RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

We apologize to our readers. If we had more time, this outline would be much shorter.

By

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This recent developments outline discusses, and provides context to understand the significance of, the most important judicial decisions and administrative rulings and regulations promulgated by the Internal Revenue Service and Treasury Department during the most recent twelve months — and sometimes a little farther back in time if we find the item particularly humorous or outrageous. Most Treasury Regulations, however, are so complex that they cannot be discussed in detail and, anyway, only a devout masochist would read them all the way through; just the basic topic and fundamental principles are highlighted – unless one of us decides to go nuts and spend several pages writing one up. This is the reason that the outline is getting to be as long as it is. Amendments to the Internal Revenue Code are discussed to the extent that (1) they are of major significance, (2) they have led to administrative rulings and regulations, (3) they have affected items previously covered in the outline, or (4) they provide an opportunity to mock our elected representatives; again, sometimes at least one of us goes nuts and writes up the most trivial of legislative changes. The outline focuses primarily on topics of broad general interest (to us, at least) – income tax accounting rules, determination of gross income, allowable deductions, treatment of capital gains and losses, corporate and partnership taxation, exempt organizations, and procedure and penalties. It deals summarily with qualified pension and profit-sharing plans, and generally does not deal with international taxation or specialized industries, such as banking, insurance, and financial services.

Despite the absence of tax legislation, there were many significant federal income tax developments in the last twelve months. The Treasury Department and the IRS provided significant administrative guidance and the courts issued many notable judicial decisions. This outline discusses the major administrative guidance issued in the last year, summarizes any recent legislative changes that, in our judgment, are the most important, and examines significant judicial decisions rendered in the last twelve months.

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I. ACCOUNTING

A. Accounting Methods

B. Inventories

C. Installment Method

D. Year of Inclusion or Deduction

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

1. Next time you earn points by staying at a hotel or use points to pay for a hotel, think of the tax issues you are creating for the hotel! Hyatt Hotels Corp. v. Commissioner, T.C. Memo. 2023-122 (10/2/23). The major issue in this case is whether the taxpayer, Hyatt Hotels Corporation (Hyatt), had gross income from its rewards program, known during the years in issue as its Gold Passport Program. Hyatt owned approximately 25 percent of Hyatt-branded hotels. The remaining 75 percent were owned by third parties and operated under either a management model, pursuant to which Hyatt employees ran the hotel pursuant to a contract, or a franchise model under which the hotel owner obtained a license to use Hyatt's brand name and other intellectual property. When a hotel guest earned rewards points by staying at a Hyatt-branded hotel, Hyatt required the hotel owner to pay a specified amount into an operating fund held by a Hyatt subsidiary. When a hotel guest used points to pay for a room at a Hyatt-branded hotel, Hyatt would make a compensating payment from the fund to the hotel owner. Hyatt also used the assets of the fund to pay administrative and advertising expenses that it determined were related to the rewards program. Some of the assets in the fund were invested in marketable securities, which resulted in interest and realized gains. According to the court, "Hyatt essentially ignored the fund, including none of its revenue in gross income and claiming no deductions for expenses paid." During an audit, the IRS took the position that Hyatt had to include in gross income the payments made into the fund as well as interest accrued and investment gains realized. The IRS also took the position that Hyatt's treatment of the fund was a method of accounting and that, because Hyatt must change the way in which it treats the fund going forward, a change in accounting method has occurred that requires Hyatt to make a positive § 481 adjustment and include in income the net revenue of the fund from its inception in 1987. Hyatt argued that its treatment of the fund was appropriate because it held the fund as a trustee, agent, or conduit for the hotel owners and was not the owner of the fund for federal income tax purposes. Hyatt also argued in the alternative that, if its treatment of the fund was not appropriate, its treatment of the fund was not a method of accounting and therefore no adjustment under § 481 was required. Finally, Hyatt argued in the alternative that, if it must include the fund's revenue in gross income, it is entitled to offset the fund's gross receipts with the estimated cost of future compensation payments to hotel owners under a regulatory provision known as the trading stamp method.

Gross income issue. The Tax Court (Judge Nega) first held that Hyatt had to include the fund's revenue in its gross income. The court rejected Hyatt's argument that the trust fund doctrine applied. Under the trust fund doctrine, recognized by the court in *Seven-Up Co. v. Commissioner*, 14 T.C. 965 (1950), and refined in subsequent decisions such as *Ford Dealers Advertising Fund, Inc. v. Commissioner*, 55 T.C. 761 (1971), aff'd, 456 F.2d 255 (5th Cir. 1972):

> when a taxpayer (1) receives funds in trust, subject to a legally enforceable restriction that they be spent in their entirety for a specific purpose and (2) does not profit, gain, or benefit from spending the funds for that purpose, then the taxpayer may exclude such funds from gross income.

The court concluded that the second element was not met because Hyatt benefitted from the fund. The court found that Hyatt exercised control over and had discretion with respect to spending from the fund for costs such as advertising, and that, as the largest single owner of Hyatt hotels, Hyatt benefitted from this spending.

Change of accounting method. The court concluded that, although Hyatt had to change from excluding the fund's revenue from gross income to including the revenue in gross income, this change was not a change in Hyatt's method of accounting. A change in accounting method, the court reasoned, involves a change in the proper time for the inclusion of income or the taking a deduction. *See* Reg. § 1.446-1(e)(2)(ii)(b). Hyatt's total exclusion of the fund's revenue from gross income did not involve timing. Accordingly, the court concluded, no § 481 adjustment was required. The government argued that this result was inappropriate because, going forward, Hyatt would deduct expenses of the fund but would not have included the fund's prior revenue in gross income. The court responded that a number of doctrines might preclude Hyatt's deductions. Presumably, the court was referring to the concept that a taxpayer cannot deduct amounts paid from funds that have not been subject to tax.

Trading stamp method. Hyatt argued that the trading stamp method permitted Hyatt to reduce the fund's revenue that it includes in gross income by the estimated cost of future compensation payments to hotel owners. The trading stamp method is an exception to the normal rules that require an accrual method taxpayer to include amounts in gross income when the all events test is satisfied. Under the trading stamp method, if an accrual method taxpayer issues trading stamps or premium coupons with sales that are redeemable in merchandise, cash, or other property, then the taxpayer can offset against gross receipts the estimated cost of its future provision of merchandise, cash, or other property. See Reg. § 1.451-4(a)(1). The court rejected Hyatt's argument on the ground that the future hotel stays to which rewards program members were entitled were not merchandise, cash, or other property within the meaning of the regulation.

2. The *Moore* we read this decision by the U.S. Supreme Court about phantom income, realization, and the Constitution, the less we think it decides — but the clear winner is the government. Moore v. United States, 144 S. Ct. 1680 (6/20/24). Put simply (and perhaps pejoratively), the issue in this U.S. Supreme Court case is whether the Constitution permits federal taxation of phantom income (i.e., gross income without the actual receipt of cash or other property). The unsurprising answer: Yes, the Constitution permits federal taxation of phantom income. (*Silly us. We didn't think the matter was open to question, but what do we know?)* Nevertheless, this case garnered much attention and made its way to the U.S. Supreme Court because of (i) the unique tax provision in question and (ii) the taxpayer's novel argument: that *realization* is a Constitutional prerequisite to federal income taxation. We elaborate below.

The facts: The taxpayers, a married couple, invested $40,000 in 2006 to acquire stock in a non-U.S. corporation conducting business in India. The taxpayers owned 13 percent of the corporation's outstanding stock. The taxpayers' investment was profitable. By 2017, the taxpayers' share of the foreign corporation's undistributed earnings and profits was approximately $508,000. Also in 2017, as part of the Tax Cuts and Jobs Act, Congress added the Mandatory Repatriation Tax ("MRT") to subpart F of the Code. *See* IRC § 965(a)(1), (c), (d). Subpart F applies to "controlled foreign corporations," commonly referred to as CFCs. Under § 957(a), a CFC generally is a non-U.S. corporation if, on any day during the corporation's taxable year, "United States shareholders" own stock possessing more than 50 percent of either the total voting power of all classes of stock entitled to vote or the total value of the corporation's stock. Pursuant to § 957(b), a "United States shareholder" is a "United States person" (see § 7701(a)(30)) who owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote (before 2018) or 10 percent or more of the total value of shares of all classes of stock of the foreign corporation (after 2017). In the Court's words, the MRT imposes "a one-time pass-through tax" that is "backward-looking" on the accumulated but undistributed income of "American-controlled foreign corporations." 144 S. Ct. at 1686. Put differently, and subject to conditions and limitations not applicable to the taxpayers in this case, the MRT effectuates a deemed repatriation (in tax parlance, "phantom income") of earnings and profits to U.S. shareholders holding 10 percent or more of the controlled foreign corporation's stock. Longstanding provisions of subpart F have operated the same way for decades, but before the MRT, subpart F mainly applied to passive

income.[1] Thus, after certain adjustments, the MRT required the taxpayers to report $132,512 of undistributed income in 2017 from their shareholdings in a foreign corporation, resulting in a *whopping* $14,729 federal income tax liability with respect to their shares.[2] The taxpayers paid the tax and then sued for a refund on the grounds that the MRT is unconstitutional. The U.S. District Court held for the government, the U.S. Court of Appeals for the Ninth Circuit affirmed the district court, and the Supreme Court granted certiorari.

The arguments. The taxpayers argued that the MRT is prohibited under Article I, §§ 8 & 9 and the Sixteenth Amendment of the Constitution because it taxes (via a deemed repatriation) *unrealized* income from their shares of the foreign corporation in which they invested. According to the taxpayers, the MRT thus is an unconstitutional "direct" tax. The Court elaborated on the taxpayers' argument as follows:

> Article I of the Constitution affords Congress broad "Power To lay and collect Taxes, Duties, Imposts and Excises." Art. I, §8, cl. 1. That power includes "two great classes of" taxes—direct taxes and indirect taxes.
>
> Generally speaking, direct taxes are those taxes imposed on persons or property. As a practical matter, however, Congress has rarely enacted direct taxes because the Constitution requires that direct taxes be apportioned among the States. To be apportioned, direct taxes must be imposed "in Proportion to the Census of Enumeration." U.S. Const., Art. I, §9, cl. 4; see also §2, cl. 3. In other words, direct taxes must be apportioned among the States according to each State's population.
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> * * * *
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> By contrast, indirect taxes are the familiar federal taxes imposed on activities or transactions. That category of taxes includes duties, imposts, and excise taxes, as well as income taxes. U.S. Const., Art. I, §8, cl. 1; Amdt. 16. Under the Constitution, indirect taxes must "be uniform throughout the United States." Art. I, §8, cl. 1. A "tax is uniform when it operates with the same force and effect in every place where the subject of it is found."
>
> Because income taxes are indirect taxes, they are permitted under Article I, §8 without apportionment.

144 S. Ct. at 1687-1688 (*case citations omitted)*.

The taxpayers reasoned that the MRT is an impermissible direct (not indirect) tax by relying on the Court's 1920 decision in *Eisner v. Macomber*, 252 U.S. 189 (1920). *Eisner v. Macomber* famously held, now codified in § 305, that a pro rata stock dividend does not give rise to gross income. The Court's opinion in *Eisner v. Macomber* stated in dicta as partial support for its holding that "what is called the stockholder's share in the accumulated profits of the company is capital, not income." 252 U.S. 219. The taxpayers latched onto this language from *Eisner v. Macomber* to support their position that the MRT is unconstitutional, arguing their phantom income in 2017 from their shares in the foreign corporation was unrealized "capital." Therefore, according to the taxpayers, the MRT is either (i) an unconstitutional direct tax (because it is not apportioned among

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[1] The MRT was enacted in 2017 to correct a perceived abuse by taxing United States shareholders on their share of post-1986 accumulated but undistributed trade or business income of "controlled foreign corporations" (as defined) even though a dividend had not been declared. Otherwise, if the income earned by the foreign corporation was never repatriated, it remained indefinitely untaxed by the U.S. The MRT also operates prospectively after 2017 with respect to "global intangible low-taxed income" (a/k/a "GILTI") See IRC § 951A.

[2] The amount of tax was inconsequential to the taxpayers; however, the taxpayers' refund suit was used as a litigation vehicle for other interested parties seeking to foreclose the possible enactment of a U.S. wealth tax.

the states) or (ii) is an unconstitutional indirect tax because *Eisner v. Macomber* requires realization, whereas the taxpayers' shares in the foreign corporation represented capital.

The government argued in response that the MRT is a permissible indirect tax under a long line of cases decided after *Eisner v. Macomber*, including cases upholding the constitutionality of pass-through tax treatment within subpart F, subchapter K (partnerships), and subchapter S (S corporations). As readers understand, so-called phantom income (gross income without an actual distribution of cash or property) under subpart F, subchapter K, and subchapter S is commonplace. Moreover, the government argued that neither *Eisner v. Macomber* nor any other authority constitutionally requires realization as a prerequisite to federal income taxation. The District Court and the Ninth Circuit agreed with the government, but the Supreme Court granted certiorari to hear the taxpayers' argument that realization is a constitutional prerequisite to federal income taxation. Yet, as discussed below, we still do not know the answer to the taxpayers' realization argument.

The Court's messy (non?) decision: By a 7-2 vote, the Supreme Court upheld the constitutionality of the MRT as applied to the taxpayers in this case, but the Court did so without explicitly ruling whether realization is constitutionally required. How did the Supreme Court get there without addressing the realization question? Well, as we said, the opinion in *Moore* is messy. Justice Kavanaugh wrote the Court's majority opinion. The reasoning among the majority, however, varied.

- Four justices (Roberts, Sotomayor, Kagan, and Jackson) joined in Justice Kavanaugh's majority opinion. Summarizing the Court's decision, Justice Kavanaugh wrote:

  > [W]e emphasize that our holding today is narrow. It is limited to: (i) taxation of the shareholders of an entity, (ii) on the undistributed income realized by the entity, (iii) which has been attributed to the shareholders, (iv) when the entity itself has not been taxed on that income. In other words, our holding applies when Congress treats the entity as a pass-through.
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  > * * * *
  >
  > The [taxpayers] argue that realization is a constitutional requirement; the Government argues that it is not. To decide this case, we need not resolve that disagreement over realization.
  >
  > Those are potential issues for another day, and we do not address or resolve any of those issues here. As to the [taxpayers'] case, Congress has long taxed shareholders of an entity on the entity's undistributed income, and it did the same with the MRT. This Court has long upheld taxes of that kind, and we do the same today with the MRT. We affirm the judgment of the U.S. Court of Appeals for the Ninth Circuit.

144 S. Ct. at 1696-1697.

- Justice Jackson agreed with the majority but would have gone further than the Court was willing, writing in a separate, concurring opinion: "[B]oth before and after the Sixteenth Amendment was adopted, the term 'income' was widely recognized as flexible enough to include both realized and *unrealized* gains." 144 S. Ct. at 1698 (emphasis added).
- Justices Barrett and Alito disagreed with Justice Kavanaugh's opinion, including his reasoning and interpretation of precedent; however, they nevertheless concurred in the result in favor of the government, stating:

  > Congress's power to attribute the income of closely held corporations to their shareholders is a difficult question — and unfortunately, the parties barely addressed it. Without focused briefing on the attribution question,[3] I would not

[3] We feel compelled to point out that over 50 briefs were filed with the Court by the parties and amici curiae.

> resolve it. Subpart F and the MRT *may or may not be constitutional*, nonarbitrary attributions of closely held foreign corporations' income to their shareholders. In this litigation, however, the [taxpayers] have conceded that subpart F is constitutional. And I agree with the Court that subpart F is not meaningfully different from the MRT in how it attributes corporate income to shareholders. Taxpayers generally bear the burden to show they are entitled to a refund. Given the [taxpayers'] concession, they have not met that burden here. For that reason, I concur in the Court's judgment affirming the judgment below.

144 S. Ct. at 1709.

The dissent: Justices Thomas and Gorsuch disagreed with both the majority and concurring opinions. Justice Thomas authored a 33-page dissenting opinion. The dissent goes deep into the history behind the adoption of the U.S. Constitution as well as the Sixteenth Amendment (which we leave to our readers' discretion) to support the conclusion that realization is indeed a constitutional prerequisite to federal income taxation. Justice Thomas wrote:

> The Court today upholds the MRT, but not because it endorses the Ninth Circuit's erroneous view that "realization of income is not a constitutional requirement." The majority acknowledges that the Sixteenth Amendment draws a distinction between income and its source. And, it does not dispute that realization is what distinguishes income from property. Those premises are sufficient to establish that realization is a constitutional requirement. Sixteenth Amendment "income" is only realized income. We should not have hesitated to say so in this case. I respectfully dissent.

144 S. Ct. at 1727 (case citations omitted).

Comment: What are the broader implications of the Supreme Court's decision in *Moore*? Other than upholding the constitutionality of the deemed repatriation, pass-through aspect of the MRT (including, perhaps, pass-through taxation within subchapter K, subchapter S, and other provisions of subpart F), we think the answer is "None." The Court did not decide if realization is constitutionally required, and the differing opinions, especially the concurring and dissenting opinions, invite such challenges in the future. Thus, in our view, *Moore* raises far more questions than it answers and provides fertile ground for challenging the constitutionality of phantom income (i.e., "unrealized" income) outside the context of subpart F, subchapter K, and subchapter S. Justice Kavanaugh admitted as much in a footnote: "[O]ur analysis today does not address the distinct issues that would be raised by (i) an attempt by Congress to tax both the entity and the shareholders or partners on the entity's undistributed income; (ii) taxes on holdings, wealth, or net worth; or (iii) taxes on appreciation."

For example, what about the Court's decision in *Commissioner v. Tufts*, 461 U.S. 300 (1983), which sanctions the determination of amount realized and gain on the disposition of property encumbered by a nonrecourse liability by taking into account the entire outstanding principal balance of the debt notwithstanding the property's lower fair market value? *See also* § 7701(g). Is unrealized *Tufts* gain unconstitutional? What about the taxation of built-in gain and passive investment income of subchapter S corporations? Sections 1374 and 1375 impose federal income taxes on the S corporation itself even though S corporation's shareholders also pay federal income tax on their allocable shares of such income. *See* §§ 1366, 1374, 1375. Are sections 1374 and 1375 taxes "on both the entity and the shareholders" as described by Justice Kavanaugh in the above-quoted footnote? Finally, what about the federal estate tax, which taxes the unrealized but appreciated value of a decedent's property (and grants a corresponding basis step-up)? *See* §§ 1014, 2001. Is the estate tax a questionable "wealth tax" as footnoted by Justice Kavanaugh? The Court upheld the constitutionality of the federal estate tax over 100 years ago in *New York Trust Company v. Eisner*, 256 U.S. 345 (1921), but does *Moore* change the analysis? We're certain there are numerous other examples of the taxation of "unrealized" appreciation.

B. Deductible Expenses versus Capitalization

C. Reasonable Compensation

D. Miscellaneous Deductions

1. Standard mileage rates for 2024. Notice 2024-8, 2024-2 I.R.B. 356 (12/14/23). The standard mileage rate for business miles in 2024 goes up to 67 cents (from 65.5 cents in 2023) and the medical/moving rate goes *down* to 21 cents per mile (from 22 cents in 2023). The charitable mileage rate remains fixed by § 170(i) at 14 cents. The portion of the business standard mileage rate treated as depreciation goes up to 30 cents per mile (from 28 cents in 2023). The maximum standard automobile cost may not exceed $62,000 (up from $60,800 in 2023) for passenger automobiles (including trucks and vans) for purposes of computing the allowance under a fixed and variable rate (FAVR) plan.

- The notice reminds taxpayers that (1) the business standard mileage rate cannot be used to claim an itemized deduction for unreimbursed employee travel expenses because, in the 2017 Tax Cuts and Jobs Act, Congress disallowed miscellaneous itemized deductions for 2024, and (2) the standard mileage rate for moving has limited applicability for the use of an automobile as part of a move during 2024 because, in the 2017 Tax Cuts and Jobs Act, Congress disallowed the deduction of moving expenses for 2024 (except for members of the military on active duty who move pursuant to military orders incident to a permanent change of station, who can still use the standard mileage rate for moving).

The following table summarizes the optional standard mileage rates:

Category	**2022**		**2023**	**2024**
	Jan.-Jun.	Jul.-Dec.		
Business miles	58.5 cents	62.5 cents	65.5 cents	67 cents
Medical/moving	18 cents	22 cents	22 cents	21 cents
Charitable mileage	14 cents	14cents	14 cents	14 cents

2. Eleventh Circuit affirms Tax Court in denying a deduction for "legal fees" determined to be related to criminal charges arising out of inappropriate personal activities. Anderson v. Commissioner, 133 A.F.T.R. 2d 2024-1551 (10th Cir. 5/17/24), *aff'g*, T.C. Memo. 2023-42 (3/28/23). The taxpayer in this case, a doctor who researched gene therapy, was arrested on allegations of sexually abusing the minor daughter of his research assistant. He was convicted in California state court and sentenced to prison. The IRS disallowed deductions for legal fees on the taxpayers' (husband's and wife's) federal income tax returns for 2013 and 2014 and issued a notice of deficiency for those years. The taxpayers responded by filing a petition in the Tax Court and argued that the legal fees were deductible as ordinary and necessary business expenses under § 162. The Tax Court (Judge Paris) disallowed the taxpayers' legal expense deductions for 2013 ($292,175) and disallowed $65,120 of the $68,120 in deductions for 2014. The Tax Court allowed the taxpayer to deduct $3,000 of the 2014 legal fees (plus an additional $10,000 not previously claimed) because those fees had been paid for an investigation related to his trade or business. On appeal, in an order and judgment by Judge Tymkovich, the U.S. Court of Appeals for the Eleventh Circuit agreed with the Tax Court's analysis. The taxpayers asserted that they had paid the legal fees, at least in part, for an investigation of the doctor's former colleague, who allegedly had filed false accusations of molestation against the doctor in an effort to steal his intellectual property. In both the Tax Court and on appeal, the taxpayers argued that the Tax Court misapplied the Supreme Court's decision in *Commissioner v. Tellier*, 383 U.S. 687 (1966). In *Tellier*, the petitioner was in the securities business and was found guilty of securities fraud. Mr. Tellier sought to deduct his legal fees as a business expense and the IRS disallowed the deduction "on the ground of tax fraud." *Tellier*, 383 U.S., at 690. The IRS conceded in *Tellier* that the legal fees were business expenses

but argued that the deductions should be disallowed as a public policy exception to § 162, which authorizes a deduction for ordinary and necessary business expenses. *Id.* The Supreme Court disagreed and held that public policy does not prohibit a deduction of legal fees related to criminal activity so long as the legal fees are an ordinary and necessary expense of the taxpayer's trade or business. *Id.* at 694-95. The Eleventh Circuit in this case distinguished *Tellier* and reasoned that the issue in this case was not whether the taxpayers' deductions were disallowed by public policy, but rather whether legal fees paid by the taxpayers were actual business expenses. Pursuant to the U.S. Supreme Court's decision in *United States v. Gilmore*, 372 U.S. 39, 48-49 (1963), the deductibility of legal fees depends on the origin and character of the claim for which the expenses were incurred and whether the claim has a sufficient connection to the taxpayer's business or income-producing activities. Under *Gilmore*, "the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test." *Id.* at 49. Here, the Eleventh Circuit agreed with the Tax Court's reasoning that the taxpayer was charged with sexual abuse of a minor that was alleged to have occurred at the taxpayer's home. Those activities were personal in nature and did not involve or arise out of the taxpayer's gene therapy business. Rather, the expenses the taxpayer attempted to deduct were primarily related to his ineffective assistance of counsel claim in his criminal case and a later proceeding in which he filed a state habeas corpus petition seeking his release from prison. The Eleventh Circuit adopted the Tax Court's reasoning that the criminal charges did not involve the taxpayer's gene therapy business or any other activity for the production or collection of income. The connection between the taxpayer's criminal proceedings and his occupation was merely tangential. Further, any economic loss to the taxpayer's business following the conviction was a collateral consequence of the criminal case and not the origin of the claimed expenses. The court therefore affirmed the Tax Court's disallowance of the majority of the taxpayer's legal expense deductions in 2013 and 2014.

E. Depreciation & Amortization

1. Section 280F 2024 depreciation tables for business autos, light trucks, and vans. Rev. Proc. 2024-13, 2024-9 I.R.B. 678 (2/6/24). Section 280F(a) limits the depreciation deduction for passenger automobiles. For this purpose, the term "passenger automobiles" includes trucks and vans with a gross vehicle weight of 6,000 pounds or less. The IRS has published depreciation tables with the 2024 depreciation limits for business use of passenger automobiles acquired after September 27, 2017, and placed in service during 2024:

2024 Passenger Automobiles with § 168(k) first year recovery:	
1st Tax Year	$20,400
2nd Tax Year	$19,800
3rd Tax Year	$11,900
Each Succeeding Year	$ 7,160
2024 Passenger Automobiles (no § 168(k) first year recovery):	
1st Tax Year	$12,400
2nd Tax Year	$19,800
3rd Tax Year	$11,900
Each Succeeding Year	$ 7,160

For leased vehicles used for business purposes, § 280F(c)(2) requires a reduction in the amount allowable as a deduction to the lessee of the vehicle. Under Reg. § 1.280F-7(a), this reduction in the lessee's deduction is expressed as an income inclusion amount. The revenue procedure

provides a table with the income inclusion amounts for lessees of vehicles with a lease term beginning in 2024. For 2024, this income inclusion applies when the fair market value of the vehicle exceeds $62,000.

F. Credits

G. Natural Resources Deductions & Credits

H. Loss Transactions, Bad Debts, and NOLs

I. At-Risk and Passive Activity Losses

III. INVESTMENT GAIN AND INCOME

A. Gains and Losses

1. There's now a statutory income tax cost for low-balling estate tax valuation. The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, § 2004(a), added § 1014(f), which requires that the basis of any property taking a § 1014 date-of-death-value shall not exceed the final value as determined for estate tax purposes, or, if the value of the property has not been finally determined for estate tax purposes, the value stated in a statement (required by new § 6035(a) to be provided by the executor of any estate required to file an estate tax return) identifying the value of the property. Section 1014(f)(2) provides that the consistency rule applies only to property the inclusion of which in the decedent's estate increased the estate tax liability (reduced by allowable credits). Thus, if the total value of the decedent's estate, as correctly determined, is less than the decedent's unified credit exemption, it appears that the consistency requirement does not apply or if the taxable estate is reduced to no more than the exclusion amount by the estate tax marital deduction or the estate tax charitable deduction. Also, an estate tax return filed solely to enable a surviving spouse to claim a deceased spouse's unused unified credit under the portability rules would not invoke the consistency requirement. The basis has been finally determined for estate tax purposes only if (1) the value of the property as shown on the estate tax return was not contested by the IRS before the statute of limitations expired, (2) the value is specified by the IRS on audit and was not timely contested by the executor of the estate, or (3) the value is determined by a court or pursuant to a settlement with the IRS.

- Act § 2004(b) also added Code § 6035. Section 6035(a)(1) and (a)(2) require the executor of any estate required to file an estate tax return to report to the IRS and each beneficiary acquiring any interest in property included in the decedent's gross estate a statement identifying the value of each interest in such property as reported on such return and any other information as the Treasury and IRS may prescribe. Section 6035(a)(3)(A) provides that each statement required to be furnished under § 6035(a)(1) or (a)(2) shall be furnished at such time as the IRS prescribes, but no later than the earlier of (i) 30 days after the due date of the estate tax return (including any extensions) or (ii) 30 days after the date the estate tax return is filed. New Code § 6035(b) directs the Treasury Department to promulgate regulations as necessary to carry out the new provision, including regulations relating to (1) the application of § 6035 to property with regard to which no estate tax return is required to be filed, and (2) situations in which the surviving joint tenant or other recipient may have better information than the executor regarding the basis or fair market value of the property.

- Act § 2004(c) added new Code § 6662(b)(8) to extend the 20 percent accuracy related penalty to "any inconsistent estate basis," which is defined in new § 6662(k) as a basis claimed on an income tax return that exceeds the basis determined under § 1014(f).

- These provisions apply to property with respect to which an estate tax return is filed after 7/31/15. However, in a series of notices, the IRS provided that the statements required by new § 6035(a)(1) and (a)(2) were not due before June 30, 2016. See Notice 2015-57, 2015-36 I.R.B. 294 (8/21/15); Notice 2016-19, 2016-9 I.R.B. 362 (2/11/16); Notice 2016-27, 2016-15 I.R.B. 576 (3/24/16). The IRS later confirmed the extension to June 30, 2016, in final regulations. Reg. § 1.6035-2(a).

- In early 2016, the IRS issued the final version of Form 8971, Information Regarding Beneficiaries Acquiring Property From a Decedent. An executor required to file Form 8971 must send Schedule A of the Form to each beneficiary receiving property included on the estate tax return. At the time the estate tax return is filed, the estate may not have made distributions and may not have identified the specific property that a beneficiary will receive. To account for this situation, the instructions to Form 8971 indicate that the Schedule A issued to a beneficiary should report "all items of property that could be used, in whole or in part, to fund the beneficiary's distribution on that beneficiary's Schedule A." When the estate later distributes property to the beneficiary, the executor must file a supplemental Form 8971 and issue a corresponding Schedule A.

a. The IRS issues final regulations. T.D. 9991, Consistent Basis Reporting Between Estate and Person Acquiring Property from Decedent, 81 F.R. 76356 (9/17/24). Treasury and the IRS have finalized proposed regulations regarding (1) the requirement of § 1014(f) that a recipient's basis in certain property acquired from a decedent be consistent with the value of the property as finally determined for federal estate tax purposes, and (2) the reporting requirements of § 6035 for executors or other persons required to file federal estate tax returns. The regulations clearly state that if, after taking into account all available credits other than the credit for prepayment of tax, no estate tax is payable, no property is subject to the basis consistency requirements. Reg. § 1.1014-10(c)(1)(ii). *See also* Staff of the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 2015, 27 (JCS-1-16, March 2016). However, for a taxable estate, the basis consistency rules do not apply to certain categories of property, including (1) property qualifying for the estate tax charitable or marital deductions, and (2) household and personal effects for which an appraisal is not required under Reg. § 20.2031-6(b), which requires an appraisal for "household and personal effects articles having marked artistic or intrinsic value of a total value in excess of $3,000." Reg. § 1.1014-10(c)(2). Until the final value of property subject to the consistency rule has been determined, the recipient may use as his unadjusted basis the amount reported to him by the executor, Reg. § 1.1014-10(b)(2) (the amount reported on Form 8971 as required by § 6035), but if final value is later determined to be different, the beneficiary may be subject to deficiency procedures. The proposed regulations provided that "after discovered or omitted property" not reported on the initial estate tax return or a supplemental return prior to the expiration of the assessment period would have a zero basis, as well as all property in an estate if no estate tax return had been filed by an estate that was required to file, until either a return was filed or a final value was determined by the IRS. Prop. Reg. § 1.1014-10(c)(3). The final regulations omit this "zero basis" rule and instead provide that the consistent basis requirement applies to "included property," defined in Reg. § 1.1014-10(d)(4) as property whose value is reported on an estate tax return or otherwise is included in the total value of the gross estate. The effect of this change is that the basis of property acquired or passed from a decedent that is not reported on an estate tax return and not otherwise included in the gross estate generally is determined under § 1014(a), without regard to the rules of § 1014(f).

Reg. § 1.6035-1 provides very detailed guidance—far more detailed than is noted here—regarding the procedures under new § 6035 requiring the executor of any estate required to file an estate tax return to furnish to the IRS and to each beneficiary acquiring any interest in property included in the gross estate a statement identifying the value of each interest in such property as reported on such return and any other information that the IRS may prescribe. The reporting requirement does not apply if a return is not required to be filed, but was filed for the purpose of making a generation skipping tax allocation, a portability election, or any protective filing to avoid penalties if value is later determined to cause a return to be required. Reg. § 1.6035-1(b)(1). An executor must file a supplemental statement when "a change [occurs] to the information required to be reported on the Information Return or Statement… [that] causes the information as reported to be incorrect or incomplete." Reg. § 1.6035-1(d)(1). The regulations make it clear that § 6035 applies more broadly than the basis consistency rule of § 1014(f), which applies only to that property included in the gross estate that causes an increase in federal estate tax liability; § 6035 requires reporting of "the value of property included on a required Federal estate tax return," which

includes, for example, an estate that is not taxable due to martial or charitable deductions that reduce the amount of tax otherwise due to less than the allowable unified credit.

Section 1.1014-10 of the final regulations applies to property described in Reg. § 1.1014-10(c)(1) of the final regulations that is acquired from a decedent or by reason of the death of a decedent if the decedent's estate tax return is filed after the date of publication of the final regulations in the Federal Register. Section §1.6035-1(j) of the regulations provides that Reg. § 1.6035-1 of the final regulations applies to executors of a decedent's estate who are required to file an estate tax return under section 6018 if that return is filed after the date of publication of these final regulations in the Federal Register, and to trustees receiving certain property included in the gross estate of such a decedent.

2. The taxpayer's virtual currency assets may have been completely wiped out in 2020 with resulting losses, but this does not mean the government is estopped from taxing the taxpayer's gains realized in virtual currency transactions in earlier years. Kim v. Commissioner, T.C. Memo. 2023-91 (7/20/23). For the years 2013-2017, the IRS received information reports from Coinbase, a virtual currency exchange. They reported the proceeds of the taxpayer's transactions in various virtual currencies, including Bitcoin, Litecoin, and Etherium. The taxpayer timely filed federal income tax returns for 2013-2016 but reported no gains or losses from the virtual currency transactions. On his timely-filed 2018 income tax return, the taxpayer reported on Schedule D $18.6 million of gross proceeds from virtual currency transactions but reported a basis in the assets sold that resulted in a gain of $42,069. The IRS audited the taxpayer's 2013-2017 returns and, when the taxpayer did not supply a computation of his gains and losses from virtual currency transactions, the revenue agent used records from Coinbase to reconstruct them using a first-in, first-out method. Based on these calculations, the revenue agent determined that the taxpayer had short-term capital gain of $75,400 for 2013, short-term capital gain of just over $4 million for 2017, and long-term capital gain of $74,565 for 2017. The IRS issued a notice of deficiency and, in response, the taxpayer filed a petition in the Tax Court. In the Tax Court, the taxpayer did not contest the amount or character of the gains calculated by the IRS. Rather, he argued that, in 2020, the virtual currency assets that produced these gains had been wiped out during the early stages of the COVID-19 pandemic, that he had been forced to liquidate his virtual currency positions with resulting large losses, and

> that the actions (or inaction) of the U.S. Government in response to the COVID epidemic "directly caused [that] harm" and that, "under the Clean Hands doctrine of US law," the IRS should be estopped from collecting tax on his 2013 and 2017 gains.

The Tax Court (Judge Lauber) ruled in favor of the government. The taxpayer's argument, the court stated, had no legal basis. The court observed that "[t]he doctrine of estoppel can be invoked against the United States only in the rarest of circumstances." Further, the "unclean hands" principle, the court concluded, did not apply because that principle withholds equitable relief from a party who has acted improperly, and the government in this case was not seeking equitable relief but rather was seeking to recover taxes due from the taxpayer under the Internal Revenue Code. Further, the court reasoned, the annual accounting principle "dictates that a taxpayer's income for a particular year be calculated on the basis of events occurring during that year." Although Congress has allowed corporations to carry capital losses both forward and back under § 1212(a)(1), it has chosen to allow individual taxpayers to carry capital losses realized in 2020 only forward, which means that losses the taxpayer might have realized in 2020 are irrelevant in determining his liabilities for 2013-2017.

3. You can't have your cake and eat it too, even if Bernie "Madoff" with the "ingredients" (i.e., the investments underlying your variable life insurance policy) Pascucci v. Commissioner, T.C. Memo. 2024-43 (4/15/24). This memorandum decision from the Tax Court (Judge Gustafson) illustrates one of the finer points of the theft loss deduction allowed by § 165(a) and (e). That is, to qualify for a deduction under § 165(a) and (e), the taxpayer himself, herself, or

itself must be the victim of the theft, not merely suffer the collateral consequences of the crime. As Judge Gustafson recited in his opinion: "An individual claiming a theft loss deduction under § 165 must show for the taxable year in question that (1) a theft occurred, (2) there was no reasonable chance of recovery of the property, and (3) he *owned the property* at the time it was stolen." T.C. Memo. at ___ (emphasis added). Based upon stipulated facts and concessions by the IRS and the taxpayers in this case, the determinative issue was whether the taxpayers owned the investments underlying the taxpayers' private placement life insurance contracts.

Facts. The husband-and-wife taxpayers held numerous private placement variable life insurance policies. Essentially, a private placement variable life insurance policy is a portfolio of investments wrapped in a life insurance policy. Unlike a traditional life insurance policy, the premiums and the death benefit can fluctuate depending upon the "variable" performance of the investments underlying the policy. Further, the owner of the policy can, within limits set by the insurance carrier, direct the investments. Insurance carriers maintain separate accounts into which a policyholder's premiums are paid and invested. Nonetheless, the insurance contract must endow the carrier with ultimate ownership and control of the investments. In fact, the private placement memorandums in this case expressly stated that, for state law purposes, the carriers were the owners of the separately maintained accounts. Otherwise, § 72 (annuities and life insurance contracts) does not apply to protect the policyholder from being taxed on the income (the "inside buildup") generated by the investments. *See generally* Mancini & Sawyer, *Understanding Private Placement Life Insurance: Planning Opportunities and Pitfalls*, 162 Tr. & Est. 35 (2023). Here, the taxpayers' private placement variable life insurance policies became worthless in 2008 after investing with Bernie Madoff. Consequently, the taxpayers claimed an $8.2 million theft loss deduction for 2008 (under § 165(a) and (e)) and carried the loss back to 2005 and 2006. (Readers may recall that Madoff famously was convicted of theft in 2009 for running a sophisticated Ponzi scheme. Madoff was convicted and sentenced in 2009 to 150 years in prison, dying in 2021 while incarcerated.) The IRS examined the taxpayers' 2008 return and disallowed the 2008 theft loss deduction and carrybacks, issuing notices of deficiency totaling approximately $3.75 million for the taxpayers' taxable years 2005, 2006, and 2008. The taxpayers timely filed a petition in the Tax Court contesting the notices of deficiency.

The Arguments and Judge Gustafson's Opinion. The IRS's argument before Judge Gustafson was relatively simple: as required by § 72, the insurance carriers (either directly or through feeder fund partnerships in which they invested), not the taxpayer, owned the investments that were stolen by Madoff. The fact that the premiums were paid into, and the investments were segregated by, the carriers' separately maintained accounts did not make the taxpayers the owners of the investments. Thus, the insurance carriers (or the feeder fund partnerships in which they invested) were the victims of the theft, not the taxpayer. See, for example, authorities holding that the decline in value of stock, even if it is due to corporate theft, does not give rise to a theft loss deduction. Reg. § 1.165-4(a); *Marr v. Commissioner*, T.C. Memo. 1995-250; *Crowell v. Commissioner*, T.C. Memo. 1986-314; Notice 2004-27, 2004-1 C.B. 782; Rev. Rul. 2009-9, 2009-14 I.R.B. 735. The taxpayer made several counterarguments, none with success. We do not discuss here all of the taxpayer's unavailing arguments but instead focus on two that we find interesting. *One*, the taxpayers argued that, despite the fact they had never included in income the "inside buildup" of the policies (consistent with § 72), their limited ability to direct the carriers' investments among the feeder funds (including the exercise of certain voting rights and ultimately suffering the economic consequences of the funds' decisions) made them the "victims" of Madoff's theft. The taxpayers cited as support for their argument *Webber v. Commissioner*, 144 T.C. 324 (2015) (applying the "investor control doctrine" to treat the policyholder, not the carrier, of a private placement variable life insurance contract as the federal income tax owner of assets held in a segregated investment account underlying the policy). In other words, the taxpayers essentially were arguing that the variable life insurance wrappers should be disregarded notwithstanding the taxpayers' inconsistent position vis-à-vis the policies prior to 2008. Judge Gustafson's response to this argument essentially was that the taxpayers cannot have their cake and eat it too. Thus, even if the taxpayers via the carriers' separately maintained accounts may have had limited rights to

pick among investment feeder funds (including concomitant voting rights), such rights were "typical rights contemplated by state law and do not qualify as an incident of ownership of the assets underlying the [p]olicies." T.C. Memo. 2024-43 at ___. *Two*, the taxpayers had qualified in 2018 for $202,766 in monetary relief from the Department of Justice's Madoff Victim Fund ("MVF"). The MVF was established by the DOJ to distribute more than $4 billion in forfeited assets to the "victims" of Bernie Madoff's Ponzi scheme. Judge Gustafson responded to this argument by clarifying that the MVF was "understood to be 'unique' (i.e., generous and broad) because of its focus on the 'ultimate investor' rather than on the feeder and mutual funds that had directly invested" with Madoff. T.C. Memo. 2024-43 at ___. Accordingly, qualifying for MVF relief was not determinative (or even particularly persuasive) that the taxpayers were "victims" of theft entitled to a deduction under § 165(a) and (e). Concluding his opinion, Judge Gustafson wrote: "The [taxpayers] are not entitled to a theft loss deduction under section 165 for the diminution in value of the assets in the separate accounts, because they did not own the assets at the time of the theft."

B. Interest, Dividends, and Other Current Income

C. Profit-Seeking Individual Deductions

D. Section 121

E. Section 1031

F. Section 1033

G. Section 1035

H. Miscellaneous

IV. COMPENSATION ISSUES

A. Fringe Benefits

1. Limits for contributions to health savings accounts for 2025. Rev. Proc. 2024-25, 2024-22 I.R.B. 1333 (5/9/24). The IRS has issued the inflation-adjusted figures for contributions to health savings accounts. For calendar year 2025, the annual limitation on deductions under § 223(b)(2)(A) for an individual with self-only coverage under a high deductible health plan is increased to $4,300 (from $4,150 in 2024). For calendar year 2025, the annual limitation on deductions under § 223(b)(2)(B) for an individual with family coverage under a high deductible health plan is increased to $8,550 (from $8,300 in 2024). For this purpose, for calendar year 2025, a "high deductible health plan" is defined under § 223(c)(2)(A) as a health plan with an annual deductible that is not less than $1,650 (increased from $1,600 in 2024) for self-only coverage or $3,300 (increased from $3,200 in 2024) for family coverage, and for which the annual out-of-pocket expenses (deductibles, co-payments, and other amounts, but not premiums) do not exceed $8,300 for self-only coverage (increased from $8,050 in 2024) or $16,600 for family coverage (increased from $16,100 in 2024).

