addressed whether, as a matter of law, that disputed fact is a 'material' fact." Indeed it is not, so hopefully Steven takes the hint and settles this dispute quickly.

XXIX. DEDUCTION FOR ACCRUED BUT UNPAID DEFERRED COMPENSATION IS NO SLAM DUNK (*Hoops, LP v. Commissioner*, T.C. Memo. 2022-9, February 23, 2022)

The Tax Court has 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 forced the Tax Court to consider 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 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 I.R.C. §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. I.R.C. §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.

C. Facts of the Case

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

XXX. TAXPAYERS SUBJECT TO FRAUD PENALTIES FOR FAILING TO REPORT $15 MILLION FROM SHAM TRUST (*Wegbreit v. Commissioner*, 7th Cir., December 29, 2021)

The Seventh Circuit Court of Appeals has affirmed a decision of the United States Tax Court finding that the taxpayers, a married couple, underreported their income by almost $15 million and engaged in tax fraud. The appellate court further ordered the taxpayers' attorney to show cause as to why he should not be sanctioned for filing a frivolous appeal.

The case concerns a supposed transfer of the husband's interest in a financial services business he founded to a trust followed by the trust's transfer of that interest to a Cook Islands insurance company as the initial premium on a substantial life insurance policy. Although the husband first met with the attorney that proposed this structure in 2003, some of the documents indicate a January, 2002, effective date. The three iterations of the trust instrument show different contributions ranging from $18,750 cash to a policy issued by another insurance company in 2004.

Early in 2005, the insurance company that owned the husband's LLC interest, at his instruction, sold that interest to another investment firm for $11.3 million. The sale proceeds were wired to the trustee, but the IRS determined that the gain from the sale, as well as other trust income, was really income to the taxpayers. When the IRS uncovered the inconsistent documents related to the trust's formation and its acquisition of the life insurance, the IRS then added a civil fraud penalty to the mix.

The Tax Court held that that the husband never effectively conveyed his LLC interest to the trust and that the trust itself was a sham that lacked economic substance. The court also imposed fraud penalties.

On appeal, the Seventh Circuit noted that the taxpayers "raise a bevy of legal topics wholly irrelevant to the tax court's decision, from statutory-diversification rules for life-insurance portfolios to the grantor-trust doctrine. When they do address germane issues, their brief fragrantly violates Rule 28's requirement to support each argument 'with citations to the authorities and parts of the record on which [they rely].'"

The appellate court found only two credible arguments on appeal. First, the taxpayers claimed that because the sale occurred in late 2004, the statute of limitations makes it too late to assess tax against the taxpayers. But "the evidence unambiguously shows, and the Wegbreits concede, that the funds were received in January 2005." Second, the taxpayers tried to argue that the IRS did not comply with required procedures when assessing the penalty, but before the Tax Court they stipulated that the IRS had in fact complied with procedures. "Their attempts to skirt this unequivocal stipulation are perfunctory and raised for the first time on appeal. Either constitutes a waiver."

But the court did not stop there. Finding the taxpayer's 78-page brief "woefully deficient" in its "rambling, unsupported assertions" with "glaring shortcomings," the court ordered the taxpayers' lawyer to show cause within 14 days as to why he should not be sanctioned for violating Rule 38 of the Federal Rules of Appellate Procedure.

XXXI. IRS FORGIVES DEFECTIVE S ELECTION WHERE WRONG SPOUSE CONSENTED TO ELECTION (*Private Letter Ruling 202205018*, February 4, 2022)

The IRS concluded that a corporation's invalid S election was inadvertent and that, therefore, the corporation would be treated as an S corporation as of the date of the invalid election under §1362(f). The corporation was wholly owned by "Spouse A," but the Form 2553, Election by a Small Business Corporation, was signed only by "Spouse B" (Spouse A's spouse, in case you were wondering). Since the corporation's sole shareholder had not consented to the election, it was ineffective.