The following table summarizes the limits for contributions to health savings accounts:

Health Savings Account Limitations				
Category	**Self-Only Coverage**		**Family Coverage**	
	2024	**2025**	**2024**	**2025**
Limit on Deductions for Contributions to HSAs	$4,150	$4,300	$8,300	$8,550
High-Deductible Health Plan				
Minimum Deductible	$1,600	$1,650	$3,200	$3,300
Limit on Out-of-Pocket Expenses	$8,050	$8,300	$16,100	$16,600

B. Qualified Deferred Compensation Plans

1. Congress has increased the age at which RMDs must begin to 73 and eventually to age 75. A provision of the SECURE 2.0 Act, Division T, Title I, § 107 of the Consolidated Appropriations Act, 2023, amended Code § 401(a)(9)(C)(i)(I) to increase the age at which required minimum distributions (RMDs) from a qualified plan (including IRAs) must begin from 72 to 73. Pursuant to this amendment, RMDs must begin by April 1 of the calendar year following the later of the calendar year in which the employee attains age 73 or, in the case of an employer plan, the calendar year in which the employee retires. This latter portion of the rule allowing deferral of RMDs from employer plans until retirement does not apply to a 5-percent owner (as defined in § 416). The increase in the age at which RMDs must begin to age 73 applies to distributions required to be made after December 31, 2022, with respect to individuals who attain age 73 after such date. Thus, an individual who attained age 72 in 2022 must take his or her first RMD by April 1, 2023, but an individual who attains age 72 in 2023 need not take the first RMD until April 1, 2025. The legislation further increases the age at which RMDs must begin to age 75 for individuals who attain age 75 after 2032.

a. Those born in 1951 (and who therefore attain age 72 in 2023) and who received distributions from January 1 through July 31, 2023, that are mischaracterized as RMDs have until September 30, 2023, to deposit such amounts in an eligible retirement plan and treat the deposit as a tax-free rollover. Notice 2023-54, 2023-31 I.R.B. 382 (7/14/23). Plan administrators and other payors made the Service aware that automated payment systems would need to be updated to reflect the legislative change in the age at which RMDs must begin. Because such changes could take time, it is possible that those born in 1951 and who therefore attain age 72 in 2023 would receive distributions in 2023 that are mischaracterized as RMDs (and therefore normally ineligible for rollover). This notice grants relief targeted at this situation. For employer-sponsored plans, the notice provides that (1) payors or plan administrators will not be treated as having failed to satisfy applicable requirements based on failure to treat a distribution as an eligible rollover distribution merely because the plan made a distribution from January 1, 2023, through July 31, 2023, to a participant born in 1951 (or the participant's surviving spouse) that would have been an RMD if Congress had not increased the age at which RMDs must begin from 72 to 73, and (2) participants born in 1951 who received such a distribution have until September 30, 2023, to roll over the mischaracterized distribution. For IRAs, the notice provides similar relief and specifies that IRA owners born in 1951 (or the owner's surviving spouse) who received a distribution from the IRA from January 1, 2023, through July 31, 2023, that would have been an RMD if Congress had not increased the age at which RMDs must begin from 72 to 73 can roll over the mischaracterized distribution to an eligible retirement plan if they do so by September 30, 2023. Although IRA owners normally can make only one tax-free rollover in a 12-month period,

the notice provides that IRA owners entitled to the relief provided by the notice can roll over the mischaracterized distribution even if they have already rolled over a distribution in the previous 12 months. A rollover of the mischaracterized distribution, however, will preclude the IRA owner from rolling over another distribution in the succeeding 12 months (but could still make a direct trustee-to-trustee transfer as described in Rev. Rul. 78-406, 1978-2 CB 157).

b. Those born in 1959 must begin taking RMDs at age 73 (and not age 75). REG-103529-23, Required Minimum Distributions, 89 F.R. 58644 (7/19/24). Treasury and the IRS have issued proposed regulations that address various issues reserved in the final regulations on RMDs issued on the same date and discussed elsewhere in this outline. Generally, the proposed regulations address issues raised by provisions Congress enacted or amended in the SECURE 2.0 Act in late 2022. One of those provisions is § 401(a)(9)(C)(i)(I), which Congress amended to provide that the required beginning date on which RMDs must begin is generally April 1 of the calendar year following the year in which the account owner attains the "applicable age." The proposed regulations clarify an issue raised by the statutory language Congress used. As amended by the 2022 legislation, Code § 401(a)(9)(C)(v) defines the term "applicable age" for purposes of determining when RMDs must begin in a way that appears to provide that those born in 1959 must begin taking RMDs both at age 73 and at age 75. Section § 1.401(a)(9)-2(b)(2)(v) of the proposed regulations clarifies that those born in 1959 must begin taking RMDs at age 73, and that those born in 1960 and later years must begin taking RMDs at age 75. The following table summarizes the age at which individuals born in specific years must begin taking RMDs:

Year of birth	Age at which RMDs must begin
Before July 1, 1949	70-½
July 1, 1949, through Dec. 31, 1950	72
1951-1959	73
1960 and later	75

2. The penalty for failing to take an RMD is now 25% (and possibly 10%) rather than 50 percent. If a taxpayer fails to take the full amount of a required minimum distribution (RMD) from a qualified retirement plan (including an IRA), § 4974(a) imposes an excise tax. The tax is a percentage of the amount by which the RMD exceeds the actual amount distributed during the year. Before legislative changes made in 2022, the percentage was 50 percent. A provision of the SECURE 2.0 Act, Division T, Title III, § 302 of the Consolidated Appropriations Act, 2023, amended Code § 4974(a) to reduce the percentage to 25 percent. New § 4974(e) further reduces the percentage to 10 percent if an individual receives all of their past-due RMDs and files a tax return that reflects the excise tax on such RMDs before the earliest of three dates: (1) the date of mailing of a notice of deficiency with respect to the excise tax, (2) the date on which the excise tax is assessed, or (3) the last day of the second taxable year that begins after the close of the taxable year in which the excise tax is imposed (apparently, the close of the second taxable year after the year of the missed RMD). These changes apply to taxable years beginning after December 29, 2022, the date of enactment of the SECURE 2.0 Act.

3. RMDs are no longer required for Roth accounts in employer-sponsored plans. A provision of the SECURE 2.0 Act, Division T, Title III, § 325 of the Consolidated Appropriations Act, 2023, amended Code § 402A(d) by adding new § 402A(d)(5), which makes Roth accounts in employer-sponsored retirement plans exempt from the requirement that required minimum distributions (RMDs) begin at age 73. Before this change, although RMDs were not required for Roth IRAs, they were required for Roth accounts in employer-sponsored retirement

plans. This change is effective for taxable years beginning after December 31, 2023, but does not apply to distributions required for 2023 that are permitted to be paid after 2023.

4. Go ahead and steal your spouse's identity, at least for purposes of receiving RMDs. A provision of the SECURE 2.0 Act, Division T, Title III, § 327 of the Consolidated Appropriations Act, 2023, amended Code § 401(a)(9)(B)(iv) to provide that, if a retirement account participant dies before reaching the age at which RMDs must begin and has designated a spouse as the sole beneficiary, then the spouse may make an irrevocable election to be treated as the participant for purposes of receiving RMDs. Making this election allows the surviving spouse to defer RMDs until the deceased spouse would have reached the age at which RMDs must begin. For example, if a husband passes away at age 63 and is survived by his wife who is age 68 and is his sole designated beneficiary, then she can elect to be treated as her husband for purposes of receiving RMDs. This means that she can defer taking RMDs from the account until her husband would have reached age 73 (a period of 10 years in this example) rather than when she attains age 73. This change is effective for calendar years beginning after December 31, 2023.

a. Guidance on the surviving spouse's election to be treated as the deceased spouse for purposes of determining when RMDs must begin. REG-103529-23, Required Minimum Distributions, 89 F.R. 58644 (7/19/24). Treasury and the IRS have issued proposed regulations that address various issues reserved in the final regulations on RMDs issued on the same date and discussed elsewhere in this outline. Generally, the proposed regulations address issues raised by provisions Congress enacted or amended in the SECURE 2.0 Act in late 2022. One of those provisions is § 401(a)(9)(B)(iv), which Congress amended to provide that, if a retirement account participant dies before reaching the age at which RMDs must begin and has designated a spouse as the sole beneficiary, then the spouse can make an irrevocable election to be treated as the participant for purposes of receiving RMDs. The proposed regulations provide a series of rules that would apply with respect to this spousal election. *First*, § 1.401(a)(9)–5(g)(3)(ii)(A) of the proposed regulations provides that, if the account owner dies before the owner's required beginning date for RMDs, then the surviving spouse is automatically treated as having made the election, i.e., the surviving spouse need not affirmatively make the election. In contrast, § 1.401(a)(9)–5(g)(3)(ii)(B) of the proposed regulations provides that, if the account owner dies *on or after* the owner's required beginning date for RMDs, then the spouse is not automatically treated as having made the election and must affirmatively make the election. The terms of the plan, however, can make this election a default election for the surviving spouse. *Second*, § 1.401(a)(9)–5(g)(3)(ii)(C) of the proposed regulations provides that, if this election is in effect for a surviving spouse, then the surviving spouse's RMDs are calculated using the Uniform Life Table in Reg. § 1.401(a)(9)-9(c) for the *surviving spouse's* age. Thus, although this election permits a surviving spouse who is older than the deceased spouse to benefit by delaying taking RMDs until the deceased spouse would have reached the age at which RMDs must begin, this benefit is somewhat reduced by the requirement that, when RMDs begin, they are calculated using the surviving spouse's age rather than the deceased spouse's age. The exception to this rule is that, if the deceased spouse died on or after the required beginning date for distributions, then the surviving spouse's RMDs are calculated using the greater of the surviving spouse's life expectancy or the deceased spouse's remaining life expectancy. *Third*, § 1.401(a)(9)–5(g)(3)(ii)(D) of the proposed regulations provides that, if this election is in effect and the surviving spouse has begun receiving RMDs (or is treated as receiving RMDs under specified rules), then the surviving spouse's beneficiary must continue taking RMDs over the surviving spouse's remaining life expectancy and must withdraw any remaining funds in the account by the end of the tenth calendar year following the year of the surviving spouse's death. In other words, the surviving spouse's beneficiary is *not* treated as an eligible designated beneficiary and therefore must withdraw all funds in the account by the end of the tenth calendar year following the year of the surviving spouse's death. *Fourth*, § 1.401(a)(9)–5(g)(3)(ii)(E) of the proposed regulations specifies the effective date of the spousal election. The spousal election is available only if the first year for which annual RMDs to the surviving spouse must be made is 2024 or later. The preamble to the proposed regulations provides the following example:

For example, if an employee who died in 2017 and before the employee's required beginning date would have reached the applicable age in 2024 or later, then the first year for which an annual required minimum distribution is due would be 2024 or later, and the spousal election could apply. However, if the employee would have reached the applicable age in 2022, then the first year for which an annual required minimum distribution is due to the spouse was 2022, and the spousal election would not be available.

Similarly, if the employee died in 2021 and after the employee's required beginning date, then the spouse must begin receiving annual required minimum distributions (based on the spouse's remaining life expectancy) in 2022, and the spousal election would not be available.

5. Individuals who are ages 60-63 will be able to make additional catch-up contributions to employer-sponsored plans beginning in 2025. Section 414(v) allows individuals who are age 50 and older to make so-called "catch-up" contributions to employer-sponsored retirement plans such as § 401(k) plans in addition to the basic amount ($22,500 in 2023) that individuals are allowed to contribute. The limit on catch-up contributions is $7,500 in 2023 and is adjusted annually for inflation. A provision of the SECURE 2.0 Act, Division T, Title I, § 109 of the Consolidated Appropriations Act, 2023, amended Code § 414(v)(2) to allow individuals who are ages 60 to 63 at the close of the taxable year to make larger catch-up contributions up to the "adjusted dollar amount," which is defined in new § 414(v)(2)(E). As defined, the adjusted dollar amount is equal to the greater of $10,000 or 150 percent of the regular catch-up contribution amount for 2024. This $10,000 figure will be adjusted annually for inflation after 2025. This change is effective for taxable years beginning after 2024.

- The ability of those ages 60 to 63 to make larger catch-up contributions to employer-sponsored plans will take effect in 2025. In that year, the limit on such catch-up contributions will be the greater of $10,000 or 150 percent of the regular catch-up contribution limit for 2024. Because the regular catch-up contribution limit is already $7,500 in 2023, and 150 percent of that figure is $11,250, the larger catch-up contribution limit for those ages 60 to 63 will be greater than $10,000 in the first year it is effective.

6. Effective in 2024, all catch-up contributions to employer-sponsored plans must be deposited in a Roth account if the participant had wages in the preceding year of more than $145,000. A provision of the SECURE 2.0 Act, Division T, Title VI, § 603 of the Consolidated Appropriations Act, 2023, amended Code § 414(v) by adding new § 414(v)(7). New § 414(v)(7) provides that, if a participant in an employer-sponsored retirement plan had wages in the preceding calendar year from the employer sponsoring the plan that exceeded $145,000, then the participant cannot make catch-up contributions unless those contributions are designated Roth contributions. This $145,000 figure will be adjusted for inflation in tax years beginning after 2024. The legislation further provides that, if this new "Roth-only" rule applies to any participant for the year, then no participant in the plan can make catch-up contributions unless the plan offers all participants a Roth option. This rule effectively will force employer-sponsored plans to offer Roth options to their participants. These changes apply to taxable years beginning after December 31, 2023.

a. Apparently, the IRS can simply ignore the effective date of a legislative change. The IRS has announced a two-year "administrative transition period" that has the effect of delaying the effective date of the "Roth-only" rule for catch-up contributions until taxable years beginning after 2025. Notice 2023-62, 2023-37 I.R.B. 817 (8/25/23). In response to concerns expressed by taxpayers regarding the timely implementation of the new "Roth-only" rule (new § 414(v)(7)) enacted as part of the Consolidated Appropriations Act, 2023, for catch-up contributions by employees with wages in the preceding calendar year that exceeded $145,000, the IRS has effectively delayed the effective date of the Roth-only rule. As enacted, the Roth-only rule applies to taxable years beginning after December 31, 2023. In this notice, however, the IRS

has announced a two-year "administrative transition period." Specifically, until taxable years beginning after December 31, 2025:

> (1) … catch-up contributions will be treated as satisfying the requirements of section 414(v)(7)(A), even if the contributions are not designated as Roth contributions, and (2) a plan that does not provide for designated Roth contributions will be treated as satisfying the requirements of section 414(v)(7)(B).

The notice also announces that the Treasury Department and the IRS plan to issue further guidance to assist taxpayers with the implementation of the new Roth-only rule. The guidance expected to be issued includes:

- "Guidance clarifying that section 414(v)(7)(A) of the Code would not apply in the case of an eligible participant who does not have wages as defined in section 3121(a) (that is, wages for purposes of the Federal Insurance Contributions Act (FICA)) for the preceding calendar year from the employer sponsoring the plan." Thus, a partner or other self-employed person, neither of whom receives wages from the business, would not be subject to the Roth-only rule.
- "Guidance providing that, in the case of an eligible participant who is subject to section 414(v)(7)(A), the plan administrator and the employer would be permitted to treat an election by the participant to make catch-up contributions on a pre-tax basis as an election by the participant to make catch-up contributions that are designated Roth contributions." Apparently, this approach would permit the plan administrator and the employer to treat an employee as having elected to make catch-up contributions to a Roth account even though the employee actually elected to make catch-up contributions on a pre-tax basis.
- "Guidance addressing an applicable employer plan that is maintained by more than one employer (including a multiemployer plan). The guidance would provide that an eligible participant's wages for the preceding calendar year from one participating employer would not be aggregated with the wages from another participating employer for purposes of determining whether the participant's wages for that year exceed $145,000 (as adjusted). For example, under that guidance, if an eligible participant's wages for a calendar year were: (1) $100,000 from one participating employer; and (2) $125,0000 from another participating employer, then the participant's catch-up contributions under the plan for the next year would not be subject to section 414(v)(7)(A) (even if the participant's aggregate wages from the participating employers for the prior calendar year exceed $145,000, as adjusted). The guidance also would provide that, even if an eligible participant is subject to section 414(v)(7)(A) because the participant's wages from one participating employer in the plan for the preceding calendar year exceed $145,000 (as adjusted), elective deferrals made on behalf of the participant by another participating employer that are catch-up contributions would not be required to be designated as Roth contributions unless the participant's wages for the preceding calendar year from that other employer also exceed that amount."

The Treasury Department and the IRS have invited comments regarding the matters discussed in the notice and any other aspect of the new Roth-only rule. Comments must be submitted on or before October 24, 2023.

7. Subject to certain exceptions, § 401(k) and § 403(b) plans established on or after December 29, 2022, must automatically enroll eligible participants beginning in 2025. A provision of the SECURE 2.0 Act, Division T, Title I, § 101 of the Consolidated Appropriations Act, 2023, amended the Code by adding new § 414A. New § 414A requires that § 401(k) and § 403(b) plans automatically enroll participants, i.e., participants are enrolled unless they elect not to participate. To meet the requirements of § 414A, the percentage of compensation contributed by participants must be at least 3 percent and not more than 10 percent in the first year of participation. Whatever the initial percentage of compensation contributed, the plan must provide

that the percentage is increased by 1 percentage point per year until the percentage contributed is at least 10 percent and not more than 15 percent of compensation. A participant can elect not to participate or to contribute less than these amounts. Certain plans are not subject to new § 414A. These include (1) § 401(k) and § 403(b) plans established before the date of enactment of the SECURE 2.0 Act (December 29, 2022), (2) plans maintained by employers that have been in existence fewer than 3 years, (3) plans maintained by employers that normally employ 10 or fewer employees, and (4) governmental plans (within the meaning of § 414(d)) and church plans (within the meaning of § 414(e)). The new rules apply to plan years beginning after December 31, 2024.

8. Beginning in 2024, the § 72(t) 10% penalty for early withdrawal from a retirement plan will not apply to distributions of up to $1,000 for "necessary personal or family emergency expenses." Subject to certain exceptions, § 72(t)(1) provides that, if a taxpayer who has not attained age 59-1/2 receives a distribution from a retirement plan, the taxpayer's tax must be increased by 10 percent of the distribution. A provision of the SECURE 2.0 Act, Division T, Title I, § 115 of the Consolidated Appropriations Act, 2023, amended § 72(t)(2) by adding § 72(t)(2)(I), which allows an individual to treat one distribution per calendar year as an "emergency personal expense distribution" that is not subject to the 10-percent additional tax. An individual who takes an emergency personal expense distribution can repay it during the 3-year period beginning on the day after the date on which the distribution was received to any eligible retirement plan to which a rollover contribution could be made. The maximum amount that can be treated as an emergency personal expense distribution is $1,000. An individual who treats a distribution as an emergency personal expense distribution cannot treat a distribution in any of the three succeeding taxable years as such a distribution unless either (1) the previous distribution is fully repaid to the plan, or (2) the aggregate contributions by the employee to the plan after the previous distribution equal or exceed the amount of the previous distribution that has not been repaid. An emergency personal expenses distribution is defined as

> any distribution from an applicable eligible retirement plan … to an individual for purposes of meeting unforeseeable or immediate financial needs relating to necessary personal or family emergency expenses.

These rules apply to distributions made after December 31, 2023.

9. Beginning in 2024, survivors of domestic abuse can withdraw up to $10,000 from a retirement plan without being subject to the § 72(t) 10% penalty for early withdrawal. Subject to certain exceptions, § 72(t)(1) provides that, if a taxpayer who has not attained age 59-1/2 receives a distribution from a retirement plan, the taxpayer's tax must be increased by 10 percent of the distribution. A provision of the SECURE 2.0 Act, Division T, Title III, § 314 of the Consolidated Appropriations Act, 2023, amended § 72(t)(2) by adding § 72(t)(2)(K), which allows an individual to treat a distribution as "an eligible distribution to a domestic abuse victim" that is not subject to the 10-percent additional tax. An individual who takes such a distribution can repay it during the 3-year period beginning on the day after the date on which the distribution was received to any eligible retirement plan to which a rollover contribution could be made. The maximum amount that can be treated as an eligible distribution to a domestic abuse victim is the lesser of $10,000 or 50 percent of the present value of the accrued benefit of the employee under the plan. The $10,000 limitation will be adjusted for inflation for taxable years beginning after 2024. An eligible distribution to a domestic abuse victim is defined as a

> distribution … from an applicable eligible retirement plan [that] is made to an individual during the 1-year period beginning on any date on which the individual is a victim of domestic abuse by a spouse or domestic partner."

For this purpose, "domestic abuse" is defined as

> physical, psychological, sexual, emotional, or economic abuse, including efforts to control, isolate, humiliate, or intimidate the victim, or to undermine the victim's

> ability to reason independently, including by means of abuse of the victim's child or another family member living in the household.

These rules apply to distributions made after December 31, 2023.

10. Beginning in 2023, terminally ill individuals can withdraw funds from a retirement plan without being subject to the § 72(t) 10% penalty for early withdrawal. Subject to certain exceptions, § 72(t)(1) provides that, if a taxpayer who has not attained age 59-1/2 receives a distribution from a retirement plan, the taxpayer's tax must be increased by 10 percent of the distribution. A provision of the SECURE 2.0 Act, Division T, Title III, § 326 of the Consolidated Appropriations Act, 2023, amended § 72(t)(2) by adding § 72(t)(2)(L), which provides that distributions to a terminally ill individual on or after the date on which a physician has certified the individual as having a terminal illness are not subject to the 10-percent additional tax. An individual who takes such a distribution can repay it during the 3-year period beginning on the day after the date on which the distribution was received to any eligible retirement plan to which a rollover contribution could be made. The term "terminally ill individual" has the same meaning as it does in § 101(g)(4)(A) except that "84 months" is substituted for "24 months," which means that a "terminally ill individual" is defined as

> an individual who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 84 months or less after the date of the certification.

New § 72(t)(2)(L)(iii) provides that an employee is not considered to be a terminally ill individual unless the employee provides sufficient evidence to the plan administrator in the form and manner required by the Secretary of the Treasury.

These rules apply to distributions made after the date of enactment of the SECURE 2.0 Act, which was December 29, 2022.

11. Could you PLESA give me some of my money back for an emergency (or, for that matter, a non-emergency)? Notice 2024-22, 2024-6 I.R.B. 662 (1/12/24). A provision of the SECURE 2.0 Act, specifically Division T, Title VI, § 127 of the Consolidated Appropriations Act, 2023, amended Code § 402A (and ERISA §§ 801-804) to authorize Pension-Linked Emergency Savings Accounts ("PLESAs") effective for plan years beginning after December 31, 2023. In general, PLESAs are *optional* short-term savings accounts established and maintained within a §§ 401(k), 403(b), or 457(b) defined contribution plan. If an employer's defined contribution plan authorizes a PLESA, eligible employees (generally, non-highly compensated employees) may make Roth-like contributions up to a maximum account balance of $2,500 (indexed annually for inflation) to a PLESA established for the employee's benefit. According to separate guidance issued by the Department of Labor Plans (see DOL's F.A.Q.s), plans have flexibility to apply the $2,500 limitation either to employee contributions or account size. For example, a plan could provide that an employee cannot contribute if the employee already has contributed $2,500, which effectively excludes earnings from the calculation, or the plan could provide that an employee cannot contribute if the total account balance would exceed $2,500, which effectively includes earnings in the calculation. Employers cannot contribute to a PLESA but must take employee contributions to the PLESA into account when determining employer matching contributions to the plan. In other words, if an employer's §§ 401(k), 403(b), or § 457(b) defined contribution plan provides for matching contributions, then employers must match an employee's PLESA contributions; however, such matching contributions are allocated to the non-PLESA portion of the plan. Withdrawals from a PLESA are tax-free regardless of the reason for the withdrawal, i.e., no real "emergency" is required for a PLESA withdrawal. *See* § 402(e)(7) (allowing withdrawals "in whole or in part at the discretion of the participant"). Employees who contribute to a PLESA may withdraw from the PLESA as frequently as monthly without reducing their linked defined contribution plan account and without incurring the normal § 72(t) early withdrawal penalty. In addition, subject to mandatory notice requirements and compensation

percentage limits, an employer may automatically enroll its eligible employees into its PLESA program.

- Recall that the authors previously have discussed other SECURE 2.0 exceptions to the early withdrawal penalty of § 72(t): up to $1,000 for "personal and family emergencies" [§ 72(t)(2)(I)]; up to $10,000 for victims of domestic abuse [§ 72(t)(2)(K)]; early distributions to a "terminally ill individual" [§ 72(t)(2)(L)]. For further background regarding PLESAs, see the F.A.Q.s recently issued by the Department of Labor.

Notice 2024-22: The notice does not provide comprehensive guidance regarding PLESA programs but instead provides initial guidance concerning specific anti-abuse rules in Code § 402A(e)(12). Although we leave the details to our readers, the anti-abuse rules under § 402A(e)(12) generally prohibit a participating employee from switching back and forth between contributing to and withdrawing from a PLESA to take advantage of an employer's matching contributions. In other words, left unchecked, an employee could contribute to a PLESA, thereby triggering an employer matching contribution, withdraw the contributed funds, and then contribute them again, triggering another employer matching contribution. The notice permits employers to combat this strategy by adopting reasonable procedures to limit the frequency or amount of an employer match. The notice provides examples of procedures that would *not* be considered reasonable, such as a plan provision that requires employees to forfeit matching contributions due to an employee's withdrawal from the PLESA. Notice 2024-22 also alleviates the concerns of some advisors that Rev. Rul. 74-55, 1974-1 C.B. 89, and Rev. Rul. 74-56, 1974-1 C.B. 89, apply to PLESAs. Oversimplifying for the sake of convenience, Rev. Rul. 74-55 and Rev. Rul. 74-56 prohibit employers from adopting certain unsanctioned withdrawal provisions within retirement plans. Notice 2024-22 states that the "Treasury Department and the I.R.S. do not view these revenue rulings as applicable in the context of PLESAs." Notice 2024-22 also invites practitioner comments and suggestions regarding the matters discussed in the notice as well as any other aspect of PLESA-enabled retirement plans.

12. Some inflation-adjusted numbers for 2025. Notice 2024-80, 2024-47 I.R.B. 1120 (11/1/24).

- The limit on elective deferrals in §§ 401(k), 403(b), and 457 plans is increased to $23,500 (from $23,000) with a catch-up provision for employees aged 50 or older that is $7,500 (unchanged from 2024). For individuals who attain ages 60-63 in 2025, the limit on catch-up contributions is $11,250.

- The limit on contributions to an IRA is increased to $7,000 (unchanged from 2024) with a catch-up provision for those aged 50 or older that is $1,000 (unchanged from 2024). The AGI phase-out range for contributions to a traditional IRA by employees covered by a workplace retirement plan is increased to $79,000-$89,000 (from $77,000-$87,000) for single filers and heads of household, increased to $126,000-$146,000 (from $123,000-$143,000) for married couples filing jointly in which the spouse who makes the IRA contribution is covered by a workplace retirement plan, and increased to $236,000-$246,000 (from $230,000-$240,000) for an IRA contributor who is not covered by a workplace retirement plan and is married to someone who is covered. The phase-out range for contributions to a Roth IRA is increased to $236,000-$246,000 (from $230,000-$240,000) for married couples filing jointly, and increased to $150,000-$165,000 (from $146,000-$161,000) for singles and heads of household.

- The limit on the annual benefit from a defined benefit plan under § 415 is increased to $280,000 (from $275,000).

- The limit for annual additions to defined contribution plans is increased to $70,000 (from $69,000).

- The amount of compensation that may be taken into account for various plans is increased to $350,000 (from $345,000), and is increased to $520,000 (from $505,000) for government plans.

- The AGI limit for the retirement savings contribution credit for low- and moderate-income workers is increased to $79,000 (from $76,500) for married couples filing jointly, increased to $59,250 (from $57,375) for heads of household, and increased to $39,500 (from $38,250) for singles and married individuals filing separately.

13. The Tax Court rules for the taxpayers in this "hot mess" case of first impression, thereby potentially salvaging deferral of almost $8 million of gain in a sale of stock to an ESOP. Berman v. Commissioner, 163 T.C. No. 1 (7/16/24). The facts and law in this case of first impression before the Tax Court are, as our children would say, a "hot mess." Ultimately, though, the Tax Court, in an opinion written by Judge Gale, sided with the taxpayers. The case required Judge Gale to analyze an issue previously unaddressed by the Tax Court: the interplay between § 453(a) (installment sales) and § 1042(a) & (e) (gain deferral and potential recapture in a sale of qualified securities to an employee stock ownership plan or "ESOP"). The case also involved a so-called "Derivium" 90-percent loan strategy that was used in the early 2000s to attempt to shelter gain recognition. The Tax Court and other courts determined over a decade ago that Derivium's 90-percent loan transactions were in substance disguised sales for federal income tax purposes. *See, e.g., Calloway v. Commissioner*, 135 T.C. 26 (2010), *aff'd*, 691 F.3d 1315 (11th Cir. 2012). The Derivium 90-percent loan transaction undertaken by the taxpayers and recharacterized as a disguised sale triggered the collision between §§ 453(a) and 1042(e) in this case. We begin by briefly recapping the rules of §§ 453 and 1042, especially the relevant statutory language interpreted by the Tax Court to resolve the dispute.

Section 453. Section 453(a) and (b)(1) of the Code generally (subject to conditions and limitations) permits a taxpayer to report gain realized from the sale of property in which at least one payment is received after the close of the taxable year (an "installment sale") under the "installment method." *See also* Reg. § 15a.453-1(a)-(b). When it applies, the installment method allows a taxpayer to defer reporting realized gain until the taxable year in which a payment or payments are received. Under § 453(c), the deferred gain is then recognized and reported as each installment payment is received, reflecting a proportionate amount of the taxpayer's total gain upon the original sale of the property. A taxpayer is not required to elect into the installment method. Instead, the installment method applies by default unless the taxpayer makes a contrary election or fully reports the gain from the disposition in the year of sale. *See* Reg. § 15a.453-1(d)(3). Specifically, and relevant to the Tax Court's decision in this case, gain from an installment sale is "*taken into account*" according to the installment method *"[e]xcept as otherwise provided in this section*." § 453(a) (emphasis added).

Section 1042. Section 1042(a) of the Code generally (subject to conditions and limitations) permits a taxpayer to elect to defer gain recognition on the sale of "qualified securities" to an ESOP if sufficient "qualified replacement property" is timely acquired. In particular, and relevant to the Tax Court's decision in this case, the flush language of § 1042(a) provides that (if the taxpayer so elects) the gain "*which would be recognized* as long-term capital gain [upon the sale of qualified securities to the ESOP] shall be recognized only to the extent that the amount realized on such sale exceeds the cost to the taxpayer of . . . qualified replacement property." § 1042(a) (emphasis added). Under § 1042(c)(3), the qualified replacement property must be acquired within the "replacement period," which extends from three months before to twelve months after the sale to the ESOP. Thus, in a typical transaction, a taxpayer sells stock ("qualified securities") in a C corporation the taxpayer controls to an ESOP sponsored by the taxpayer's corporation and elects under § 1042(a) to defer reporting (a/k/a "roll over") gain from the sale. Next, to comply with § 1042(a), the taxpayer later (but within twelve months) acquires "qualified replacement property" at a cost equal to or greater than the *amount realized* upon the sale of the qualified securities to the ESOP. Accordingly, under § 1042(d), the taxpayer's cost basis in the qualified replacement property is adjusted downward by the gain "rolled over" from the sale of stock to the ESOP. If, however, the taxpayer subsequently disposes of the qualified replacement property, then (and relevant to the Tax Court's decision in this case) § 1042(e) provides that, "*notwithstanding any other provision of this title*, gain (if any) shall be recognized to the extent of the gain which was

not recognized under [§ 1042(a)] by reason of the acquisition by such taxpayer of such qualified replacement property." § 1042(e)(1) (emphasis added).

Spoiler alert. Normally, a taxpayer selling qualified securities to an ESOP receives cash and makes the roll over election under § 1042(a). The taxpayer subsequently reinvests the entire amount of cash (the "amount realized") in qualified replacement property, thereby deferring any gain that otherwise would have been recognized on the sale of the qualified securities to the ESOP. The taxpayer's cost basis in the qualified replacement property is adjusted downward under § 1042(d) by the corresponding amount of "rolled over" gain. Thereafter, if the taxpayer subsequently disposes of the qualified replacement property, *even in a nonrecognition transaction*, the rolled over gain is recaptured by § 1042(e). *See*, *e.g.*, Rev. Rul. 2000-18, 2000-1 C.B. 847 (§ 1042(e) overrides § 721 upon a contribution of qualified replacement property to a partnership). In this case, though, the taxpayers received installment notes from the ESOP in exchange for their stock. The taxpayers then used margin debt to separately finance and acquire qualified replacement property which they later "sold" via a Derivium 90-percent loan transaction. As explained below, this unique installment sale aspect of the taxpayers' transfer of qualified securities to an ESOP forced the Tax Court to decide whether § 453(a) installment sale treatment can apply to avoid recapture gain under § 1042(e) upon a subsequent disposition of qualified replacement property. *Confused?* Read on.

The 2002 facts. The taxpayers in this case consisted of a husband and wife and the husband's cousin. (The individual cases were consolidated and the facts were stipulated for purposes of the taxpayers' and the IRS's cross-motions for partial summary judgment.) Together, the taxpayers owned 100 percent of an S corporation whose taxable year ran from September 1 to August 31. As of September 1, 2002, though, the corporation voluntarily terminated its S corporation status (thereby becoming a C corporation) and established an ESOP. The corporation was recapitalized after September 1, 2002, when it issued certain preferred and common stock to the taxpayers. Next, on November 8, 2002, the taxpayers sold a portion of their low basis, recapitalized preferred stock in the corporation to the ESOP for promissory notes with a total face amount of $8.3 million. About $8 million of the entire $8.3 million sales price for the preferred stock represented realized gain. For their 2002 taxable years, though, the taxpayers did not report any gain from their sale of stock to the ESOP. Instead, the taxpayers made the § 1042(a) election to defer reporting gain by filing a "Statement of Section 1042 ESOP Rollover Election" with their 2002 federal income tax returns. The taxpayers did not include an IRS Form 6252, Installment Sale Income, with their 2002 returns. The IRS accepted and never audited the taxpayers' 2002 returns.

The 2003 facts. On October 22, 2003, the taxpayers purchased "qualified replacement property" (as defined in § 1042).[4] The qualified replacement property consisted of floating rate notes and was acquired within the period allowed by § 1042(c)(3). The taxpayers used cash and margin debt to acquire the floating rate notes. A day later, on October 23, 2003, the taxpayers transferred the floating rate notes and margin debt to Bancroft Ventures, Ltd., an affiliate of Derivium Capital LLC, in 90-percent loan transactions. The IRS asserted and the taxpayers ultimately conceded that the 90-percent loan transactions were in substance sales of their qualified replacement property. The next day, on October 24, 2003, Bancroft Ventures sold the floating rate notes, satisfied the margin debt, retained a 10 percent fee, and paid the net balance remaining from the disguised sales to the taxpayers. Also in 2003, and important to the Tax Court's analysis, the ESOP paid roughly $900,000 of principal on the installment notes issued to the taxpayers in connection with the 2002 sale of stock to the ESOP. With respect to the foregoing transactions, the taxpayers reported no income, either in the form of § 1042(e) recapture or § 453 installment sales gain, on their 2003 federal income tax returns.

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[4] Whether the taxpayers purchased sufficient qualified replacement property remains a disputed fact and may yet require the taxpayers to report § 1042(e) recapture gain notwithstanding the Tax Court's decision in the present case.

The 2004 facts. In 2004, the taxpayers received further principal payments of approximately $100,000 on their ESOP installment sale notes. Again, the taxpayers reported no income on their 2004 federal income tax returns, either in the form of § 1042(e) recapture or § 453 installment sales gain.

Notices of deficiency and Tax Court petition. In October 2012, the IRS sent notices of deficiency to the taxpayers for their taxable years 2003 through 2008. With respect to 2003, the IRS adjusted the taxpayers' reported income by increasing their long-term capital gain for the year by roughly $8 million. The IRS based its adjustment on the taxpayers' disposition of the qualified replacement property in the Derivium 90-percent loan transactions, which were in substance disguised sales. The taxpayers timely filed petitions in the Tax Court setting the stage for the following arguments on cross-motions for partial summary judgment, as explained by Judge Gale:

> Citing the section 1042(e) recapture rule, [the IRS] takes the position that [the taxpayers'] sale of the [qualified replacement property or "QRP"] in 2003 requires them to recognize the entire $4,122,572 of gain each deferred, notwithstanding the fact that each had received a payment of only $449,277 for the [ESOP] stock in that year (and nothing in 2002). [The taxpayers] contend that because they disposed of their stock in installment sales, they are entitled to recognize any gains on the sales — no longer shielded by section 1042 — under the installment method. In that event, the gains they are required to recognize for 2003 would be that proportion of the $449,277 payment each received in 2003 which the gross profit on the sale bears to the total contract price. *See* §453(c). For the reasons discussed hereinafter, we agree with [the taxpayers].

Judge Gale's Analysis. After considering but dismissing certain other arguments by the taxpayers seeking to invalidate their irrevocable election to defer gain from their sale of stock under § 1042,[5] Judge Gale proceeded to analyze the interplay between §§ 453(a) and 1042(e). The IRS's position, of course, was that the taxpayers' irrevocable election under § 1042(a) to roll over approximately $8 million in ESOP-sale gain for 2002, and their corresponding purchase (under § 1042(c)(3)) and disguised sale (ala Derivium 90-percent loan) of qualified replacement property in 2003, meant that § 1042(e) was triggered, thereby recapturing $8 million in gain deferred from the 2022 ESOP sale. More specifically, the IRS argued that § 1042(e) is the <u>exclusive</u> means for determining and reporting the $8 million of roll over gain from the ESOP sale because the subsection states in relevant part, "notwithstanding any other provision of this title." The taxpayers posited that, in the unique circumstances of this case, § 453(a) applied in 2002 to determine the gain from their ESOP sale. Because the taxpayers received no installment payments in 2002, there was no roll over gain from that year to recapture under § 1042(e) despite the 2003 disposition of the qualified replacement property. As support, the taxpayers pointed not to §1042(e) but to the

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[5] The taxpayers initially made two arguments that their elections under § 1042 on their 2002 federal income tax returns were invalid. The taxpayers made these arguments to persuade the Tax Court that § 453 installment sales treatment exclusively applied to defer gain on their 2002 sales of stock to the ESOP such that § 1042(e) recapture in 2003 was inapplicable. First, the taxpayers argued that the revocation of the corporation's subchapter S status as of September 1, 2002, was improper. Therefore, the taxpayers argued, their sale of stock to the ESOP in November 2002 did not qualify under § 1042(a) notwithstanding their irrevocable election to the contrary. Agreeing with the IRS's counterargument, Judge Gale determined that the "duty of consistency" in filing federal income tax returns estops the taxpayers from claiming the revocation of their corporation's subchapter S status was improper. 163 T.C. at ___. Second, the taxpayers argued that their elections under § 1042 were invalid and revocable due to material mistakes of fact — claiming in part that they were "fraudulently induced" to make the election based upon "misrepresentations by their attorneys . . . and investment advisors." 163 T.C. at ___. As to this second argument, Judge Gale agreed with the IRS that the taxpayers' § 1042 elections were irrevocable in accordance with the regulations under § 1042 and the "doctrine of election" as stated by the Second Circuit in *United States v. Helmsley*, 941 F.2d 71 at 86 (1991): "Under the doctrine of election, a taxpayer who makes a conscious election may not, without the consent of the Commissioner, revoke or amend it merely because events do not unfold as planned."

language in § 1042(a) regarding the deferral of gain "*which would be recognized*" but for the § 1042 election. § 1042(a) (emphasis added). Put differently, the taxpayers argued that the gain "which would be recognized" in 2002 was zero due to the application of the installment method; hence, the recapture gain for 2003 under § 1042(e) was zero.

Citing legislative history and noting that § 1042 was enacted in 1986, six years after the modern-day version of § 453 was enacted in 1980, Judge Gale reasoned that Congress "must have been aware" of installment sales treatment under § 453 when it enacted six years later the deferral provision of § 1042(a) and the recapture provision of § 1042(e). Essentially, in Judge Gale's view, the application of § 453 in this case resulted in no recognized gain to the taxpayers upon their sale of stock to the ESOP in 2002. Judge Gale reasoned that the installment method was controlling and operated by default to leave the $8 million of realized gain from the 2002 ESOP sale unrecognized. Judge Gale wrote:

> When securities have been sold to an ESOP in an installment sale where no payment is received in the year of sale, then the gain that *would be recognized* for that year in the absence of a section 1042 election is zero, because that is the result under the installment method. As petitioners sold their ESOP stock in 2002 in installment sales pursuant to which no payment was made in that year, their gain "which would be recognized as long-term capital gain" for that year if no section 1042 election had been made is zero.

163 T.C. at ___ (emphasis added). Judge Gale also wrote in a footnote that the taxpayers' failures to report gains consistent with the installment method on their 2002, 2003, and 2004 returns "have no impact on the applicability of the installment method of reporting the gain on the sale of their ESOP stock." 163 T.C. at ___ note 34. Judge Gale then determined that rather than $8 million in gain for 2003 as urged by the IRS, the taxpayers need only report installment sales gain of approximately $900,000 for 2003 and $100,000 for 2004 due to the installment payments received from the ESOP during those years. Finally, in accordance with § 1042(d), the taxpayers were required in 2003 to adjust their basis in the qualified replacement property downward (from an initial cost basis of around $8.3 million) by roughly $900,000 of recognized installment sales gain. Therefore, after the downward adjustment in basis, the taxpayers had another $60,000 (approximately) of gain from the disguised sale of the qualified replacement property to Bancroft Ventures (a Derivium affiliate) in 2003. With respect to 2004 (as noted above), the taxpayers must recognize about $100,000 of gain from their 2002 installment sale of stock to the ESOP due to the 2004 installment payment of $100,000 of principal. The court did not, however, address whether and how this 2004 recognized gain might result in a downward adjustment to any remaining qualified replacement property retained by the taxpayers after 2003.[6]

Comment. Again, in the normal course of a sale of qualified securities to an ESOP, the selling taxpayer receives cash, not an installment obligation. Had that happened in this case, § 453(a) would *not* have applied, and the taxpayers would have had to rely solely upon their timely and sufficient acquisition and retention of qualified replacement property in 2003 and thereafter to defer $8 million (approximately) in gain from the 2002 ESOP sale. Thus, perhaps the Tax Court's decision in *Berman* presents a planning opportunity to "hedge" against § 1042(e) recapture gain as follows.

- *One*, the taxpayer sells qualified securities to an ESOP (electing under § 1042(a) to roll over any gain) for a § 453(a) installment obligation (instead of cash).

[6] As previously mentioned, Judge Gale's opinion on behalf of the Tax Court does not resolve the case entirely. The IRS and the taxpayers apparently continue to dispute whether the taxpayers properly acquired, held, and disposed of sufficient qualified replacement property.

- *Two*, if desired, the taxpayer subsequently finances and acquires qualified replacement property within the replacement period allowed by § 1042(c)(3).
- *Three*, the taxpayer thereby obtains—at least temporarily—an unadjusted cost basis in the qualified replacement property equal to the full amount paid for the property.
- *Four*, no (or minimal) installment payments are made to the taxpayer by the ESOP (which, incidentally, is controlled by the taxpayer's corporation).
- *Five*, according to *Berman*, the taxpayer is free to dispose of the qualified replacement property later for cash with no or modest gain (due to the property's unadjusted cost basis) and pay off any debt used to acquire the qualified replacement property without triggering § 1042(e) recapture gain (except, of course, to the extent the taxpayer has received any installment payments).
- *Query* whether the taxpayer could at any time dispose of the installment note itself received in the ESOP sale (rather than the qualified replacement property) and, due to the § 1042(a) roll over election, reduce the taxpayer's basis in the retained qualified replacement property by the gain otherwise required to be recognized under § 453B upon disposition of an installment obligation.

The foregoing hedge strategy, however, may run counter to a taxpayer's normal desire to wholly or partially "cash out" from sales of qualified securities to an ESOP. And, the taxpayer (or the taxpayer's transferee) bears the credit risk that the ESOP eventually can pay the installment note received upon the initial sale of the qualified securities.