Fortunately, §1362(f) provides that where the circumstances resulting in an ineffective S election are inadvertent and corrective steps are taken within a reasonable period of time after discovery of the circumstances causing the ineffective election, the IRS will consider the election to be effective although it may require the consenting shareholders and the corporation to make corrective adjustments consistent with the treatment of the corporation as an S corporation. In this case the IRS determined that the botched election here was inadvertent and unintended, so it granted the corporation's request to be treated as an S corporation as of the date of the ineffective election, contingent on Spouse A signing a written statement consenting to the election within 120 days of this ruling.

Rulings of this sort are routine, but it's helpful from time to time to remember that confession and repentance can cleanse the corporate soul. For the price of a private ruling user fee errors causing either invalid elections or inadvertent terminations of S corporation status can often be forgiven.

XXXII. TUITION PAYMENT BENEFITTING THE BOYFRIEND OF THE SHAREHOLDER'S DAUGHTER NEITHER DEDUCTIBLE NOR A CONSTRUCTIVE DIVIDEND (*Sherwin Community Painters Inc. v. Commissioner*, T.C. Memo. 2022-19 (March 9, 2022)

The Tax Court has held that tuition paid by a C corporation that allowed a boyfriend of the shareholder's daughter to take coding classes at Northwestern University was not a deductible expense. The court also held, however, that the payment did not represent a constructive dividend to the shareholder.

The taxpayer is a commercial painting contractor for commercial buildings and residential complexes. A C corporation, the taxpayer has one shareholder, and both the shareholder and her spouse work for the business. After meeting their daughter's boyfriend, the shareholder and her spouse offered to pay the tuition for him to take a coding course at Northwestern. The boyfriend (now son-in-law) had experience in construction but no prior coding experience. After completing the course, the boyfriend used his new coding skills to revamp the taxpayer's website. The taxpayer paid him nothing for this work.

But the taxpayer did deduct the tuition it paid for the class, and that's one of the items the IRS balked at while reviewing the taxpayer's 2016 return. The IRS disallowed the deduction as a personal expense. Before the Tax Court, the taxpayer argued that it received website services in exchange for the tuition, but the court rejected this claim. The boyfriend was not an employee of the taxpayer and there was no agreement that he would perform services in exchange for the tuition payment. "Sherwin paid the tuition without any expectation of a return and thus did not have a business purpose for the payment. The tuition was a personal expense, and Sherwin is not entitled to deduct it."

The IRS then claimed that the shareholder received a constructive dividend in the amount of the disallowed deduction, but the court was quick to reject this argument. "Sherwin's failure to substantiate the business purpose of the disallowed deductions does not render the amount a constructive dividend under the circumstances of these cases. There is no indication that the [shareholder] received an economic benefit from the amount of disallowed expenses. Accordingly, we hold that the [shareholder] did not receive any unreported dividends from Sherwin."

XXXIII. FAILURE TO FILE RETURN MEANS NO ITEMIZED DEDUCTIONS AVAILABLE (*Salter v. Commissioner*, T.C. Memo. 2022-29, April 5, 2022).

The Tax Court has held that a taxpayer cannot claim itemized deductions after failing to file a return. The court also upheld the imposition of an early withdrawal penalty from a retirement plan.

During the taxable year at issue (2013), the taxpayer worked for Home Depot as a district loss prevention manager in charge of supervising loss prevention practices at ten stores in the

Phoenix metropolitan area. When he was laid off that year, he withdrew nearly $38,000 from his retirement plan, though he was not yet age 59-½ at the time.

When the taxpayer failed to file a return for the year, the IRS prepared a substitute return for him that included the distribution in gross income. It also calculated a 10% penalty on the early distribution. That prompted the taxpayer to file (in 2021) his own return for 2013, on which he claimed itemized deductions including $2,816 in unsubstantiated charitable contributions and $10,455 in unreimbursed employee expenses. The IRS did not accept this form for filing.

The Tax Court held that because the taxpayer did not file a return for 2013, he failed to elect to itemize deductions. Section 63 requires taxpayers electing to itemize deductions in lieu of the standard deduction to do so on the taxpayer's return. Citing multiple decisions, the court confirmed that when the IRS prepares a substitute return, the taxpayer has not elected to itemize deductions and thus may not claim itemized deduction. The taxpayer claimed to have filed a return through H&R Block but he could not provide any evidence to substantiate this claim.