14. Final regulations on required minimum distributions. T.D. 10001, Required Minimum Distributions, 89 F.R. 58,886 (7/19/24). Treasury and the IRS have finalized proposed regulations (REG-105954-20, Required Minimum Distributions, 87 F.R. 10504 (2/24/22)) that address required minimum distributions (RMDs) from qualified retirement plans and annuity contracts and related matters. The final regulations update existing regulations to reflect a number of statutory changes. The most significant of these statutory changes were made by the SECURE Act, enacted on December 20, 2019, as Division O of the 2020 Further Consolidated Appropriations Act. Among other changes, the SECURE Act amended Code § 401(a)(9)(E) to modify the RMD rules for inherited retirement accounts (defined contribution plans and IRAs). The final regulations are lengthy and address these and a number of other issues. This discussion will focus on only the guidance provided by the final regulations on the change made by the SECURE Act to RMDs for inherited retirement accounts. Readers should consult the final regulations for additional guidance.

The SECURE Act changes to RMDs from inherited retirement accounts. A provision of the SECURE Act, Division O, Title IV, § 401 of the 2020 Further Consolidated Appropriations Act, amended Code § 401(a)(9)(E) to modify the required minimum distribution (RMD) rules for inherited retirement accounts (defined contribution plans and IRAs). The amendments require all funds to be distributed by the end of the 10th calendar year following the year of death (the "10-year rule"). The current rules, which permit taking RMDs over life expectancy, continue to apply to a designated beneficiary who is an "eligible designated beneficiary," which is any designated beneficiary who is: (1) a surviving spouse, (2) a child of the participant who has not reached the age of majority, (3) disabled within the meaning of § 72(m)(7), (4) a chronically ill individual within the meaning of § 7702B(c)(2) with some modifications, or (5) an individual not in any of the preceding categories who is not more than 10 years younger than the deceased individual. These changes generally apply to distributions with respect to those who die after December 31, 2019.

The final regulations' interpretation of the 10-year rule in the SECURE Act. The final regulations, like the proposed regulations, adopt an interpretation of the 10-year rule that appears to differ from the plain language of the statute and from the interpretation of the legislation of most advisors. The statute provides that, when the designated beneficiary is *not* an eligible designated

beneficiary, all funds must be distributed by the end of the 10th calendar year following the year of death and that this rule applies whether or not RMDs to the employee or IRA owner have begun. There appears to be no requirement in the statutory provisions to withdraw any minimum amount before that date. The final regulations, however, like the proposed regulations, distinguish between situations in which the employee or IRA owner dies before the required beginning date for distributions, and situations in which death occurs after such date. When the employee or IRA owner dies *before* the required beginning date for distributions, the final regulations provide that no distribution is required before the 10th calendar year following the year of death. However, in situations in which the employee or IRA owner dies *after* the required beginning date for distributions, the final regulations provide that a designated beneficiary who is *not* an eligible designated beneficiary must begin taking RMDs over the beneficiary's life expectancy in the year following the year of death and must withdraw all funds in the account by the end of the 10th calendar year following the year of death. The preamble to the proposed regulations described this rule as follows:

> For example, if an employee died after the required beginning date with a designated beneficiary who is not an eligible designated beneficiary, then the designated beneficiary would continue to have required minimum distributions calculated using the beneficiary's life expectancy as under the existing regulations for up to nine calendar years after the employee's death. In the tenth year following the calendar year of the employee's death, a full distribution of the employee's remaining interest would be required.

87 F.R. 10514. This interpretation arguably differs from the plain language of the statute and, ironically, even from the interpretation in IRS Publication 590-B (page 11), which was issued for 2021. Treasury and the IRS have adhered to this interpretation in the final regulations despite a significant number of comments on the proposed regulations arguing that, for all beneficiaries who are not eligible designated beneficiaries, the relevant statutory provisions do not require RMDs prior to the tenth year after the year of death.

Prior guidance on missed RMDs. In a series of notices, the IRS provided relief to those who inherited IRAs and who, in the IRS's view, had failed to take RMDs under the interpretation of the 10-year rule set forth in the proposed regulations. The most recent of these notices was Notice 2024-35, 2024-19 I.R.B. 1051 (4/16/24).[7] These notices provide that the IRS will not assert that an excise tax is due under § 4974 from an individual who did not take a "specified RMD." A "specified RMD" is defined as any distribution required to be made in 2021, 2022, 2023, or 2024 under a defined contribution plan or IRA if the payment would be required to be made to (1) a designated beneficiary of an employee or IRA owner who died in 2020, 2021, 2022, or 2023 and on or after the employee or IRA owner's required beginning date, and (2) the designated beneficiary is not taking lifetime or life expectancy payments as required by § 401(a)(9)(B)(iii). In other words, the IRS will not assert that the excise tax of § 4974 is due from a beneficiary who (1) is not an eligible designated beneficiary (and who therefore is subject to the 10-year rule), (2) inherited the retirement account from an employee or IRA owner who died in 2020, 2021, 2022, or 2023 and on or after the required beginning date of distributions, and (3) were required to take RMDs in 2021, 2022, 2023, or 2024 under the interpretation of the 10-year rule in the proposed regulations but failed to do so. These notices provide the same relief to beneficiaries of eligible designated beneficiaries if the eligible designated beneficiary died in 2020, 2021, 2022, or 2023 and was taking lifetime or life expectancy distributions.

Clarification that beneficiaries subject to the 10-year rule need not make up missed RMDs. One significant issue that arose under the notices discussed above was what corrective action, if any, was required after the relief period provided by the notices. For example, assume the

[7] The others were Notice 2022-53, 2022-45 I.R.B. 437 (10/7/22) and Notice 2023-54, 2023-31 I.R.B. 382 (7/14/23).

designated beneficiary of an IRA is *not* an eligible designated beneficiary (and therefore subject to the 10-year rule) and inherited the account in 2020 from the account owner who died that year when he was already taking RMDs. Under the interpretation of the proposed (and now final) regulations, this designated beneficiary should have begun taking RMDs in 2021. If this designated beneficiary failed to take any RMDs through 2024, the question is how much the beneficiary must withdraw in 2025, the first year for which the IRS did not effectively waive RMDs in this situation. Can the beneficiary simply begin taking RMDs for 2025 and future years and not worry about those for 2021 through 2024, or must the beneficiary withdraw in 2025 those missed in 2021 through 2024 *and* the one for 2025? The final regulations clarify that beneficiaries in this situation need not make up missed RMDs. Therefore, in the example just given, the beneficiary can simply begin taking RMDs for 2025 and future years and need not withdraw the amounts the beneficiary failed to take for 2021 through 2024. The years of the missed RMDs, however, still count as years within the 10-year period. Therefore, this beneficiary must take RMDs for 2025 through 2029 (the five years remaining in the first nine years after the year of death) and must withdraw any remaining funds from the account in 2030.

Effective date. The regulations are generally effective on September 17, 2024, but the rules apply for purposes of determining RMDs for calendar years beginning after 2024.

C. Nonqualified Deferred Compensation, Section 83, and Stock Options

D. Individual Retirement Accounts

1. Want to give the funds in your IRA to charity? Congress has made it even easier. Section 408(d)(8)(A) permits individuals who have reached age 70-1/2 to transfer up to $100,000 per year directly from one or more IRAs to one or more public charities or private operating foundations and treat the amounts transferred as tax-free distributions from the IRA. A provision of the SECURE 2.0 Act, Division T, Title III, § 307 of the Consolidated Appropriations Act, 2023, amended Code § 408 by adding § 408(d)(8)(G), which indexes the $100,000 annual limit for inflation for taxable years beginning after 2023. In addition, the legislation permits a taxpayer, beginning in 2023, to make a one-time $50,000 distribution directly from an IRA to a "split-interest entity" and make a one-time election to treat the contributions as if they were qualified charitable distributions made directly to a charitable entity. For this purpose, a split-interest entity is defined as (1) a charitable remainder unitrust that is funded exclusively by qualified charitable distributions, (2) a charitable remainder annuity trust that is funded exclusively by qualified charitable distributions, or (3) charitable gift annuity trust that is funded exclusively by qualified charitable distributions and that begins fixed payments of 5 percent or greater not more than one year from the date of funding.

2. The $1,000 limit on catch-up contributions to IRAs will be indexed for inflation beginning in 2024. Section 219(b)(5)(B) allows individuals who are age 50 or older to make so-called "catch-up" contributions to IRAs in addition to the basic amount that individuals are allowed to contribute ($6,500 in 2023). According to § 219(b)(5)(B)(ii), the limit on catch-up contributions is $1,000. The limit on the basic amount that individuals are permitted to contribute has long been adjusted annually for inflation but, until recent legislation, the limit on catch-up contributions was not. A provision of the SECURE 2.0 Act, Division T, Title I, § 108 of the Consolidated Appropriations Act, 2023, amended Code § 219(b)(5)(C) by adding § 219(b)(5)(C)(iii), which indexes the $1,000 annual limit on catch-up contributions for inflation for taxable years beginning after 2023.

3. Honey, I shrunk the IRAs! Being incarcerated is bad enough without learning that your wife has depleted your IRAs and other accounts and filed for divorce and that the IRS seeks to collect tax on the withdrawals Balint v. Commissioner, T.C. Memo. 2023-118 (9/25/23). The taxpayer was incarcerated from late 2013 through January 6, 2015. While incarcerated, he wrote a letter to his wife that stated:

> You do need to get power-of-attorney!! ASAP!! Call Glen Abbott & explain the situation. He will help us! And remember, it's confidentia[l] so don[']t be worried. Tell him I want to give you everything! House, cars, motorcycles & my bank accounts—all of them in your name, making me beneficiary! He will know what to do. You need to do this now!! In case something happens to me. And the state can[']t take it when this is all over. Call now!! Meet with him & get it done. I will have to sign, but he will know how to take care of that with me here. Ok!! Now! . . . So you won[']t lose anything [&] you have access to everything. Use this letter if he needs it!

His attorney, Glenn Abbott, then prepared a proposed power of attorney for the taxpayer's signature. The power of attorney was broadly worded and gave his wife "full power and authority to perform any act, power, or duty that I may now or hereafter have and to exercise any right that I now have or may hereafter acquire." It specifically authorized her to withdraw money from financial and retirement accounts, to make gifts of his property, and to engage in acts that otherwise would constitute prohibited self-dealing. Pursuant to this authority, his wife withdrew large amounts of money from the taxpayer's IRAs and his pension and annuity accounts and transferred the money from the couple's joint checking account into her own separate bank account. She used the funds to move from their residence in Florida to Kentucky, to renovate a house there, and to pay living expenses and care for her ailing mother. She then initiated a proceeding for divorce. After the taxpayer was released from prison in early 2015, he filed a federal income tax return for 2014 with the filing status of married filing separately on which he reported all withdrawals from the accounts, including those taken by his wife, as income because he received information returns (presumably Forms 1099-R) that reported the withdrawals as taxable to him. When he could not pay the balance due, the IRS issued a final notice of intent to levy, in response to which the taxpayer requested a collection due process (CDP) hearing. The IRS Settlement Officer who conducted the CDP hearing issued a notice of determination sustaining the proposed levy, and the taxpayer then filed a petition in the U.S. Tax Court. While the taxpayer's case in the Tax Court was pending, the taxpayer filed his own action for divorce and the state court issued an order in which it concluded that his wife should be liable for tax on the amounts she withdrew because the taxpayer did not benefit from the withdrawals and they were made without his knowledge or consent.

Issues. The Tax Court (Judge Gale) addressed two issues: (1) whether the government was bound through the doctrines of res judicata or collateral estoppel by the state court's order that the wife was liable for the tax due on the withdrawals, and (2) whether the taxpayer had to include the disputed withdrawals in gross income.

No preclusive effect of state court order. The Tax Court concluded that the government was not bound by the state court's order through the doctrines of res judicata or collateral estoppel. Both doctrines, the court reasoned, generally require identity of parties, i.e., the party against whom the doctrine is asserted must have been a party to the prior action in order for the prior action to bind the party. The government, the court concluded, was not a party to the taxpayer's divorce proceeding, and therefore was not bound by the state court's order that his wife should be liable for tax on the amounts she withdrew.

No gross income from the disputed withdrawals. The taxpayer argued that he should not have to include approximately $159,811 that his wife had withdrawn from his IRAs and life insurance policy. The Tax Court held that these distributions were not includible in the taxpayer's gross income under § 408(d)(1), which provides that the "payee or distributee" must include in gross income in the manner provided under § 72 any amount paid or distributed out of an individual retirement plan. The court reasoned that the taxpayer was not a payee or distributee within the meaning of § 408(d)(1) because he had not authorized the withdrawals and did not benefit from them. Although the power of attorney signed by the taxpayer was broadly worded and gave his wife authority to make gifts of his property and to engage in acts that otherwise would be prohibited self-dealing, the court interpreted the power of attorney as limiting her authority to actions undertaken for the purpose of financial or estate planning for the taxpayer's benefit or for

qualifying for public assistance for which the taxpayer might be eligible. The relevant language in the power of attorney, the court concluded,

> strictly construed, does not amount to an open-ended authorization for [the taxpayer's wife] to exercise her authority under the POA for her own benefit. Instead, its clear implication is that [she] was authorized to take actions that would benefit herself only if the benefit to her was incidental to planning undertaken primarily to benefit petitioner, or to ensuring that petitioner would qualify for public assistance.

In reaching its conclusion that the taxpayer did not have to include the disputed amounts in gross income, the court relied on its prior decision in *Roberts v. Commissioner*, 141 T.C. No. 569 (2013), in which the court concluded that a taxpayer did not have to include in gross income IRA withdrawals taken by his wife, who had forged the taxpayer's signature on the withdrawal requests. The court also relied on prior decisions in which it had held that a taxpayer did not have to include in gross income amounts withdrawn from retirement or other financial accounts by the taxpayer's agent when the agent's actions were unauthorized and the taxpayer received no economic benefit from the withdrawn funds. *See Grant v. Commissioner*, T.C. Memo. 1995-29; *Wilkinson v. Commissioner*, T.C. Memo. 1993-336. The court upheld the IRS's levy, but only to the extent of the taxpayer's correct tax liability after reduction for the tax attributable to the amounts withdrawn by his wife.

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

B. Miscellaneous Income

C. Hobby Losses and § 280A Home Office and Vacation Homes

D. Deductions and Credits for Personal Expenses

1. A nonresident alien is entitled to a personal exemption deduction in 2018 through 2025, but the amount of the deduction is zero under the 2017 Tax Cuts and Jobs Act. Bell v. United States, 169 Fed. Cl. 466 (1/25/24). The taxpayer in this case, Mr. Cecil Bell, was a Jamaican citizen and a nonresident alien of the United States.[8] The Court of Federal Claims, in an opinion by Judge Horn, held that, although the taxpayer was entitled to one deduction of the "exemption amount" under § 151(a) and § 151(b), the exemption amount was zero pursuant to § 151(d)(5), as applicable during the years 2018 through 2025. The effect of this holding is that the taxpayer did not receive any reduction in income or the refund he requested.

Section 151(a) and (b) authorize a deduction equal to the "exemption amount" for a taxpayer. The 2017 Tax Cuts and Jobs Act, § 11041, amended Code § 151(d) by adding § 151(d)(5). Section 151(d)(5)(A) reduces the exemption amount to zero for taxable years beginning after 2017 and before 2026. The intended effect of this amendment was to eliminate the deduction for personal exemptions authorized by § 151(a).

The arguments in this case primarily revolve around the specific wording of §§ 151(d)(5)(B) and 873(a)-(b). Section 151(d)(5)(B) provides:

> For purposes of any other provision of this title, the reduction of the exemption amount to zero under subparagraph A shall not be taken into account in determining whether a deduction is allowed or allowable, or whether a taxpayer is entitled to a deduction, under this section.

[8] The taxpayer was represented by the Low Income Taxpayer Clinic at Syracuse University College of Law.

Section 873(a) provides that deductions are allowed for a nonresident alien individual only to the extent they are connected with income that is effectively connected with the conduct of a trade or business in the United States. Despite this general rule, § 873(b) provides that certain deductions are allowed for a nonresident alien individual *whether or not* they are connected with income with income that is effectively connected with the conduct of a trade or business in the United States. Pursuant to § 873(b)(3), one of these deductions is "the deduction for personal exemptions allowed by section 151 …"

The taxpayer filed an amended return for 2018 on which he claimed a personal exemption deduction and a refund of $415. The taxpayer argued that, despite Congress's reduction of the exemption amount to zero for 2018, he was entitled to a personal exemption deduction under § 873(b)(3). The taxpayer focused on the language in § 151(d)(5)(B) providing that the reduction of the exemption amount to zero "shall not be taken into account in determining whether…a taxpayer is entitled to a deduction, under this section." The taxpayer asserted that this language, in conjunction with the language of § 873(b)(3), which provides that a nonresident alien individual is allowed "the deduction for personal exemptions allowed by section 151 …," entitles a nonresident alien to a personal exemption deduction. In sum, taxpayer asserted that Congress suspended a U.S. citizen's right to personal exemption deduction while, at the same time, preserving a nonresident alien taxpayer's entitlement to the same deduction.

The government responded that the language in § 151(d)(5)(B), which provides that the reduction of the exemption amount to zero is not taken into account in determining whether a taxpayer is entitled to a deduction under § 151, "applies when there is a Code section that asks whether someone would be eligible for a deduction under § 151, and then grants some other tax status or benefit on the basis of eligibility." For example, the parties agreed that a taxpayer's right to the child tax credit under § 24 or head of household filing status under § 2 is preserved because the personal exemption deduction remains in effect for purposes of determining the benefits under these provisions. The government disagreed, however, that § 151(d)(5)(B), in conjunction with § 873(b)(3), allows a nonresident alien to take a personal exemption deduction in 2018 through 2025.

The court agreed with the government. Judge Horn reasoned that the issue is whether the language of § 151(d)(5)(B) in conjunction with § 873(b)(3) allows a nonresident alien to ignore the reduction of the exemption amount to zero. Persuaded by the government's reading of the statutes, Judge Horn reasoned that

> the plain language of … § 151(d)(5) establishes two separate concepts: (1) the process of determining whether a taxpayer's deduction is "allowed," "allowable," or is "entitled to," and (2) the actual exemption amount.

According to the court, the language of § 151(d)(5)(B) providing that the reduction of the exemption amount to zero is not taken into account in determining whether a taxpayer is entitled to a deduction under § 151 simply means that, in determining whether a deduction is allowed (or not) or whether a taxpayer is entitled to a deduction (or not), the reduction of the exemption amount to zero is not taken into consideration. In reaching this conclusion, the court reasoned that the taxpayer's theory that nonresident aliens are treated differently under the statute than U.S. citizens would create an unintended discriminatory effect against U.S. citizens and in favor of nonresident aliens. Judge Horn observed that, if Congress had intended such a distinction, it surely would added explicit language to the statute and Congress had not done so. The court concluded that, like a U.S. citizen, the taxpayer was entitled to one personal exemption deduction and that the deduction was equal to the exemption amount of zero.

2. Standard deduction for 2025. Rev. Proc. 2024-40, I.R.B. 1100 (10/22/24). The standard deduction for 2025 will be $30,000 for joint returns and surviving spouses (increased from $29,200), $15,000 for unmarried individuals and married individuals filing separately (increased from $14,600), and $22,500 for heads of households (increased from $21,900). For individuals who can be claimed as dependents, the standard deduction cannot exceed the greater

of $1,350 (increased from $1,300) or the sum of $450 (unchanged from 2024) and the individual's earned income. The additional standard deduction amount for those who are legally blind or who are age 65 or older is $2,000 (increased from $1,900) for those with the filing status of single or head of household (and who are not surviving spouses) and is $1,600 (increased from $1,550) for married taxpayers ($3,200 on a joint return if both spouses are age 65 or older).

The following table sets forth the standard deduction for each filing status a taxpayer might have:

Filing Status	2023	2024	2025
Single/MFS	$13,850	$14,600	$15,000
Head-of-Household	$20,800	$21,900	$22,500
MFJ and Surviving Spouses	$27,700	$29,200	$30,000

E. Divorce Tax Issues

F. Education

1. Beginning in 2024, beneficiaries of § 529 college savings plans that have been open for more than 15 years will be able to roll over up to $35,000 during their lifetime from the 529 plan to a Roth IRA (subject to annual Roth IRA contribution limits). A provision of the SECURE 2.0 Act, Division T, Title I, § 126 of the Consolidated Appropriations Act, 2023, amended Code § 529(c)(3) by adding § 529(c)(3)(E), which permits distributions from a § 529 college savings account to be tax-free if they are rolled over to a Roth IRA maintained for the benefit of the designated beneficiary of the § 529 account provided that certain requirements are met. The requirements are that (1) the § 529 account must have been maintained for the 15-year period ending on the date of the distribution, (2) the distribution does not exceed the amount contributed to the § 529 plan (plus earnings) before the 5-year period ending on the date of the distribution, and (3) the distribution is paid in a direct trustee-to-trustee transfer to a Roth IRA maintained for the benefit of the designated beneficiary of the § 529 account. The amount rolled over each year is subject to two limitations. *First*, the amount rolled over cannot exceed the annual limit on Roth IRA contributions for the designated beneficiary reduced by the aggregate contributions made during the year to all IRAs maintained for the benefit of the designated beneficiary. For example, the limit on Roth IRA contributions for 2023 is $6,500. If the designated beneficiary of a § 529 account contributes $1,000 to a traditional IRA for the year, then the maximum amount that the individual could roll over from the § 529 account to the Roth IRA would be $5,500. *Second*, the amount rolled over in the current year and in all prior years cannot exceed $35,000, i.e., the lifetime limit on rollovers from the § 529 account to a Roth IRA is $35,000. This change applies to distributions from § 529 accounts made after December 31, 2023.

G. Alternative Minimum Tax

VI. CORPORATIONS

A. Entity and Formation

B. Distributions and Redemptions

1. A new excise tax of 1% on redemptions of stock by publicly-traded U.S. corporations. The Inflation Reduction Act, § 138102, adds new Code § 4501, which imposes a 1 percent excise tax on the value of stock "repurchased" by a "covered corporation" (generally, a U.S. publicly-traded corporation) during the corporation's taxable year. The term "repurchase" is defined as a redemption within the meaning of Code § 317(b) plus any other "economically similar" transaction as determined by the Secretary of Treasury. The amount subject to the new 1

percent excise tax is the fair market value of stock redeemed during the year reduced by (i) the value of any new stock issued to the public for the year and (ii) the value of stock issued to the employees of the corporation for the year. A subsidiary of a publicly-traded U.S. corporation that performs the buyback for its parent or a U.S. subsidiary of a foreign corporation that buys back its parent's stock is subject to the excise tax. The provision also excludes certain repurchases from the excise tax, as explained further below. Section 4501 applies to repurchases of stock after December 31, 2022.

a. Interim guidance issued pending regulations. Notice 2023-2, 2023-3 I.R.B. 374 (12/27/22). The Treasury Department and the IRS have announced interim guidance under § 4501 in the form of Notice 2023-2. The notice is extensive and foreshadows the inevitably complicated regulations that ultimately will be promulgated under § 4501. Section 2 of Notice 2023-2 summarizes relevant law and provides introductory guidance, including the meaning of a "covered corporation" and "covered repurchases." Section 2 further identifies certain transactions that trigger the tax even if § 317(b) technically may not apply, such as stock purchases by a "specified affiliate" and "transactions economically similar to a § 317(b) redemption." Section 2 of Notice 2023-2 also clarifies that, pursuant to § 275(a)(6), any tax paid under § 4501 is not deductible by the covered corporation. Section 3 of Notice 2023-2 comprises the bulk of the new guidance. Section 3 provides rules concerning amounts includable in the excise tax base, amounts excludable from the excise tax base, and other aspects of the application of § 4501. Section 3 also includes twenty-six helpful examples, including application of the new excise tax to preferred stock redemptions, stock dividends, boot in acquisitive reorganization transactions, cash paid for fractional shares in an acquisitive reorganization, corporate liquidations, and purchases by a disregarded entity. Section 4 provides rules for reporting and paying the 1 percent excise tax.

b. Final and proposed regulations issued under § 4501. T.D. 10002, Excise Tax on Repurchase of Corporate Stock—Procedure and Administration, 89 F.R. 55045 (7/3/24) and REG-115710-22, Excise Tax on Repurchases of Corporate Stock, 89 F.R. 25980 (4/12/24). Treasury and the IRS have issued final and proposed regulations providing further guidance under § 4501.

The final regulations (T.D. 10002 cited above) address reporting and payment obligations with respect to the 1 percent excise tax and may be found at Reg. §§ 58.6001-1 through 58.6696-1. As first announced in Notice 2023-2, the final regulations provide that (i) the stock repurchase excise tax must be reported on IRS Form 720, *Quarterly Federal Excise Tax Return*, (ii) taxpayers must attach an additional form to the Form 720 reflecting the computation of the stock repurchase excise tax, (iii) the stock repurchase excise tax must be reported once per taxable year on the Form 720 that is due for the first full quarter after the close of the taxpayer's taxable year, (iv) the deadline for payment of the stock repurchase excise tax is the same as the filing deadline, and (v) no extensions are permitted for reporting or paying the stock repurchase excise tax. In addition, the final regulations add items relevant to the stock repurchase excise tax to tax returns other than Form 720, including Form 1120, *U.S. Corporation Income Tax Return*, and Form 1065, *U.S. Return of Partnership Income*. The final regulations apply to stock repurchase excise tax returns (and to the extent relevant, claims for refund) required to be filed after the date of publication (7/3/2024) and during taxable years ending after the date of publication. The final regulations clarify, though, that Form 720 is not required to be filed for any year that a covered corporation does not engage in a stock repurchase transaction subject to § 4501.

The proposed regulations (REG-115710-22 cited above) address computational matters concerning the § 4501 excise tax and may be found at Prop. Reg. §§ 58.4501-1 through -7. The computational matters addressed concern the types of transactions subject to the § 4501 excise tax (including transactions that are "economically similar" to § 317(b) stock redemptions) and stock issuances that reduce the amount otherwise subject to the § 4501 tax (the "netting rule"). Generally, the proposed regulations are consistent with guidance published in Notice 2023-2. In particular, the proposed regulations republish and clarify numerous examples that were originally

announced in Notice 2023-2. A total of 40 examples are provided in the proposed regulations, such as:

- Transactions generally subject to the § 4501 excise tax:
  - Repurchases of mandatorily redeemable preferred stock. *See* Prop. Reg. § 58.4501-5 Ex. 1.
  - Acquiring a target corporation's stock for boot in an acquisitive reorganization (an "economically similar" transaction to a redemption). *See* Prop. Reg. § 58.4501-5 Ex. 6.
- Transactions generally not subject to the § 4501 excise tax:
  - Cash paid in lieu of fractional shares in an acquisitive reorganization. *See* Prop. Reg. § 58.4501-5 Ex. 7.
  - Distributions in complete liquidation. *See* Prop. Reg. § 58.4501-5 Ex. 16.
- Issuances that do not count toward the netting rule and thus do not reduce the potential amount of excise tax imposed under § 4501:
  - Pro rata stock dividend. *See* Prop. Reg. § 58.4501-5 Ex. 5.

Tax advisors to U.S. publicly-traded corporations should consider the proposed regulations and examples carefully. The proposed regulations generally apply to transactions occurring after the date of publication (4/12/2024).

C. Liquidations

D. S Corporations

1. Disproportionate distributions from an S Corporation do not create a second class of stock and do not terminate an S election. Maggard v. Commissioner, T.C. Memo 2024-77 (8/7/24). The taxpayer and his business associate formed a corporation under California law and elected to have it classified for federal tax purposes as a subchapter S corporation. The taxpayer and his business associate each received equal shares of the S corporation's common stock. Under California corporate law, owners of common stock are entitled to a pro rata share of dividends, distributions, and liquidation proceeds. See Cal. Corp. Code §§ 159, 400(b). The taxpayer's business associate sold his shares to the taxpayer, who in turn sold 60 percent of his interest to two other individual shareholders (40 percent to one individual and 20 percent to the other). These two individual shareholders (Two Shareholders) caused the corporation to make substantially disproportionate distributions to themselves. When the taxpayer confronted them about their alleged looting of the corporation, they cut the taxpayer off from the corporation's accounting records and did not allow the taxpayer to attend company meetings. The taxpayer prepared his federal income tax returns for 2014 through 2016 without having received a Schedule K-1 from the S corporation. When the taxpayer requested this information through an attorney, he received a single figure on a cocktail napkin. This figure was $300,000 for 2014 and $50,000 for 2015. These figures allegedly represented the taxpayer's shares of losses of the S corporation for these years. After the taxpayer filed his returns, the S corporation issued Schedules K-1 showing that the taxpayer had a share of income for each year. Upon audit, the IRS disallowed the losses reported by the taxpayer and determined that the taxpayer had failed to report his allocable share of the S corporation's income correctly in the years audited. The taxpayer argued that the corporation's S election terminated prior to the years being audited because the Two Shareholders caused the S corporation to make disproportionate distributions to themselves. The taxpayer maintained that the disproportionate distributions violated the requirement that an S corporation have only a single class of stock. *See* § 1361(b)(1)(D). Because the S corporation allegedly had violated the single class of stock requirement, he argued, its S election had terminated and therefore the corporation's income no longer passed through to the shareholders under the regime of subchapter S. The Tax Court (Judge Holmes) disagreed and held that the disproportionate distributions did not terminate the corporation's S election. The court acknowledged that an S corporation can only have one class of stock. Relevant Treasury regulations provide that the one class of stock requirement is met if all outstanding shares of the S corporation confer identical

rights to distribution and liquidation proceeds. Reg. § 1.1361-1(*l*)(1). The regulations further provide that

> [t]he determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions).

Reg. § 1.1361-1(*l*)(2)(1). In Rev. Proc. 2022-19, § 3.02, 2022-41 I.R.B. 282, the IRS indicated that it will not treat any actual disproportionate distributions as violating the one class of stock rule if the distribution provisions in the governing documents provide for identical distribution rights. Based on this authority and the court's own precedent, the court held that the disproportionate distributions in this case did not violate the one class of stock rule. The court noted that it had reached a similar conclusion in prior cases. *See Mowry v. Commissioner*, T.C. Memo. 2018-105; *Minton v. Commissioner*, T.C. Memo. 2007-372, *aff'd*, 562 F.3d 730 (5th Cir. 2009).Accordingly, the court held that the S corporation's election had not terminated and that the corporation's income from the audited years passed through to the taxpayer.

E. Mergers, Acquisitions and Reorganizations

F. Corporate Divisions

G. Affiliated Corporations and Consolidated Returns

H. Miscellaneous Corporate Issues

1. Much ado about nothing . . . or an open can of worms full of you know what flung against a fan?!?! A U.S. corporation with a tax year straddling the effective date of the TCJA was entitled to a deduction under § 245A for a deemed dividend from a CFC the U.S. corporation was required to include in income under § 78. Varian Medical Systems Inc. v. Commissioner, 163 T.C. No. 4 (8/26/24). Candidly, we are not sure if this reviewed case of first impression from the Tax Court is a yawner or a gobsmacker. Only time will tell. The taxpayer took advantage of *both* § 78 *and* § 245A for its 2018 tax year due to conflicting effective date language in the 2017 Tax Cuts and Jobs Act (TCJA). Except in circumstances almost identical to this case (where a multinational corporate taxpayer's taxable year straddles the enactment of the TCJA), taking advantage of both § 78 and § 245A is expressly prohibited. *See* IRC § 78. *Yes, we told you the case has extremely narrow application, but that's not really the important part, so keep reading.* The Tax Court's precedential opinion does not entirely settle the case, but it does resolve competing cross-motions for summary judgment filed by the taxpayer and the IRS.

Broader implications of the case. On one hand, the Tax Court addressed an unusually narrow set of facts, largely ruling in favor of a clever multinational corporate taxpayer who for *one taxable year* took advantage of a known, limited-time loophole: a mismatch in the TCJA's effective date provisions concerning § 78 and § 245A. On the other hand, the Tax Court reached its decision by completely disregarding a Treasury regulation that purported to close the loophole. The Treasury regulation sought to close the loophole retroactively as had been proposed in technical corrections legislation that our dysfunctional Congress drafted but never passed. The authors believe that the Tax Court, as explained in a well-written opinion by Judge Toro, reached the correct result, especially considering the straightforward but conflicting effective date language in the relevant statutes. Nevertheless, the real significance of the case is the Tax Court's willingness to completely disregard the loophole-closing Treasury regulation on point. Going forward, it seems clear that the Tax Court (and other federal courts as well) will exercise independent judgment when evaluating government agency interpretations of statutes. Thus, the Tax Court no longer will defer to Treasury's admittedly self-interested interpretation of ambiguous, or arguably ambiguous, Code provisions. Instead, interpretative (as opposed to legislative) Treasury regulations and other administrative guidance not satisfying the new *Loper Bright* "best interpretation" standard adopted by the U.S. Supreme Court may be disregarded or invalidated. We elaborate below.

Factual Background. The taxpayer was the parent company of a consolidated group of medical device and software manufacturers headquartered in the U.S. The taxpayer also operated internationally, including through controlled foreign corporation ("CFC") subsidiaries within the meaning of subpart F of the Code. *See* IRC § 957.[9] The taxpayer and its CFC subsidiaries previously had adopted a fiscal (as opposed to a calendar) taxable year for federal income tax purposes. The taxpayer's fiscal taxable year in this case ran from September 30, 2017, through September 28, 2018 (the "2018 tax year"). The TCJA was enacted late in 2017. Thus, the taxpayer's 2018 tax year straddled the enactment of the TCJA. Reading between the lines, we believe that for its 2018 tax year the taxpayer was subject to the § 965 "Mandatory Repatriation Tax" ("MRT") enacted by the TCJA as part of Congress's overhaul of subpart F of the Code.[10] Accordingly, the taxpayer was keen to ameliorate the adverse impact of the MRT. Regardless, the taxpayer's international operations via its CFC subsidiaries for its 2018 tax year permitted the taxpayer to claim approximately $161 million in § 901 foreign tax credits. Those claimed foreign tax credits in turn implicated § 78 (deemed dividends relating to claimed foreign tax credits) and § 245A (deduction relating to dividends received from specified 10-percent owned foreign corporations).

Legal Background. As noted above, § 245A was enacted at the end of 2017 as part of the TCJA's extensive revisions to subpart F of the Code. Generally, § 245A grants a dividends-received deduction ("DRD") to a domestic corporation that is a United States shareholder with respect to any "specified 10-percent owned foreign corporation" for any dividend received from the foreign corporation. *See* § 245A(a). Importantly, § 245A became effective for "distributions made after December 31, 2017." Thus, § 245A applied to any dividends received by the taxpayer from its CFC subsidiaries on or after January 1, 2018. The dividends-received deduction authorized by § 245A eliminates U.S. taxation of distributions (or deemed distributions) of untaxed foreign-source income. Contrastingly, § 78 has been a part of the Code since 1962. Section 78 was enacted to achieve tax parity between U.S. corporations operating internationally through foreign branches vis-a-vis those operating through CFCs. Section 78 achieves this tax parity by "grossing up" a U.S. corporate CFC shareholder's dividends received by the amount of foreign taxes imposed on the foreign earnings and deemed paid and claimed by the U.S. corporate shareholder as a foreign tax credit under § 960. For example, if the U.S. corporate shareholder receives a dividend of $70 from a CFC and the CFC has paid $30 in foreign taxes for which the U.S. corporate shareholder claims a foreign tax credit under § 960, then, under § 78, the U.S. corporate shareholder would be treated as receiving a dividend of $100 ($70 + $30) and would claim a

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[9] Under § 957(a), a CFC generally is a non-U.S. corporation if, on any day during the corporation's taxable year, "United States shareholders" own stock possessing more than 50 percent of either the total voting power of all classes of stock entitled to vote or the total value of the corporation's stock. Pursuant to § 957(b), a "United States shareholder" is a "United States person" (see § 7701(a)(30)) who owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote (before 2018) or 10 percent or more of the total value of shares of all classes of stock of the foreign corporation (after 2017).

[10] We previously summarized the MRT in connection with our discussion of SCOTUS's decision in Moore v. United States, 602 U.S. ___ (6/20/2024). The MRT imposes "a one-time pass-through tax" that is "backward-looking" on the accumulated but undistributed income of "American-controlled foreign corporations." *Moore*, 144 S. Ct. at 1686. Put differently, the MRT effectuates a deemed repatriation (in corporate tax parlance, "deemed dividend") of earnings and profits to U.S. shareholders holding 10 percent or more of the controlled foreign corporation's stock. Longstanding provisions of subpart F have operated the same way for decades, but before the TCJA-enacted MRT, subpart F mainly applied to passive income. The MRT was enacted in 2017 to correct a perceived abuse by taxing U.S. shareholders on their share of post-1986 accumulated but undistributed trade or business income of "controlled foreign corporations" (as defined) even though a dividend had not been declared. Otherwise, if the income earned by the foreign corporation was never repatriated, it remained indefinitely untaxed by the U.S. The MRT also operates prospectively after 2017 with respect to "global intangible low-taxed income" (a/k/a "GILTI") *See* IRC § 951A.

foreign tax credit of $30 against the corporation's U.S. tax liability.[11] In this example, § 78 treats the $30 of foreign tax deemed paid as a dividend received by the U.S. corporate shareholder. This gross-up of the dividend is designed to prevent the U.S. corporate shareholder from effectively obtaining both a deduction and a credit for foreign tax deemed paid. The deemed dividend under § 78, however, has never been eligible for the normal § 245 DRD and, except as applied in this case, was not supposed to be eligible for the § 245A DRD. (The normal § 245 DRD was not relevant to this case.) Specifically, before the TCJA, § 78 stated that the foreign taxes deemed paid by the U.S. corporate shareholder "shall be treated for purposes of this title (*other than section 245*) as a dividend received by such domestic corporation from the foreign corporation." *See* IRC § 78 (2016) (emphasis added). Therefore, in connection with enacting new § 245A, the TCJA amended the above-quoted parenthetical in § 78 to add a cross-reference to § 245A as follows: "(other than sections 245 *and 245A*)." *See* § 78 (2024) (emphasis added). Nonetheless amended § 78's effective date provision under the TCJA — and here's the big "*Oops*" at the crux of the case — states that the revised statute applies for "taxable years of foreign corporations beginning after December 31, 2017, and . . . taxable years of United States shareholders in which or with which such taxable years of foreign corporations end." TCJA § 14301(d), 131 Stat. at 2225. As noted above, then, § 245A applies to "distributions made after December 31, 2017." Thus, as Judge Toro put it in the Tax Court's opinion, the TCJA's mismatched effective date language left a narrow "gap" during which both § 78 and § 245A theoretically could apply to taxpayers with a fiscal year straddling the enactment of TCJA. 163 T.C. at ___. As a result, a U.S. corporation exploiting this gap could claim a foreign tax credit for foreign taxes actually paid by the foreign corporation paying the dividend (and deemed paid by the U.S. corporation receiving the dividend) and simultaneously deduct the dividend received. However, as discussed below, a corporation claiming a deduction under § 245A for the deemed dividend required by § 78 must reduce the amount of its foreign tax credit by virtue of § 245A(d)(1).

Treasury's Attempted "Gap" Fix. Treasury, the IRS, and Congress were well aware of this unintended "gap" in the TCJA's mismatched effective date language concerning §§ 78 and 245A. On January 2, 2019, the House Ways and Means Committee published a *Tax Technical and Clerical Corrections Act Discussion Draft* that would have retroactively closed the "gap" as of the enactment of the TCJA. The proposed fix, however, was never passed by Congress. Regardless, Treasury published on June 21, 2019, a revised, interpretative regulation under § 78 that disallowed the § 245A deduction for the deemed dividend engineered by § 78. The revised regulation under § 78 purported to be retroactively effective to § 78 deemed dividends occurring on or after January 1, 2018, despite the contrary effective date language (as quoted above) in the TCJA regarding amended § 78. *See* Reg. 1.78-1 (stating in part and emphasis added: "A section 78 dividend is treated as a dividend for all purposes of the Code, except that it is not treated as a dividend for purposes of sections 245 *or 245A* . . . .").

The Arguments. Because the case has such narrow applicability regarding potentially affected taxpayers, we have minimized our discussion of the taxpayer's and the IRS's arguments regarding whether §§ 78 and 245A could apply to the taxpayer's 2018 fiscal tax year. Essentially, the taxpayer relied on the plain language of the statutes, including the TCJA effective date provisions, while the IRS was left to make the following unsuccessful "should be" arguments:

- § 245A should be read to apply, even for the "gap" period, only to dividends *actually* received rather than deemed § 78 dividends;

[11] Stating the obvious, perhaps, we have greatly oversimplified the tax analysis pertaining to foreign tax credits and subpart F of the Code, including the deemed dividend, increase to taxable income, the § 245A DRD, and the tax parity achieved by § 78. Judge Toro's opinion, however, provides a helpful but also somewhat simplified illustration at 163 T.C. ___ -___. We commend it to readers curious about the interrelationship between subpart F, foreign tax credits, § 78, and § 245A.

- § 275(a)(4) (disallowing a deduction for foreign or territorial taxes for which tax credits are claimed) and § 261 (referencing Code §§ 262 through 280H, which consist of a long list of prohibited deductions for specified items such as personal expenses, capital expenditures, entertainment expenses, etc.) should be read broadly (*somehow?*) to disallow the taxpayer's § 245A DRD for the "gap" period; and
- allowing a DRD under § 245A for a § 78 deemed dividend only within the "gap" period should be considered absurd and contrary to congressional policy and intent.

None of the foregoing arguments were found persuasive by the Tax Court. If you are incurably curious and must understand why the Tax Court rejected the above IRS arguments, read Judge Toro's opinion.

Here's the "Beef"—Impact of Loper Bright on Treasury Regulations. Finally, the IRS argued that Reg. § 1.78-1 (as cited and quoted above) closed the effective date "gap" retroactive to January 1, 2018. Judge Toro wrote in response to this argument:

> The rule adopted by the revised regulations essentially gives one of the TCJA's amendments to section 78 an earlier effective date than provided for in the TCJA to prevent taxpayers like Varian from deducting section 78 dividends. But, as we have already observed, the plain text of the statutes provides for the deduction. As the Supreme Court has said, "self-serving regulations never 'justify departing from the statute's clear text.'"

163 T.C. at ___. The IRS argued in response that its interpretation of §§ 78 and 245A, as reflected in Reg. § 1.78-1, nevertheless should be considered "permissible" and entitled to deference. 163 T.C. at ___. Judge Toro disagreed, though, based upon the U.S. Supreme Court's recent *Loper Bright* decision overturning so-called "*Chevron* deference" previously granted by the courts to administrative interpretations of statutes and promulgation of interpretative regulations. *See Loper Bright Enterprises v. Raimonda*, 603 U.S. ___ (2024), *overruling in part Chevron, U.S.A., Inc. v. Natural Resources Council, Inc.*, 467 U.S. 837 (1984). Instead, Judge Toro flatly refused to apply Reg. § 1.78-1 to close the "gap" against the taxpayer in this case, concluding:

> As the Supreme Court observed in *Loper Bright*, "statutes, no matter how impenetrable, do—in fact, must—have a single, best meaning. That is the whole point of having written statutes; 'every statute's meaning is fixed at the time of enactment.' And, in cases involving ambiguity, "instead of declaring a particular party's reading 'permissible' . . . , courts [must] use every tool at their disposal to determine the best reading of the statute and resolve the ambiguity." Put another way, "in an agency case as in any other . . . even if some judges might (or might not) consider the statute ambiguous, there is a best reading all the same—the reading the court would have reached if no agency were involved."
>
> In short, "[i]n the business of statutory interpretation, if it is not the best, it is not permissible." And, as we have shown above, the best (indeed the unambiguous) reading of the provisions at issue here permits [the taxpayer's] deduction.

163 T.C. at ___.

The IRS's Consolation Prize. Although the Tax Court rejected the IRS's arguments that § 245A should not apply to a § 78 deemed dividend arising within the "gap" period created by the TCJA's relevant effective date provisions, the Tax Court did embrace the IRS's argument relating to the determination of the taxpayer's allowed foreign tax credits. As mentioned above, the taxpayer claimed roughly $161 million in foreign tax credits for its 2018 tax year. The IRS's position was that, if the Tax Court determined the taxpayer could take the § 245A DRD attributable to the § 78 deemed dividend for its 2018 tax year, then the taxpayer's claimed foreign tax credits must be reduced under § 245A(d)(1). Section 245A(d)(1) provides: "No credit shall be allowed under section 901 [(foreign taxes)] for any taxes paid or accrued (or treated as paid or accrued) with respect to any dividend for which a deduction is allowed under this section." The taxpayer

contended that § 245A(d)(1) was not relevant to a § 78 deemed dividend but was only meant to apply to foreign taxes paid *on* a dividend (whether actual or deemed). The taxpayer paid $0 foreign taxes "on" its § 78 deemed dividend for 2018. Judge Toro, however, was not persuaded by the taxpayer's argument. Instead, Judge Toro adopted the IRS's position that the phrase "with respect to" in § 245A(d)(1) should be read broadly to mean "concerning" or "related to," not simply "on." Therefore, because the taxpayer's § 78 deemed dividend unquestionably relates to the foreign tax credits claimed by the taxpayer, the § 245A(d)(1) limitation applies. Further, because the amount of the § 78 deemed dividend "represents the share of a foreign corporation's earnings that were paid out to a foreign country as tax," Judge Toro likewise adopted the IRS's proposed formula for calculating the § 245A(d)(1) disallowance of a portion of the taxpayer's otherwise allowable foreign tax credits for its 2018 tax year. The formula considers the taxpayer's § 78 deemed dividend and the taxpayer's § 965 subpart F income to reduce the taxpayers claimed § 901 foreign tax credits for its "gap"-controlled 2018 taxable year as follows:

$$\textit{Disallowed Foreign Tax Credit} = \textit{Deemed Paid Foreign Tax Credit} \times \left(\frac{\textit{Section 78 gross-up}}{\textit{Net section 965 inclusion} + \textit{section 78 gross-up}}\right)$$

The same analysis would apply if a U.S. corporation included in income its share of subpart F income of a CFC under the general subpart F inclusion rule of § 951(a) rather than an amount calculated pursuant to the MRT of § 965.

Comment: Kudos if you have read the foregoing summary and fully appreciate the somewhat disguised significance of the Tax Court's recent decision in *Varian Medical Systems*. Query whether we will begin referring to the "*Varian* test" for Treasury regulations or the "*Varian* formula" where § 245A(d)(1) applies to "gap"-controlled taxable years of multinational corporate taxpayers. One author guesses that the *Varian* formula or some variation thereof will appear in future Treasury regulations interpreting § 245A(d)(1). Of course, the opportunity to apply § 245A, including subsection (d)(1), in the context of a § 78 deemed dividend is limited (at least according to the Tax Court) to those multinational U.S. corporate taxpayers with CFC subsidiaries claiming foreign tax credits within a fiscal taxable year that straddled the enactment of the TCJA. In any event, we strongly suspect other taxpayers will be emboldened by the Tax Court's pronouncement in *Varian Medical Systems* that interpretive (as opposed to legislative) Treasury regulations must satisfy the new *Loper Bright* "best interpretation" standard adopted by SCOTUS. *Let the games (a/k/a litigation) begin . . . .*

- The authors understand that other corporations with tax years that straddle the effective date of the TCJA are now examining their eligibility to deduct under § 245A the deemed dividend required by § 78. For example, the Tax Court recently entered an order granting the motion for partial summary judgment filed by Sysco Corporation on the basis that the court's opinion in *Varian Medical* fully resolved Sysco's eligibility for a deduction under § 245A for the deemed dividend required by § 78. *Sysco Corporation v. Commissioner*, No. 5728-23 (9/13/24).

VII. PARTNERSHIPS

A. Formation and Taxable Years

B. Allocations of Distributive Share, Partnership Debt, and Outside Basis

C. Distributions and Transactions Between the Partnership and Partners

D. Sales of Partnership Interests, Liquidations and Mergers

1. Judge Gustafson revisits *Grecian Magnesite*, but this time rules against this non-U.S. taxpayer selling her partnership interest due to § 751. Rawat v. Commissioner, T.C. Memo 2023-14 (2/7/23). We previously have written about the entity-theory versus aggregate-

theory dust-up between the IRS and non-U.S. persons selling interests in partnerships conducting business in the U.S. For example, in *Grecian Magnesite Mining, Industrial & Shipping Co., S.A. v. Commissioner*, 149 T.C. 63 (2017), the Tax Court (Judge Gustafson) ruled against the IRS (and against the IRS's position in Rev. Rul. 91-32, 1991-1 C.B. 107) to hold that a non-U.S. person's gain from the sale of an interest in a partnership conducting a U.S. trade or business is not U.S.-source income (because the partnership interest is personal property) and therefore is not subject to U.S. taxation unless such gain (i) is captured by § 897(g) (gain attributable to U.S. real property) or (ii) is captured by § 865(e)(2) (gain attributable to a U.S. office or fixed place of business). The IRS in *Grecian Magnesite* had argued that a non-U.S. person's gain from the sale of an interest in a partnership conducting business in the U.S. should be analyzed under the aggregate-theory of partnership taxation, meaning that the gain would be considered U.S. source income because it is attributable to the underlying U.S. assets held by the partnership. *See* Rev. Rul. 91-32, 1991-1 C.B. 107. Nevertheless, Judge Gustafson declined to adopt the IRS's reasoning (labeling the IRS's analysis in Rev. Rul. 91-32 as "cursory") and ruled for the taxpayer. Importantly, *Grecian Magnesite* did not address whether the result might be different if the partnership conducting business in the U.S. held inventory items subject to § 751.

Rawat Decision by Judge Gustafson. In *Rawat v. Commissioner*, T.C. Memo 2023-14 (2/7/23), Judge Gustafson got the chance to address the issue left open in *Grecian Magnesite*: whether gain from a non-U.S. person's sale of an interest in a partnership holding inventory items and conducting business in the U.S. is considered U.S. source income by virtue of § 751 and the U.S. income-sourcing rules of §§ 861-865. This time, the Tax Court (again, Judge Gustafson) adopted the IRS's aggregate-theory argument and held against the taxpayer. The taxpayer in *Rawat* was a Canadian citizen and nonresident of the U.S. during 2007 and 2008. In 2008, the taxpayer sold her interest in a partnership doing business in the U.S. in exchange for a promissory note with a face amount of $438 million. The principal of the promissory note was not payable until 2028. The IRS sought to tax $6.5 million of the taxpayer's gain ("inventory gain") in 2008 because that amount was attributable to § 751 inventory items held by the partnership and allocable to the taxpayer's partnership interest. The taxpayer argued that, because the inventory gain was realized and recognized prior to the enactment of § 864(c)(8) (see below), the Tax Court's decision in *Grecian Magnesite* controlled. The IRS disagreed, arguing that the inventory gain, unlike the gain in *Grecian Magnesite*, was subject to § 751, thereby rendering the gain as U.S. source income under §§ 861-865 and the IRS's aggregate theory asserted in *Grecian Magnesite*. This time around, Judge Gustafson ruled for the IRS and against the taxpayer. Judge Gustafson reasoned that, although § 751 is not a sourcing rule, the rule in § 741 generally treating the sale of a partnership interest as the disposition of a capital asset is expressly subject to the § 751 carve-out for inventory items. Then, examining the special sourcing rules under §§ 861(a)(6) (sale or exchange of inventory property) and 865(b) (exception for inventory property), Judge Gustafson concluded that the taxpayer's inventory gain from the sale of her partnership interest should be considered U.S.-source income subject to U.S. tax notwithstanding the Tax Court's holding in *Grecian Magnesite* regarding more general § 741 gain.

a. D.C. Circuit reverses the Tax Court, but almost seven years ago (see below), Congress had the last word. Rawat v. Commissioner, 108 F.4th 891 (D.C. Cir. 7/23/24), *rev'g* T.C. Memo 2023-14 (2/7/23). After losing in the Tax Court, the taxpayer appealed to the U.S. Court of Appeals for the D.C. Circuit. In an opinion by Chief Judge Srinivasan, the court aptly summarized the dispute between the taxpayer and the IRS as follows:

> While the parties agreed that § 751(a) requires inventory gain to be taxed as ordinary income, the Commissioner argued that it does more than that: in his view, § 751(a) also deems gain on the sale of a partnership interest attributable to inventory to be gain on the sale *of* inventory, such that it can be taxable as U.S.-source income. Rawat, however, contended that § 751(a) has a more limited scope. She insisted that it does not give rise to a deemed sale of inventory and thus does not render taxable what would otherwise be nontaxable income. Rather, according

> to Rawat, § 751(a) merely subjects inventory gain to ordinary-income taxation *if* the gain is otherwise taxable. And Rawat considered the inventory gain she realized to be nontaxable, as it arose from the sale of a partnership interest, not from the actual sale of inventory. Accordingly, she maintained, the gain constitutes proceeds from the sale of general personal property (as opposed to inventory) and is foreign-source income because she is a nonresident alien.

108 F.4th at 894. After framing the issue in the above-quoted manner, the court's analysis turned to the essential question: did the non-U.S. taxpayer sell inventory (by virtue of § 751(a)), or did the non-U.S. taxpayer sell a partnership interest? In his opinion, Chief Judge Srinivasan repeatedly emphasized that, as a matter of fact, the taxpayer sold a partnership interest, not the underlying inventory itself. Further, Chief Judge Srinivasan disagreed with the IRS's and Judge Gustafson's position that § 751(a) and the regulations thereunder should be read to treat the taxpayer as if she had sold inventory. Instead, Judge Srinivasan agreed with the taxpayer's argument that § 751(a) is merely a recharacterization provision by taking into account the amount of inventory held by a partnership. Section 751(a) does not convert or treat a partnership interest sale as a disposition of the underlying inventory. Thus, § 751(a) does not modify the then-existing sourcing provisions of §§ 861-865, which *Grecian Magnesite* previously had established did not reach a non-U.S. person's gain from the sale of an interest in a partnership conducting business in the U.S. Chief Judge Srinivasan's opinion concluded: "The short of it is that § 751(a) does not of its own force render Rawat's inventory gain taxable because it does not change the fact that she sold a partnership interest, not inventory." 108 F.4th at 899. Accordingly, the court reversed Judge Gustafson's decision and held for the non-U.S. taxpayer.

- *The final word: 2017 Tax Cuts and Jobs Act.* Regardless of the Tax Court's earlier holding in *Grecian Magnesite* and the D.C. Circuit's holding in *Rawat*, readers may recall that the 2017 Tax Cuts and Jobs Act, § 13501, amended § 864(c) by adding § 864(c)(8) effective for dispositions after November 27, 2017. Section § 864(c)(8) provides that gain or loss (after 11/27/17) on the sale or exchange of all (or any portion of) a partnership interest owned by a nonresident alien individual or a foreign corporation in a partnership engaged in any trade or business within the U.S. is treated as effectively connected with a U.S. trade or business (and therefore taxable by the U.S. unless provided otherwise by treaty) to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. The amount of gain or loss treated as effectively connected under this rule is reduced by the amount of such gain or loss that is already taxable under § 897 (relating to U.S. real property interests). Put differently, § 864(c)(8) adopts the aggregate theory of partnership taxation with regard to dispositions of partnership interests. Section 864(c)(8) legislatively overrules the Tax Court's holding in *Grecian Magnesite* and the D.C. Circuit's holding in *Rawat* but only for partnership interest gain realized and recognized after November 27, 2017.

- *Comment*: If *Grecian Magnesite* and *Rawat* are any indication, the courts seem inclined to adopt the entity theory and reject the IRS's aggregate theory of partnership taxation, at least as it relates to a taxpayer's sale or other disposition of a partnership interest. Generally, this is good news for taxpayers because § 741 characterizes a partnership interest as a capital asset, subject to any express exceptions in the Code. Of course, § 751(a) remains an express exception for U.S. taxpayers selling an interest in a partnership holding "hot assets," while relatively new § 864(c)(8) is an express exception for non-U.S. taxpayers selling an interest in a partnership conducting business in the U.S.

E. Inside Basis Adjustments

1. Channeling one-hit-wonder Meghan Trainor, Treasury and IRS sing ♪♫"I'm all about that bas[is], no treble"♫♪ -- especially for "overlooked" partnerships and partners "exploiting" inside/outside basis adjustments (a/k/a "tax technology"???). To understand the recent developments discussed immediately below, some deeper background is necessary regarding basis adjustments allowed by subchapter K. Normally under subchapter K,

the aggregate basis of the partners of a partnership in their partnership interests ("outside basis") equals the partnership's aggregate basis in the assets held inside the partnership ("inside basis"). This typical inside/outside basis equilibrium is one of the hallmarks of "flow-through taxation" reflected in subchapter K. Knowledgeable readers know, though, that even if a partnership's aggregate outside basis equals aggregate inside basis, a partnership may have certain assets with a high basis relative to their fair market value and other assets with a low basis relative to their fair market value. Generally, such assets can be distributed in-kind to partners without the partnership or the partners recognizing gain or loss. *See* § 731. Carefully planning and targeting such in-kind distributions to partners with a relatively high or low outside basis compared to the asset's fair market value can have federal income tax advantages. These advantages include increased cost recovery deductions or, upon disposition of an asset, reduced sale or exchange gain or increased sale or exchange loss. Further, under certain circumstances, the usual partnership inside/outside basis equilibrium does not hold true. For example, the death of a partner and the resulting basis step-up in the decedent's partnership interest under § 1014(a)(1) often creates an inside/outside basis disparity. A transfer of an interest in a partnership also can result in an inside/outside basis disparity—because the buyer of a partnership interest obtains a cost basis, but (absent an election under § 754) the transfer does not alter the partnership's inside basis in its assets. *See* § 743. Moreover, a current or liquidating in-kind distribution of partnership property may result in an inside/outside basis disparity under § 732(a), (b), or (c). Inside/outside basis disparities created upon partner contributions of property to partnerships (including upon formation) are somewhat rare, but nevertheless possible. *See* §§ 731(a); 732(a), (b), (d); 733; 734; 743. An optional election under § 754 (adjustment to basis of partnership property), coupled with the application of § 755 (rules for allocation of basis), can rectify these inside/outside basis disparities when it is beneficial from a federal income tax standpoint to do so. The inside/outside basis disparities are (*imperfectly?*) rectified via adjustments to the basis of distributed property, partnership property, or both. *See* §§ 734(b); 743(b); 754; 755. Of course, clever taxpayers, especially related parties, tax-indifferent parties, or parties with a common economic interest, can obtain significant federal income tax advantages (such as increased cost recovery deductions, reduced gain, or increased loss) by manipulating the inside/outside basis adjustment rules of subchapter K. For instance, an in-kind distribution of partnership property to a partner by a partnership with a § 754 election in effect, or with respect to which there is a "substantial basis reduction" (as described in § 734(d)), may result in an adjustment to the basis of the partnership's remaining property under § 734(b). A transfer of a partnership interest in a sale or exchange (or upon the death of a partner) where a § 754 election is in effect, or with respect to which there is a "substantial built-in loss" (as described in § 743(d)(1)), may result in an adjustment to the basis of partnership property under § 743(b) with respect to the transferee partner. These longstanding basis adjustment rules under subchapter K are well-accepted (albeit complicated), but at least according to Treasury and the IRS, are subject to abuse, especially where taxpayer-partners are not bargaining at arm's length.

a. Treasury and IRS plan to audit more partnerships and challenge "basis-shifting" transactions. IRS News Release 2024-166 (6/17/2024); IRS Fact Sheet 2024-21 (6/17/24); Notice 2024-54, 2024-28 I.R.B. 24 (6/17/24); Rev. Rul. 2024-14, 2024-28 I.R.B. 18 (6/17/24); REG-124593-23, Certain Partnership Related-Party Basis Adjustment Transactions as Transactions of Interest, 89 F.R. 51476 (6/17/24). Apparently, Treasury and the IRS have been hard at work understanding and combatting "carefully structured" partnership transactions that "exploit the [above-described] mechanical basis-adjustment provisions of subchapter K to produce significant tax benefits." *See* Notice 2024-54, § 3.04. According to the IRS, "these transactions may employ several steps over a period of years and use sophisticated tax technology to ensure that little or no tax is paid while large amounts of tax basis is 'stripped' from certain assets and shifted to other assets to generate tax benefits," thereby allowing "increased depreciation deductions or reduced gain on the sale of an asset with little or no substantive economic consequence." *See* IRS Fact Sheet 2024-21 cited above. In connection with issuing the new guidance, IRS Commissioner Werfel stated: "This announcement signals the IRS is accelerating our work in the partnership arena, which has been overlooked for more than a decade and allowed

tax abuse to go on for far too long. We are building teams and adding expertise inside the agency so we can reverse long-term compliance declines that have allowed high-income taxpayers and corporations to hide behind complexity to avoid paying taxes. Billions are at stake here." *See* IRS News Release 2024-166 cited above. The new guidance issued by Treasury and the IRS, with more coming soon in the form of proposed regulations, is summarized below.

b. Soon-to-be-issued proposed regulations regarding (i) related-party basis adjustments under subchapter K and (ii) basis-shifting among partner-members of a consolidated group. Notice 2024-54, 2024-28 I.R.B. 24 (6/17/24). This notice announces that Treasury and the IRS intend to publish two sets of proposed regulations addressing certain "basis-shifting" transactions concerning partnerships and related parties. The arrangements targeted by Notice 2024-54 ("covered transactions") involve increases to the basis of property by partnerships and partners under §§ 732 (basis of distributed property other than money), 734(b) (adjustment to basis of undistributed partnership property), or 743(b) (special basis adjustments relating to transfers of partnership interests). The first set of regulations ("Related-Party Basis Adjustments" or "RPBA"), to be issued under the authority of §§ 482, 732, 734(b), 743(b), 755, and 7805, will create special rules concerning cost recovery deductions attributable to "covered transactions." The RPBA regulations will implement mechanical rules applicable to all "covered transactions" without regard to the taxpayer's intent or whether the transactions could be considered abusive or lacking in economic substance. (See the further discussion below regarding Rev. Rul. 2024-14 and the application of the economic substance doctrine.) The second set of regulations, to be issued under the authority of the consolidated return provisions of §§ 1501 and 1502, will apply a "single-entity approach" to interests in a partnership held by members of a consolidated group. This "single-entity approach" will be designed to prevent direct or indirect basis shifts from "covered transactions" among the partner members of the consolidated group. The to-be-published proposed regulations previewed in Notice 2024-54 potentially could have retroactive effect, applying to taxable years ending on or after June 17, 2024. Further, Notice 2024-54 states that the regulations, once finalized, will "govern the availability and amount of cost recovery deductions and gain or loss calculations for taxable years ending on or after June 17, 2024, even if the relevant 'covered transaction' was completed in a prior year. The potential retroactive effect of the proposed regulations previewed by Notice 2024-54 has engendered strong objections from some commentators. For further analysis of Notice 2024-54, see New York State Bar Association Tax Section, Report on Proposed Regulations Regarding Partnership Basis Adjustments and Application of Notice 2024-54 to Previously Effected Transactions, Report #1498 (Aug. 16, 2024).

Alright, you got our attention, but exactly what types of partnership transactions are under the microscope? The partnership "covered transactions" Treasury and the IRS have identified as abusive or potentially abusive generally fall into one of three (or four, depending upon how you cut it) categories. The following descriptions and examples are taken from the recently-issued guidance cited above, especially IRS Fact Sheet 2024-21, Notice 2024-54, and the preamble to REG-124593-23, Certain Partnership Related-Party Basis Adjustment Transactions as Transactions of Interest. The basis adjustment illustrated in each example below is equal to or greater than $5 million because, as discussed further below, $5 million is the reporting threshold for Prop. Reg. § 1.6011-18 regarding "transactions of interest." The proposed regulations previewed by Notice 2024-54, however, presumably will not include any type of minimum basis adjustment threshold before applying special rules concerning cost recovery deductions to partnerships and partners engaging in "covered transactions." Certain partners described in the examples below are related within the meaning of §§ 267(b) (without regard to the attribution rules of § 267(c)(3)) or § 707(b)(1). In general, related parties for this purpose include the following: members of a person's family (siblings, spouse, ancestors, lineal descendants); certain trust grantors, fiduciaries, and beneficiaries; certain estates, executors, and beneficiaries; and more-than-50-percent-controlled corporations and partnerships.

(1) *Transfer of partnership interest to a related party*: A partner with a low share of the partnership's inside basis but a high outside basis transfers the partner's interest in a

nonrecognition transaction (as defined in § 7701(a)(45), but including a sale for no gain or loss) to a related person or to a person who is related to other partners in the partnership. The transfer to the related party (along with a § 754 election) generates a special basis increase under § 743(b) to the transferee partner's share of the partnership's inside basis, thereby benefitting the transferee partner via increased cost recovery deductions, reduced gain, or increased losses.

- *Example 4 in the preamble to REG-124593-23*: AB Partnership is owned by partners A and B. A owns 95 percent of the capital and profits interests in AB Partnership and is allocated 95 percent of all losses. B owns 5 percent of the capital and profits interests in AB Partnership and is allocated 5 percent of all losses. A's outside basis is $6 million and share of inside basis is $1 million. AB Partnership owns depreciable property it uses in a trade or business. In a taxable year in which AB Partnership has a section 754 election in effect, A transfers its entire partnership interest to C, a person related to A within the meaning of proposed § 1.6011-18(b)(8) and (b)(9)(ii), in a nonrecognition transaction in which no gain was recognized. Because AB Partnership has a section 754 election in effect for the taxable year of the transfer, under section 743(b)(1), AB Partnership increases the basis of the partnership property with respect to C by $5 million. Assume that under sections 743(c) and 755 and the regulations thereunder, the basis increase with respect to C of $5 million is allocated to partnership property that is depreciable. As a result, C may be allocated depreciation deductions over the recovery periods of the partnership properties equal to the amount of the basis increase under section 743(b)(1).

(2) *Basis "stripping" current distribution of property to a related party*: A partnership with related partners makes a current distribution of a high inside basis asset to a related-party partner who has a low outside basis. The distributee partner takes a low substituted basis in the asset under § 732(a), allowing the partnership (with a § 754 election in effect) to increase the basis of its remaining assets by the "stripped" excess high basis of the distributed asset over the distributee partner's low outside basis. The basis increase to the partnership's remaining assets results in higher depreciation deductions, reduced gain, or increased loss benefitting the related party partners.

- *Example 1 in the preamble to REG-124593-23*: XY Partnership is owned by partners X and Y. The partners are related to each other within the meaning of proposed § 1.6011-18(b)(8) and (b)(9)(i). Each partner directly owns 50 percent of the capital and profits interests in XY Partnership and shares losses equally. X has an outside basis of $10 million, and Y has an outside basis of $1 million. XY Partnership owns property it uses in its trade or business, including Property 1 and Property 2. For Federal income tax purposes, Property 1 is depreciable property and Property 2 is nondepreciable property. XY Partnership has an adjusted basis in Property 1 of zero, and an adjusted basis in Property 2 of $10 million. XY Partnership has a section 754 election in effect for the taxable year and makes a current distribution of Property 2 to Y. Under section 732(a)(2), Y's basis in distributed Property 2 is limited to Y's adjusted basis in its partnership interest of $1 million. As a result of the distribution to Y, Property 2's adjusted basis is decreased from $10 million immediately before the distribution to $1 million in Y's hands. Under section 734(b), XY Partnership must increase the basis of its remaining property. The amount of the basis increase is equal to the excess of XY Partnership's basis in Property 2 immediately before the distribution of $10 million over Y's adjusted basis in Property 2 after the distribution of $1 million, which results in an increase to the basis of XY Partnership's remaining property of $9 million. Under sections 734(c) and 755 and the regulations thereunder, XY Partnership allocates the basis increase of $9 million to Property 1. As a result, XY Partnership claims depreciation deductions based on an increased basis in Property 1.

(3) *Basis boost via liquidation of or current distribution to a related partner*: A partnership with related partners makes a liquidating or current distribution to a particular partner. The partnership distributes a low inside basis asset that was subject to accelerated cost recovery to a partner with a high outside basis, after which the distributee partner increases his/her/its basis in the asset under § 732(b) or makes the election authorized by § 732(d) and secures increased cost recovery deductions or sells the asset for little or no gain.

- *Example 2 in the preamble to REG-124593-23*: DEF Partnership is owned by partners D, E and F. The partners are related to each other within the meaning of proposed § 1.6011-18(b)(8) and (b)(9)(i). D's outside basis is $7 million. E and F each have an outside basis of $1 million. DEF Partnership owns only two properties, Property 1 and Property 2, both of which it uses in its trade or business. For Federal income tax purposes, Property 1 is depreciable property and Property 2 is nondepreciable property. DEF Partnership has an adjusted basis in Property 1 of zero, and an adjusted basis in Property 2 is $9 million. DEF Partnership distributes Property 1 to D in liquidation of D's partnership interest. Under section 732(b), D's basis in distributed Property 1 is equal to $7 million. As a result, D claims depreciation deductions based on a $7 million basis in Property 1.

- *Example 3 in the preamble to REG-124593-23*: XYZ Partnership is owned by partners X, Y and Z. The partners are related to each other within the meaning of proposed §1.6011-18(b)(8) and (b)(9)(i). Each partner directly owns one-third of the capital and profits interests in XYZ Partnership and shares losses equally. XYZ Partnership owns Property 1, Property 2, and Property 3. Property 1 is depreciable property, and XYZ Partnership's adjusted basis in Property 1 is zero. Property 2 and Property 3 are nondepreciable property. X acquired its interest in XYZ Partnership in a nonrecognition transaction from a person related to X within the meaning of proposed §1.6011-18(b)(8). At the time of the transfer, XYZ Partnership did not have a section 754 election in effect. Immediately after the transfer, X's outside basis was $12 million and share of inside basis was $2 million. If XYZ Partnership had a section 754 election in effect at the time of the transfer, XYZ Partnership would have adjusted X's share of inside basis under section 743(b). Assume that the adjustment under section 743(b) would have resulted in a basis increase to Property 1 of $10 million. In a taxable year that is within two years[12] of the transfer of the partnership interest to X, XYZ Partnership makes a current distribution of Property 1 to X. Under section 732(a)(1), X's adjusted basis in Property 1 is zero. However, X makes an election under section 732(d) to adjust the basis of Property 1 to the adjusted basis it would have if the adjustment under section 743(b) were in effect with respect to the partnership property at the time X acquired its interest. As a result of the election under 732(d), because the adjusted basis of Property 1 under section 743(b) with respect to X would have been increased by $10 million, X takes a basis in Property 1 equal to $10 million and claims depreciation deductions based on a $10 million basis in Property 1.

c. The IRS will not be shy about applying the economic substance doctrine to related-party basis adjustment transactions involving consolidated group partnerships and partners. Rev. Rul. 2024-14, 2024-28 I.R.B. 18 (6/17/24). This revenue ruling clarifies that the IRS may apply the "economic substance doctrine" of § 7701(o) to disallow tax benefits (such as increased cost recovery deductions, reduced gain, or increased loss) arising from related-party partnerships taking advantage of inside and outside basis adjustments (particularly in the consolidated return context). Recall that § 7701(o)(5)(A) defines the economic substance doctrine as "the common law doctrine under which tax benefits . . . with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose." Further recall that § 7701(o)(1) generally treats a transaction as having economic substance only if "(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction." Achieving a financial accounting benefit is not considered a valid "purpose" (within the meaning of § 7701(o)) if the origin of such financial accounting benefit is a reduction of Federal income tax. *See* § 7701(o)(4). Under § 7701(o)(5)(D), a "transaction" (within the meaning of § 7701(o)) includes a series of transactions. Finally, § 7701(o)(2)(A) provides that if a taxpayer relies on profit potential to prove a transaction has economic substance, the potential profit will be considered probative "only if the present value of

[12] IRC § 732(d) grants a two-year window after the transfer of a partnership interest for a transferee-distributee partner to secure a basis adjustment as if the § 754 election had been in effect for the year of the transfer.

the reasonably expected pre-tax profit of the transaction is substantial in relation to the present value of the expected net tax benefits" otherwise allowable. Rev. Rul. 2024-14 describes three different scenarios in the consolidated return context in which partnerships owned and controlled by members of the consolidated group either make (i) liquidating distributions of property under § 732(b) or (ii) engage in contributions or distributions (via partnerships with selective § 754 elections in effect) to obtain basis adjustments in contributed or distributed property under §§ 734(b) or 743(b). The corresponding basis adjustments to property held within the consolidated group provide enhanced tax benefits (i.e., increased cost recovery deductions, reduced gain, or increased loss) to the group. Importantly, however, Rev. Rul. 2024-14 stipulates two critical facts in this regard: (1) previous "contributions, distributions, and allocations" to partnerships held within the consolidated group "were undertaken intentionally with a view to creating" future inside/outside basis adjustments and (2) the purported financial "cost savings" (i.e., profit potential) from subsequent in-kind partnership contributions and distributions vis-à-vis the consolidated group members are "insubstantial in relation to the reduction in the aggregate Federal income liability" of the group. *Talk about loading the dice!* Rev. Rul. 2024-14 then unsurprisingly concludes that all three "basis shifting" scenarios lack economic substance, thereby allowing the IRS to disallow any enhanced tax benefits claimed by the consolidated group as a result of the transactions.

d. Proposed regulations under § 6011 identify certain related-party partnership basis adjustments as "transactions of interest" subject to heightened disclosure rules and penalties. REG-124593-23, Certain Partnership Related-Party Basis Adjustment Transactions as Transactions of Interest, 89 F.R. 51476 (6/17/24). Treasury has proposed regulations, to be contained in new Reg. § 1.6011-18, that would identify partnership related-party basis adjustment transactions such as those described above, and substantially similar transactions, as "transactions of interest," a type of "reportable transaction" (as such terms are defined in Reg. § 1.6011-4). Related parties for this purpose are those persons described in §§ 267(b) (without regard to the attribution rules of § 267(c)(3)) or § 707(b)(1). In general, then, related parties for this purpose include the following: members of a person's family (siblings, spouse, ancestors, lineal descendants); certain trust grantors, fiduciaries, and beneficiaries; certain estates, executors, and beneficiaries; and more-than-50-percent-controlled corporations and partnerships. Generally, taxpayers participating in these types of transactions are required to file special disclosures with the IRS under § 6011(a). *See also Form 8886, Reportable Transaction Disclosure Statement*. Material advisors (as defined) to such participating taxpayers also are subject to special disclosure and list maintenance requirements under §§ 6111(a) and 6012(a). *See also Form 8918, Material Advisor Disclosure Statement*. In addition, affected taxpayers and their material advisors are potentially subject to special penalties for failure to properly disclose, and for participating in, such transactions. See §§ 6662A; 6707; 6707A; 6708. Fortunately, perhaps, Prop. Reg. § 1.6011-18 will include a $5 million minimum threshold requirement such that only transactions involving a $5 million or greater basis adjustment in a taxable year are subject to the special disclosure and penalty provisions. Prop. Reg. § 1.6011-18 is slated to become effective as of the date final regulations are published in the Federal Register. For further analysis of Prop. Reg. § 1.6011-18, see New York State Bar Association Tax Section, Report on Proposed Regulations Regarding Partnership Basis Adjustments and Application of Notice 2024-54 to Previously Effected Transactions, Report #1498 (Aug. 16, 2024).

F. Partnership Audit Rules

G. Miscellaneous

1. Hot penalty relief for "hot asset" reporting by partnerships with respect to 2023 § 751(a) exchanges. Notice 2024-19, 2024-5 IRB 627 (1/11/24). This notice announces penalty relief under § 6722 (failure to furnish correct payee statements) for partnerships that missed the January 31, 2024, deadline for providing a copy of the recently revised IRS Form 8308 (Report of a Sale or Exchange of Certain Partnership Interests) to the transferor and transferee of

a "751(a) exchange" occurring during calendar year 2023. Form 8308 is required to be filed as an attachment to a partnership's Form 1065 (U.S. Return of Partnership Income) for the taxable year of the partnership that includes the last day of the calendar year in which the "§ 751(a) exchange" took place. Form 8308 is due at the time for filing the partnership return, *including extensions*; however, Form 8308 was revised in October of 2023, and new Part IV of Form 8308 requires a partnership to report, among other items, the partnership's and the transferor partner's share of § 751 gain and loss, collectibles gain under § 1(h)(5), and unrecaptured § 1250 gain under § 1(h)(6). The newly released Part IV of Form 8308 prompted concerns from tax advisors that the affected partnerships might not have the information required by Part IV of Form 8308 by the January 31, 2024, due date. These concerns ultimately resulted in the penalty relief announced in Notice 2024-19. By way of background, a "751(a) exchange" within the meaning of the notice is defined as "a sale or exchange of an interest in the partnership (or portion thereof) in which any money or other property received by a transferor from a transferee in exchange for all or part of the transferor's interest in the partnership is attributable to § 751 property." As readers undoubtedly know, § 751 property of a partnership consists of so-called "hot assets" -- unrealized receivables or inventory items described in § 751(a). Code § 6050K and Reg. § 1.6050K-1 generally require a partnership with § 751 property to provide information to each transferor and transferee of a sale or exchange of an interest in the partnership (or portion thereof). The required information is contained in a properly completed IRS Form 8308, including Part IV thereof, which ordinarily should be attached to the partnership's Form 1065 for the year of the 751(a) exchange. Reg. § 1.6050K-1(c)(1) further provides that each partnership required to file a Form 8308 must furnish a statement to the transferor and transferee by the later of (a) January 31 of the year following the calendar year in which the § 751(a) exchange occurred, or (b) 30 days after the partnership has received notice of the exchange as specified under Code § 6050K and Reg. § 1.6050K-1. A partnership must use a copy of the completed Form 8308 as the required statement unless the Form 8308 contains information for more than one § 751(a) exchange. Reg. § 1.6050K-1(c)(1) provides that if the partnership does not use a copy of the Form 8308 as the required statement, the partnership must furnish a statement that includes the information required to be shown on the Form 8308 with respect to the § 751(a) exchange to which the person to whom the statement is furnished is a party. Subject to a reasonable cause exception in § 6724, Code § 6722 imposes a penalty for failure to furnish correct payee statements on or before the required date, and for any failure to include the information required to be shown on the statement or the inclusion of incorrect information. For this purpose, "payee statements" include statements required to be furnished to transferors and transferees under § 6050K. *See* § 6724(d)(2)(P). The penalty relief from § 6722 announced in Notice 2024-19 is subject to certain conditions as follows:

- The relief only applies to failure to timely furnish a copy of the Form 8308 (or the required information contained therein) to the transferor and transferee as required by § 6722. The notice does not provide penalty relief under § 6721 for failure to timely file Form 8308 as an attachment to a partnership's Form 1065.
- The relief applies solely for failure to furnish Form 8308 with a completed Part IV by the due date specified in § 1.6050K-1(c)(1) for a partnership that (1) timely and correctly furnishes to the transferor and transferee a copy of Parts I, II, and III of Form 8308, or a statement that includes the same information, by the later of (a) January 31, 2024, or (b) 30 days after the partnership is notified of the § 751(a) exchange, and (2) furnishes to the transferor and transferee a copy of the complete Form 8308, including Part IV, or a statement that includes the same information and any additional information required under Reg. § 1.6050K-1(c), by the later of (a) the due date of the partnership's Form 1065 (including extensions), or (b) 30 days after the partnership is notified of the § 751(a) exchange.

VIII. TAX SHELTERS

A. Tax Shelter Cases and Rulings

B. Identified "tax avoidance transactions"

C. Disclosure and Settlement

D. Tax Shelter Penalties

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. It will cost you $600, but exempt § 501(c)(3) organizations now may obtain a determination letter to switch to another type of § 501(c) organization. Rev. Proc. 2024-5, 2024-5 I.R.B. 1 (1/2/24), *as corrected by* Ann. 2024-7, 2024-7 I.R.B. 673 (2/9/24). As readers know, the IRS publishes guidance each year in January for taxpayers seeking various types of private rulings and determination letters. Typically, we do not discuss such routine, periodic guidance from the IRS. This year, however, the IRS significantly altered its longstanding policy regarding determination letters issued to tax-exempt organizations. Previously, a tax-exempt entity qualifying under § 501(c)(3) ("charitable" organizations) could not obtain a determination letter regarding the termination of its (c)(3) status and transition to another type of § 501(c) organization. For instance, an existing (c)(3) "charitable" organization could not unilaterally apply for IRS approval to operate instead as a § 501(c)(c)(4) "social welfare organization." The primary difference between (c)(3) organizations and other types of § 501(c) tax-exempt entities is the charitable deduction. Under § 170, taxpayers generally may take a charitable deduction (subject, of course, to numerous limitations and qualifications) for contributions to (c)(3) organizations. Taxpayers generally cannot take a § 170 deduction for contributions to other tax-exempts such as (c)(4) "social welfare organizations," (c)(6) "trade associations," or (c)(7) "social clubs." *Note*: A deduction under § 162 (trade or business expense) may be available to taxpayers paying such non-(c)(3) organizations but not a § 170 deduction. Starting in 2024, though, section 3.01(1) of Rev. Proc. 2024-5 provides that the IRS will issue a determination letter to an existing (c)(3) seeking recognition under a different subparagraph of § 501(c) if the organization establishes the following as of the date of its application: (i) it has distributed its assets to another § 501(c)(3) organization or government entity and (ii) it otherwise meets the requirements for the § 501(c) status requested. Rev. Proc. 2024-5 further clarifies that any favorable determination letter so issued is effective only from and after the submission date of the application. Nonetheless, for (c)(3) organizations whose exempt status was revoked automatically under § 6033(j) (failure to file a return), Rev. Proc. 2024-5 allows the organization to apply for retroactive reinstatement under a different paragraph of § 501(c). Organizations use either IRS Form 1024 or Form 1024-A to apply for the change in status and must pay a user fee of $600.

B. Charitable Giving

1. After 2022, syndicated conservation easements are on life support if not DOA. A well-hidden provision of the SECURE 2.0 Act, Division T, Title VI, § 605 of the Consolidated Appropriations Act, 2023, amended Code § 170(h) to add a new subsection (7) severely restricting charitable deductions for "qualified conservation contributions" by partnerships, S corporations, and other pass-through entities. "Qualified conservation contributions" are defined by § 170(h)(1) to include (but are not limited to) conservation easements granted to charitable organizations in connection with syndicated conservation easements. As described in Notice 2017-10, 2017-4 I.R.B. 544, a typical syndicated conservation easement involves a promoter offering prospective investors the possibility of a charitable contribution deduction in exchange for investing in a partnership. The partnership subsequently grants a conservation easement to a qualified charity, allowing the investing partners to claim a charitable contribution deduction under § 170.

New "2.5 times" proportionate outside basis rule will limit the charitable deduction for conservation contributions by pass-through entities. New § 170(h)(7)(A) generally provides that a contribution by a partnership is not treated as a qualified conservation contribution (and therefore no deduction is allowed)—whether via a direct contribution or as an allocable share from a lower-tier partnership—if the amount of the contribution exceeds "2.5 times the sum of each partner's

relevant basis" in the partnership. The term "relevant basis" is defined by new § 170(h)(7)(B)(i) to mean that portion of a partner's "modified basis" which is allocable (under rules similar to those used under § 755) to the real property comprising the qualified conservation contribution. "Modified basis" (defined in § 170(h)(7)(B)(ii)) essentially refers to a partner's outside basis exclusive of the partner's share of partnership liabilities under § 752. Thus, reading between the lines and subject to further guidance, relevant basis appears to equate to an investor's cash investment (a/k/a initial tax and book capital account) in a syndicated conservation easement partnership. Many syndicated conservation easement partnerships claim that investors may secure a charitable deduction that is five times their cash investment. New § 170(h)(7)(A) thus limits the charitable deduction to "2.5 times" an investor's cash contribution, making a syndicated conservation easement much less attractive. New § 170(h)(7) also contains three exceptions: (i) partnerships making conservation easement contributions after a three-year holding period applicable at the partnership- and partner-level, including through tiered partnerships; (ii) "family partnerships" (as defined) making conservation easement contributions; and (iii) partnerships making conservation easement contributions relating to historic structures. *See* IRC §§ 170(f)(19), 170(h)(7)(C)-(E). Moreover, new § 170(h)(7)(F) authorizes Treasury to issue regulations applying similar rules to S corporations and other pass-through entities. Related provisions of the legislation make dovetailing amendments to (i) § 170(f) (charitable contribution substantiation and reporting requirements); (ii) §§ 6662 and 6664 (underpayment penalties attributable to valuation misstatements); (iii) § 6011 (reportable transactions); and (vi) §§ 6235 and 6501 (statute of limitations). New § 170(h)(7) applies to qualified conservation contributions made by partnerships and other pass-through entities after December 29, 2022.

Some welcome news for non-syndicated conservation easement donors? In an uncodified provision (*see* § 605(d)), the legislation directs Treasury to publish "safe harbor deed language for extinguishment clauses and boundary line adjustments" relating to qualified conservation contributions (whether via partnerships or otherwise). Treasury is directed to publish such safe harbor deed language within 120 days of the date of enactment of new § 170(h)(7) (i.e., by April 28, 2023), and donors have 90 days after publication of the safe harbor language to execute and file corrective deeds. This special, uncodified relief provision seems to be targeted toward donors like those who lost battles with the IRS over highly technical language in their conservation easement deeds. *See* *Oakbrook Land Holdings LLC v. Commissioner*, 154 T.C. 180 (5/12/20) (deed's extinguishment clause violated the proportionate benefit rule), *aff'd*, 28 F.4th 700 (6th Cir. 3/14/22), and *Pine Mountain Preserve, LLLP v. Commissioner*, T.C. Memo. 2018-214 (12/27/18) (deed improperly allowed substituted property), *rev'd in part, aff'd in part, and vacated and remanded*, 978 F.3d 1200 (5th Cir. 10/22/20). Importantly, however, the foregoing uncodified relief provision does not apply to syndicated conservation easements as described in Notice 2017-10 or to conservation easement cases (and related penalty disputes) docketed in the federal courts before the date a corrective deed is filed.

a. Safe harbor conservation easement deed language published by the IRS with a short (now passed) deadline to file amended deeds. Notice 2023-30, 2023-17 I.R.B. 766 (4/10/23). As directed by Congress, the IRS has published safe harbor deed language for extinguishment and boundary line adjustment clauses relating to conservation easements.