The taxpayer then argued that the penalty on his early distribution should be reduced the amount of unreimbursed medical expenses, but the Tax Court observed that the statute only allows for a reduction in the penalty for medical expenses "allowable as a deduction under section 213." IRC §72(t)(2)(B). In 2013, medical expenses were only deductible to the extent they exceeded 10% of a taxpayer's adjusted gross income. Unfortunately for the taxpayer, his medical expenses in 2013 did not exceed 10% of his adjusted gross income. So the Tax Court upheld the full amount of the penalty plus an addition to tax under §6651 for failure to file a return.

The result in the case is a sober reminder of the harsh consequences for both failing to file a return and for taking an early distribution from a retirement plan. Though early distributions sometimes have to happen because of sad circumstances, the failure to file a return puts a taxpayer on a path with no happy ending.

XXXIV. 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).

XXXV. REMEMBER THE ALIMONY DEDUCTION?

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. Should the "old" regime ever come back into existence, these cases will be helpful reminders of the many traps that captured unsuspecting taxpayers that failed to pay attention to the many rules that applied.

A. Child Support Payments Continue to be Nondeductible (*Rojas v. Commissioner*, T.C. Memo. 2022-77, July 18, 2022)

The Tax Court has held that monthly payments made to an ex-spouse in 2016 were in fact payments of "child support" and not "alimony," thus precluding the payor spouse from a deduction available under prior law. This case concerns the tax treatment of payments made in 2016 from one spouse (Alejandro) to a former spouse (Cristina) pursuant to a divorce decree issued in 2012, so the rules from the old regime apply.

The 2012 divorce decree requires Alejandro to pay $4,500 to Cristina every month as "family support" until both of their minor children reach adulthood or Cristina remarries, whichever occurs first. If Cristina remarries before the children reach adulthood, the payment drops to $2,500 per month. In the taxable year at issue (2016), Alejandro made 12 monthly payments to Cristina of $5,824, for a total of $69,888. (The court mentions in a footnote that there is no explanation in the record for why Alejandro's payments exceed the amount required by the divorce decree.) Alejandro deducted $69,880 (was the extra $8 a tip?) on his 2016 federal income tax return filed with his new spouse, Elena. When the IRS disallowed the deduction, Alejandro and Elena went to Tax Court.

Section 215(a) allows Alejandro to deduct the payments made to Cristina only if Cristina is required to include them in her gross income under §71. And §71(c) says that child support payments are not includible in the recipient's gross income. More specifically, §71(c)(2)(A) provides that an amount is treated as child support if it will be reduced "on the happening of a contingency specified in the [divorce decree] relating to a child (such as attaining a specified age, marrying, dying, leaving school, or a similar contingency)." Here, the monthly payments required from Alejandro completely terminate once the children become emancipated. Thus, the entirety of the monthly payment is "child support" and not "alimony," which, in turn, means that none of the payments is deductible by Alejandro.

Alejandro argued that because the monthly amount would also be reduced by Cristina's remarriage, at least that portion of the monthly payment should qualify as "alimony." But the Tax Court rejected this position, citing precedent that child support remains so "without regard to the existence of other contingencies." Alejandro also pointed to a provision in the divorce decree under which the court orders that there be no payment of "child support," but the Tax Court said that had no weight. For one thing, "family support" encompasses "combined, but unallocated, child support and spousal support." But more importantly, a label assigned by a state court is not binding on the federal income tax treatment of an item. It is the substance of the payment that matters, not the label assigned to the payment by a state court. The Tax Court thus upheld the disallowance of the claimed deduction.

B. Cash Transfers Were Property Division and Not Alimony (*Redleaf v. Commissioner*, 8th Cir., August 5, 2022)

The Eighth Circuit Court of Appeals has affirmed a decision from the Tax Court that payments made in 2012 and 2013 pursuant to a marital dissolution agreement were not "alimony" and, therefore, neither deductible by the payor nor includible in the gross income of the payee. The payor spouse argued that his liability to make the payments would have terminated upon the payee spouse's death. If he was right, there would have been a good argument for a deduction. But the terms of the divorce agreement indicated to the contrary, and thus deductions totaling $51 million were improper. The case is notable both for the staggering amount of the disallowed deduction and for the reminder that, prior to 2018, the terms of a divorce agreement were very important in determining the tax consequences of cash transfers between ex-spouses.