Extinguishment Clauses. *Section 1.04* of the notice sets forth the IRS's litigating position with respect to extinguishment clauses in conservation easement deeds. The IRS's litigating position is that, upon destruction or condemnation of conservation easement property and the collection of any proceeds therefrom, Reg. § 1.170A-14(g)(6)(ii) (the "extinguishment regulation") requires the charitable donee to share in the proceeds according to a "proportionate benefit fraction" set forth in the conservation easement deed. (Keep in mind, however, that the validity of the extinguishment regulation has been called into question. The Eleventh and Sixth Circuits have reached opposite conclusions regarding whether Treasury and the IRS complied with the Administrative Procedures Act in promulgating the regulation. *Compare* *Hewitt v. Commissioner*, 21 F.4th 1336 (11th Cir. 12/29/21) (extinguishment regulation invalid) *with* *Oakbrook Land Holdings, LLC v.*

Commissioner, 28 F.4th 700 (6th Cir. 3/14/22) (extinguishment regulation valid). Thus far, the Supreme Court of the United States has declined to resolve the circuit split. See *Oakbrook Land Holdings, LLC v. Commissioner*, ___ U.S. ___, 143 S. Ct. 626 (1/9/2023).) The IRS's view of the allowed language in the conservation easement deed has been fairly narrow, requiring that the proportionate benefit fraction be fixed and unalterable *as of the date of the donation* according to the following ratio: the value of the conservation easement as compared to the total value of the property subject to the conservation easement. Therefore, according to the IRS and as upheld by several court decisions, if the conservation easement deed either (i) allows the donor to reclaim from the charitable donee any portion of the donated conservation easement property in exchange for substitute property of equivalent value or (ii) grants the donor credit for the fair market value of subsequent improvements to the donated conservation easement property, the proportionate benefit fraction language in the deed is flawed and the charitable deduction must be disallowed. *See, e.g., Pine Mountain Preserve, LLLP v. Commissioner*, 151 T.C. 247 (2018), including its companion case, *Pine Mountain Preserve, LLLP v. Commissioner*, T.C. Memo. 2018-214 (deed allowed substituted property), *aff'd in part, vac'd in part, rev'd in part*, 978 F.3d 1200 (11th Cir. 2020); *PBBM Rose Hill, Ltd. v. Commissioner*, 900 F.3d 193 (2018) (deed reduced charitable donee's benefit for subsequent improvements made by taxpayer donor); *Coal Property Holdings, LLC v. Commissioner*, 153 T.C. 126 (2019). *Section 4.01* of Notice 2023-30 then sets forth what the IRS considers acceptable language regarding the proportionate benefit fraction as is relates to extinguishment clauses in conservation easement deeds.

Boundary Line Adjustment Clauses. *Section 4.02* of Notice 2023-30 provides sample boundary line adjustment clause language. Unlike the background discussion relating extinguishment clauses in conservation easement deeds, the notice does not explain why Congress determined that the IRS should publish sample boundary line adjustment clause language. The IRS acknowledges in Notice 2023-30 that "[n]either the Code nor the regulations specifically address boundary line adjustments."

Amendments. Section 3 of the Notice sets forth the process and timeline for amending an original "flawed" (in the eyes of the IRS) conservation easement deed to adopt the IRS-approved proportionate benefit fraction or boundary line adjustment language. Corrective, amended deeds must be properly executed by the donor and the donee, must be recorded by July 24, 2023, and must relate back to the effective date of the original deed.

b. Final regulations on the disallowance of deductions for conservation easements by partnerships and S corporations. T.D. 9999, Statutory Disallowance of Deductions for Certain Qualified Conservation Contributions Made by Partnerships and S Corporations, 89 F.R. 54284 (6/28/24). The Treasury Department and the IRS have finalized proposed regulations[13] under amended Code § 170(h)(7) and the related information reporting rule of Code § 170(f)(19). The final regulations apply to partnerships and S corporations that claim qualified conservation contributions and partners and shareholders to whom the contribution deduction is allocated. The final regulations provide guidance on the statutory disallowance rule of § 170(h)(7), definitions of terms, methods of calculating the "relevant basis" of a partner or an S corporation shareholder, three statutory exceptions, as well as other reporting requirements. The final regulations apply to qualified conservation contributions by pass-through entities (partnerships and S corporations). They do not apply to contributions by individuals or C corporations.

General rules. In general, under § 170(h)(7)(A), a contribution by a partnership (or S corporation) is not treated as a qualified conservation contribution if the amount of the contribution exceeds "2.5 times the sum of each partner's [or S corporation shareholder's] relevant basis" in

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[13] REG–112916–23, Statutory Disallowance of Deductions for Certain Qualified Conservation Contributions Made by Partnerships and S Corporations, 88 F.R. 80910 (11/20/23).

the partnership or S corporation. Thus, if the amount of a contribution by a partnership or S corporation exceeds this limit, then no deduction is allowed. There are three statutory exceptions to this disallowance rule. One exception applies to contributions made three or more years after the later of (i) the last date on which the pass-through entity acquired any interest in the real property with respect to which the contribution is made or (ii) the last date on which any owner or upper tier pass-through entity acquired an interest in the pass-through entity that made the contribution. See § 170(h)(7)(C). The second exception is for contributions by family partnerships. See § 170(h)(7)(D). The third exception is for contributions to preserve certified historic structures. See § 170(h)(7)(E).

Relevant basis, modified basis. As discussed above, no deduction is allowed for a conservation contribution by a partnership or S corporation if the amount of the contribution exceeds 2.5 times the sum of each partner's or S corporation shareholder's relevant basis. The term "relevant basis" means the portion of a partner's "modified basis" in the partnership which is allocable (under rules similar to those of § 755) to the portion of the real property with respect to which the contribution is made. IRC § 170(h)(7)(B)(i). The term "modified basis" (defined in § 170(h)(7)(B)(ii)) essentially refers to a partner's outside basis exclusive of the partner's share of partnership liabilities under § 752.

Ultimate members. The final regulations use the term "ultimate member" and apply the statutory limit with reference to the relevant basis of a partnership's or S corporation's ultimate members. Specifically, the final regulations provide that no deduction is allowed for a conservation easement contribution by a partnership or S corporation if

> the amount of the qualified conservation contribution exceeds 2.5 times the sum of each of the contributing partnership's or contributing S corporation's ultimate member's relevant basis ….

Reg. § 1.170A-14(j)(2)(i). For this purpose, an "ultimate member" is any partner or S corporation shareholder that (i) is not itself a partnership or S corporation, and (ii) receives a distributive share or pro rata share, directly or indirectly, of a qualified conservation contribution. Reg. § 1.170A-14(j)(3)(x). Thus,

> ultimate members will either be partners holding a direct interest in a partnership, which may be the contributing partnership or an upper-tier partnership, or shareholders holding a direct interest in an S corporation, which may be the contributing S corporation or an upper-tier S corporation. Upper-tier S corporations and upper-tier partnerships themselves are not considered ultimate members.

Reg. § 1.170A-14(j)(3)(x). The regulations thus contemplate that a partnership or S corporation must identify its ultimate members and determine the sum of the relevant basis of each of those ultimate members.

Rules for tiered entities. The final regulations provide rules for tiered entities (partnerships and S corporations). Under these rules, an allocated portion (i.e., distributive share) of the contribution deduction received by an upper-tier entity is disallowed if either (i) the contribution is a disallowed contribution with respect to the entity (partnership or S corporation) that allocated the deduction to the upper-tier entity (partnership or S Corporation), or (ii) the allocated portion exceeds 2.5 times the sum of the upper-tier entity's ultimate member's relevant basis. Reg. § 1.170A-14(j)(2)(ii). In general, if a contribution deduction is disallowed for a lower-tier entity, then that contribution deduction is also disallowed for the upper tier entity that owns an interest in the lower-tier entity. However, if a contribution deduction is allowed for a lower-tier entity, then the same analysis moves to the next higher tier to determine once again whether the upper-tier entity has a disallowed amount. The test keeps getting reapplied at each tier up the entity chain.

Examples. The final regulations contain numerous complex examples that illustrate the application of the rules described above. While it is beyond the scope of this outline to review each of the examples, the following examples from Reg. § 1.170A-14(j)(6) illustrate the basic rules:

Example 1: Disallowed qualified conservation contribution.

a) Facts. A, an individual, and B, a C corporation, form AB Partnership, a partnership for Federal income tax purposes. AB Partnership acquires real property. Two years later, AB Partnership makes a qualified conservation contribution with respect to the property and claims a contribution of $100X on its return. AB Partnership allocates the contribution equally to A and B. A's relevant basis is $30X, and B's relevant basis is $8X.

b) Analysis. A and B are the ultimate members of AB Partnership because they each receive a distributive share of the qualified conservation contribution and are not partnerships or S corporations. The claimed amount of AB Partnership's qualified conservation contribution is $100X, which exceeds 2.5 times the sum of A's and B's relevant bases, which is $95X ($95X = 2.5 x (A's $30X relevant basis + B's $8X relevant basis)). Therefore, AB Partnership's contribution is a disallowed qualified conservation contribution. No person may claim any deduction with respect to this contribution, even though A's $50X distributive share of the contribution does not exceed 2.5 times A's $30X relevant basis.

Example 3: Tiered partnerships

a) Facts. Individuals E and F form UTP Partnership, a partnership for Federal income tax purposes. UTP Partnership and G, a C corporation, form LTP Partnership, a partnership for Federal income tax purposes. LTP Partnership acquires real property. Two years later, LTP Partnership makes a qualified conservation contribution with respect to the property and claims a contribution of $100X on its return. LTP Partnership allocates the contribution $5X to G and $95X to UTP Partnership. UTP Partnership allocates its $95X portion of the contribution $45X to E and $50X to F. G's relevant basis is $10X, E's relevant basis is $11X, and F's relevant basis is $21X.

b) Analysis for LTP Partnership. The ultimate members of LTP Partnership are G, E, and F because they each receive a distributive share of the qualified conservation contribution and are not a partnership or S corporation. Because UTP Partnership is a partnership, it is not an ultimate member of LTP Partnership, even though it receives a distributive share of the qualified conservation contribution. The amount of LTP Partnership's qualified conservation contribution is $100X, which does not exceed 2.5 times the sum of each of the ultimate member's relevant basis, which is $105X ($105X = 2.5 x (G's $10X relevant basis + E's $11X relevant basis + F's $21X relevant basis)). Therefore, LTP Partnership's contribution is not a disallowed qualified conservation contribution (that is, is not disallowed by section 170(h)(7) and this paragraph (j)) with respect to LTP Partnership and G.

c) Analysis for UTP Partnership. Because UTP Partnership receives an allocated portion, UTP Partnership must apply this paragraph (j) and paragraphs (k) through (m) of this section to determine whether its allocated portion is a disallowed qualified conservation contribution. The ultimate members of UTP Partnership are E and F because they each receive a distributive share of UTP Partnership's allocated portion and are not partnerships or S corporations. The amount of UTP Partnership's allocated portion of LTP Partnership's qualified conservation contribution is $95X, which exceeds 2.5 times the sum of E's and F's relevant bases, which is $80X ($80X = 2.5 x (E's $11X relevant basis + F's $21X relevant basis)). Therefore, UTP Partnership's allocated portion of LTP Partnership's contribution is a disallowed qualified conservation contribution with respect to UTP Partnership, E, and F. No partner of UTP Partnership may claim any deduction with respect to this contribution, even though F's $50X distributive share of the contribution does not exceed 2.5 times F's $21X relevant basis. This does not affect the determination that G's distributive share of the contribution is not a disallowed qualified conservation contribution.

2. With more than 750 conservation easement cases on the docket, the Tax Court's flip-flop on the validity of the extinguishment proceeds regulation is not going to help matters. Valley Park Ranch, LLC v. Commissioner, 162 T.C. No. 6 (3/28/24). In a reviewed opinion (7-2-4) by Judge Jones, the Tax Court refused to follow its prior decision in a conservation easement case decided just four years earlier, *Oakbrook Land Holdings, LLC v. Commissioner*, 154 T.C. 180 (2020), *aff'd,* 28 F.4th 700 (6th Cir. 2022). Instead, rejecting *Oakbrook*, a majority of the Tax Court in this case appealable to the Tenth Circuit determined that Reg. § 1.170A-14(g)(6)(ii), one of the chief weapons the IRS has used to combat conservation easements, is procedurally invalid under the Administrative Procedure Act ("APA"). It is fair to say that the Tax Court's decision in *Valley Park Ranch* will have a significant impact on current and future conservation easement litigation between the taxpayers and the IRS.

Background. Other than challenging valuations, the IRS's most successful strategy in combating syndicated conservation easements generally has centered around the "protected in perpetuity" requirement of § 170(h)(2)(C) and (h)(5)(A). The IRS has argued in the Tax Court that the "protected in perpetuity" requirement is not met where the taxpayer's easement deed fails to meet the strict requirements of the "extinguishment regulation." *See* Reg. § 1.170A-14(g)(6)(ii). The extinguishment regulation ensures that conservation easement property is protected in perpetuity because, upon destruction or condemnation of the property and collection of any proceeds therefrom, the charitable donee must proportionately benefit. According to the IRS's reading of the extinguishment regulation, the charitable donee's proportionate benefit must be determined by a fraction determined at the time of the gift as follows: the value of the conservation easement as compared to the total value of the property subject to the conservation easement (hereinafter the "proportionate benefit fraction"). *See Coal Property Holdings, LLC v. Commissioner*, 153 T.C. 126 (10/28/19). Thus, upon extinguishment of a conservation easement due to an unforeseen event such as condemnation, the charitable donee must be entitled to receive an amount equal to the product of the proportionate benefit fraction multiplied by the proceeds realized from the disposition of the property.

Facts. The taxpayer partnership in this case claimed a $14.8 million charitable contribution deduction for its 2016 tax year after granting to a charity a conservation easement over 45.76 acres of Oklahoma land it acquired in 1998 for $91,610. The easement deed recited in part that the contributed property was to be held "forever predominantly in its natural, scenic, and open space condition" and that "the duration of the Easement shall be in perpetuity." 162 T.C. at ___. The easement deed further provided in relevant part that if the land was taken by eminent domain, the taxpayer and the charity would, "after the satisfaction of prior claims," share in the condemnation proceeds "as determined by a Qualified Appraisal meeting standards established by the United States Department of Treasury." 162 T.C. at _____. Upon audit, the IRS took the position, as it has in many prior cases, that the taxpayer's deduction should be disallowed for failing to meet the proportionate benefit fraction requirement of the extinguishment proceeds regulation, Reg. § 1.170A-14(g)(6)(ii). The IRS's litigating position is that the proportionate benefit fraction must be fixed and unalterable *as of the date of the donation* according to the following ratio: the value of the conservation easement as compared to the total value of the property subject to the conservation easement. Thus, according to the IRS, leaving the proportionate benefit upon condemnation to be determined later by a qualified appraisal meeting certain standards is insufficient. (*Note:* Section 4.01 of Notice 2023-30, 2023-17 I.R.B. 766 (4/10/23), sets forth what the IRS considers acceptable language regarding the proportionate benefit fraction as it relates to extinguishment clauses in conservation easement deeds.) After petitioning the Tax Court, the taxpayer argued alternatively that either (i) the easement deed met the requirements of Reg. § 1.170A-14(g)(6)(ii) by "explicit incorporation," or (ii) the regulation is procedurally invalid under the APA, in which case the easement deed need not strictly comply with the regulation as long as it meets the more general requirements of the applicable subsections of the statute, § 170(h) (qualified conservation contribution). The case was heard by the Tax Court on cross-motions for summary judgment.

The Tax Court's Majority Opinion. In a reviewed opinion (7-2-4) by Judge Jones (joined by Judges Foley, Urda, Toro, Greaves, Marshall, and Weiler), the court began its analysis by reviewing the conflicting decisions of the Sixth and Eleventh Circuits concerning the procedural validity of Reg. § 1.170A-14(g)(6)(ii) under the APA. See *Hewitt v. Commissioner*, 21 F.4th 1336 (11th Cir. 2021) (concluding that the regulation is invalid under the APA); *Oakbrook Land Holdings, LLC v. Commissioner*, 28 F.4th 700 (6th Cir. 2022) (concluding that the regulation satisfies the APA). The majority emphasized that a divided (2-1) Sixth Circuit panel decided *Oakbrook*, whereas a unanimous (3-0) Eleventh Circuit panel decided *Hewitt*. Thus, in a footnote, Judge Jones pointed out that of the six appellate court judges who have considered the issue, four decided that Reg. § 1.170A-14(g)(6)(ii) is invalid under the APA while only two upheld the regulation. Noting that the case is appealable to the Tenth Circuit, which has not taken a position on the validity of Reg. § 1.170A-14(g)(6)(ii), Judge Jones concluded for the majority that "after careful consideration of the Eleventh Circuit's reasoning in *Hewitt*, we find it appropriate to change our position." 162 T.C. at ____. The majority gave a nod to the principle of *stare decisis*—following established precedent—but reasoned that its holding in *Oakbrook*, even though affirmed by the Sixth Circuit, is not "entrenched precedent," thereby allowing the Tax Court to strike down Reg. § 1.170A-14(g)(6)(ii) as procedurally invalid under the APA in line with *Hewitt*. 162 T.C. at ____.

Upon agreeing with the Eleventh Circuit that Reg. § 1.170A-14(g)(6)(ii) is procedurally invalid under the APA, the majority then turned to the applicable statute itself and the language of the easement deed. Specifically, the majority examined § 170(h)(2)(C), which requires a "restriction (granted in perpetuity)" on the use of the property subject to a conservation easement. The majority also examined § 170(h)(5), which states that a contribution is not exclusively for conservation purposes unless it is "protected in perpetuity." Agreeing again with the Eleventh Circuit, but this time based upon the Eleventh Circuit's decision in *Pine Mountain Preserve, LLLP v. Commissioner*, 978 F.3d 1200 (11th Cir. 2020), *aff'g in part, rev'g in part, vacating and remanding* 151 T.C. 247 (2018), the majority concluded that the § 170(h)(2)(C) requirement of a "restriction (granted in perpetuity)" was met because the deed in this case recited that the easement property was to be held for conservation purposes "forever predominantly in its natural, scenic, and open space condition." 162 T.C. at ___. Further, as the Eleventh Circuit held in *Pine Mountain*, the majority agreed that a broad limitation on the use of the property as a whole for conservation purposes satisfies § 170(h)(2)(C) even if there are narrow exceptions to that limitation in the easement deed. Concerning the "protected in perpetuity" requirement of § 170(h)(5), the majority again followed the Eleventh Circuit's decision in *Pine Mountain*. The Eleventh Circuit reasoned in *Pine Mountain* that the "protected in perpetuity" language of § 170(h)(5) draws upon the common law usage of the term, meaning simply that the granted property will not automatically revert to the grantor or the grantor's heirs and assigns. The majority concluded that its "review of the entire deed reveals nothing in the grant that 'envisions a reversion of the easement interest to the landowner, its heirs, or assigns.'" 162 T.C. at ____ (quoting *Pine Mountain*, 978 F.3d at 1206). Lastly, the majority rejected a last-ditch argument by the IRS that the easement deed's language about sharing eminent domain proceeds "after the satisfaction of prior claims" violated the "perpetuity" requirement of either § 170(h)(2)(C) or (h)(5). The majority rejected this argument by the IRS because (i) the IRS conceded that there were no existing "prior claims" at the time the taxpayer granted the conservation easement, and (ii) the IRS could not point to any interpretation under Oklahoma law that the "after the satisfaction of prior claims" language applies to claims arising after the conservation easement deed is granted but before the condemnation or other disposition of the property.

Concurring opinion. Judge Buch, joined by Judge Copeland, concurred in the result, but wrote separately to express his opinion that the majority could have decided the case on the basis of the conservation easement deed and the relevant statutory language without invalidating the "extinguishment proceeds regulation" (Reg. § 1.170A-14(g)(6)(ii)). Judge Buch and Judge Copeland apparently would have accepted the taxpayer's first argument that the easement deed met the requirements of Reg. § 1.170A-14(g)(6)(ii) by "explicit incorporation."

Dissenting opinion. Judge Kerrigan, joined by Judges Nega, Pugh, and Ashford), dissented from the majority and concurring opinions, writing succinctly:

> I disagree with the opinion of the Court for three reasons. First, I do not think it necessary to decide the validity of Treasury Regulation § 1.170A-14(g)(6)(ii) to resolve the Cross-Motions for Partial Summary Judgment. Second, I supported the opinion of the Court in [*Oakbrook*], and I find no compelling reason to change my position. Third, the longstanding principle of stare decisis should be followed.

162 T.C. at ____.

Comment. The slim (7-2-4) Tax Court majority in this case (Jones, Foley, Urda, Toro, Greaves, Marshall, and Weiler) sustained taxpayer arguments that an overwhelming (12-1-1) majority (Lauber, Foley, Gale, Thornton, Paris, Morrison, Kerrigan, Buch, Nega, Pugh, Ashford, and Copeland) rejected only four years earlier in *Oakbrook*. Moreover, as mentioned above, *Oakbrook* was upheld by the Sixth Circuit in 2022. Consequently, the Tax Court has now aligned itself with the Eleventh Circuit, which, as mentioned above, struck down the extinguishment proceeds regulation in 2021 as procedurally invalid under the APA. Further, the Tax Court has reversed itself even though the U.S. Supreme Court declined in 2023 to resolve the split between the Sixth and Eleventh Circuits. *See Oakbrook Land Holdings, LLC v. Commissioner*, 143 S.Ct. 626 (1/9/23). On one hand, as Judge Jones wrote for the majority, perhaps the Tax Court's recent flip-flop "is the right time to 'gracefully and good naturedly surrender . . . former views to a better considered position.'" 162 T.C. at ____. On the other hand, if the Tax Court desires to resolve the hundreds of conservation easement cases on its docket, completely changing its mind from just a few years ago may not be the best course. As Judge Kerrigan wrote in dissent, "In 21 cases between 2016 and 2021, [the Tax Court] sustained the disallowance of charitable contribution deductions because the deeds of easement failed to comply with the [extinguishment] proceeds regulation." 162 T.C. at ____. *We cannot help but wonder if the taxpayers who lost in those 21 prior Tax Court cases are a bit upset and are scrambling to file claims for refund (assuming, of course, the statute of limitations has not expired).*

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

1. Is the IRS ever going to learn that the § 6751(b) supervisory approval requirement is not met unless the required supervisory approval of a penalty occurs *before* the initial determination that formally communicates the penalty to the taxpayer? Laidlaw's Harley Davidson Sales, Inc. v. Commissioner, 154 T.C. 68 (1/16/20). The taxpayer, a C corporation, failed to disclose its participation in a listed transaction as required by § 6011 and Reg. § 1.6011-4(a). The IRS revenue agent examining the taxpayer's return issued a 30-day letter to the taxpayer offering the opportunity for the taxpayer to appeal the proposal to the IRS Office of Appeals (IRS Appeals). The 30-day letter proposed to assess a penalty under § 6707A for failing to disclose a reportable transaction. Approximately three months after the 30-day letter was issued, the revenue agent's supervisor approved the penalty by signing a Civil Penalty Approval Form. Following unsuccessful discussions with IRS Appeals, the IRS assessed the penalty and issued a notice of levy. The taxpayer requested a collection due process (CDP) hearing with Appeals, following which Appeals issued a notice of determination sustaining the proposed levy. In response to the notice of determination, the taxpayer filed a petition in the Tax Court. In the Tax Court, the taxpayer filed a motion for summary judgment on the basis that the IRS had failed to comply with the supervisory approval requirement of § 6751(b). Section 6751(b)(1) requires that the "initial determination" of the assessment of a penalty be "personally approved (in writing) by the immediate supervisor of the individual making such determination." The Tax Court (Judge Gustafson) granted the taxpayer's motion. The court first concluded that the supervisory approval requirement of § 6751(b) applies to the penalty imposed by § 6707A. Next, the court concluded that the supervisory approval of the §6707A penalty in this case was not timely because it had not occurred before the IRS's initial determination of the penalty. The parties stipulated that the 30-

day letter issued to the taxpayer reflected the IRS's initial determination of the penalty. The supervisory approval of the penalty occurred three months later and therefore, according to the court, was untimely. The IRS argued that the supervisory approval was timely because it occurred before the IRS's *assessment* of the penalty. In rejecting this argument, the court relied on its prior decisions interpreting § 6751(b), especially *Clay v. Commissioner*, 152 T.C. 23 (2019), in which the court held in a deficiency case "that when it is 'communicated to the taxpayer formally … that penalties will be proposed', section 6751(b)(1) is implicated." In *Clay*, the IRS had issued a 30-day letter when it did not have in hand the required supervisory approval of the relevant penalty. The IRS can assess the penalty imposed by § 6707A without issuing a notice of deficiency. Nevertheless, the court observed "[t]hough Clay was a deficiency case, we did not intimate that our holding was limited to the deficiency context." The court summarized its holding in the present case as follows:

> Accordingly, we now hold that in the case of the assessable penalty of section 6707A here at issue, section 6751(b)(1) requires the IRS to obtain written supervisory approval before it formally communicates to the taxpayer its determination that the taxpayer is liable for the penalty.

The court therefore concluded that it had been an abuse of discretion for the IRS Office of Appeals to determine that the IRS had complied with applicable laws and procedures in issuing the notice of levy. The court accordingly granted the taxpayer's motion for summary judgment.

a. "We are all textualists now," says the Ninth Circuit. When the IRS need not issue a notice of deficiency before assessing a penalty, the language of § 6751(b) contains no requirement that supervisory approval be obtained before the IRS formally communicates the penalty to the taxpayer. Laidlaw's Harley Davidson Sales, Inc. v. Commissioner, 29 F.4th 1066 (9th Cir. 3/25/22), *rev'g* 154 T.C. 68 (1/16/20). In an opinion by Judge Bea, the U.S. Court of Appeals for the Ninth Circuit has reversed the decision of the Tax Court and held that, when the IRS need not issue a notice of deficiency before assessing a penalty, the IRS can comply with the supervisory approval requirement of § 6751(b) by obtaining supervisory approval of the penalty before assessment of the penalty provided that approval occurs when the supervisor still has discretion whether to approve the penalty. As previously discussed, the taxpayer, a C corporation, failed to disclose its participation in a listed transaction as required by § 6011 and Reg. § 1.6011-4(a). The IRS revenue agent examining the taxpayer's return issued a 30-day letter to the taxpayer offering the opportunity for the taxpayer to appeal the proposal to the IRS Office of Appeals (IRS Appeals). The 30-day letter proposed to assess a penalty under § 6707A for failing to disclose a reportable transaction. After the taxpayer had submitted a letter protesting the proposed penalty and requesting a conference with IRS Appeals, and approximately three months after the revenue agent issued the 30-day letter, the revenue agent's supervisor approved the proposed penalty by signing Form 300, Civil Penalty Approval Form. The Tax Court held that § 6751(b)(1) required the IRS to obtain written supervisory approval before it formally communicated to the taxpayer its determination that the taxpayer was liable for the penalty, i.e., before the revenue agent issued the 30-day letter. On appeal, the government argued that § 6751(b) required only that the necessary supervisory approval be secured before the IRS's *assessment* of the penalty as long as the supervisory approval occurs at a time when the supervisor still has discretion whether to approve the penalty. The Ninth Circuit agreed. In agreeing with the government, the court rejected the Tax Court's holding that § 6751(b) requires supervisory approval of the *initial determination* of the assessment of the penalty and therefore requires supervisory approval before the IRS formally communicates the penalty to the taxpayer. According to the Ninth Circuit, "[t]he problem with Taxpayer's and the Tax Court's interpretation is that it has no basis in the text of the statute." The court acknowledged the legislative history of § 6751(b), which indicates that Congress enacted the provision to prevent IRS revenue agents from threatening penalties as a means of encouraging taxpayers to settle. But the text of the statute as written, concluded the Ninth Circuit, does not support the interpretation of the statute advanced by the Tax Court and the taxpayer. The court summarized its holding as follows:

> Accordingly, we hold that § 6751(b)(1) requires written supervisory approval before the assessment of the penalty or, if earlier, before the relevant supervisor loses discretion whether to approve the penalty assessment. Since, here, Supervisor Korzec gave written approval of the initial penalty determination before the penalty was assessed and while she had discretion to withhold approval, the IRS satisfied § 6751(b)(1).

The court was careful to acknowledge that supervisory approval might be required at an earlier time when the IRS must issue a notice of deficiency before assessing a penalty because, "once the notice is sent, the Commissioner begins to lose discretion over whether the penalty is assessed." The IRS can assess the penalty in this case, imposed by § 6707A, without issuing a notice of deficiency.

Dissenting opinion by Judge Berzon. In a dissenting opinion, Judge Berzon emphasized that the 30-day letter the revenue agent sent to the taxpayer was an operative determination. The letter indicated that, if the taxpayer took no action in response, the penalty would be assessed. Judge Berzon analyzed the text of the statute and its legislative history and concluded as follows:

> In my view, then, the statute means what it says: a supervisor must personally approve the "initial determination" of a penalty by a subordinate, or else no penalty can be assessed based on that determination, whether the proposed penalty is objected to or not. 26 U.S.C. §§ 6751(b)(1). That meaning is consistent with Congress's purpose of preventing threatened penalties never approved by supervisory personnel from being used as a "bargaining chip" by lower-level staff, S. Rep. No. 105-174, at 65 (1998); see *Chai v. Commissioner*, 851 F.3d 190, 219 (2d Cir. 2017), which is exactly what happened here.

Because the 30-day letter was an operative determination, according to the dissent, "supervisory approval was required at a time when it would be meaningful-before the letter was sent."

b. Is the tide turning in favor of the government? The Eleventh Circuit has held that, when the IRS must issue a notice of deficiency before assessing tax, the government can comply with the requirement of § 6751(b) that there be written supervisory approval of penalties by securing the approval at any time before assessment of the penalty. Kroner v. Commissioner, 48 F. 4th 1272 (11th Cir. 9/13/22), *rev'g* T.C. Memo. 2020-73. In an opinion by Judge Marvel, the U.S. Court of Appeals for the Eleventh Circuit has held that, when the IRS must issue a notice of deficiency before assessing a penalty, the IRS can comply with the supervisory approval requirement of § 6751(b) by obtaining supervisory approval at any time before assessment of the penalty. The court's holding is contrary to a series of decisions of the Tax Court and contrary to a decision of the U.S. Court of Appeals for the Second Circuit. Section 6751(b)(1) provides:

> No penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate.

Second Circuit's reasoning in Chai v. Commissioner. In *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017), the Second Circuit focused on the language of § 6751(b)(1) and concluded that it is ambiguous regarding the timing of the required supervisory approval of a penalty. Because of this ambiguity, the court examined the statute's legislative history and concluded that Congress's purpose in enacting the provision was "to prevent IRS agents from threatening unjustified penalties to encourage taxpayers to settle." That purpose, the court reasoned, undercuts the conclusion that approval of the penalty can take place at any time, even just prior to assessment. The court held "that § 6751(b)(1) requires written approval of the initial penalty determination no later than the date the IRS issues the notice of deficiency (or files an answer or amended answer) asserting such penalty." Further, the court held "that compliance with § 6751(b) is part of the Commissioner's

burden of production and proof in a deficiency case in which a penalty is asserted. … Read in conjunction with § 7491(c), the written approval requirement of § 6751(b)(1) is appropriately viewed as an element of a penalty claim, and therefore part of the IRS's prima facie case."

Tax Court's prior decisions in other cases. In *Graev v. Commissioner*, 149 T.C. 485 (2017), a reviewed opinion by Judge Thornton, the Tax Court (9-1-6) reversed its earlier position and accepted the interpretation of § 6751(b)(1) set forth by the Second Circuit in *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017). Since *Graev*, the Tax Court's decisions have focused on what constitutes the *initial determination* of the penalty in question. These decisions have concluded that the initial determination of a penalty occurs in the document through which the IRS Examination Division notifies the taxpayer in writing that the examination is complete and it has made a decision to assert penalties. *See, e.g.*, *Belair Woods, LLC v. Commissioner*, 154 T.C. 1 (2020); *Beland v. Commissioner*, 156 T.C. 80 (2021). Accordingly, if the IRS notifies the taxpayer that it intends to assert penalties in a document such as a revenue agent's report, and if the IRS fails to secure the required supervisory approval before that notification occurs, then § 6751(b)(1) precludes the IRS from asserting the penalty.

Facts of this case. In the current case, *Kroner v. Commissioner*, the taxpayer failed to report as income just under $25 million in cash transfers from a former business partner. The IRS audited and, at a meeting with the taxpayer's representatives on August 6, 2012, provided the taxpayer with a letter (Letter 915) and revenue agent's report proposing to increase his income by the cash he had received and to impose just under $2 million in accuracy-related penalties under § 6662. The letter asked the taxpayer to indicate whether he agreed or disagreed with the proposed changes and provided him with certain options if he disagreed, such as providing additional information, discussing the report with the examining agent or the agent's supervisor, or requesting a conference with the IRS Appeals Office. The letter also stated that, if the taxpayer took none of these steps, the IRS would issue a notice of deficiency. The IRS later issued a formal 30-day letter (Letter 950) dated October 31, 2012, and an updated examination report. The 30-day letter provided the taxpayer with the same options as the previous letter if he disagreed with the proposed adjustments and stated that, if the taxpayer took no action, the IRS would issue a notice of deficiency. The 30-day letter was signed by the examining agent's supervisor. On that same day, the supervisor also signed a Civil Penalty Approval Form approving the accuracy-related penalties. The IRS subsequently issued a notice of deficiency and, in response, the taxpayer filed a timely petition in the U.S. Tax Court.

Tax Court's reasoning in this case. The Tax Court (Judge Marvel) upheld the IRS's position that the cash payments the taxpayer received were includible in his gross income but held that the IRS was precluded from imposing the accuracy-related penalties. The Tax Court reasoned that the August 6 letter (Letter 915) was the IRS's initial determination of the penalty and that the required supervisory approval of the penalty did not occur until October 31, and therefore the IRS had not complied with § 6751(b).

Eleventh Circuit's reasoning in this case. The Eleventh Circuit rejected the reasoning of the Tax Court as well as the reasoning of the Second Circuit in *Chai v. Commissioner*:

> We disagree with Kroner and the Tax Court. We conclude that the IRS satisfies Section 6751(b) so long as a supervisor approves an initial determination of a penalty assessment before it assesses those penalties. *See Laidlaw's Harley Davidson Sales, Inc. v. Comm'r*, 29 F.4th 1066, 1071 (9th Cir. 2022). Here, a supervisor approved Kroner's penalties, and they have not yet been assessed. Accordingly, the IRS has not violated Section 6751(b).

The Eleventh Circuit first reasoned that the phrase "determination of such assessment" in § 6751(b) is best interpreted not as a reference to communications to the taxpayer, but rather as a reference to the IRS's conclusion that it has the authority and duty to assess penalties and its resolution to do so. The court explained:

> The "initial" determination may differ depending on the process the IRS uses to assess a penalty. … But we are confident that the term "initial determination of such assessment" has nothing to do with communication and everything to do with the formal process of calculating and recording an obligation on the IRS's books.

The court then turned to the question of *when* a supervisor must approve a penalty in order to comply with § 6751(b). The court analyzed the language of § 6751(b) and concluded: "We likewise see nothing in the text that requires a supervisor to approve penalties at any particular time before assessment." Thus, according to the Eleventh Circuit, the IRS can comply with § 6751(b) by obtaining supervisory approval of a penalty at any time, even just before assessment.

Finally, the court reviewed the Second Circuit's decision in *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017), in which the court had interpreted § 6751(b) in light of Congress's purpose in enacting the provision, which, according to the Second Circuit, was to prevent IRS agents from threatening unjustified penalties to encourage taxpayers to settle. According to the Eleventh Circuit, the *Chai* decision did not take into account the full purpose of § 6751(b). The purpose of the statute, the court reasoned, was not only to prevent unjustified threats of penalties, but also to ensure that only accurate and appropriate penalties are imposed. There is no need for supervisory approval to occur at any specific time before the assessment of penalties, the court explained, to ensure that penalties are accurate and appropriate and therefore carry out this aspect of Congress's purpose in enacting the statute. Further, the Eleventh Circuit concluded, there is no need for a pre-assessment deadline for supervisory approval to reduce the use of penalties as a bargaining chip by IRS agents. This is so, according to the court, because negotiations over penalties occur even after a penalty is assessed, such as in administrative proceedings after the IRS issues a notice of federal tax lien or a notice of levy. (This latter point by the court seems to us to be a stretch. Although it is possible to have penalties reduced or eliminated post-assessment, such post-assessment review does not meaningfully reduce the threat of penalties by IRS agents to encourage settlement at the examination stage.)

Concurring opinion by Judge Newsom. In a concurring opinion, Judge Newsom cautioned against interpreting statutes by reference to their legislative histories: "Without much effort, one can mine from § 6751(b)'s legislative history other—and sometimes conflicting—congressional 'purposes.'" The legislative history, according to Judge Newsom, is "utterly unenlightening." Statutes, in his view, should be interpreted by reference to their text.

c. Yes, the tide seems to be turning. The Tenth Circuit has held that, when the IRS must issue a notice of deficiency before assessing tax, the government can comply with the requirement of § 6751(b) that there be written supervisory approval of penalties by securing the approval no later than the date the IRS issues the notice of deficiency formally asserting a penalty. Minemyer v. Commissioner, 131 A.F.T.R.2d 2023-364 (10th Cir. 1/19/23), *aff'g in part and rev'g in part* T.C. Memo. 2020-99 (7/1/20). In an unpublished order and judgment by Judge Tymkovich, the U.S. Court of Appeals for the Tenth Circuit has held that, when the IRS must issue a notice of deficiency before assessing a penalty, the IRS can comply with the supervisory approval requirement of § 6751(b) by obtaining supervisory approval on or before the date on which the IRS issues a notice of deficiency.

The taxpayer in this case was indicted on two counts of tax evasion for the years 2000 and 2001. The taxpayer pleaded guilty with respect to the year 2000 and, in exchange, the government dismissed the count for 2001. Subsequently, the IRS asserted deficiencies for 2000 and 2001 and § 6663 civil fraud penalties for both years. In 2010, an IRS revenue agent visited the taxpayer in prison and obtained his signature on Form 4549, Income Tax Examination Changes, in which the IRS proposed the deficiencies and penalties for 2000 and 2001. At that time, the agent's supervisor had not approved the penalties. The taxpayer later requested that his agreement to the deficiencies and penalties be withdrawn. The IRS agreed to the withdrawal and later issued a 30-day letter (Letter 950) asserting the same deficiencies and penalties. The 30-day letter was signed by the

revenue agent's supervisor. The IRS later issued a notice of deficiency asserting the deficiencies and penalties for both years.

Tax Court's Analysis. The taxpayer challenged the notice of deficiency by filing a petition in the U.S. Tax Court. The Tax Court (Judge Kerrigan) granted summary judgment in favor of the IRS as to the deficiencies for both years and as to the fraud penalty for 2000. Following a trial, the Tax Court held that the IRS was precluded from asserting the fraud penalty for 2001 by § 6751(b)(1). (The court also held that conviction for tax evasion on the 2000 count collaterally estopped the taxpayer from challenging the civil fraud penalty for 2000.) Section 6751(b)(1) provides:

> No penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate.

The Tax Court's prior decisions have focused on what constitutes the *initial determination* of the penalty in question. These decisions have concluded that the initial determination of a penalty occurs in the document through which the IRS Examination Division notifies the taxpayer in writing that the examination is complete and it has made a decision to assert penalties. *See, e.g.*, *Belair Woods, LLC v. Commissioner*, 154 T.C. 1 (2020); *Beland v. Commissioner*, 156 T.C. 80 (2021). Accordingly, if the IRS notifies the taxpayer that it intends to assert penalties in a document such as a revenue agent's report, and if the IRS fails to secure the required supervisory approval before that notification occurs, then § 6751(b)(1) precludes the IRS from asserting the penalty. In this case, the Tax Court held, the IRS had failed to comply with § 6751(b)(1) because the Form 4549 the revenue agent presented to the taxpayer in prison was the initial determination of the penalties, and the IRS had not secured the required supervisory approval before the agent presented the form to the taxpayer.

Tenth Circuit's Analysis. On appeal, the U.S. Court of Appeals for the Tenth Circuit affirmed the Tax Court's grant of summary judgment to the government as to the deficiencies for both years and as to the fraud penalty for 2000 but reversed the Tax Court's decision as to the penalty for 2001. The court observed that the U.S. Courts of Appeal for the Ninth and Eleventh Circuits have disagreed with the Tax Court's position that the supervisory approval before the IRS first communicates to the taxpayer that it intends to assert penalties. See *Laidlaw's Harley Davidson Sales, Inc. v. Commissioner*, 29 F.4th 1066 (9th Cir. 3/25/22); *Kroner v. Commissioner*, 48 F. 4th 1272 (11th Cir. 9/13/22). The court agreed with the Ninth and Eleventh Circuits:

> We agree with these assessments of § 6751(b)(1) and hold that its plain language does not require approval before proposed penalties are communicated to a taxpayer.

The Tenth Circuit then addressed the question of what timing requirement, if any, § 6751(b)(1) imposes on the government to obtain the necessary supervisory approval. The court analyzed the Second Circuit's decision in *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017), and agreed with the Second Circuit's analysis:

> We are persuaded by the Second Circuit's reasoning and hold that with respect to civil penalties, the requirements of § 6751(b)(1) are met so long as written supervisory approval of an initial determination of an assessment is obtained on or before the date the IRS issues a notice of deficiency.

Because the revenue agent's supervisor had approved the 2001 civil fraud penalty before the IRS issued the notice of deficiency, the Tenth Circuit reversed the Tax Court's decision as to the 2001 penalty and remanded a determination of whether the taxpayer was liable for the penalty.

d. The turning tide now seems to have washed over the Tax Court--at least in this case appealable to the Ninth Circuit. Kraske v. Commissioner, 161 T.C. No. 7 (10/26/23). This Tax Court decision presents an opportunity to synthesize for our readers the case law

developments over the last few years (as detailed above) concerning the supervisory approval requirement of § 6751(b)(1). Readers will recall that § 6751(b)(1) requires the "initial determination" of the assessment of certain (but not all) federal income tax penalties be "personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate." The bare language of the poorly drafted statute is ambiguous, leaving room for various interpretations as evidenced by numerous recent court decisions. For a thorough discussion and analysis of the "hundreds of cases" that have been decided under § 6751(b)(1), see Gianni, *Supervisory Approval of Penalties: The Opening of a Graev Pandora's Box*, 76 Tax Lawyer 41 (2022). Professor Gianni ultimately concludes that § 6751(b)(1) should be retroactively repealed and replaced as proposed (but never passed) in H.R. 5376, 117th Cong. §§ 138404(a), 138404(c)(1). Professor Gianna also details in her article the many penalties that are and are not subject to the supervisory approval requirement of § 6751(b)(1).

The Tax Court. The Tax Court has taken an expansive view of § 6751(b)(1) regarding what constitutes the *initial determination* of the penalty in question. In a series of cases beginning with *Graev v. Commissioner*, 149 T.C. 485 (2017), the Tax Court reversed its earlier position that supervisory approval need only occur before assessment of the penalties subject to § 6751(b)(1). Instead, the Tax Court in *Graev* accepted the Second Circuit's interpretation of § 6751(b)(1) as set forth in *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017): "that § 6751(b)(1) requires written approval of the initial penalty determination no later than the date the IRS issues the notice of deficiency (or files an answer or amended answer) asserting such penalty." Then, in subsequent cases, the Tax Court has gone further, generally holding that:

- The supervisory approval requirement of § 6751(b)(1) applies to both "assessable penalties" (i.e., penalties not subject to deficiency procedures, like § 6707A concerning failure to disclose a reportable transaction) and to penalties that are subject to deficiency procedures (like the § 6662(a) and (b)(2) accuracy-related penalties); and
- Supervisory approval must be obtained under § 6751(b)(1) on or before the date of the *initial determination* of the penalty in question, which is the earlier of (1) the date on which the IRS issues the notice of deficiency or (2) the date on which the IRS "formally communicates" (such as in a Revenue Agent's Report) to the taxpayer the assertion of a penalty or penalties subject to § 6751(b)(1).

See, e.g., *Clay v. Commissioner*, 152 T.C. 23 (2019), *aff'd on other grounds*, 990 F.3d 1296 (11th Cir. 2021), *cert. denied*, 142 S. Ct. 342 (2021); *Belair Woods, LLC v. Commissioner*, 154 T.C. 1 (2020); *Beland v. Commissioner*, 156 T.C. 80 (2021).

The Circuit Courts. The Circuit Court interpretations of § 6751(b)(1) have not been as expansive as the Tax Court's, but they have not been consistent either.

- As mentioned above, the Second Circuit in *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017), *aff'g in part and rev'g in part*, T.C. Memo 2015-42, held that, for penalties subject to deficiency procedures (like the § 6662 accuracy-related penalties) "§ 6751(b)(1) requires written approval of the initial penalty determination no later than the date the IRS issues the notice of deficiency (or files an answer or amended answer) asserting such penalty."
- The Ninth Circuit in *Laidlaw's Harley Davidson Sales, Inc. v. Commissioner*, 29 F.4th 1066 (9th Cir. 2022), *rev'g*, 154 T.C. 68 (2020), held that for an "assessable penalty" not requiring a deficiency procedure (like the penalty imposed by § 6707A for failure to disclose a reportable transaction) the § 6751(b)(1) supervisory approval requirement applies "before the assessment of the penalty or, if earlier, before the relevant supervisor loses discretion whether to approve the penalty assessment."
- The Eleventh Circuit in *Kroner v. Commissioner*, 48 F. 4th 1272 (11th Cir. 2022), *rev'g*, T.C. Memo. 2020-73, held that, for penalties subject to deficiency procedures,

the IRS may comply with § 6751(b)(1) by obtaining supervisory approval at any time, even just before assessment. Writing in reversal of the Tax Court, the Eleventh Circuit stated: "The 'initial' determination may differ depending on the process the IRS uses to assess a penalty…But we are confident that the term 'initial determination of such assessment' has nothing to do with communication and everything to do with the formal process of calculating and recording an obligation on the IRS's books."

- The Tenth Circuit, in an unpublished opinion, *Minemyer v. Commissioner*, 131 A.F.T.R.2d 2023-364 (10th Cir. 2023), *aff'g in part and rev'g in part*, T.C. Memo. 2020-99 (2020), aligned itself with the Second Circuit by holding in a case concerning penalties subject to deficiency procedures that "the requirements of § 6751(b)(1) are met so long as written supervisory of an initial determination of an assessment is obtained on or before the date the IRS issues a notice of deficiency.

The Facts in Kraske. The Tax Court in *Kraske v. Commissioner*, 161 T.C. No. 7 (10/26/23), a case appealable to the Ninth Circuit, signaled that it may be reconsidering its expansive interpretation of § 6751(b)(1) and backing off its view that supervisory approval must come on or before the IRS "formally communicates" proposed penalties to a taxpayer. On June 2, 2014, the examining agent within the IRS's Small Business and Self-Employed Division sent the taxpayer in *Kraske* a Letter 692 (15-day letter) proposing in part the imposition of accuracy-related penalties under § 6662. The 15-day letter further advised that if the taxpayer did not respond within 15 days, a notice of deficiency would be issued. Almost a month after the deadline passed for responding to the 15-day letter, the taxpayer on July 16, 2014, mailed the IRS examining agent a letter disagreeing with the examining agent's proposed tax adjustments and penalties. Coincidentally, on that same day, July 16, 2024, the examining agent, not having received a response to the 15-day letter from the taxpayer after having been promised it several times, closed the case as unagreed and forwarded it to the agent's group manager, who was the agent's immediate supervisor. On July 21, 2014, the group manager reviewed the case, signed approval forms regarding the agent's assertion of accuracy-related penalties under § 6662, and approved the case for closure. The case was then forwarded to Appeals on July 24, 2014, immediately after the IRS received on that date the taxpayer's July 16, 2014, letter objecting to the proposed tax adjustments and penalties. IRS Appeals received the case on August 12, 2014, and after the taxpayer and Appeals were unable to settle matters, a notice of deficiency was issued to the taxpayer on July 28, 2015. Before the Tax Court, the taxpayer argued that imposition of any accuracy-related penalty under § 6662 was improper because the IRS had not timely obtained supervisory approval under § 6751(b)(1).

The Tax Court's Opinion in Kraske. In an opinion written by Judge Gale, the Tax Court acknowledged that under the court's holding in *Clay v. Commissioner*, 152 T.C. 23 (2019), *aff'd on other grounds*, 990 F.3d 1296 (11th Cir. 2021), *cert. denied*, 142 S. Ct. 342 (2021), the supervisory approval obtained in *Kraske* would be considered untimely under § 6751(b)(1) because it came after a "formal communication" (i.e., the 15-day letter) of the proposed penalties was sent to the taxpayer. Judge Gale noted, however, that because the case was appealable to the Ninth Circuit, the Ninth Circuit's decision in *Laidlaw's Harley Davidson Sales, Inc. v. Commissioner*, 29 F.4th 1066 (9th Cir. 2022), *rev'g*, 154 T.C. 68 (2020), must be considered. As noted above, *Laidlaw's Harely Davidson Sales, Inc.* concerned an "assessable penalty," not a penalty subject to deficiency procedures as in *Kraske*. Arguably, then, *Laidlaw's Harley Davidson Sales, Inc.* was distinguishable, and the Tax Court was not necessarily bound to follow it under a strict application of *Golsen v. Commissioner*, 54 T.C. 742, 756-57 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971) (holding that "better judicial administration...requires us to follow a Court of Appeals decision which is squarely in point where appeal from our decision lies to that Court of Appeals and to that court alone)." Judge Gale also noted, though, that the so-called *Golson* doctrine allows the Tax Court to examine not just the narrow holding of a binding Circuit Court decision, but also the underlying rationale of the decision. On this basis, Judge Gale determined that the

Golsen doctrine should apply in *Kraske*, resulting in the Tax Court ruling in favor of the government and against the taxpayer. Judge Gale wrote:

> The rationale of the Ninth Circuit's holding in *Laidlaw's Harley Davidson* is clear regarding the timing of supervisory approval. The Ninth Circuit rejected outright our position in *Clay* that the supervisory approval required by section 6751(b)(1) is timely only if it is obtained before a formal communication to the taxpayer that penalties would be proposed, finding that our interpretation "has no basis in the text of the statute." [Citation omitted.] Instead, the Ninth Circuit opined that approval is timely at any time before assessment, provided the supervisor retains discretion to give or withhold approval.

Judge Gale then ruled that the timeline for supervisory approval under § 6751(b)(1) in *Kraske* was "well within the parameters . . . found timely by the Ninth Circuit in *Laidlaw's Harley Davidson*," explaining further:

> When the supervisor approved the penalties on July 21, 2014, it was more than a month past the deadline for [the taxpayer] to respond to the 15-day letter, and the [examining agent] had not received a written request for Appeals' consideration from him. Although [the taxpayer] had mailed such a request on July 16, 2014, it was not received by the [examining agent] until July 24, 2014--three days after written supervisory approval had been given. The case was not received by Appeals until August 12, 2014--over three weeks after supervisory approval had been given. Thus, the [examining agent's] immediate supervisor retained discretion to approve or to withhold approval of the penalties when she did so on July 21 because the case had not yet been transferred to Appeals (at which time the Small Business and Self-Employed Division's jurisdiction over the case, and the supervisor's discretion, may have terminated).

2. What's the point of a penalty if the IRS is precluded from collecting it? The Tax Court has held that there is no statutory authority for the IRS to assess penalties imposed by § 6038(b) for failure to file information returns with respect to foreign business entities and that the IRS therefore cannot proceed to collect the penalties through a levy. Farhy v. Commissioner, 160 T.C. No. 6 (4/3/23). Section 6038(a) requires every United States person to provide information with respect to any foreign business entity the person controls (defined in § 6038(e)(2) as owning more than 50 percent of all classes of stock, measure by vote or value). The form prescribed for providing this information is Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations. Section 6038(b)(1) imposes a penalty of $10,000 for each annual accounting period for which a person fails to provide the required information. In addition, § 6038(b)(2) imposes a continuation penalty of $10,000 for each 30-day period that the failure continues up to a maximum continuation penalty of $50,000 per annual accounting period. In this case, the taxpayer was required to file Form 5471 for several years with respect to two wholly-owned corporations organized in Belize but failed to do so. The IRS assessed a penalty under § 6038(b)(1) of $10,000 and a continuation penalty of $50,000 for each of the years in issue. In response to a notice of levy, the taxpayer requested a collection due process (CDP) hearing. In the CDP hearing, the taxpayer argued that the IRS had no legal authority to assess § 6038 penalties. Following the CDP hearing, the IRS issued a notice of determination upholding the proposed collection action and the taxpayer challenged this determination by filing a petition in the Tax Court. The Tax Court (Judge Marvel) agreed with the taxpayer and held that there is no statutory authority for the IRS to assess § 6038 penalties. The IRS argued that § 6201(a), which authorizes the Secretary of the Treasury to make the "assessments of all taxes (including interest, additional amounts, additions to the tax, and assessable penalties) imposed by this title" authorizes assessment of penalties imposed by § 6038. The court disagreed, however, and reasoned that the term "assessable penalties" in § 6201(a) does not automatically apply to all penalties in the Code. The court observed that (1) §§ 6671(a) and 6665(a)(1) provide that penalties imposed by specified Code sections shall be assessed and collected in the same manner as taxes and

(2) Code sections other than those specified by §§ 6671(a) and 6665(a)(1) commonly provide that the penalty is a tax or assessable penalty for purposes of collection or are expressly covered by (or contain a cross-reference to) one of the specified Code sections. In contrast, the court explained, § 6038 is not one of the Code sections specified by §§ 6671(a) and 6665(a)(1) and contains only a cross-reference to a criminal penalty provision. The court also rejected the IRS's argument that § 6038 penalties are "taxes" within the meaning of § 6201(a) and therefore subject to assessment. In short the court held, although § 6038(b) provides penalties for failure to provide the information required by § 6038(a), there is no statutory authority for assessment of those penalties and the IRS therefore is unable to collect those penalties through a levy.

- The court's holding that there is no authority for assessment of § 6038 penalties suggests that (1) the IRS would be precluded from exercising its other administrative collection powers, such as a lien or a refund offset, and (2) the mechanism for the IRS to collect § 6038 penalties is a civil action under 28 U.S.C. § 2461(a).

- The court's decision is appealable to the U.S. Court of Appeals for the D.C. Circuit.

a. The Tax Court has again held that the IRS lacks authority to assess penalties under § 6038(b) and has held that penalties imposed by § 6677 for failure to file information returns regarding foreign trusts are not fines and therefore do not violate the Excessive Fines clause of the Eighth Amendment. Mukhi v. Commissioner, 162 T.C. No. 8 (4/8/24). The taxpayer in this case held controlling interests in a foreign trust and a foreign corporation. The taxpayer failed to comply with three reporting requirements:

- Section 6038(a) requires every United States person to provide information with respect to any foreign business entity the person controls (defined in § 6038(e)(2) as owning more than 50 percent of all classes of stock, measure by vote or value). The form prescribed for providing this information is Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations.
- Section 6048(a) requires written notice to the IRS of either the creation of a foreign trust by a United States person or the transfer of money or property to a foreign trust by a United States person. The form prescribed for complying with § 6048(a) is Forms 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts.
- Section 6048(b) requires every United States person to provide information with respect to any foreign trust of which the person is treated as the owner. The form prescribed for complying with § 6048(b) is Form 3520-A, Annual Information Return of Foreign Trust With a U.S. Owner.

As previously discussed in connection with the *Farhy* decision, § 6038(b) imposes significant penalties for failure to file Form 5471 to provide information with respect to any foreign business entity the person controls. In addition, § 6677(a)-(b) imposes penalties for failure to file an information return disclosing ownership of a foreign trust (Form 3520-A). For returns required to be filed after December 31, 2009, the penalty is the greater of $10,000 or 5 percent of the gross value of the portion of the trust assets that a United States person is treated as owning. Section 6677(a) imposes penalties for failure to file an information return disclosing the transfer of money or property to a trust (Form 3520). For returns required to be filed after December 31, 2009, the penalty is the greater of $10,000 or 35 percent of the money or property transferred to the foreign trust.

The IRS assessed approximately $5 million in penalties for the taxpayer's failure to file Form 3520, $5.9 million in penalties for failure to file Form 3520-A, and $120,000 in penalties for failure to file Form 5471.

After the IRS issued a final notice of intent to levy and a notice of federal tax lien, the taxpayer requested a collection due process (CDP) hearing. Based on the IRS's estimate of the taxpayer's

reasonable collection potential, the Settlement Officer who conducted the CDP hearing rejected the taxpayer's alternative requests for an installment agreement or an offer-in-compromise. The Settlement Officer issued a notice of determination sustaining the collection action and the taxpayer responded by filing a petition in the Tax Court.

In the Tax Court, the taxpayer argued principally that (1) the IRS had violated his Fifth Amendment due process rights because the Settlement Officer was not independent, (2) the Settlement Officer had abused his discretion in rejecting the taxpayer's offer-in-compromise, and (3) the foreign reporting penalties imposed by §§ 6038(b) and 6677 violate the Excessive Fines Clause of the Eighth Amendment. The Tax Court (Judge Greaves) efficiently disposed of the taxpayer's first two arguments and, because they are highly fact-specific, this discussion will not address those arguments. The significance of the Tax Court's opinion is its holding regarding the third argument.

Section 6038(b) penalties. The Tax Court declined to address whether the penalties imposed by § 6038(b) for failure to timely file Form 5471 violated the Excessive Fines clause of the Eighth Amendment because the court had previously concluded in *Farhy* that the IRS lacks the authority to assess the penalties imposed by § 6038(b). Because the IRS is precluded, in the Tax Court's view, from assessing the penalties, it is precluded from collecting them through a lien or levy. The court declined to reconsider its decision in *Farhy*. The court noted that its decision in *Farhy* was on appeal to the D.C. Circuit and reasoned that, even if the D.C. Circuit reversed the Tax Court's decision in *Farhy*, the holding of the D.C. Circuit would not be binding in this case because any appeal in the current case would be heard by the Eighth Circuit. *See Golsen v. Comm'r*, 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971). The Tax Court then granted summary judgment to the taxpayer and held that the IRS was precluded from collecting the penalties imposed by § 6038(b).

Section 6677 penalties. The Tax Court held that the penalties imposed by § 6677 are not fines and therefore do not violate the Excessive Fines Clause of the Eighth Amendment. In its prior decisions, including its decision in *Thompson v. Commissioner*, 148 T.C. 59, 66 (2017), the Tax Court held that the purpose of civil tax penalties and additions to tax is to encourage voluntary compliance and that such penalties or additions therefore are not punitive. Similarly, the court noted, the U.S. Court of Appeals for the First Circuit concluded in *United States v. Toth*, 33 F.4th 1, 19 (1st Cir. 2022), that penalties for failure to file a Foreign Bank Account Report (FBAR) are not fines. The Eighth Circuit, the court noted, has not ruled on whether the penalties imposed by § 6677 are fines. Because the penalties imposed by § 6677 are civil penalties designed to encourage voluntary compliance, the court held, they are not fines and therefore do not violate the Excessive Fines Clause of the Eighth Amendment. Further, the court held, even if the penalties imposed by § 6677 are fines, they do not violate the Eighth Amendment because they are not excessive. The court reasoned that, under the U.S. Supreme Court's decision in *United States v. Bajakajian*, 524 U.S. 321 (1998):

> To pass the constitutional proportionality inquiry under the Excessive Fines Clause, the amount of the forfeiture or fine must bear some relationship to the gravity of the offense that it is designed to punish. See *Bajakajian*, 524 U.S. at 334. A fine violates the Excessive Fines Clause if "the amount of the forfeiture is grossly disproportional to the gravity of the defendant's offense." *Id*. at 337

The court noted that it had consistently concluded that penalties similar to the penalties imposed by § 6677 are not disproportionate. Accordingly, the court held, even if the penalties imposed by § 6677 are fines, they do not violate the Eighth Amendment.

b. The Tax Court got it wrong, says the D.C. Circuit. Despite the absence of explicit language authorizing the assessment of penalties imposed by § 6038(b), the text, structure, and function of § 6038(b) indicate that the penalties it imposes are assessable. Farhy v. Commissioner, 100 F.4th 223 (D.C. Cir. 5/3/24), *rev'g* 160 T.C. No. 6 (4/3/23). In an opinion by Judge Pillard, the U.S. Court of Appeals for the D.C. Circuit has reversed the Tax Court

and held that statutory authority exists for the assessment of penalties imposed by § 6038(b) and that the IRS therefore is able to collect those penalties through its administrative collection powers, such as a levy. The court first rejected the parties' competing readings of § 6201(a), which authorizes the Secretary of the Treasury to make the "assessments of all taxes (including interest, additional amounts, additions to the tax, and assessable penalties) imposed by this title." The IRS argued that § 6201(a) authorizes the assessment of all taxes and penalties unless the Code expressly requires a different process for a given exaction. The taxpayer argued that § 6201(a) authorizes the assessment of a penalty only if the penalty is explicitly characterized as a "tax" or designated as assessable. The court declined to adopt either interpretation of § 6201(a) and instead based its holding on the text, structure, and function of the specific provision at issue, § 6038(b). The court placed primary emphasis on the history and legislative purpose underlying § 6038(b). Congress enacted § 6038 in 1960. As originally enacted, the penalty for failure to file the required informational return regarding a foreign corporation was a 10-percent reduction in the U.S. taxpayer's foreign tax credit. Congress amended § 6038 in the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, Title III, § 338, 96 Stat. 324, 631, commonly known as TEFRA. The 1982 amendments moved the 10-percent reduction of a taxpayer's foreign tax credit to current § 6038(c) and amended § 6038(b) to impose a new, fixed-dollar penalty for failure to file the required informational return. Amended § 6038(c)(3) coordinates the two penalties by providing that the § 6038(c) reduction of a taxpayer's foreign tax credit is reduced by any fixed-dollar penalty imposed by § 6038(b). These changes, the court observed, were intended to bolster and streamline enforcement of the penalty. The parties in this case agreed that the penalty imposed by § 6038(c) is assessable because a reduction of a taxpayer's foreign tax credit has the effect of increasing a taxpayer's tax liability, and § 6201(a) authorizes the assessment of all taxes imposed by the Internal Revenue Code. The remaining question was whether authority exists for the IRS to assess the penalty imposed by § 6038(b). The court emphasized that Congress's purpose in amending § 6038 in 1982 to add the fixed-dollar penalty currently provided by § 6038(b) was to streamline collection of the penalty. Under the interpretation of § 6038 advanced by the taxpayer, the IRS can assess and therefore collect through its administrative collection powers the penalty imposed by § 6038(c) (the 10-percent reduction in a taxpayer's foreign tax credit) but must instead enforce the fixed-dollar penalty imposed by § 6038(b) by bringing legal action against the taxpayer in a United States District Court. Such an interpretation, the court concluded, does not make sense:

> It would be "highly anomalous" for Congress to have responded to the identified problem of the underuse of subsection (c) penalties by promulgating a penalty that, while simpler to calculate, is much harder to enforce. … That view is contradicted by the clear congressional purpose behind the enactment of subsection (b).

The court also reasoned that the availability of a reasonable cause defense to the penalty imposed by § 6038(b) suggests that the penalty is assessable. A taxpayer can avoid the penalty imposed by § 6038(b) by showing reasonable cause for the noncompliance. See I.R.C. § 6038(c)(4); Reg. § 1.6038-2(k)(3)(ii). Section 6038(c)(4)(B), the court reasoned, "expressly treats the reasonable cause showing for failure to file the relevant informational returns as within the purview of the Service." Further, the court observed, "[i]f the subsection (b) penalty were not assessable, there would be no post-assessment administrative process in which the taxpayer could make a reasonable cause showing to the Secretary." The express contemplation of § 6038 that the Secretary of the Treasury will determine the availability of a reasonable cause defense to the penalties imposed by § 6038 supports treating the penalties imposed by both § 6038(b) and § 6038(c) as assessable. Finally, the court, observed, interpreting the § 6038(b) penalty as not being assessable and therefore collectible only through an action in U.S. District Court and the § 6038(c) penalty as being assessable and collectible through the IRS's administrative collection powers with judicial review of the collection process (following a collection due process hearing) in the Tax Court could lead to inconsistent holdings in the two courts for the same taxpayer and would raise other potential issues:

> We decline to adopt a reading of section 6038(b) that attributes to Congress the intent to respond to the problem it identifies in a manner that is not only ineffective, but counterproductive.

3. Tax Court holds IRS does not need written supervisory approval to apply the 6% excise tax of § 4973 to excess contributions to an IRA. Couturier v. Commissioner, T.C. Memo. 2024-6 (1/17/24). In general, under § 7491(c), the IRS has the burden of production with respect to "any penalty, addition to tax, or additional amount." To satisfy this burden, § 6751(b)(1) requires the IRS to prove that "the initial determination of [the] assessment … [of any penalty was] personally approved (in writing) by the immediate supervisor of the individual making such determination." *See, e.g.*, *Frost v. Commissioner*, 154 T.C. 23, 34-35 (2020). Pursuant to § 6751(c), the term "penalties" as used in § 6571 includes "any addition to tax or any additional amount."

In this case, the taxpayer, a corporate executive, participated in several deferred compensation arrangements. These included shares in an employee stock ownership plan (ESOP) (a qualified retirement plan) and several compensatory plans, none of which was a qualified plan. In 2004, as part of a corporate reorganization, the taxpayer accepted a $26 million buyout from his company, which took the form of a $12 million cash payment to the taxpayer's IRA and a $14 million promissory note payable to his IRA, which the company satisfied in 2005. On his 2004 federal income tax return, he characterized the $26 million as a tax-free "rollover contribution" to his IRA. He left blank line 59, "Additional tax on IRAs, other qualified retirement plans, etc." Similarly, he filed his tax returns for 2005 through 2014 leaving blank line 59. He also did not attach to any of his returns Form 5329, "Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts."

The IRS audited the taxpayer and ultimately issued two notices of deficiency, one for 2004 through 2008 and another for 2019 through 2014. The IRS asserted that, of the $26 million contributed to the taxpayer's IRA, $25.1 million was attributable to his relinquishment of his rights in the non-ESOP deferred compensation plans, which were not eligible for treatment as a tax-free rollover. The IRS's position in the notices of deficiency was that this $25.1 million was an "excess contribution" subject to the 6% excise tax of § 4973(a). Further, under § 4973(b)(2), the excise tax continues to apply for future years until the original excess contribution is distributed to the taxpayer and included in income. Therefore, according to the IRS, the taxpayer owed for the years involved an excise tax in the aggregate amount of approximately $8.5 million. In response to the notices of deficiency, the taxpayer petitioned the Tax Court. He subsequently filed an amended petition in which he argued that the 6% excise tax imposed by § 4973(a) is a penalty subject to the supervisory approval requirement of § 6751(b)(1) and that the IRS was precluded from assessing the penalty because it had failed to comply with the supervisory approval requirement. In the Tax Court, the IRS moved for partial summary judgment and argued that the exaction imposed by § 4973(a) is a "tax" and not a "penalty" and that the supervisory approval requirement of § 6751(b)(1) therefore did not apply.

The Tax Court (Judge Lauber) held that the § 4973(a) exaction is a "tax" and not a "penalty." Because it is a "tax," the court held, it is not subject to the § 6751(b)(1) written supervisory approval requirement. In reaching this conclusion, Judge Lauber relied primarily on the language of § 4973. He noted that the flush language of § 4973(a) refers to the exaction four times and describes it in each case as a "tax." The term "penalty," Judge Lauber observed, "appears nowhere in section 4973(a) or in any of the provision's other six subsections." The court further relied on the placement of § 4973 in the Code. Congress placed § 4973 in Subtitle D, chapter 43 of the Code. Subtitle D, the court pointed out, is captioned "Miscellaneous Excise Taxes" and chapter 43, captioned "Qualified Pension, Etc., Plans," contains 18 Code sections that impose excise taxes on various actions. The court emphasized that, in several prior decisions, it had "held that an exaction constitutes a tax where Congress used the term 'tax' in the Code provision imposing it and situated that provision in a chapter of the Code that provides for 'taxes.' *See, e.g.*, *Grajales v. Commissioner*, 156 T.C. 55 (2021) (holding that the 'additional tax' imposed by section 72(t) is a

'tax' and not a 'penalty' for section 6751(b) purposes), *aff'd*, 47 F.4th 58 (2d Cir. 2022)." In contrast, the court noted, Congress has generally situated penalties in Subtitle F of the Code, captioned "Procedure and Administration." The court also reviewed the legislative history of § 4973 and prior judicial decisions in which a taxpayer's failure file Form 5329 to report the exaction imposed by § 4973 had resulted in an "addition to tax" under § 6651(a)(1) for failure to timely file a return or under § 6651(a)(2) for failure to timely pay tax. "These precedents show that the exaction imposed by section 4973 is "a tax"; otherwise, no "additions to the tax" could have been sustained. No provision of the Code authorizes the imposition of "additions to the tax" with respect to penalties." Finally, the court emphasized that interpreting the exaction imposed by § 4973(a) as a tax is supported by common sense. Congress's purpose in enacting § 6751(b), the court stated, was to help ensure that IRS revenue agents did not threaten penalties to induce taxpayers to settle. A revenue agent, the court observed, could not plausibly assert an excise tax under § 4973(a) at the conclusion of an income tax audit to induce settlement. The court rejected the taxpayer's arguments that (1) in determining whether an exaction is a penalty, the court should look past the statutory text and engage in a functional analysis that treats as penalties all exactions that function as penalties, i.e., that are punitive in nature, (2) the placement of provisions such as § 4973 in the Code is irrelevant in determining whether they impose a penalty because § 7806(b) provides that "[n]o inference, implication, or presumption of legislative construction shall be...made by reason of the location...of any particular [Code] section," and (3) the exaction imposed by § 4973 is an "additional amount" within the meaning of § 6751(c) and therefore a penalty within the meaning of § 6751(b)(1). Accordingly, the court granted the IRS's motion for summary judgment on the issue of whether the supervisory approval requirement of § 6751(b)(1) applied.

B. Discovery: Summonses and FOIA

C. Litigation Costs

D. Statutory Notice of Deficiency

1. Ever heard of a 424-day letter? Well, now you have in this case of first impression from the Tax Court. Dodson v. Commissioner, 162 T.C. No. 1 (1/3/24). The taxpayers in this case received a notice of deficiency dated October 7, *2021* ("first 90-day letter"). The first 90-day letter specified December 5, *2022*, as the last day for filing a petition in the Tax Court. (FYI, December 5, 2022, is 424 days after October 7, 2021.) Promptly realizing its mistake, on October 8, 2021, the IRS sent the taxpayers a "corrected" notice of deficiency ("second 90-day letter") substantially the same as the first 90-day letter but specifying January 6, *2022*, as the last day for filing a petition in the Tax Court. A cover sheet to the second 90-day letter stated: "PREVIOUS NOTICE SENT WITH INCORRECT DATE. CORRECTED NOTICE WITH CORRECT DATES." The taxpayers stated that they did not receive the second 90-day letter. The taxpayers also produced tracking information from the USPS indicating that the second 90-day letter left a distribution center near the taxpayers' address but did not show delivery. On March 3, 2022, 147 days after October 7, 2021, the taxpayers filed a petition in the Tax Court disputing the adjustments proposed by the IRS in the first 90-day letter. The IRS moved to dismiss the taxpayers' petition on the grounds that it was untimely because it was filed beyond the 90-day period specified in § 6213(a) (which was the date reflected in the IRS's corrected, second 90-day letter). The taxpayers, however, argued that their petition in response to the IRS's first 90-day letter was timely because, as the last sentence of § 6213(a) states: "Any petition filed with the Tax Court on or before the last date specified for filing such petition by the Secretary in the notice of deficiency shall be treated as timely filed." In a case of first impression, the Tax Court (Judge Marvel) agreed with the taxpayers. Judge Marvel reasoned that the above-quoted last sentence of § 6213(a) controlled in this case, especially because the IRS did not rescind the first 90-day letter as permitted by § 6212(d). Section 6212(d) permits the IRS to rescind a notice of deficiency mailed to a taxpayer if the taxpayer consents on a properly executed Form 8626 (Agreement to Rescind Notice of Deficiency) or other acceptable document reflecting an agreement to rescind between the IRS and the taxpayer. *See also* Rev. Proc. 98-54, 1998-2 C.B. 529 at 530 (§ 5.07). Judge Marvel further

determined that the second 90-day letter sent by the IRS was insufficient to unilaterally rescind the first 90-day letter. Moreover, the Tenth Circuit, to which an appeal from the Tax Court would lie in this case, has stated: "[I]f a notice indicates a petition date that is more than 90 days after the date of mailing, that date controls." *Smith v. Commissioner*, 275 F.3rd 912 at 916 (10th Cir. 2001). Judge Marvel rejected the IRS's argument that the 90-day period set forth in § 6213(a) nevertheless should apply because the date in the first 90-day letter was an "obvious mistake." The IRS's argument relied in part upon two prior decisions in which the 90-day period in § 6213(a) was enforced even though the notice of deficiency completely omitted a date by which a petition in the Tax Court was required to be filed. *See Smith v. Commissioner*, 114 T.C. 489 (2000), *aff'd* 275 F.3rd 912 (10th Cir. 2001) (notice of deficiency was valid despite failure to specify last date to file a petition in Tax Court); *Rochelle v. Commissioner*, 116 T.C. 356 (2001) (petition filed 143 days after mailing of notice of deficiency was untimely despite failure of notice to specify last date to file a petition in Tax Court). Judge Marvel distinguished *Smith* and *Rochelle* because those cases dealt with circumstances where no filing date for a Tax Court petition was specified, not a situation like the present case in which the specified filing date incorrectly extended beyond the 90-day period of § 6213(a). Judge Marvel reasoned that the IRS's argument "attempts to create uncertainty about the meaning of the last sentence of section 6213(a) where there is none." Anticipating a future case, perhaps, Judge Marvel also wrote: "This is not a case where a taxpayer petitions us for redetermination of a deficiency in a notice that purports to correct a prior notice of deficiency, a circumstance for which we express no view on the application of the last sentence of section 6213(a)."

E. Statute of Limitations

1. The 90-day period specified in § 6213(a) for filing a petition in the U.S. Tax Court is jurisdictional and is not subject to equitable tolling, according to the Tax Court. Hallmark Research Collective v. Commissioner, 159 T.C. No. 6 (11/29/22). In a unanimous, reviewed opinion by Judge Gustafson, the Tax Court has held that the 90-day period specified by § 6213(a) within which taxpayers can challenge a notice of deficiency by filing a petition in the Tax Court is jurisdictional and is not subject to equitable tolling. In this case, the IRS sent a notice of deficiency to the taxpayer. Pursuant to § 6213(a), the taxpayer then had 90 days within which to challenge the notice of deficiency by filing a petition in the U.S. Tax Court. The last day of this 90-day period was September 1, 2021. The taxpayer electronically filed its petition on September 2, 2021, which was one day late. In the petition, the taxpayer stated: "My CPA . . . contracted COVID/DELTA over the last 40 days and kindly requests additional time to respond." In other words, it appears that the taxpayer was requesting an extension of the § 6213(a) 90-day period.

Procedural history. The Tax Court issued an order to show cause in which it ordered the parties to respond as to why the court should not, on its own motion, dismiss the action for lack of jurisdiction. The taxpayer requested that the court defer ruling on the matter until the U.S. Supreme Court issued its opinion in *Boechler, P.C. v. Commissioner,* 142 S. Ct. 1493 (4/21/22), which was pending in the Supreme Court. The Tax Court declined to defer ruling and dismissed the taxpayer's action. After the U.S. Supreme Court issued its opinion in *Boechler*, the taxpayer moved to vacate the court's order of dismissal. After receiving briefing, the court issued a unanimous, reviewed opinion denying the motion to vacate its prior order of dismissal.

Tax Court's holding. In a lengthy (57 pages) and extraordinarily thorough opinion, the Tax Court examined the text and history of § 6213(a) and concluded that Congress had clearly indicated that the 90-day period specified in the statute is jurisdictional. The court observed that the Tax Court is a court of limited jurisdiction and has only whatever jurisdiction it has been granted by Congress. Accordingly, because the 90-day period is jurisdictional, in the court's view, the court must dismiss cases, such as this one, in which the taxpayer's petition is filed late. And because the statute is jurisdictional, the court concluded, it is not subject to equitable tolling, i.e., taxpayers cannot argue for exceptions on the basis that they had good cause for failing to meet the deadline. The court also concluded rather briefly that its view on the jurisdictional nature of § 6213(a) was not affected by the U.S. Supreme Court's decision in *Boechler, P.C. v.*

Commissioner, 142 S. Ct. 1493 (4/21/22). In *Boechler*, the Court held that the 30-day period specified in § 6330(d)(1) for requesting review in the Tax Court of a notice of determination following a collection due process hearing is *not* jurisdictional and *is* subject to equitable tolling. According to the Tax Court, *Boechler* "emphatically teaches that" § 6213(a) and § 6330(d)(1) "are different sections" that "[e]ach must be analyzed in light of its own text, context, and history." The fact that, in *Boechler*, the Supreme Court concluded that the 30-day period specified in § 6330(d)(1) is *not* jurisdictional did not change the Tax Court's view that the 90-day period specified in § 6213(a) *is* jurisdictional. Accordingly, the Tax Court dismissed the taxpayer's action.

a. The Third Circuit disagrees. The 90-day period specified in § 6213(a) for filing a petition in the U.S. Tax Court is *not* jurisdictional and *is* subject to equitable tolling. Culp v. Commissioner, 75 F.4th 196 (3d Cir. 7/19/23). In an opinion by Judge Ambro, the U.S. Court of Appeals for the Third Circuit has held that the 90-day period specified by § 6213(a) within which taxpayers can challenge a notice of deficiency by filing a petition in the Tax Court is *not* jurisdictional and *is* subject to equitable tolling. Although the Third Circuit's opinion does not provide specific dates, it states that the IRS mailed a notice of deficiency to the taxpayers, a married couple, as well as a second notice of deficiency, both with respect to the taxable year 2015. The taxpayers filed a petition in the Tax Court seeking redetermination of the deficiency well outside the 90-day period specified in § 6213(a) for doing so. In an unpublished order, the Tax Court dismissed the taxpayers' petition for lack of jurisdiction. On appeal, the taxpayers, backed by amicus curiae represented by the Legal Services Center of Harvard Law School, argued that the 90-day period provided by § 6213(a) is not jurisdictional and is subject to equitable tolling in appropriate circumstances. The court framed the issue in this way:

> The central question in this appeal is whether the Culps' late filing deprives the Tax Court of jurisdiction to consider their petition. Put another way, is § 6213(a)'s 90-day requirement jurisdictional or is it a claims-processing rule?

The court first analyzed the text of § 6213(a), which provides in part:

> Within 90 days … after the notice of deficiency authorized in section 6212 is mailed …, the taxpayer may file a petition with the Tax Court for a redetermination of the deficiency. … The Tax Court shall have no jurisdiction to enjoin any action or proceeding or order any refund under this subsection unless a timely petition for a redetermination of the deficiency has been filed and then only in respect of the deficiency that is the subject of such petition.

The court concluded that the provision's text did not indicate that the 90-day period specified in § 6213(a) is jurisdictional. The language Congress used, the court reasoned, does not link the 90-day deadline to the Tax Court's jurisdiction. The statute provides that the Tax Court has no jurisdiction to enjoin actions or order a refund if the taxpayer's petition is not timely filed, which indicates that "Congress knew how to limit the scope of the Tax Court's jurisdiction." But the provision does not similarly limit the Tax Court's jurisdiction to review petitions that are not timely filed. Further, according to the court, neither the context of the statute nor the court's own precedent interpreting § 6213(a) indicates that the 90-day period is jurisdictional.

After holding that the 90-day period specified in § 6213(a) is not jurisdictional, the court considered whether the period is subject to equitable tolling. According to the court, neither the text nor the context of the statute suggests that Congress intended the period not to be subject to equitable tolling. Accordingly, the court remanded the case to the Tax Court with instructions for the Tax Court to consider whether the taxpayers could demonstrate sufficient grounds for the 90-day period to be equitably tolled.

b. In a reviewed opinion, the Tax Court has held that it will not follow the Third Circuit's decision in *Culp* in cases appealable to other Circuits. Sanders v. Commissioner, 161 T.C. No. 8 (11/2/23). In a reviewed opinion (10-1-2) by Judge Nega, the Tax

Court has reaffirmed its position that the 90-day period specified in § 6213(a) for filing a petition in the Tax Court in response to a notice of deficiency is jurisdictional and therefore not subject to equitable exceptions. In this case, the IRS issued a notice of deficiency that stated the last day to file a petition in the Tax Court to challenge the notice of deficiency was June 21, 2022. The taxpayer mailed her petition to the Tax Court using the U.S. Postal Service's Priority Mail service and the envelope she mailed bore a postmark of June 23, 2022. The IRS moved to dismiss for lack of jurisdiction on the ground that the taxpayer had filed the petition outside the permitted 90-day period and that this time period is jurisdictional. The court reviewed its prior decision in *Hallmark Research Collective v. Commissioner*, 159 T.C. No. 6 (11/29/22), and the Third Circuit's conflicting decision in *Culp v. Commissioner*, 75 F.4th 196 (3d Cir. 7/19/23). Under the rule of *Golsen v. Commissioner*, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971), the Tax Court follows the precedent of the U.S. Court of Appeals that will hear the appeal of a case from the Tax Court. Therefore, in decisions appealable to the Third Circuit, the Tax Court will follow the holding of *Culp* that the 90-day period of § 6213(a) is not jurisdictional and therefore is subject to equitable exceptions. The present case, however, was appealable to the Fourth Circuit, which has not issued a precedential opinion on point, and therefore the Tax Court was not constrained by the *Golsen* rule. The court reaffirmed its view that the 90-day period of § 6213(a) is jurisdictional:

> After thoroughly considering the Third Circuit's reasoning in *Culp*, we reaffirm *Hallmark* and will continue to treat the 90-day deficiency deadline as jurisdictional in cases appealable outside the Third Circuit, including in cases appealable to the First and Fourth Circuits. … Nothing in the Third Circuit's reasoning in *Culp* causes us to abandon or otherwise modify our application of the traditional tools of statutory construction or our holding as to the jurisdictional nature of the 90-day deficiency deadline.

Accordingly, the court granted the government's motion to dismiss for lack of jurisdiction.

Concurring opinion of Judge Buch. In a very thorough concurring opinion, Judge Buch (joined by Judges Kerrigan, Nega, Pugh, Ashford, Urda, Copeland, Toro, Greaves, and Marshall) reviewed both the statutory text and the context of § 6213(a) as well as the historical treatment of the provision and concluded that the 90-day period specified in the statute is jurisdictional.

Dissenting opinion of Judge Foley. In a dissenting opinion, Judge Foley (joined by Judge Weiler) reasoned that a limitations period is jurisdictional only if Congress has clearly stated that it is, and that Congress did not make such a clear statement in § 6213(a). In Judge Foley's view, the 90-day period of § 6213(a) is analogous to the 30-day period for filing a petition in the Tax Court in response to a notice of determination following a collection due process (CDP) hearing, which the U.S. Supreme Court held is not jurisdictional and therefore is subject to equitable exceptions. *Boechler, P.C. v. Commissioner,* 142 S. Ct. 1493 (4/21/22).

c. The Tax Court will not follow the Third Circuit's decision in *Culp* in cases appealable to the Tenth Circuit. Nguyen v. Commissioner, T.C. Memo 2023-151 (12/20/23). In a case decided after the Third Circuit issued its decision in *Culp v. Commissioner*, 75 F.4th 196 (3d Cir. 7/19/23), the Tax Court refused to apply equitable tolling in a case appealable to the Tenth Circuit. Briefly, the taxpayer's Tax Court petition arrived one day after the 90-day period of § 6213(a) had expired. Moreover, the "timely-mailed, timely-filed" rule of § 7502 did not apply because the taxpayer used FedEx Ground instead of one of the other FedEx delivery services permitted under § 7502 pursuant to Notice 2016-30, 2016-18 I.R.B. 676. The Tax Court (Judge Lauber) refused to apply equitable tolling principles and dismissed the taxpayer's petition for lack of jurisdiction, stating in footnote 2 of the opinion:

> Absent stipulation to the contrary this case is appealable to the Tenth Circuit, and we thus follow its precedent, which is squarely on point. See *Golsen v. Commissioner*, 54 T.C. 742, 756–57 (1970), aff'd, 445 F.2d 985 [27 AFTR 2d 71-1583] (10th Cir. 1971). The Tenth Circuit has long agreed with this Court's

holdings that the statutory period prescribed by section 6213(a) is a jurisdictional requirement. See *Armstrong v. Commissioner*, 15 F.3d at 973 n.2; *Foster v. Commissioner*, 445 F.2d 799, 800 [28 AFTR 2d 71-5210] (10th Cir. 1971). Thus, we need not address a recent ruling by the U.S. Court of Appeals for the Third Circuit that the statutory filing deadline in deficiency cases is a non-jurisdictional "claims-processing" rule. *See Culp v. Commissioner*, 75 F.4th 196, 205 [132 AFTR 2d 2023-5198] (3d Cir. 2023).