Andrew and Elizabeth divorced in 2008. Pursuant to their court-approved marital termination agreement, Elizabeth did not receive "spousal maintenance" but was entitled to (among other things) monthly cash payments of $1.5 million for five years plus a lump sum cash payment of $30 million in 2013. The agreement stated the payments represented a property division whereby Andrew would keep his 84.5-percent ownership interest in a hedge fund asset management firm he established in 1999. But on his federal income tax returns for 2012 and 2013, Andrew deducted the cash payments as "alimony" under former §215. Section 215, remember, allowed a deduction for the payment of "alimony," as defined by former §71. Section 71, in turn, defined alimony as, in relevant part, cash payments pursuant to a divorce or separation instrument the liability for which ceases upon the death of the payee spouse.

The IRS determined that Andrew's payments did not meet the statutory definition of "alimony" and thus denied his claimed deduction. The Tax Court and the Eighth Circuit agreed. The agreement was clear that Elizabeth was entitled to the cash payments at issue in lieu of taking any share of Andrew's interest in hedge fund business. Under applicable state law (Minnesota), Elizabeth's estate would be entitled to the cash payments as her successor in interest. For that reason, the cash payments do not qualify as "alimony." Furthermore, the marital termination agreement expressly stated that Elizabeth was not entitled to spousal maintenance, an award

that typically ends upon the recipient's death. The Eighth Circuit thus rejected Andrew's claim that the cash payments in fact represented spousal maintenance.

XXXVI. FREE STAND-BY FLIGHTS TO NON-DEPENDENT RELATIVES ARE GROSS INCOME TO RETIRED PILOT (*Mihalik v. Commissioner*, T.C. Memo. 2022-36, April 13, 2022).

The Tax Court has held that a retired United Airlines pilot must include the value of airline tickets provided to non-dependent relatives by the airline. Although the value of free stand-by flights provided to the taxpayer, his spouse, and his dependent daughter are excludable from gross income, there is no similar exclusion available for flights awarded to a retired employee's friends or other family members.

United Airlines sponsors a "Retiree Pass Travel Program" under which retired pilots, their immediate family members, and certain friends receive free stand-by tickets. During the taxable year at issue (2016), the taxpayer, a retired pilot, traveled extensively under this program, as did his spouse and daughter. The taxpayer enrolled two other relatives as "friends" for purposes of this program, and they too traveled for free under United's program. United reported the value of stand-by tickets awarded to the two friends ($5,478) as income to the taxpayer on a Form 1099-MISC, but the taxpayer did not include this amount in gross income on his joint federal income tax return. When the IRS issued a deficiency notice largely due to this missing income, the taxpayer navigated his way to Tax Court.

Section 132(a)(1) excludes the value of any "no-additional-cost service" from the gross income of an employee. Stand-by flights to employees of commercial airlines are perhaps the quintessential example of the no-additional-cost service. Reg. §§1.132-2(a)(2); 1.132-2(c). Section 132(h)(2) further provides that benefits conferred to an employee's spouse and dependent children are treated as benefits conferred to the employee. Finally, §132(h)(1) provides that a retiree is still considered an employee for purposes of this exclusion. Under these rules, it is clear that the stand-by flights conferred to the taxpayer, his spouse, and his dependent daughter qualified for the exclusion. But there is no basis for excluding from gross income the value of the flights furnished to the other relatives.

In a rather cryptic petition, the taxpayer alleged that the IRS was attempting to tax "the value of de minimus (sic) travel provided to retired pilots." The Tax Court held that if this was meant to argue that the free stand-by flights awarded to the non-dependent relatives was excludable as a de minimis fringe, it was wrong. While §132(a)(4) does exclude the value of a "de minimis fringe" from an employee's gross income, §132(e)(1) defines a de minimis fringe as one with a value "so small as to make accounting for it unreasonable or administratively impracticable." The taxpayer was given many chances by the court to explain how the free flights would qualify as de minimis fringes, but the taxpayer never did so. What's more, said the court, it was apparent that United did account for the free flights as evidenced by its filing of the Form 1099-MISC. So it was hardly the case that forcing United to account for the flights would be unreasonable. Accordingly, since no exclusion from gross income applied, the taxpayer had gross income from the value of the flights furnished to non-dependent relatives.

XXXVII. FOUNDATION'S FOUNDER AND SOLE SOURCE OF INCOME IS AN EMPLOYEE (*The REDI Foundation v. Commissioner*, T.C. Memo. 2022-34, April 11, 2022).

The Tax Court has held that the founder and controlling officer of a tax-exempt organization was an employee of the organization, rendering the organization liable for the payment of employment taxes on compensation paid to the founder.

Richard Michael Abraham, a "real estate developer, innovator and visionary" according to his website, founded The REDI Foundation, an online real estate development course. See redii.org/about-us. The Foundation is a §501(c)(3) organization. During the period at issue (the second half of 2014), Abraham was a director and officer of the Foundation. Abraham "had complete control over all aspects of the online course and was its only teacher." He devoted over 60 hours per week to the course, and tuition from the course was the sole source of the Foundation's revenues. Although the Foundation issued Abraham a Form 1099-MISC reporting payments of $91,918 during 2014, the Foundation forgot to pay quarterly taxes that year. Indeed, the Foundation has never paid employment taxes from its inception to the present day.

In a notice of determination, the IRS concluded that Abraham was an employee of the Foundation and that the Foundation owed back employment taxes and additions to tax. The Foundation chose to challenge these determinations in Tax Court, where the Commissioner's determinations are presumed correct. Abraham was an officer who devoted more than 60 hours a week to conducting the Foundation's online course, its only source of revenue. So yeah, he's an employee of the Foundation. As the court observed, "when services performed by a corporate officer are responsible for the entirety of a corporate taxpayer's income and that corporate officer receives remuneration for those services, the Court has concluded that such an officer is properly considered a statutory employee."

The Foundation argued that the payments to Abraham were royalties for the use of his book in the online course, but the Tax Court quickly rejected the Foundation's "self-serving characterization of the payments as royalties." Id. at 6. Seeking to minimize the bite for back employment taxes, the Foundation also argued that Abraham worked as both an officer-employee and as an independent contractor. But the Tax Court concluded there was no credible evidence to support this claim. Just because the Foundation issued a Form 1099-MISC it does follow that Abraham was an independent contractor.

The Foundation then argued that Abraham's employment was limited to minor administrative duties for which he received no compensation, but the Tax Court did not buy that claim either, concluding that "[t]he overwhelming weight of the evidence shows that the services Mr. Abraham provided to petitioner were far more than minor." Finally, the Foundation argued that it had no control over Abraham, but the Tax Court rejected reliance on this common law factor for determining status as an employee, finding the assertion that the founder and primary officer of the Foundation could not exert control over his own activities on behalf of the Foundation "illogical." As the court states: "In operating his real estate course through the

corporate vehicle of petitioner, Mr. Abraham chose to accept both the benefits and the burdens of the corporate form, including its separate identity. Respecting the distinctness of that corporate form means that we must carefully scrutinize payments made by a closely held corporation to an officer who performs substantial services, regardless of the characterization of the payments by the corporation."

The Tax Court thus concluded that the Foundation was liable for back taxes plus two additions to tax under §6651(a).

XXXVIII. PROPOSED REGULATIONS UPDATE ACTUARIAL TABLES AND MOVE THEM ONLINE (Prop. Reg. §§1.642(c)-6(e), 1.664-4(e), 20.2031-7(d), and 25.2512-5(d) (May 5, 2022).

Treasury has issued proposed regulations relating to the use of actuarial tables in valuing annuities, interests for life or a term of years, and remainder or reversionary interests. These proposed regulations reflect updates to the mortality tables used to compute life expectancies. The updated tables will apply to interests valued on or after the first day of the month following the date on which the proposed regulations are finalized.