2. If I'm high on cannabis and forget the 30-day deadline, will "equitable tolling" get me a few extra days to file my collection due process hearing request with IRS Appeals? Maybe. Organic Cannabis Foundation, LLC v. Commissioner, 161 T.C. No. 4 (9/27/23). Ala *Boechler*, the Tax Court, in a reviewed opinion (14-0-3), introduces "equitable tolling" to the 30-day deadline under § 6320(a)(3)(B) for requesting a collection due process ("CDP") hearing with IRS Appeals, overruling *Kennedy v. Commissioner*, 116 T.C. 255 (2001). Recall that in *Boechler, P.C. v. Commissioner,* 596 U.S. 199, (2022), the Supreme Court of the United States held that the 30-day period specified in § 6330(d)(1) for requesting *judicial* review in the Tax Court of a notice of determination following a CDP hearing with IRS Appeals is *not* jurisdictional and *is* subject to equitable tolling. In this case, the taxpayer missed the 30-day deadline in another provision, § 6320(a)(3)(B), which permits a taxpayer to request an *administrative* hearing with IRS Appeals after receiving a notice of the filing of federal tax lien ("NFTL") under § 6323(a). More specifically, the taxpayer, a single-member LLC subsidiary that had elected subchapter C status, had unpaid tax for three years: 2010, 2011, and 2018. The IRS issued notices of federal tax lien filings to the taxpayer for all three years. For tax years 2010 and 2011, the taxpayer timely requested a CDP hearing with IRS Appeals within the 30-day period under § 6320(a)(3)(B). For some reason, however, the taxpayer's § 6320(a)(3)(B) request for a CDP hearing with IRS Appeals for 2018 was filed one day late. IRS Appeals determined that the taxpayer's hearing request for 2018 was untimely and provided an equivalent hearing under Treas. Reg. § 301.6320-1(i)(1). Ultimately, IRS Appeals issued an adverse notice of determination to the taxpayer for 2010 and 2011 and an adverse decision letter for 2018. The taxpayer then filed a petition in Tax Court seeking review for all three years. In response, the IRS moved to dismiss the taxpayer's Tax Court petition with respect to 2018 for lack of jurisdiction, arguing that IRS Appeals did not make a "determination" for the Tax Court to review under § 6330(d)(1). See *Kennedy v. Commissioner*, 116 T.C. 255 (2001). The taxpayer argued that the 30-day period for requesting a CDP *administrative* hearing with IRS Appeals under § 6320(a)(3)(B) should be equitably tolled, similar to SCOTUS's ruling in *Boechler* under § 6330(d)(1) for a *judicial* hearing in Tax Court. The Tax Court, in a thirty-one-page opinion written by Judge Goeke reached the following holdings:

- IRS Appeals has authority under § 6320 to hold CDP hearings and issue a notice of determination even when a taxpayer files a request after the 30-day period of § 6320(a)(3)(B).
- The Regulations under § 6320 do not preclude the application of the doctrine of equitable tolling with respect to the 30-day period.
- The 30-day period is subject to equitable tolling where the circumstances so warrant.
- *Kennedy v. Commissioner*, 116 T.C. 255 (2001), is overruled to the extent that it holds that IRS Appeals is not authorized under § 6320(a)(3)(B) to waive the 30-day period and issue a notice of determination (instead of a decision letter after a CDP equivalent hearing) where circumstances warrant application of the doctrine of equitable tolling.

The Tax Court then remanded the case to IRS Appeals to determine if the taxpayer's circumstances warranted equitable tolling.

Concurring and dissenting opinion of Judge Jones. In a concurring and dissenting opinion by Judge Jones (joined by Judges Buch and Foley), Judge Jones dissented from the majority's holding

that the Regulations under § 6320 do not preclude equitable tolling and would have held for the IRS and against the taxpayer on that basis.

3. Despite the availability of electronic filing, if the office of the clerk of the Tax Court is inaccessible on the last day for filing a Tax Court petition, then under § 7451(b), the 90-day period for filing the petition is tolled for the number of days of inaccessibility plus an additional 14 days. Sall v. Commissioner, 161 T.C. No. 13 (11/30/23). The taxpayer received a notice of deficiency that stated the last day to file a petition with the Tax Court was Friday, November 25, 2022, which was the day after Thanksgiving. The Tax Court was administratively closed on that day. The taxpayer, who resided in Colorado, mailed his petition to the court on Monday, November 28, 2022. The court received the petition on December 1, 2022. The IRS filed a motion to dismiss for lack of jurisdiction on the basis that the taxpayer had filed the petition late. The Tax Court (Judge Buch) held that the taxpayer had timely filed the petition and denied the IRS's motion. Section 7451(b), added to the Code in 2021 by the Infrastructure Investments and Jobs Act, tolls the period for filing a Tax Court petition if a filing location is inaccessible. Section 7451(b)(1) provides:

> Notwithstanding any other provision of this title, in any case (including by reason of a lapse in appropriations) in which a filing location is inaccessible or otherwise unavailable to the general public on the date a petition is due, the relevant time period for filing such petition shall be tolled for the number of days within the period of inaccessibility plus an additional 14 days.

Section 7451(b)(2) defines the term "filing location" as either "(A) the office of the clerk of the Tax Court, or (B) any on-line portal made available by the Tax Court for electronic filing of petitions." The court reasoned that, because the office of the clerk of the Tax Court, which is a filing location, was inaccessible on November 25, 2022 (the date the petition was due), § 7451(b) tolled the period for filing the taxpayer's petition by one day (the period of inaccessibility) plus an additional 14 days. Accordingly, the taxpayer had until December 10, 2022, to file the petition. Further, because December 10, 2022, was a Saturday, under § 7503, the taxpayer had until Monday, December 12, 2022, to file the petition. The taxpayer's petition was filed on December 1, 2022, the date on which it was received by the Tax Court, and therefore was timely. Although the taxpayer could have filed the petition at any time through Dawson, the court's electronic filing system, the court concluded that, because "a fling location" was inaccessible on November 25, 2022, "the availability of the Court's electronic filing system is immaterial."

4. The limitations period for the IRS to assess the 6% excise tax imposed by § 4973(a) on excess contributions to an IRA is six years if the taxpayer does not file Form 5329, but only for returns filed on or after December 29, 2022. For returns filed before that date without Form 5329, the limitations period never begins to run. Couturier v. Commissioner, 162 T.C. No. 4 (2/28/24) (reviewed). In this case, the taxpayer, a corporate executive, participated in several deferred compensation arrangements. These included shares in an employee stock ownership plan (ESOP) (a qualified retirement plan) and several compensatory plans, none of which was a qualified plan. In 2004, as part of a corporate reorganization, the taxpayer accepted a $26 million buyout from his company, which took the form of a $12 million cash payment to the taxpayer's IRA and a $14 million promissory note payable to his IRA, which the company satisfied in 2005. On his 2004 federal income tax return, he characterized the $26 million as a tax-free "rollover contribution" to his IRA. He left blank line 59, "Additional tax on IRAs, other qualified retirement plans, etc." Similarly, he filed his tax returns for 2005 through 2014 leaving blank line 59. He also did not attach to any of his returns Form 5329, "Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts."

The IRS audited the taxpayer and ultimately issued two notices of deficiency, one for 2004 through 2008 and another for 2019 through 2014. The IRS asserted that, of the $26 million contributed to the taxpayer's IRA, $25.1 million was attributable to his relinquishment of his rights in the non-ESOP deferred compensation plans, which were not eligible for treatment as a tax-free rollover.

The IRS's position in the notices of deficiency was that this $25.1 million was an "excess contribution" subject to the 6% excise tax of § 4973(a). Further, under § 4973(b)(2), the excise tax continues to apply for future years until the original excess contribution is distributed to the taxpayer and included in income. Therefore, according to the IRS, the taxpayer owed for the years involved an excise tax in the aggregate amount of approximately $8.5 million. The IRS issued the two notices of deficiency on June 16, 2016. In response to the notices of deficiency, the taxpayer petitioned the Tax Court.

The taxpayer filed a motion for summary judgment in which he argued that the period of limitations during which the IRS could assess the excise tax imposed by § 4973(a) had expired for the years 2004-2008 before the IRS issued the notice of deficiency for those years on June 16, 2016. (The taxpayer did not challenge the timeliness of the notice of deficiency for the years 2009-2014.)

Section 6501(a) provides that, subject to various exceptions, any tax imposed must be assessed within three years after the return was filed. For this purpose, § 6501(a) provides that "the term 'return' means the return required to be filed by the taxpayer." If the taxpayer does not file a return, then pursuant to § 6501(c)(3), the tax may be assessed at any time, i.e., there is no limitations period on the IRS's assessment of the tax. In prior decisions, the Tax Court had held that the limitations period for the IRS to assess the excise tax imposed by § 4973(a) begins to run only if the taxpayer files a return that includes sufficient information for the IRS to determine the taxpayer's liability for the excise tax. Specifically, the Tax Court previously had held that a taxpayer's filing of a return on Form 1040 does not start the running of the limitations period for the IRS to assess the § 4973(a) excise tax unless the taxpayer files Form 5329, "Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts," or provides the required information elsewhere on Form 1040. *Paschall v. Commissioner*, 137 T.C. 8, 16 (2011); *Mazzei v. Commissioner*, 150 T.C. 138, 149 n.15 (2018), *rev'd on other grounds*, 998 F.3d 1041 (9th Cir. 2021).

Section 6501(*l*)(4), enacted in 2022 as part of the Consolidated Appropriations Act, 2023, Pub. L. No. 117-328, provides:

> (A) For purposes of any tax imposed by section 4973 or 4974 in connection with an individual retirement plan, the return referred to in this section shall include the income tax return filed by the person on whom the tax under such section is imposed for the year in which the act (or failure to act) giving rise to the liability for such tax occurred.
>
> …
>
> (C) In any case in which the return with respect to a tax imposed by section 4973 is the individual's income tax return for purposes of this section, subsection (a) shall be applied by substituting a 6-year period in lieu of the 3-year period otherwise referred to in such subsection.

The effect of § 6501(*l*)(4) is that a three-year limitations period applies if the taxpayer files Form 5329, but a six-year limitations period will apply if the taxpayer files a return on Form 1040 but fails to attach Form 5329. When Congress enacted § 6501(*l*)(4), it specified that the amendment "shall take effect on the date of the enactment of this Act," which was December 29, 2022.

The question before the court was whether § 6501(*l*)(4) applied retroactively. The taxpayer filed timely returns on Form 1040 for the years 2004-2008 but, as discussed earlier, failed to attach Form 5329 to any of the returns. If § 6501(*l*)(4) applied retroactively, then the IRS had six years from the date of filing within which to assess the § 4973(a) excise tax and the notice of deficiency for 2004-2008, issued on June 16, 2016, was untimely.

In a reviewed opinion (7-5-2) by Judge Lauber (joined by Judges Kerrigan, Nega, Pugh, Ashford, Copeland, and Weller), the Tax Court held that § 6501(*l*)(4) applies prospectively only and therefore did not bar the IRS's assessment of the § 4973(a) excise tax for the taxpayer's 2004-2008

taxable years. In reaching this conclusion, the court rejected the taxpayer's argument that Congress intended § 6501(*l*)(4) to apply to all disputes pending with the IRS as of the date of enactment. When Congress had previously amended § 6501 to apply to returns filed before the date of enactment, the court observed, it had said so explicitly in the relevant effective date provision. Congress failed to do so in this instance. The most natural reading of the effective date provision for § 6501(*l*)(4), the court held, was that the new rule applies to returns filed on or after the effective date of December 29, 2022:

> In short, section 6501(*l*)(4) specifies the consequences of filing tax returns. Because Congress provided that this amendment "shall take effect on the date of the enactment," we think the amendment is logically read to apply to tax returns filed on or after the date of enactment.

Nevertheless, the court assumed for the sake of argument that the effective date provision was ambiguous and considered whether application of § 6501(*l*)(4) as the taxpayer proposed would have a retroactive effect. A statute has retroactive effect, the court stated, "if it 'would impair rights a party possessed when he acted.'" 162 T.C. No. 4, at 11 (quoting *Landgraf v. USI Film Products*, 511 U.S. 244, 280 (1994)). If a statute would have retroactive effect, the court observed, a court must determine whether "clear congressional intent" militates in favor of retroactive application. In making this determination, a court must apply a presumption that Congress did not intend for a statute to apply retroactively if the statute affects substantive rights because doing so "would contravene principles of fair notice, reasonable reliance, and settled expectations." In this case, the court held, the taxpayer's interpretation of § 6501(*l*)(4) would have retroactive effect and the presumption against retroactivity applied because applying the statute retroactively would alter the IRS's substantive rights to assess tax. When the IRS issued the notice of deficiency for 2004-2008 on June 16, 2016, the court noted, the notice was timely because, under the Tax Court's existing interpretation of § 6501, the taxpayer's failure to file Form 5329 meant that the limitations period on assessment never began to run. Further, pursuant to § 6503, the taxpayer's filing of a Tax Court petition suspended the running of the limitations period on assessment until 60 days after the Tax Court's decision became final. Applying § 6501(*l*)(4) as the taxpayer proposed, the court concluded, would contravene principles of fair notice, reasonable reliance, and settled expectations.

In summary, the court held that § 6501(*l*)(4) applies prospectively only and therefore did not bar the IRS's assessment of the § 4973(a) excise tax for the taxpayer's 2004-2008 taxable years.

Concurring opinion of Judge Toro. In a very lengthy concurring opinion, Judge Toro (joined by Judge Greaves and joined in part by Judges Buch and Urda) concurred in the result but heavily criticized the court's opinion. In Judge Toro's view, § 6501(*l*)(4) focuses on assessment of tax and can apply to returns filed before December 29, 2022, the date of enactment. Judge Toro concluded:

> Under my reading of section 313(b) of the Act, the Commissioner no longer possesses the authority to assess any taxes imposed by section 4973 if the taxpayer filed an income tax return more than six years ago (or was not required to file such a return, as provided in section 6501(l)(4)(B)) and a notice of deficiency with respect to those taxes is not issued within the six-year period (or the three-year period, for a taxpayer who was not required to file an income tax return). As relevant here, the only exception to this rule is for taxpayers (like Mr. Couturier) to whom notices of deficiency were already issued before December 29, 2022, and whose circumstances are governed by section 6503(a)(1).

Dissenting opinion of Judge Foley. In a brief dissenting opinion, Judge Foley (joined by Judge Marshall) argued that, because § 6501(*l*)(4) became effective on December 29, 2022, the IRS was required to send a notice of deficiency within six years after the taxpayer filed his returns for 2004-2008. Because the IRS failed to do so, he argued, the court should grant the taxpayer's motion for summary judgment.

5. The Tax Court declined to give *Chevron* deference to Treasury regulations and held that the taxpayers' petition was timely filed by virtue of § 7508A(d), which provides a mandatory extension for federally declared disasters. Abdo v. Commissioner, 162 T.C. No. 7 (4/2/24). In this case, the IRS issued a notice of deficiency indicating that March 2, 2020, was the last day for filing a petition in the Tax Court. The taxpayers, however, mailed their petition on March 17, 2020. On March 31, 2020, under the Robert T. Stafford Disaster Relief and Emergency Assistance Act, the President issued a major disaster declaration with respect to the State of Ohio as a result of the COVID-19 pandemic. The declaration provided that the disaster conditions began on January 20, 2020. The IRS moved to dismiss on the basis that the taxpayers had filed their petition after the March 2 deadline. The taxpayers argued that § 7508A(d), which provides a mandatory 60-day extension of specified tax related deadlines by reason of a federally declared disaster, extended the time within which they could file their petition and that their petition was timely filed. Ultimately, the parties' dispute narrowly focused on the proper interpretation of § 7508A(d) and whether Reg. § 301.7508A-1(g)(1) and (2) provide a valid construction of the statute. It is important for readers to note that the analysis in the opinion is based on the Code and Regulations in effect on March 17, 2020. In a reviewed opinion (13-2-0) by Judge Marshall, the Tax Court held that the taxpayers had timely filed their petition.

Pursuant to § 7508A(a), the IRS has discretion to postpone certain tax-related deadlines for up to one year for taxpayers determined to be affected by a federally declared disaster. In contrast, § 7508A(d) provides a mandatory 60-day extension of specified tax related deadlines by reason of a federally declared disaster. In June of 2021, Treasury and the IRS issued final regulations under § 7508A(d). Under these regulations, taxpayers whose principal residence is located in a disaster area are entitled to a mandatory 60-day postponement period in relation to certain time sensitive acts. Reg. § 301.7508A-1(g)(1). Time sensitive acts are "acts determined to be postponed by the Secretary's exercise of authority under section 7508A(a) or (b)." Reg. § 301.7508A-1(g)(2). In other words, the regulations provide that § 7508A(d) extends a deadline only if the IRS has exercised its discretionary authority to extend the deadline. Because the IRS had not exercised its discretionary authority to extend the deadline for filing Tax Court petitions as a result of the Ohio disaster declaration, the IRS argued that § 7508A(d) did not operate to extend the deadline for the taxpayers to file their petition. The IRS contended that the final regulations applied to the case and the regulations were entitled to deference under *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

Chevron Analysis. Under *Chevron*, when a court reviews an agency's construction of a statute, there are two questions. First, whether Congress has directly spoken on the precise question at issue. *Chevron*, 467 U.S. at 842-843. If Congress' intent is clear, courts and agencies must give effect to the unambiguous intent of Congress. *Id.* If the court determines that Congress has not directly addressed the precise question at issue, the court does not impose its own construction on the statute. *Id.* Second, if the statute is silent or ambiguous with respect to an issue, the court must ask whether the agency's interpretation is based on a permissible construction of the statute. *Id.* However, a court must defer to the agency's interpretation unless it is "arbitrary, capricious or manifestly contrary to the statute." *Id.* at 843-44. With respect to the first question, the Tax Court considered the plain language of both § 7508A(a) and § 7508A(d). The court agreed with the taxpayer's argument that § 7508A(d) is not ambiguous in its provision of a self-executing postponement period. In contrast, the court observed, the language in § 7508A(a) is discretionary. The language of § 7508A(d), the court reasoned, provides that a specifically defined period *"shall be disregarded"* in a defined manner. The court concluded that § 7508A(d) provides for a mandatory extension period for filing a Tax Court petition.

Deference to Treas. Regulation §301.7508A-1(g)(1) and (2). Having concluded under the *Chevron* analysis that § 7508A(d) was unambiguous and that the court did not have to accord *Chevron* deference to the regulations, the court also concluded that Reg. § 301.7508A-1(g)(1) and (2) were invalid. The regulations were invalid to the extent that these two subsections limit the non-pension-related "time sensitive acts that are postponed for the mandatory 60-day

postponement period…[to] the acts determined to be postponed by the Secretary's exercise of authority under 7508(a)." In so holding, the court stated that the regulation, promulgated after the petition in this case was filed, cannot change the result dictated by an unambiguous statute.

Follow-Up Based on the Supreme Court's Decision in Loper. On June 28, 2024, in *Loper Bright Enterprises v. Raimondo*, 2024 WL 3208360, the United States Supreme Court addressed the question of whether *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc*., 467 U.S. 837, should be overruled or clarified. In *Loper,* the Supreme Court held that *Chevron* deference, as determined under the two-step analysis described above, cannot be reconciled with the Administrative Procedure Act. The Supreme Court, therefore, overruled *Chevron*. While in *Abdo*, the Tax Court applied the two-part *Chevron* analysis, the Tax Court did not accord *Chevron* deference to the Treasury's regulations. Anticipating the possibility that *Chevron* could be overruled, in his concurring opinion, Judge Buch noted that the continued viability of Chevron was in question. Further, regardless of whether the Supreme Court overruled *Chevron*, the concurrence notes that the Tax Court would reach the same conclusion in this case. Therefore, the holding in *Abdo* here should not be impacted by the Supreme Court's decision in *Loper*.

6. Tax Court retains jurisdiction holding that the 90-day period to file a petition for redetermination of a notice of employment tax determination is a nonjurisdictional claim processing rule. Belagio Fine Jewelry, Inc. v. Commissioner, 162 T.C. No. 11 (6/25/24). The IRS audited the taxpayer, a corporation, to determine the employment status of individuals performing services for the taxpayer. After determining that the taxpayer had an employee, the IRS issued and mailed a notice of employment tax determination (the Notice) dated August 24, 2021. Pursuant to the 90-day rule provided in § 7436(b)(2), the Notice stated that the last day for the taxpayer to file a petition for redetermination of employment status was November 22, 2021. Taxpayer mailed its petition via FedEx Express Saver on November 18, 2021, which arrived at the Tax Court on November 23, 2021, one day after the 90-day deadline. When the petition arrives after the deadline, however, § 7502(a) provides that a petition is considered to be timely if the taxpayer delivered the petition to the U.S. Postal Service (USPS) before the end of the 90-day period. Under this rule, the petition is considered timely filed if it is timely deposited in the USPS mail before the deadline. Under § 7502(f) this "timely mailed is timely filed" rule continues to apply if certain specifically designated delivery services are used by the taxpayers. The FedEx Express Saver service used by the taxpayer, however, was not, during the year in question, a specifically designated private delivery service. *See* IRS Notice 2016-30, 2016-18 I.R.B. 676. The IRS argued that, because the petition was received a day late, the Tax Court lacked jurisdiction to hear the case. In order to determine whether the petition was a day late, the court first needed to determine the date that the IRS had mailed the notice of employment tax determination to the taxpayer to begin the 90-day period.

Burden of Proof. An IRS agent issuing a notice is required to complete USPS Form 3877, Firm Mailing Book for Accountable Mail, to establish the date of mailing of the notice. See I.R.M. 4.8.10.8.2 (Apr. 20, 2018). Having never previously addressed the issue of which party (the IRS or the taxpayer) has the burden of proving when a notice of employment tax determination was mailed, the Tax Court (Judge Greaves) relied on its prior decisions relating to the mailing of notices of deficiency. In relation to notices of deficiency, the Commissioner has the burden of proving the date of mailing because (1) it was the Commissioner's motion, and (2) the relevant information is within the Commissioner's knowledge. *Casqueira v. Comm'r*, T.C. Memo. T.C. Memo 1981-428. *See also S. Cal. Loan Assoc. v. Comm'r*, 4 B.T.A. 223, 224-25 (1926). Placing the burden on the IRS, the Tax Court concluded that the Form 3877 in this case was incomplete because it did not bear a USPS date stamp. However, even though the Form 3877 did not bear a proper USPS stamp, the court concluded that the form was valid because the IRS agent filled out and initialed the form on August 24, 2021. The IRS also provided evidence that the mailing number listed on the USPS Form 3877 matched the stamp on the Notice. Further, the IRS submitted a sworn declaration by the IRS employee that she completed the forms on the same day. This evidence supported the Court's finding that the IRS carried its burden of proof that the Notice was mailed on August 24,

2021. The issue then became whether the Tax Court had jurisdiction to determine whether the taxpayer's petition had been filed within the 90-day period of § 7436(a).

Clear Statement Standard. The Tax Court began with the Supreme Court's rule that, where a federal court's subject matter jurisdiction depends on a filing deadline, failure by a litigant to comply with the deadline deprives the court of jurisdiction to hear the case. *Kontrick v. Ryan*, 540 U.S. 443, 455 (2004). However, where a party is required under a rule to complete specific procedural steps at certain specified times but the rule does not condition a court's authority to hear the case on compliance with such steps, the rule is treated as a nonjurisdictional "claims processing" rule. *See Boechler, P.C. v. Comm'r*, 142S.Ct. 1493, 1497 (2022). Such claims processing rules do not deprive a court of its jurisdiction to hear a case. *U.S. v. Wong*, 575 U.S. 402, 410 (2015). A procedural requirement is treated as jurisdictional if Congress "clearly states" that a deadline is jurisdictional. In order to determine whether Congress has clearly stated that a requirement is jurisdictional, the Court must examine the (1) text, (2) context, and (3) historical treatment of the requirement. *See Reed Elsevier, Inc. v. Muchnick*, 559 U.S. 154, 166 (2010). The Tax Court first addressed the "text" of § 7436(b)(2) finding that, while the statute provides the 90-day deadline, it does not use the word "jurisdiction". Rather, the statute provides only that a proceeding may not be initiated in the Tax Court if the 90-day rule is not complied with. Thus, nothing in the statute textually restricts the Court's ability to hear the case. Second, the court reasoned that the statutory "context" of the statute supports the conclusion that Congress did not "clearly state" that the 90-day deadline in the statute. The court noted that mere proximity of the jurisdictional grant and the procedural requirement does not indicate that the requirement is jurisdictional. Here, the jurisdictional grant is found in § 7436(a) whereas the 90-day deadline is found in subsection (b)(2). Such a separation without a clear tie of the jurisdictional grant to the 90-day rule supported the court's conclusion that the 90-day deadline is not jurisdictional. In addition to the separation of the jurisdictional grant from the deadline, the court concluded that § 7436(b)(2) has limited applicability because the 90 day deadline applies only to a subset of cases covered by § 7436. Further, the 90-day deadline applies only to cases in which the Commissioner sends a notice of employment tax determination to the taxpayer by certified mail. In cases in which the Commissioner fails to properly send its determination via the mail, the 90-day rule is inapplicable. The Court reasoned that its jurisdiction is based on the IRS determination and not on whether the notice of determination was actually mailed, or not. Third, from a historical context, the Court reasoned that § 7436, as well as similarly worded statutes, lack any historical precedent interpreting deadlines as jurisdictional. As such, the court held, the relevant historical treatment of § 7436 does not reflect an intent on the part of Congress that the 90-day rule be jurisdictional.

Conclusion. After considering the text, statutory context, and history of the statute, the court reasoned that it was not deprived of jurisdiction because of the taxpayer's late filing. The court therefore denied the IRS's motion to dismiss based on a lack of jurisdiction.

F. Liens and Collections

G. Innocent Spouse

1. Better clean up those social media posts featuring sailboats or ski vacations before filing a petition in the Tax Court seeking innocent spouse relief. Such posts are "newly discovered evidence" within the meaning of § 6015(e)(7) and therefore admissible even if they existed before the taxpayer requested innocent spouse relief. Thomas v. Commissioner, 160 T.C. No. 4 (2/13/23). The Taxpayer First Act, Pub. L. No. 116-25, § 1203, enacted in 2019, amended Code § 6015 to clarify the scope and standard of review in the Tax Court of any determination with respect to a claim for innocent spouse relief, i.e., any claim for relief under § 6015 from joint and several liability for tax liability arising from a joint return. Among other changes, the legislation added § 6015(e)(7), which provides:

> Any review of a determination made under this section shall be reviewed de novo by the Tax Court and shall be based upon—

A. the administrative record established at the time of the determination, and

B. any additional newly discovered or previously unavailable evidence.

The amendment was generally consistent with the Tax Court's holding in *Porter v. Commissioner*, 132 T.C. 203 (2009), but resolved conflicting decisions in cases in which the taxpayer sought equitable innocent spouse relief under § 6015(f), some of which had held that the Tax Court's review was limited to the administrative record and that the Tax Court's standard of review was for abuse of discretion.

Procedural history. In this case, the taxpayer filed joint returns with her husband for the years 2012, 2013, and 2014 but some of the tax liability reported on those returns remained unpaid. Her husband died in 2016. The taxpayer submitted to the IRS a request for innocent spouse relief for those years, which the IRS denied. The taxpayer responded by filing a petition in the Tax Court seeking review pursuant to § 6015(e) and asking the court to determine that she was entitled to innocent spouse relief under § 6015(f). At trial, the IRS sought to introduce into evidence Exhibit 13-R, which consisted of a series of blog posts from the taxpayer's personal blog. These posts ranged in date from November 2, 2016, to January 5, 2022. The taxpayer moved to strike all blog posts that existed before September 8, 2020, the date on which the taxpayer submitted her administrative request for innocent spouse relief, on the ground that the posts had not been in the administrative record and were not "newly discovered evidence" within the meaning of § 6015(e)(7).

Tax Court's analysis. In a unanimous, reviewed opinion by Judge Toro, the Tax Court concluded that the blog posts were "newly discovered evidence" within the meaning of § 6015(e)(7). The court began with the language of the statute and concluded that § 6015 does not define the term "newly discovered evidence." Accordingly, the court reasoned, "[w]e must therefore discern the ordinary meaning of that phrase in 2019." The court turned to the dictionary definition of the phrase "*newly discovered*" and concluded that the ordinary meaning of the phrase as of 2019 "was 'recently obtained sight or knowledge of for the first time.'" The court concluded that the blog posts the IRS sought to introduce into evidence were "newly discovered evidence" because the IRS had first discovered them by searching the internet after the taxpayer had filed her petition in the Tax Court. In reaching this conclusion, the court rejected the taxpayer's argument that § 6015(e)(7)(B) should be read to incorporate an additional limitation similar to that in Federal Rule of Civil Procedure (FRCP) 60(b)(2). Rule 60(b)(2) provides that a court can relieve a party from a final judgement, order, or proceeding on the basis of "newly discovered evidence *that, with reasonable diligence, could not have been discovered in time to move for a new trial.*" (emphasis added). The taxpayer argued that the IRS could have discovered the blog posts that existed before September 8, 2020, once she had submitted her administrative request for innocent spouse relief on that date and that they therefore should not be considered "newly discovered evidence." The court rejected this argument. The court reasoned that Congress had not included a reasonable diligence standard in the language of § 6015(e)(7)(B) and, in fact, the statute's use of the phrase "*any* additional newly discovered evidence" counseled against reading such a limitation into the statute. The court also observed that the statute's specification that the Tax Court's standard of review of an IRS determination concerning innocent spouse relief is de novo (rather than an abuse-of-discretion standard) supported "the conclusion that evidence unknown to a participant in the innocent spouse administrative proceeding should be admissible if that participant (now a party in our Court) offers it in the proceedings before us." Finally, the court noted that § 6015(e)(7) applies in a context entirely different from that of FRCP 60(b)(2). When a party moves for relief from a judgment under FRCP 60(b)(2), both parties have had an opportunity to conduct discovery and introduce evidence at trial. In contrast, "in the context of section 6015(e)(7), the Court considers a case for the first time following a relatively limited administrative proceeding." Accordingly, the court concluded that the blog posts offered into evidence by the IRS were admissible.

- *Concurring opinion of Judge Buch.* In a concurring opinion joined by Judges Ashford and Copeland, Judge Buch emphasized that, although the court's holding was faithful

to the language of § 6015(e)(7), that language "may not have captured what Congress intended." Specifically, Judge Buch reasoned that the statute's language permitting the introduction of "newly discovered or previously unavailable evidence" might be a one-way street that benefits only the government. Judge Buch gave an example of a spouse who is abused by her husband, posts about the abuse on social media, and submits an administrative request for innocent spouse relief that does not mention the social media posts. Such a spouse might be precluded from introducing the social media posts at trial in a subsequent Tax Court proceeding because she created the posts and therefore it might be difficult for her to establish that the posts were "newly discovered or previously unavailable" to her. This problem, he observed, is not limited to social media posts but could apply to "a vast array of evidence" that could be helpful to a requesting spouse to prove entitlement to innocent spouse relief.

a. When the court's findings of fact refer to trips to New York for a birthday celebration, trips to Rome, Paris, and Florence, a trip to Napa for wine tastings, purses from Dior and Kate Spade, a 5-carat diamond ring, a home in an affluent suburb of San Francisco, and a vacation home in Lake Tahoe, you don't need to read further to know that the court denied the taxpayer's request for innocent spouse relief. Thomas v. Commissioner, 162 T.C. No. 2 (1/30/24). As discussed above, the taxpayer filed joint returns with her husband for the years 2012, 2013, and 2014 but some of the tax liability reported on those returns remained unpaid. Her husband died in 2016. The taxpayer submitted to the IRS a request for innocent spouse relief for those years, which the IRS denied. The taxpayer responded by filing a petition in the Tax Court seeking review pursuant to § 6015(e) and asking the court to determine that she was entitled to innocent spouse relief under § 6015(f). Following a trial, the Tax Court (Judge Toro) issued this opinion, which addresses two basic issues: (1) whether certain letters from third parties that the taxpayer submitted to the IRS as part of her administrative request for innocent spouse relief had to be excluded from evidence as inadmissible hearsay, and (2) whether the taxpayer was entitled to innocent spouse relief under § 6015(f).

Whether portions of the administrative record were excluded as hearsay. With respect to the first issue, the court held that the letters the taxpayer had submitted to the IRS with her administrative request for innocent spouse relief were admissible and rejected the Service's argument that the letters were inadmissible hearsay. The letters the taxpayer submitted had been written by two of her friends. The court began with the proposition that "[t]he rule against hearsay applies only when it is not supplanted by federal statute, other rules of the Federal Rules of Evidence, or any rules prescribed by the Supreme Court." In this case, the court reasoned, a federal statute, § 6015(e)(7), supplanted the rule against hearsay. Section 6015(e)(7) provides:

> Any review of a determination made under this section shall be reviewed de novo by the Tax Court and shall be based upon—
>
> A. the administrative record established at the time of the determination, and
>
> B. any additional newly discovered or previously unavailable evidence.

Because § 6015(e)(7) directs the court to base its determination on the administrative record, and because the administrative record included the letters the taxpayer had submitted, the court concluded, "[t]o apply the rule against hearsay to exclude these documents from our consideration would undermine Congress's clear direction as articulated in section 6015(e)(7)." The court reviewed analogous situations in which statutes override the rule against hearsay and in which courts reviewing administrative records to determine whether there was an abuse of discretion have admitted evidence that otherwise would have been inadmissible hearsay. Nevertheless, the court cautioned that, "as in a case we review for abuse of discretion, here (where we review de novo) there may be questions as to whether evidence in the administrative record is probative and reliable" and that, in determining the probative value and reliability of evidence, it would "consider indicia of reliability such as whether a document is or contains hearsay."

Eligibility for innocent spouse relief under § 6015(f). Section 4.01 of Rev. Proc. 2013-34, 2013-2 C.B. 297, sets forth seven threshold requirements that apply to all requests for equitable relief under § 6015(f). The parties agreed that the taxpayer satisfied the threshold requirements. Section 4.02 of Rev. Proc. 2013-34 sets forth the conditions under which the IRS will make streamlined determinations granting equitable relief under § 6015(f). A streamlined determination is available if (1) the requesting spouse is no longer married to the non-requesting spouse, (2) the requesting spouse would suffer economic hardship if relief were not granted, and (3) in underpayment cases such as this one, the requesting spouse "did not know or have reason to know that the non-requesting spouse would not or could not pay the underpayment of tax reported on the joint income tax return." The IRS asserted that the taxpayer had not established that she would suffer economic hardship if relief were not granted, and the court agreed. The court reviewed her sources of income and her assets, including a house in an affluent suburb of San Francisco and a vacation home near ski resorts in Lake Tahoe, and concluded that she had not established that she would suffer economic hardship if relief were not granted. Accordingly, the court concluded that she was not eligible for a streamlined determination without reaching the question of whether she knew or had reason to know that the non-requesting spouse would not pay the underpayment of tax. Section 4.03 of Rev. Proc. 2013-34 provides a nonexclusive list of factors for consideration in determining whether a spouse who does not qualify for streamlined relief is nevertheless relieved under § 6015(f) of federal income tax liability resulting from the filing of a joint return. Although Rev. Proc. 2013-34 lists seven equitable factors, the only factors in dispute were whether the taxpayer would suffer economic hardship absent relief, whether she knew or had reason to know that her former husband would not or could not pay the income tax liabilities, and whether she significantly benefited from the underpayment of tax. The court concluded that the taxpayer had not established that she would suffer economic hardship if relief were not granted and that, even if the taxpayer knew or had reason to know that her former husband would not or could not pay the income tax liabilities, this factor was outweighed by the significant benefit to her of the unpaid tax liabilities. In reaching the conclusion that the taxpayer had significantly benefitted from the underpayment of tax, the court took into account her purchase of a luxury vehicle (a 2013 Land Rover), several vacations she took with her daughters to New York, Europe, and Napa Valley, and her blog posts about a green Dior bag she purchased for her daughter's 18th birthday as well as several designer bags she owned herself and about paying a business coach $220 an hour for private sessions.

2. The Sixth Circuit joins other circuits in holding that recklessness is sufficient to establish a willful FBAR violation. United States v. Kelly, 92 F.4th 598 (6th Cir. 2/8/24). The U.S. Court of Appeals for the Sixth Circuit has held that for purposes of imposing an FBAR civil penalty, a "willful violation of the FBAR reporting requirements includes both knowing and reckless violations." With this holding, the Sixth Circuit joins all the other circuits that have addressed this issue. See, e.g., *United States v. Rum*, 995 F.3d 882 (11th Cir. 2021) (per curiam); *Kimble v. United States*, 991 F.3d 1238, 1242 (Fed. Cir. 2021); *United States v. Horowitz*, 978 F.3d 80, 88 (4th Cir. 2020); *Norman v. United States*, 942 F.3d 1111 (Fed. Cir. 2019); *Bedrosian v. United States*, 912 F.3d 144, 153 (3d Cir. 2018). The Sixth Circuit here in *Kelly* adopted the same line of reasoning as the *Norman* and *Horowitz* courts, relying on the U.S. Supreme Court's decision in *Safeco Ins. Co. v. Burr*, 551 U.S. 47, 57 (2007). In *Safeco*, the Supreme Court observed that, when willfulness is a statutory condition of civil (as opposed to criminal) liability, the Court had "generally taken it to cover not only knowing violations of a standard, but reckless ones as well." For purposes of determining whether a reckless (and therefore willful) FBAR violation occurred, the Sixth Circuit also adopted the meaning of recklessness set forth in *Safeco.* Under *Safeco,* reckless conduct in the civil context is determined by application of an objective standard and is defined as an "…action entailing an unjustifiably high risk of harm that is either known or so obvious that it should be known." 551 U.S. at 685 (internal quotations and citations omitted). Based on this authority, the Sixth Circuit stated:

> …in the context of a civil FBAR penalty, the government can establish a willful violation "based on recklessness" by proving that "the defendant (1) clearly ought

> to have known that (2) there was a grave risk that an accurate FBAR was not being filed and [that] (3) he was in a position to find out for certain very easily.

92 F.4th at 603-04 (citing *Horowitz*, 978 F.3d at 89).

In this case, the taxpayer was a U.S. citizen who closed his U.S. domestic bank accounts and opened an interest-bearing account at Finter Bank in Switzerland, into which he deposited over $1.8 million. After an investigation, the IRS determined that the taxpayer had willfully failed to timely file FBARs for multiple years and imposed substantial penalties. When the taxpayer failed to pay the penalties, the government initiated an action against him in a U.S. District Court. The district court granted the IRS's motion for summary judgment. In affirming the district court, the Sixth Circuit concluded that the taxpayer had taken steps to intentionally evade his legal duties. The taxpayer designated his Finter account as "numbered" so that his name would not appear on the bank statements and he requested that the bank retain any account related communications. The Sixth Circuit concluded that these efforts allowed the taxpayer to shield his assets from U.S. authorities and that this evidenced more than mere negligence. Only after Finter notified the taxpayer that it would disclose his account to U.S. authorities did the taxpayer then begin complying with FBAR reporting obligations. The taxpayer did not seek professional advice about his reporting obligations or the tax implications of the assets in the Swiss bank account. Finter temporarily closed the taxpayer's account and warned him that it was required to report to U.S. authorities. Finter also recommended that the taxpayer get professional tax counsel. The taxpayer then requested to participate in the IRS's Offshore Voluntary Disclosure Program (OVPD). The government preliminarily accepted his voluntary disclosure. The taxpayer later transferred the funds in his Swiss bank account to an account with Bank Alpinum in Lichtenstein. He submitted a Form 433-A, Collection Information Statement, to the IRS that failed to disclose the Lichtenstein account. The government later removed the taxpayer from the OVDP because he had failed to provide information about his foreign assets. The court found that the taxpayer was aware of his reporting requirements and that he failed to file future FBAR reports. The taxpayer never consulted tax counsel. Because the taxpayer should have known about the risk of failing to comply and he could have found out by simply asking, the court held that his failure was, at a minimum, reckless. In summary, the court concluded that the taxpayer knew about his foreign account, took steps to keep it secret, did not consult with professionals about his tax obligations, and then, after learning that he had not met reporting requirements in the past, failed to file FBARs for the years at issue. Accordingly, the court held that the taxpayer's failure to satisfy his FBAR requirements for the years in issue was a willful violation of the Bank Secrecy Act.

3. Tax Court holds that innocent spouse relief is not available for a taxpayer's liability arising from an erroneous refund of interest paid by the IRS. LaRosa v. Commissioner, 163 T.C. No. 2 (7/17/24). The taxpayers, a husband and wife, reached agreement with the IRS that they had underpaid their tax (including interest) for 1981 through 1983 by $9.7 million and that they had overpaid their tax (including interest) for 1984 and 1985 by $6.1 million. The taxpayers paid to the IRS the $3.6 million difference. The taxpayers subsequently filed a claim for refund asserting that they had overpaid interest. The IRS initially denied the refund claim, but after the taxpayers' congressional representative intervened, the IRS issued a refund of approximately $1.5 million. The government later determined that the refund was erroneous because of a clerical error in computing interest. On behalf of the IRS, the Department of Justice (DOJ) brought an action in federal district court under § 7405(b) to recover the erroneously refunded interest. The District Court concluded that the taxpayers were not entitled to the refund and the court's decision was affirmed on appeal. *See U.S. v. LaRosa*, 993 F.Supp. 907 (D. Md. 1997), *aff'd per curiam*, 155 F.3d 562 (4th Cir. 1998). In 2017, the District Court granted the DOJ's motion to reopen the case and renew the lien on the taxpayers' real property and the DOJ then filed an action to foreclose on the lien. In response, Mrs. LaRosa filed an administrative request for innocent spouse relief on Form 8857 that sought innocent spouse relief under § 6015(f) (equitable relief). The District Court granted her motion to stay the proceedings until her claim for innocent spouse relief was resolved. The IRS responded to her request for innocent spouse relief

with a letter stating that it could not process her request because innocent spouse relief is not available for erroneous refunds. The taxpayer then timely filed a petition in the Tax Court challenging this determination.

Jurisdiction. Initially, the court addressed the IRS's motion to dismiss for lack of jurisdiction. The Tax Court (Judge Buch) declined to accept the IRS's arguments. The court reasoned that the statutory provision that grants the Tax Court jurisdiction to hear innocent spouse cases, § 6015(e)(1)(A), provides two independent avenues through which the court has jurisdiction. The court concluded that the first avenue, which gives the court jurisidction over a case involving an individual against whom a defieicncy has been asserted, was inapplicable because the IRS had not asserted a deficiency against Mrs. LaRosa. Under the second avenue, however, the court has jurisdiction over a case involving "an individual who requests equitable relief under subsection (f)" of § 6015. The court concluded that, because Mrs. LaRosa sought equitable relief under § 6015(f) and had timely filed a petition in the Tax Court, the court had jurisdiction to hear her case. Accordingly, the court treated the government's motion to dismiss for lack of jurisdiction as a motion for summary judgment and turned to the merits of the issue whether innocent spouse relief is available when the government seeks to recover an erroneous refund.

Innocent spouse relief under § 6015. In general, under § 6013(d)(3), married taxpayers who file a joint return are jointly and severally liable for all tax due in connection with the return. An exception to joint and several liability is provided under § 6015 if certain conditions are met. Under § 6015(f), the IRS is authorized to provide equitable relief to a spouse for any "unpaid tax or deficiency" if it would be inequitable to hold the spouse liable for the unpaid tax or deficiency. Necessarily, then, if there is neither an unpaid tax nor a deficiency, relief is not available under § 6015(f).

Whether the erroneous refund of interest created an unpaid tax. The court concluded that whether an erroneous refund gives rise to an unpaid tax depends on whether the erroneous refund is a rebate refund or a nonrebate refund. Rebate refunds are issued on the basis of a recalculation of a taxpayer's tax liability. According to the court, rebate refunds revive a tax liability. For example, if the IRS determines that the amount of tax due is less than the amount of tax shown on the taxpayer's return and issues a refund, the refund is a rebate refund. If the recalculation of tax liability is incorrect and an erroneous refund is issued, the IRS can recover the erroneous rebate refund. The IRS can recover an erroneous rebate refund either by filing suit under § 7405(b) (as it had done in this case) or by pursuing an additional assessment through deficiency procedures. *O'Bryant v. U.S*. 49 F.3d 340, 342-43 (7th Cir. 1995). In contrast, nonrebate refunds are those issued because of a clerical or computer error. Such errors do not require a recalculation of tax and may, for example, include instances where a refund is erroneously issued twice or where the IRS applied payment to the wrong tax year. However, erroneous "nonrebate" refunds can only be recovered through an action under § 7405. *See YRC Reg'l Transp., Inc. v. Commissioner,* T.C. Memo. 2014-112. Unlike a rebate refund, nonrebate refunds cannot be recovered through deficiency procedures. *Id*. This is because rebate refunds give rise to a deficiency, whereas nonrebate refunds do not. In this case, the court reasoned that the erroneous refund was a nonrebate refund because it did not involve recalculation of any portion of the taxpayer's underlying tax liability. Rather, the taxpayers had paid their tax liabilities in full. The refund made to the taxpayers was issued due to an error in determining the date on which the interest accruals ended and was not based on a redetermination of the taxpayers' tax liabilities. Based on this analysis, the court held that the erroneous refund made to the taxpayers was a nonrebate refund and did not give rise to an unpaid tax or a deficiency. Because the erroneous refund did not give rise to an unpaid tax or deficiency, Mrs. LaRosa was not eligible for innocent spouse relief under § 6015(f).