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. 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 proposed 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 current Table S, for example, the value of a life estate retained by a 60 year-old donor is currently worth 44.795 percent of the value of the transferred property (assuming interest at 3.0 percent). Under the proposed new table, that same life estate is worth 47.149 percent of the value of the transferred property.

The proposed regulations contain various transition rules generally providing that in the case of gifts made (and decedents dying) after 2020 and before the date the regulations are finalized, taxpayers may use either the current or proposed tables for valuation purposes.

XXXIX. LAWYER'S SALE OF REAL ESTATE DISTRIBUTED FROM PARTNERSHIP CREATES CAPITAL (NOT ORDINARY) LOSS (*Musselwhite v. Commissioner*, T.C. Memo. 2022-57, June 8, 2022).

The Tax Court had held that a sale of four parcels of land in 2012 generated a capital loss and not an ordinary loss as the taxpayer claimed. The taxpayer, a personal injury attorney, owned an interest in a partnership that held the parcels at issue in the case. For many years, the partnership filed Forms 1065 indicating its principal activity was "investment" and reporting various capital gains and losses from the sale of real estate. Starting in 2011, the partnership listed the four lots (and some other properties) as "inventories." In July, 2012, the partnership distributed the lots at issue to the taxpayer, who then sold them months later for a loss of just over $1 million. The taxpayer's 2012 joint return reported the loss as an ordinary one, nicely offsetting the bulk of the $1.2 million the taxpayer earned from his law practice. The IRS assessed a deficiency on the basis that the loss was a capital loss, bringing us to the Tax Court for resolution.

The Tax Court noted that because an appeal would lie in the Fourth Circuit (the taxpayer resides in North Carolina), its analysis would use the eight factors the Fourth Circuit held to be relevant in determining whether a parcel of land is inventory or an investment. These factors are: "(1) the purpose for which the property was acquired; (2) the purpose for which the property was held; (3) improvements, and their extent, made to the property by the taxpayer; (4) the frequency, number, and continuity of sales; (5) the extent and substantiality of the transaction; (6) the nature and extent of the taxpayer's business; (7) the extent of advertising or lack thereof; and (8) the listing of the property for sale directly or through a broker." T.C. Memo. 2022-57 at 11. The Tax Court observed that the Fourth Circuit says no one factor is determinative and that objective factors carry more weight than subjective statements of intent. *Id.* With this framework, the Tax Court went about its analysis.

The Tax Court concluded that the first six factors weighed against the finding of an ordinary loss. Regarding the first two factors, the four lots were acquired for an investment purpose and were so held. Indeed, the taxpayer testified that the activities of he and his partners through the partnership were "really investment" and that the four lots were an opportunity to invest in a subdivision that was being developed by an established developer. This is consistent with the partnership's representations on its tax returns that the entity's principal activity was "investment." As for the third factor, the court observed that no improvements had been made to the lots since 2008. The fourth factor also weighed against the taxpayer since the partnership had never reported ordinary income or loss from any sale of land from its inception. That makes the taxpayer's claimed sale of inventory property a unique and isolated event. The fifth factor weighed against the taxpayer too since "the record is silent as to any continued involvement by [the taxpayer] with the lots, e.g. development plans, after he sold them." Finally, the fact that the taxpayer spends most of his time and earns most of his income from his law practice and not from real estate sales tilts the sixth factor toward a finding of capital loss.

The last two factors favored the taxpayer, however. The taxpayer did hire a broker to market and sell the lots and the evidence supported a finding that the broker spent substantial time and effort marketing the lots for sale. But this was not enough to counter the "overwhelming weight" of the factors in favor of the IRS's conclusion that the taxpayer realized a capital loss.

XL. DISGORGEMENT IS NONDEDUCTIBLE PENALTY (*Ziroli v. Commissioner*, T.C. Memo. 2022-75, July 14, 2022).

The Tax Court has held that a disgorgement payment made by the taxpayer in connection with an alleged violation of federal securities laws was a nondeductible "penalty" since the taxpayer could not prove that the payment was imposed as a remedial measure to compensate any victim of his misconduct.

The taxpayer was president and a 1% shareholder in a corporation that was investigated by the Securities and Exchange Commission for alleged violations of federal securities laws in connection with certain residential mortgage-backed securities. The investigation expanded to include the taxpayer and five other executives. In 2016, the taxpayer reached a settlement with the SEC pursuant to which, among other things, the taxpayer agreed to pay "disgorgement" in an amount just over $411,000 plus a $200,000 civil penalty. The taxpayer deducted the disgorgement payment as a loss on his 2016 federal income tax return. When the IRS issued a notice of deficiency in which it determined that the deduction was disallowed, the taxpayer sought relief in the Tax Court.

Section 162(f) denies a deduction "for any fine or similar penalty paid to a government for the violation of any law." Regulation §1.162-21(b) defines a "fine or similar penalty" as, among other things, an amount "paid as a civil penalty imposed by Federal, State, or local law" or an amount "paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal)." The question posed by this case, then, is whether the disgorgement paid by the taxpayer falls within this definition of a "fine or similar penalty." Precedent states that civil penalties imposed for purposes of enforcing the law are not deductible, but penalties imposed to encourage prompt compliance with the law or as compensation to another party remain deductible. So if the penalty here is primarily about law enforcement, it is not deductible. But if the penalty is primarily for the purpose of compensating another party, there is a case for a deduction.

The Tax Court reasoned that because deductions are a matter of legislative grace, the taxpayer has the burden to prove that the payment was more compensatory in nature than punitive in nature. The Tax Court went on to hold that the taxpayer did not meet this burden. The judgment stated that the disgorgement "represents profits gained as a result of the conduct alleged in the Complaint." But it fails to mention whether the amount represents compensation to the government or to investors that suffered losses. Further, there was no proof that the SEC forwarded the disgorgement amount to any harmed investors or otherwise segregated the funds so as to benefit the investors. As the court noted, the taxpayer "failed to show how the

disgorgement compensates either the government (which was not harmed in its [proprietary] capacity) or harmed investors (who apparently did not receive the disgorged funds)."

The taxpayer also argued that the disgorgement violated the Eighth Amendment since he was also ordered to pay a $200,000 civil penalty for the same offense. But the court summarily rejected the argument, observing a long line of precedent that denial of a deduction is not a "punishment" and thus cannot violate the Eight Amendment.

XLI. DISBARRED VEXATIOUS LITIGATOR'S COSTS IN FIGHTING WITH THE STATE BAR AND NEIGHBORS ARE PERSONAL, NOT BUSINESS EXPENSES (*Kinney v. Commissioner*, T.C. Memo. 2022-81, July 28, 2022).

The Tax Court has held that a disbarred lawyer could not deduct costs associated with fighting sanctions and with ongoing property disputes with neighbors. The taxpayer was a licensed lawyer in California from 1975 until 2014. Back in 2008, a California superior court declared the taxpayer was a "vexatious litigant" for initiating and maintaining numerous legal claims without merit. The "vexatious litigant" label meant the taxpayer had to post a $20,000 bond and get judicial leave before litigating any case in which he was a party. The taxpayer had brought baseless lawsuits against a neighbor in Laguna Beach and against another neighbor in the Silver Lake area of Los Angeles. When the taxpayer was disbarred in 2016, he commenced a lawsuit challenging the disbarment.

On his 2016 federal income tax return, the taxpayer claimed a net loss of about $14,000 on Schedule C, wherein he stated he was in the business of providing "consulting, teaching, and technical services." Included among the Schedule C expenses were costs related to his attempt to overturn his disbarment. He also claimed costs in connection with waging a contractual fraud case against the Los Angeles neighbor. The Tax Court upheld the IRS's disallowance of these costs. "Nothing in the record suggests that individuals were taking advantage of or threatening to destroy petitioner's business. It was petitioner who chose to make full use of the judicial system to challenge his vexatious litigant declaration and disbarment, and no evidence was presented as to how his status as a disbarred attorney affects his self-employment business."

The taxpayer claimed other costs as deductible business expenses, including life insurance premiums and car and truck expenses related to a "transportation of property for hire" business. The court likewise rejected these claims either because there was no connection to a trade or business activity or because the taxpayer lacked sufficient records to substantiate the claimed expenses.