H. Miscellaneous

1. Anti-abuse judicial doctrines create confusion and headaches for everybody. GSS Holdings (Liberty) Inc. v. United States, 81 F.4th 1378 (Fed. Cir. 9/21/23), vacating and remanding 154 Fed. Cl. 481 (2021). This somewhat esoteric 2-1 opinion from the

Court of Appeals for the Federal Circuit vacating a decision by the Claims Court and remanding the case for further proceedings is not, in our opinion, a "must read" for tax advisors. In fact, we are unsure whether a firm conclusion can be drawn from the court's opinion. The case concerns whether the Claims Court conflated and therefore misapplied the judicially created economic substance and step-transaction anti-abuse doctrines. If we count Judge Bruggink's Claims Court's opinion and the dissenting opinion of Judge Newman against the two-judge majority opinion of the Court of Appeals for the Federal Circuit, we have a tie. Perhaps, though, the case offers some lessons: one practical and one academic, as explained further below.

Facts: The background of the case is complicated, involving multiple parties entering numerous contracts and related financial transactions across tax years 2006 through 2011. The essential facts, though, concern 2011 and are as follows. The taxpayer, GSS Holdings (Liberty) Inc. was a member of a limited liability company treated as a partnership for federal income tax purposes. Under a contract originally executed by the LLC-partnership in 2006 but amended and closed in 2011, the LLC-partnership was compelled for financial and regulatory reasons to dispose of certain assets. The assets consisted of (i) a promissory note with a par value and basis higher than the note's fair market value plus (ii) cash that the LLC-partnership had to "rebate" to compensate the buyer for acquiring the devalued promissory note at its par value (instead of its fair market value). The total loss suffered by the LLC-partnership from the transaction with the buyer was approximately $22.5 million. The loss was allocated entirely to the taxpayer via the LLC-partnership. On the one hand, in the view of the IRS (and as originally reported by the LLC-partnership on its 2011 Form 1065), the loss derived from a § 165 sale or exchange of a capital asset (the promissory note, coupled with the rebate of cash) and because the loss arose from a sale or exchange with a related party, the loss must be disallowed under § 707(b)(1). On the other hand, in the view of the taxpayer (and as subsequently reported on an amended return and refund claim filed in 2013), the loss was ordinary and stemmed solely from the cash that the LLC-partnership had to "rebate" to the buyer in a transaction separate and distinct from the disposition of the promissory note. Thus, the fundamental dispute was whether the transaction with the buyer consisted of one sale of assets (a promissory note and the cash rebate) resulting in a disallowed capital loss or, instead, two separate transactions: a sale of the promissory note at par value (no gain or loss) and a separate, independent § 165 ordinary loss "rebate" of cash to the buyer. (Again, we could spend pages explaining the entire factual background and the reasons that the promissory note was acquired from the LLC-partnership by the buyer at its par value along with cash "rebated" to the buyer, but suffice it to say that the case involves complex financial transactions and relationships that are not critical to the appeals court's reversal of the lower court.)

Claims Court Decision: The Claims Court (Judge Bruggink) found for the IRS, denying the taxpayer's refund claim on the basis that the disposition of the promissory note and cash late in 2011 was a single sale or exchange transaction. Judge Bruggink reasoned that the disposition of the promissory note and the rebate of the cash were inextricably linked. Therefore, economic substance as well as the step transaction doctrine mandated sale or exchange treatment as argued by the IRS.

Federal Circuit Decision: The majority of the three-judge panel of the Court of Appeals for the Federal Circuit (Judges Cunningham and Reyna) disagreed, holding that Judge Bruggink of the Claims Court "erred by applying a hybrid legal standard that improperly conflated the step transaction doctrine and the economic substance doctrine." 81 F.4th at 1381. In the opinion of the majority, Judge Bruggink should not have mixed the economic substance and step transaction doctrines in his analysis. Instead, Judge Bruggink should have applied the so-called "end result" test (examining and collapsing a multi-step transaction from the outset based upon the intent of the taxpayer) of the step transaction doctrine by determining which was the first step of the transaction: 2006 (the date the contract originally was executed) or 2011 (when the contract was amended and the transaction closed)? Although the majority vacated Judge Bruggink's decision and remanded the case for further proceedings, Judge Cunningham's majority opinion also stated,

"We are not suggesting any particular outcome; we are simply instructing the Claims Court to apply the correct legal standard." 81 F.4th at 1383.

Dissenting Opinion: The dissent, written by Judge Newman, would have upheld the Claims Court's decision. In Judge Newman's opinion, the economic substance and step transaction doctrines are subsumed by longstanding "substance over form" principles, so Judge Bruggink's analysis did not improperly conflate the two doctrines.

Practical Lesson—File Consistently: Yet again we see a case where a taxpayer took a position on an originally filed return followed by a different position taken on a subsequently filed amended return. An IRS audit and ensuing litigation almost seem certain when this happens.

Academic Lesson—What's the Law?: The traditional anti-abuse judicial doctrines (substance over form, economic substance, and step transaction) employed by the courts in some federal income tax cases do not have clear boundaries, and the decisions applying these doctrines are confusing. Predicting whether and how such doctrines apply to particular circumstances is all but impossible. To wit, the majority and dissenting opinions in *GSS Holdings (Liberty) Inc. v. United States* cited the same precedent as support for their differing analyses: *Falconwood Corp. v. United States*, 422 F.3d 1339 at 1349 (Fed. Cir. 2005) which, quoting an earlier case, states:

> The step transaction doctrine is a judicial manifestation of the more general tax law ideal that effect should be given to the substance, rather than the form, of a transaction, "by ignoring for tax purposes, steps of an integrated transaction that separately are without substance."

2. Here we go again as another front opens in the FUBAR-FBAR war, but the Eleventh Circuit's decision is only a pyrrhic victory for this particular taxpayer. United States v. Schwarzbaum, 134 F.4th 1319 (11th Cir. 8/30/24). Readers will recall that The Bank Secrecy Act provides in part that U.S. persons owning an interest in foreign accounts with an aggregate balance of more than $10,000 must file an annual disclosure report. *See* 31 U.S.C. 5314; 31 C.F.R. § 1010.306 (2021). The Financial Crimes Enforcement Network's ("FinCEN") Form 114 — Report of Foreign Bank and Financial Accounts ("FBAR") is used to file the report. Failure to properly file FinCEN Form 114 may result in varying penalties under 31 U.S.C. 5321(a)(5), depending upon whether the failure was willful or non-willful. The penalty for willfully failing to file an FBAR disclosure is severe: the greater of $100,000 or 50 percent of each offending account per year. Due to the severity of the FBAR penalty for willfully failing to file, an Eighth Amendment Excessive Fines Clause issue has been lurking beneath the surface of the litigated cases. The Excessive Fines Clause of the Eighth Amendment to the U.S. Constitution states, "Excessive bail shall not be required, nor excessive fines imposed, nor cruel and unusual punishments inflicted." U.S. Const. amend. VIII. The U.S. Court of Appeals for the First Circuit in *United States v. Toth*, 33 F.4th 1 (1st Cir. 2022) held (as explained further below) that FBAR penalties for willful failure to file are remedial, not punitive, in nature. In other words, the penalty safeguards the U.S. fisc by reimbursing the IRS and Treasury for the time and expense of investigating and uncovering a taxpayer's circumvention of U.S. tax laws. Because the nature of the willful FBR penalty is remedial, not punitive, the First Circuit determined that the penalty is not a "fine" subject to scrutiny under the Excessive Fines Clause of the Eighth Amendment. After the First Circuit's decision in *Toth*, the U.S. Supreme Court denied certiorari to review the court's holding. *See Toth v. United States*, 143 S. Ct. 552 (1/23/23). One might have thought that the U.S. Supreme Court's denial of certiorari in *Toth* settled the matter; yet, in this case, in an opinion by Judge Marcus, the Eleventh Circuit agreed with the taxpayer that the Eighth Amendment's Excessive Fines Clause applies to willful FBAR penalties. As explained in detail below, however, the taxpayer's victory in the Eleventh Circuit was a pyrrhic one, as the court held that only $300,000 of a total of $12.5 million in FBAR penalties sought by the IRS were "excessive" within the meaning of the Eighth Amendment's Excessive Fines Clause. Regardless of the extent of the taxpayer's success before the Eleventh Circuit in *Schwarzbaum*, the court's holding that the Excessive Fines Clause applies to limit willful FBAR penalties creates a clear split with the First

Circuit. Thus, notwithstanding the U.S. Supreme Court's decision in *Bittner v. United States*, 598 U.S. 85 (2023), in which the Court held that *non-willful* FBAR violations are subject to a maximum penalty of $10,000 regardless of the number of accounts the taxpayer falls to disclose, and its denial of certiorari in *Toth*, the Supreme Court may not be out of the FUBAR-FBAR war just yet.

Background of Schwarzbaum. The facts and procedural history of *Schwarzbaum* are somewhat complicated. The taxpayer was a wealthy German and U.S. citizen with multiple foreign bank accounts. Specifically, the taxpayer had seventeen Swiss and four Costa Rican bank accounts from 2006-2009. Accordingly, the taxpayer was required to file FBAR reports concerning his foreign accounts. The taxpayer filed a few FBAR reports for 2008 and 2009 but did not disclose all of his foreign bank accounts. Then, in 2010, the taxpayer's IRS troubles began in earnest when he finally reported all of his foreign bank accounts for the first time in connection with the IRS's Offshore Voluntary Disclosure Initiative ("OSVDI"). The taxpayer later opted out of the OSVDI program for unknown reasons. An IRS investigation of the taxpayer's foreign bank accounts ensued, and litigation followed in the U.S. District Court for the Southern District of Florida (Judge Bloom). After some procedural ups and downs (including a prior appeal to the Eleventh Circuit[14]), Judge Bloome upheld the IRS's imposition of roughly $12.5 million in *willful* FBAR penalties against the taxpayer for 2007-2009. The taxpayer subsequently appealed (*again!*) to the Eleventh Circuit.

Eighth Amendment Excessive Fines Clause Appeal. The taxpayer argued before the Eleventh Circuit that the IRS's imposition of approximately $12.5 million in FBAR penalties across his foreign accounts for 2007-2009 violated the Excessive Fines Clause of the Eighth Amendment. The taxpayer urged the Eleventh Circuit to conclude, contrary to *Toth*, that the FBAR penalties for willfully failing to disclose foreign bank accounts are punitive, not remedial. Therefore, the taxpayer argued, willful FBAR penalties are "fines" subject to the Eighth Amendment's Excessive Fines Clause. The IRS, of course, argued as it had in *Toth* that FBAR penalties are remedial—like other federal tax penalties intended to safeguard the fisc and reimburse the IRS and Treasury for the time and expense of investigating and uncovering circumvention of U.S. tax laws.

Eleventh Circuit Declines to follow Toth. Judge Marcus wrote the opinion on behalf of the Eleventh Circuit. After reviewing precedent interpreting the Excessive Fines Clause and surveying the legislative history of the FBAR regime, Judge Marcus reasoned: "The Government can impose a $1,000,000 penalty on a $2,000,000 account regardless of whether the Government spent a million dollars investigating the case or whether it spent nothing at all, or any number in between." ____ F.4th at ____. Judge Marcus also reasoned that, based upon precedent, a civil penalty such as that in the FBAR statute need only be *partially* punitive to be subject to the Excessive Fines Clause.[15] Declining to follow *Toth*, Judge Marcus concluded: "No matter how you cut it, it's

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[14] The taxpayer has had several battles with the IRS, some of which have been discussed in prior versions of these materials. *See United States v. Schwarzbaum*, 24 F.4th 1355 (11th Cir. 2022) (vacating and remanding for penalty redetermination *United States v. Schwarzbaum*, 125 A.F.T.R.2d 2020-2109 (5/18/20). *See also United States v. Schwarzbaum*, 125 A.F.T.R.2d 2020-1323 (S.D. Fl. 3/20/20) (bench trial opinion).

[15] In this regard, although the U.S. Supreme Court denied certiorari in *Toth*, Justice Gorsuch dissented from the Court's refusal to hear the case, writing of the First Circuit's opinion:

> This decision is difficult to reconcile with our precedents . . . . The government did not calculate [the FBAR] penalty with reference to any losses or expenses it had incurred. The government imposed its penalty to punish [the taxpayer] and, in that way, deter others. Even supposing, however, that [the taxpayer's] penalty bore both punitive and compensatory purposes, it would still merit constitutional review. Under our cases a fine that serves even "*in part* to punish" is subject to analysis under the Excessive Fines Clause.

143 S. Ct. at _____ (emphasis in original). In *Schwarzbaum*, Judge Marcus's opinion relied in part upon Justice Gorsuch's above-quoted dissent as support for the Eleventh Circuit's conclusion that willful FBAR penalties are subject to the Excessive Fines Clause of the Eighth Amendment.

apparent that [the FBAR penalty] statute is designed to inflict punishment at least *in part* . . . . We hold, therefore, that the FBAR penalty is a fine subject to the Eighth Amendment's Excessive Fines Clause." ____ F.4th at ____ (emphasis added).

Account-by-Account Analysis: Having concluded that the willful FBAR penalty is a "fine" subject to the Eighth Amendment's Excessive Fines Clause, the Eleventh Circuit next had to determine whether the FBAR penalties asserted against the taxpayer in this case were "excessive." The Eleventh Circuit rejected the taxpayer's argument that the Excessive Fines Clause analysis should focus on the taxpayer's total FBAR penalties for 2007-2009. Instead, Judge Marcus wrote that the court must determine, *on an account-by-account basis*, whether the asserted FBAR penalties are "grossly disproportional" to the balances in the taxpayer's offending accounts across each of the years 2007-2009. *See United States v. Bajakajian*, 524 U.S. 321 (1998) (a punitive forfeiture of currency in a U.S. customs matter violates the Excessive Fines Clause if it is "grossly disproportional" to the gravity of the offense). Judge Marcus's opinion includes a comparison chart listing the taxpayer's offending accounts from 2007 through 2009. The chart, reproduced below, compares the taxpayer's maximum account balances (where known), June 30 balances (the FBAR due date for the years in issue, but now April 15), and the maximum allowable penalty per account per year.[16]

Bank Account	**Maximum Balance (Prior Calendar Year) ($)**	**June 30 Balance ($)**	**Maximum Statutory Penalty ($)**
2007			
Aargauische	15,809	11,872	100,000
UBS 6308	1,988,799	8,615,602	4,307,801
UBS 9250	15,022,514	(5,571)	100,000
UMB	672,185	*Unknown*	100,000
Scotiabank de Costa Rica 0588	*Unknown*	*Unknown*	100,000
2008			
Aargauische	13,487	10,601	100,000
Bank Linth	2,605,399	*Unknown*	100,000
BSI	3,880,596	*Unknown*	100,000
Clariden Leu	3,712,704	4,106,132	2,053,066
Raiffeisen	3,101,437	3,137,728	1,568,864
St. Galler	3,353,964	*Unknown*	100,000
UBS 6308	8,615,602	*Closed*	100,000
UBS 9250	15,630,205	*Closed*	100,000
UMB	672,185	*Unknown*	100,000
Scotiabank de Costa Rica 0588	*Unknown*	*Unknown*	100,000
Scotiabank de Costa Rica 1472	*Unknown*	*Unknown*	100,000
2009			
Aargauische	15,758	9,966	100,000
Banca Arner	3,096,278	3,078,492	1,539,246

[16] Notice that the maximum allowable FBAR penalty potentially assessable against the taxpayer according to Judge Marcus's chart (roughly $13.5 million) exceeds by about $1 million the FBAR penalty the IRS actually asserted in the case (roughly $12.5 million). Judge Marcus explained that the IRS asked the District Court to forgo the $1 million difference, and although the taxpayer attempted to argue that this was improper and triggered a statute of limitations question, the Eleventh Circuit ruled that it was permissible for the IRS to seek less than the maximum allowable FBAR penalty.

Bank Account	Maximum Balance (Prior Calendar Year) ($)	June 30 Balance ($)	Maximum Statutory Penalty ($)
Bank Linth	2,955,271	*Unknown*	100,000
BSI	4,311,494	*Unknown*	100,000
Clariden Leu	4,374,222	4,504,702	2,252,351
Raiffeisen	3,139,508	*Closed*	100,000
St. Galler	4,267,212	*Unknown*	100,000

What Is "Excessive"? After setting forth the above chart, Judge Marcus's opinion examines the annual balances in each account to compare the balances against the maximum permissible FBAR penalties—a facts and circumstances analysis. Unfortunately for the taxpayer, Judge Marcus's facts and circumstances analysis concludes that only one account ("Aargauische") suffered "grossly disproportional" FBAR penalties in violation of the Excessive Fines Clause of the Eighth Amendment. A total of $300,000 in FBAR fines ($100,000 per year) were associated with the Aargauische account, but the account never had more than about a $16,000 balance throughout 2007-2009. Judge Marcus determined that a fine "over six times the greatest amount ever held in the account" is excessive. ____ F.4th ___. As for the rest of the taxpayer's accounts and associated FBAR penalties, Judge Marcus found that the penalties asserted were not "grossly disproportional" within the meaning of the Excessive Fines Clause. Summarizing, Judge Marcus wrote: "Going account by account, we are not persuaded that any of the remaining fines—even those taking fifty percent of an account in a given year—are excessive as applied to [the taxpayer]." ___ F.4th at ___. Lastly, after rejecting several procedural challenges raised by the taxpayer, the Eleventh Circuit remanded the case to the District Court to enter a judgment against the taxpayer for approximately $12.2 million in willful FBAR penalties ($300,000 less than initially determined by the IRS and the District Court) plus late fees and interest for the years 2007-2009.

Comment: In our view, even if one agrees with the result, Judge Marcus's Excessive Fines Clause analysis in this willful FBAR penalty case leaves much to be desired. The account-by-account, facts and circumstances analysis employed by the Eleventh Circuit provides no guiding principles or measuring rules (other than the "grossly disproportional" standard) for resolving future willful FBAR penalty cases. Theoretically, any taxpayer residing outside the First Circuit, especially those within the Eleventh Circuit, may challenge the IRS's imposition of willful FBAR penalties under the Eighth Amendment's Excessive Fines Clause. Presumably, outside the First Circuit, the IRS will be left to exercise its discretion regarding the "proportionality" of any willful FBAR penalty it asserts, hoping that the penalties imposed eventually will be sustained by the courts against an Excessive Fines Clause challenge.

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

B. Self-employment Taxes

1. "Sticks and stones may break my bones but …" calling someone a limited partner in a state-law limited partnership does not necessarily exempt that person from self-employment tax on their distributive share of partnership income. Soroban Capital Partners LP v. Commissioner, 161 T.C. No. 12 (11/28/23). The petitioner in this case, Soroban Capital Partners LP (Soroban), is a limited partnership that, for the years in question, was subject to the former TEFRA unified audit and litigation procedures. Soroban had one general partner (a limited liability company) and three individual limited partners, Messrs. Mandelblatt, Kapadia, and Friedman. On its partnership tax returns for 2016 and 2017, Soroban included in net earnings from self-employment the guaranteed payments received by the three limited partners and the general partner's distributive share of the partnership's ordinary business income. On the other hand, Soroban excluded from net earnings from self-employment the limited partners' distributive shares

of the partnership's ordinary business income. Following an audit, the IRS issued Notices of Final Partnership Administrative Adjustment for 2016 and 2017 in which the IRS proposed increasing net earnings from self-employment by the limited partners' distributive shares of the partnership's ordinary business income. On behalf of the partnership, the general partner filed a petition in the Tax Court challenging this adjustment. In the Tax Court, Soroban filed a motion for summary judgment asking the court to determine as a matter of law that the limited partners' shares of the partnership's ordinary business income were excluded from net earnings from self-employment or, alternatively, that any inquiry into the roles of the limited partners in the partnership's business did not concern a partnership matter and therefore could not be resolved in this TEFRA partnership-level proceeding. The government filed a motion for partial summary judgment asking the court to determine as a matter of law that an inquiry into the limited partners' roles could be determined in this partnership-level proceeding. The Tax Court (Judge Buch) denied Soroban's motion and granted the government's motion. Under § 1402(a), a partner's distributive share of partnership income generally is treated as net earnings from self-employment, but § 1402(a)(13) excludes from this treatment "the distributive share of any item of income or loss of a limited partner, as such …" (other than guaranteed payments for services). The court reviewed the legislative history of § 1402(a)(13) and the government's issuance of proposed regulations in 1997 that sought to define the scope of this limited partner exception and that led to a congressional moratorium on the issuance of regulations. The court also reviewed prior judicial interpretation of the limited partner exception in § 1402(a)(13), including the court's prior decision in *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011). In *Renkemeyer*, the court held that partners in a law firm organized as a limited liability partnership were subject to self-employment tax on their distributive shares of partnership income because that income was derived from legal services performed by the partners in their capacity as partners, and therefore "they were not acting as investors in the law firm." The Tax Court had not previously addressed whether a limited partner in a state law limited partnership is automatically a "limited partner, as such" within the meaning of § 1402(a)(13) or instead must satisfy a functional analysis test like the one applied in *Renkemeyer* to be entitled to the limited partner exception. The partnership, Soroban, argued that, because Soroban was a state law limited partnership and its Limited Partnership Agreement identified Messrs. Mandelblatt, Kapadia, and Friedman as limited partners, § 1402(a)(13) was satisfied. The court, however, disagreed and concluded that "[a] functional analysis test should be applied when determining whether the limited partner exception under section 1402(a)(13) applies to limited partners in state law limited partnerships." Because this test requires analysis of the functions and roles of the limited partners, which are factual determinations, the court denied the partnership's motion for summary judgment. The court also held that this examination of the roles of the limited partners is a partnership item that the court had jurisdiction to determine in this TEFRA partnership-level proceeding.

C. Excise Taxes

XII. TAX LEGISLATION

A. Enacted

1. The SECURE 2.0 Act increases the age at which required minimum distributions must begin, modifies the rules regarding catch-up contributions, and makes many other significant changes that affect retirement plans. The Consolidated Appropriations Act, 2023, Pub. L. No. 117-328, signed by the President on December 29, 2022, includes the SECURE 2.0 Act of 2022, which increases the age at which required minimum distributions (RMDs) must begin to age 73, reduces the penalty for failure to take RMDs, modifies the rules for catch-up contributions to qualified retirement plans, and makes many other significant changes that affect retirement plans.

XIII. TRUSTS, ESTATES & GIFTS

A. Gross Estate

1. Case results in a clear split between Eighth and Eleventh Circuits concerning inclusion of corporate-owned life insurance proceeds in estate tax value of closely-held stock. Connelly v. United States, 70 F.4th 412 (8th Cir. 6/2/23). In this federal estate tax case, the U.S. Court of Appeals for the Eighth Circuit had to decide whether corporate-owned life insurance proceeds were includable in the estate tax value of a deceased shareholder's redeemed shares or should be excluded from such value as the Eleventh Circuit had held in *Estate of Blount v. Commissioner*, 428 F.3rd 1338 (11th Cir. 2005). Two brothers owned all 500 outstanding shares of stock of Crown C Corporation ("Crown"), a building-materials company located in St. Louis. One brother owned a majority (385.9 shares or 77.18%) of Crown's outstanding stock, while the other brother owned a minority (114.1 shares or 22.82%) of Crown's outstanding stock. Crown and the two brothers had entered into a stock purchase agreement that would take effect upon the death of either brother. Under the agreement, the surviving brother had an option to purchase the deceased brother's shares, or if the surviving brother declined the option, the corporation, Crown, was obligated to redeem the deceased brother's shares. The agreement set the price for the decedent's shares via either (i) a contemporaneous "Certificate of Agreed Value" executed between the brothers each year or (ii) an appraisal process if the brothers failed to execute a "Certificate of Agreed Value" for the relevant year. Furthermore, Crown owned separate $3.5 million insurance policies on the life of each brother to facilitate a redemption of stock upon the death of either brother. When the brother owning the majority of Crown's shares died in 2013, the surviving brother's and Crown's rights under the stock purchase agreement were triggered. No "Certificate of Agreed Value" had been executed between the brothers for 2013 (or, for that matter, ever), and the surviving brother declined to exercise his purchase option. Therefore, Crown proceeded to redeem the deceased brother's shares (385.9 shares or 77.18%) for $3 million, funded by the $3.5 million corporate-owned life insurance policy on the decedent's life, with Crown retaining the $500,000 excess of life insurance proceeds over the redemption price. Rather than the redemption price being set by the agreement itself, however, the deceased brother's son and the surviving brother, as executor of the deceased brother's estate, had agreed to the $3 million value for the deceased brother's shares as part of an "amicable and expeditious" settlement of several estate-administrative matters. Not surprisingly, the decedent's estate reported the value of the redeemed stock at $3 million for federal estate tax purposes. On audit, the IRS challenged the reported $3 million estate tax value of the decedent's shares, arguing that Crown's overall fair market value, including the $3.5 million in life insurance proceeds, was $6.86 million ($3.36 million exclusive of the $3.5 million in life insurance proceeds). The IRS further argued that the higher company-level value informs the estate tax value of the decedent's stock, not merely the $3 million redemption price agreed to by the decedent's son and the surviving brother. The IRS (supported by expert testimony) thus set the value of the deceased brother's shares at about $5.3 million (77.17% x $6.86 million) and assessed a $1 million estate tax deficiency against the decedent's estate. The estate paid the deficiency and filed a refund suit in U.S. District Court, where the lower court held for the IRS. The estate then appealed to the Eighth Circuit.

The Estate's Arguments. The estate of the deceased brother made two arguments that the $3 million redemption price for the decedent's shares was proper for estate tax purposes. The estate's first argument was that the stock purchase agreement complied with § 2703(b) and therefore sets the value of the deceased brother's shares for estate tax purposes. Section 2703(a) generally provides that the estate tax value of property is determined without regard to any agreement restricting the property's sale or setting the property's price at less than fair market value. Section 2703(b), though, provides an exception, thereby potentially allowing an agreement to set the estate tax value of property via agreement if three requirements are met: (i) it is a bona fide business arrangement; (ii) it is not a device to transfer property among family members for less than full and adequate consideration; and (iii) its terms are comparable to arms' length transactions entered into by unrelated persons. The estate's second argument was that the $3 million price set for the

deceased bother's shares reflected the stock's fair market value exclusive of the $3.5 million of life insurance proceeds, which is the proper result under *Estate of Blount v. Commissioner*, 428 F.3d 1338 (11th Cir. 2005). The Eleventh Circuit in *Blount* held under similar circumstances that the estate tax value of a decedent's shares subject to a stock purchase agreement at death should not include corporate-owned life insurance proceeds used to redeem the decedent's shares. The Eighth Circuit reasoned that any such life insurance proceeds have no net effect on the value of the redeemed shares because the proceeds received by the corporation are offset by a concomitant liability to purchase the decedent's stock. The Eighth Circuit stated in *Blount*, "To suggest that a reasonably competent business person, interested in acquiring a company, would ignore a $3 million liability strains credulity and defies any sensible construct of fair market value." 428 F.3rd at 1346. *See also Estate of Cartwright v. Commissioner*, 183 F.3rd 1034 (9th Cir. 1999).

The Eighth Circuit's Opinion. The Eighth Circuit rejected both arguments by the estate and accepted the IRS's position that Crown's overall fair market value upon the decedent's death was $6.86 million, resulting in the deceased brother's shares being valued at approximately $5.3 million for estate tax purposes, inclusive of the $3.5 million of corporate-owned life insurance proceeds. In an opinion by Chief Judge Smith, the Eighth Circuit reasoned that the estate's first argument concerning § 2703 was flawed because the stock purchase agreement did not contain a fixed price or formula to set the value of the deceased brother's shares for estate tax purposes. Courts, including the Eleventh Circuit in *Blount*, have recognized that, under Reg. § 20.2031-2(h), a stock purchase agreement must contain a fixed or determinable price if it is to be binding for estate tax valuation purposes. Reg. § 20.2031-1(h) provides in part that "[l]ittle weight will be accorded a price" in an agreement where the decedent was "free to dispose of" stock at any price during the decedent's lifetime. Section 2703 was enacted against the backdrop of Reg. § 20-2031-2(h), and thus the courts have applied the two in tandem to control the determination of value for estate tax purposes. Chief Judge Smith thus concluded that the stock purchase agreement at issue in Connelly v. United States could not establish the estate tax value of the decedent's shares under § 2703 or Reg. § 20.2023-2(h) because, in the absence of a pre-determined and binding "Certificate of Agreed Value" or a compulsory appraisal, the agreement had no fixed or determinable method for setting the stock's redemption price as of the decedent's death. The Eighth Circuit also declined to adopt the estate's second argument that *Blount* controlled to exclude the $3.5 million of corporate-owned life insurance proceeds from the determination of the estate tax value of the deceased brother's shares. Chief Judge Smith cited as support both the general willing buyer/willing seller rule of Reg. § 20.2031-2(a) and the more specific rule of Reg. § 20.2031-2(f)(2), which states that in valuing shares of a closely-held corporation for estate tax purposes "consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company." Chief Judge Smith emphasized this latter point by noting that the $500,000 of excess life insurance proceeds not used to redeem the decedent's shares benefitted Crown and augmented its overall fair market value. Chief Judge Smith wrote further:

> The IRS has the better argument. *Blount*'s flaw lies in its premise. An obligation to redeem shares is not a liability in the ordinary business sense . . . A buyer of Crown would therefore pay up to $6.86 million [for all of Crown's outstanding stock], having "taken into account" the life insurance proceeds, and extinguish [the stock purchase agreement] or redeem [the deceased brother's shares] as desired. *See* 26 C.F.R. § 20.2031-2(f)(2). On the flip side, a hypothetical willing seller of Crown holding all 500 shares would not accept only $3.86 million knowing that the company was about to receive $3 million in life insurance proceeds, even if those proceeds were intended to redeem a portion of *the seller's own shares*. To accept $3.86 million would be to ignore, instead of "take[ ] into account," the anticipated life insurance proceeds. (Emphasis in original.)

Chief Judge Smith also wrote of the estate's argument and the court's decision not to follow *Blount*:

> To further see the illogic of the estate's position, consider the resulting windfall to [the surviving brother]. If we accept the estate's view and look to Crown's value exclusive of the life insurance proceeds intended for redemption, then upon [the deceased brother's] death, each share was worth $7,720 before redemption. After redemption, [the deceased brother's] interest is extinguished, but [the surviving brother] still has 114.1 shares giving him full control of Crown's $3.86 million value. Those shares are now worth about $33,800 each. Overnight and without any material change to the company, [the surviving brother's] shares would have quadrupled in value. This view of the world contradicts the estate's position that the proceeds were offset dollar-by-dollar by a "liability." A true offset would leave the value of [the surviving brother's] shares undisturbed.

Comment. Never leave it to clients to mutually agree to the value stock on an annual basis as part of a stock purchase agreement triggered by a stockholder's death, especially if they are related. Moreover, consider having any life insurance policies that are intended to fund the purchase of a deceased shareholder's stock being held outside the corporation, such as in a trust or a partnership that is a party to the stock purchase agreement.

a. It's (Unbelievably?) Unanimous! SCOTUS resolves the conflict by affirming *Connelly* (8th Circuit) and implicitly overruling *Estate of Blount* (11th Circuit). Connelly v. United States, 144 S. Ct. 1406 (6/6/24), *aff'g* 70 F.4th 412 (8th Cir. 6/2/23). After the Eighth Circuit's decision in *Connelly*, the Supreme Court of the United States granted certiorari. Oral arguments were heard on March 27, 2024. The Supreme Court, in an incredibly swift decision by today's standards, unanimously upheld the Eighth Circuit's opinion in favor of the IRS and against the estate. The Court rejected the estate's arguments—which were substantially the same as before the Eighth Circuit—and agreed with the IRS that the federal estate tax value of the deceased brother's shares in Crown must consider the life insurance proceeds payable to the company. The Supreme Court thus determined that Crown's overall fair market value upon the decedent's death was $6.86 million, resulting in the deceased brother's shares being valued at approximately $5.3 million for estate tax purposes, inclusive of the $3.5 million of corporate-owned life insurance proceeds. The Court declined to rule, as the Eleventh Circuit did in *Estate of Blount*, that Crown's obligation to redeem the decedent's shares should be treated as an offsetting liability for federal estate tax purposes. Justice Thomas wrote the unanimous opinion of the Court, reasoning as follows:

> An obligation to redeem shares at fair market value does not offset the value of life-insurance proceeds set aside for the redemption because a share redemption at fair market value does not affect any shareholder's economic interest. A simple example proves the point. Consider a corporation with one asset—$10 million in cash—and two shareholders, A and B, who own 80 and 20 shares respectively. Each individual share is worth $100,000 ($10 million ÷ 100 shares). So, A's shares are worth $8 million (80 shares x $100,000) and B's shares are worth $2 million (20 shares x $100,000). To redeem B's shares at fair market value, the corporation would thus have to pay B $2 million. After the redemption, A would be the sole shareholder in a corporation worth $8 million and with 80 outstanding shares. A's shares would still be worth $100,000 each ($8 million ÷ 80 shares). Economically, the redemption would have no impact on either shareholder. The value of the shareholders' interests after the redemption—A's 80 shares and B's $2 million in cash—would be equal to the value of their respective interests in the corporation before the redemption. Thus, a corporation's contractual obligation to redeem shares at fair market value does not reduce the value of those shares in and of itself.

144 S. Ct. at 1411-1412. Importantly, however, Justice Thomas clarified in a footnote that the Court's holding in *Connelly* does not mean a redemption obligation can never decrease a corporation's value for estate tax purposes. "A redemption obligation could, for instance, require

a corporation to liquidate operating assets to pay for the shares, thereby decreasing its future earning capacity. We simply reject [the estate's] position that all redemption obligations reduce a corporation's net value. Because that is all this case requires, we decide no more." 144 S. Ct. at 1413 note 2.

B. Deductions

C. Gifts

1. In these gift tax cases involving QTIP trusts, what's good for the goose and gander is bad for the goslings. Estate of Anenberg v. Commissioner, 162 T.C. No. 9 (5/20/24) and McDougall v. Commissioner, 163 T.C. No. 5 (9/17/24). The issue in each of these reviewed Tax Court decisions was whether the unique commutation of "qualified terminal interest property" ("QTIP") trusts (as described in §§ 2056(b)(7) and 2523(f)) resulted in a taxable gift within the meaning of § 2501(a). As explained further below, the Tax Court (Judge Toro) held that, despite § 2519 (dispositions of certain life estates), the QTIP trust commutations in these two cases did not result in taxable gifts by the lifetime spousal beneficiaries of the trusts. Judge Toro's opinions explain that, because in each case the pre-agreed terms of the commutations resulted in the spouse receiving *all of the property* in the QTIP trusts, there was no taxable "gift" of the remainder interest by the spouse within the meaning of § 2501(a). (Normally, each beneficiary in a trust "commutation" receives a portion of the trust's assets in exchange for surrendering the beneficiary's right to future distributions from the trust. Contrastingly, the lifetime QTIP trust beneficiaries in *Anenberg* and *McDougall* received all of the QTIP trust assets while the remaindermen received nothing—at least as part of the commutation.) The Tax Court did not address whether the commutation of the QTIP trust in *Anenberg* could give rise to taxable gifts by the remainderman-children beneficiaries of the QTIP trusts. In *McDougall*, however, the Tax Court addressed the question left open in *Anenberg*, concluding that the QTIP trust commutation in *McDougall* was a taxable gift from the remaindermen-children beneficiaries to the spouse as the lifetime income beneficiary of the QTIP trust. Apparently, several of these QTIP trust commutation cases are winding their way through the Tax Court, in part perhaps due to the pending 2026 sunset of the currently large estate and gift tax exclusions ($13.61 million for individuals and $27.22 million for married couples). *See* § 2010(c)(3). We elaborate below.

QTIP Regime. The federal estate and gift tax includes special provisions, § 2056(b)(7) (estate tax) and § 2523(f) (gift tax), permitting a decedent or donor to avoid estate or gift taxation on a gratuitous transfer to a spouse even though the property transferred is limited to a life estate with a remainder interest in designated beneficiaries other than the spouse (usually children). Normally, such transfers would be at least partially taxable because the remainder interest does not qualify for the marital deduction of either § 2056 (estate tax) or § 2523 (gift tax). By making an election under either § 2056(b)(7) (estate tax) or § 2523(f) (gift tax), though, "qualified terminal interest property" or "QTIP" may qualify for the marital deduction and avoid tax. The property subject to the QTIP election essentially is treated as 100% owned by the spouse for estate and gift tax purposes notwithstanding the interest of the remaindermen. As Judge Toro put it in *Anenberg*, the QTIP "regime" creates a "legal fiction" whereby the entire property subject to the election is considered owned by the spouse "to ensure that, if not consumed by the surviving spouse during [the spouse's] lifetime, the QTIP is subject to either the estate or gift tax." 162 T.C. at ____. Most often, the property transferred from one spouse to the other (either at death or *inter vivos*) is held in trust—a "qualified terminal interest property" or "QTIP" trust—which is includable in the transferee spouse's federal taxable estate under § 2044 at its fair market value when the spouse dies. Moreover, § 2519 backstops § 2044 during the transferee spouse's life by treating "any disposition of the [transferee] spouse's income interest in QTIP as if the [transferee] spouse transferred 100% of the remainder interests in QTIP." 162 T.C. at ___. Oftentimes (but not in *Anenberg* or *McDougall*, as explained below), this deemed disposition of the QTIP remainder

interest under § 2519(a) results in a taxable gift by the spouse who is the lifetime QTIP income beneficiary.[17]

TCJA Rollback of the Estate and Gift Tax Exclusion. Of course, property held in a QTIP trust for the spouse's benefit during his or her life may appreciate substantially, creating a potential estate tax burden on the trust assets upon the spouse's death.[18] This potential estate tax burden is becoming more pressing as we draw closer to 2026. Specifically, the 2017 Tax Cuts and Jobs Act, § 11061, amended § 2010(c)(3) by adding a new subsection (C). New § 2010(c)(3)(C) increased the basic estate and gift tax exclusion amount from $5 million to $10 million for decedents dying after 2017 *but before 2026*. Pursuant to § 2010(c)(3)(B), both the $5 and $10 million exclusion amounts are adjusted annually for inflation after 2011. Accordingly, for 2024, the basic exclusion amount (determined by reference to the $10 million exclusion in § 2010(c)(3)(C)) is $13.61 million for individuals and $27.22 million for married couples. *See* Rev. Proc. 2023-34, 2023-48 I.R.B. 1287. Starting January 1, 2026, however, the basic exclusion amount (determined by reference to the $5 million exclusion in § 2010(c)(3)(A)) rolls back to an *estimated* $7 million for individuals and an *estimated* $14 million for married couples. Of course, Congress may change the law before 2026, but that is by no means a certainty. Accordingly, wealthy taxpayers have begun taking steps to mitigate the impact of the potential rollback of the basic exclusion amount to $7 million for individuals and $14 million for married couples. One such tactic seems to be terminating highly-appreciated QTIP trusts exceeding the potentially reduced estate and gift exclusion scheduled for 2026. After termination of the QTIP trust, surviving spouses are implementing other estate and gift tax mitigation strategies to avoid a potentially heavy estate tax burden on their QTIP trusts at their deaths. *Anenberg* and *McDougall* appear to exemplify this type of estate and gift tax planning.

a. Good for the goose and gander: *Anenberg*. The Anenbergs, a married couple, established a family trust as part of their estate planning. The family trust held shares of stock in Mr. Anenberg's closely-held company. Upon Mr. Anenberg's death in 2008, some of the stock in Mr. Anenberg's company held by the family trust passed to marital subtrusts in which Ms. Anenberg had an income interest for life. Some cash and a 50% interest in the Anenberg's home also passed to the marital subtrusts upon Mr. Anenberg's death. The remainder (including the company stock) left in the marital subtrusts after Ms. Anenberg's death was designated to pass to Mr. Anenberg's children by a prior marriage. Mr. Anenberg's children and one grandchild were active in the company both before and after Mr. Anenberg's death. The executor of Mr. Anenberg's estate and trustee of the marital subtrusts (one of Mr. Anenberg's children) elected QTIP treatment for the subtrusts, thereby qualifying them for the marital deduction and avoiding estate tax. Later, in March 2012, the state court with jurisdiction over the matter approved a petition by the trustee to terminate the QTIP subtrusts based upon pre-agreed terms between Ms. Anenberg and Mr. Anenberg's children. The state court terminated the QTIP subtrusts and ordered the trustee to transfer the entirety (not just a portion representing the income interest) of the assets held by the subtrusts to Ms. Anenberg as previously agreed. Subsequently, in August of 2012, Ms. Anenberg gifted to Mr. Anenberg's children some of the company stock she received in the commutation of the QTIP subtrusts. Then, in September 2012, Ms. Anenberg sold the rest of the company stock she received in the commutation to Mr. Anenberg's children in exchange for an installment

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[17] For instance, as cited by Judge Toro in *Anenberg* at 162 T.C. ___, see *Estate of Morgens v. Commissioner*, 678 F.3d at 772–73 (addressing a surviving spouse who gave her income interest in QTIP to the decedent's heirs, receiving nothing in return, and was deemed to transfer the remainder interest under section 2519); Reg. § 25.2519-1(g) (example 1) (treating a surviving spouse as making a gift of both the life interest and the remainder when she transferred to decedent's children for no consideration the entire interest in the personal residence in which she had been left a life estate); Reg. § 25.2519-1(g) (example 2) (treating a surviving spouse as making a gift of the remainder interest when she transferred to decedent's children the entire interest in the personal residence in which she had been left a life estate and was compensated only for her life interest).

[18] The estate tax (if any) can be paid out of the assets of the QTIP trust. *See* § 2207A(a).

promissory note with a maturity date of September 1, 2021. For her 2012 tax year, Ms. Anenberg filed a gift tax return (Form 709, U.S. Gift (and Generation-Skipping Transfer) Tax Return). Ms. Anenberg's 2012 gift tax return reported the gifts of company stock to Mr. Anenberg's children but took the position that selling the company stock to the children was not a taxable gift. Ms. Anenberg died in 2016. Upon examination of Ms. Anenberg's estate and her prior gifts, especially the events of 2012, the IRS determined a gift tax deficiency for her estate of over $9 million plus an accuracy-related penalty of over $1.8 million. The estate filed a petition in Tax Court contesting the IRS's determination.

Arguments. The IRS's position before the Tax Court was that either of the following 2012 events relating to Ms. Anenberg's QTIP subtrusts was a "disposition of all or part of a qualifying income interest for life" (within the meaning of § 2519), thereby resulting in a taxable gift of the remainder interests to Mr. Anenberg's children: (i) the agreed-upon commutation of the QTIP subtrusts or (ii) the sale to the children of the company stock received in the commutation. Ms. Anenberg's estate argued that neither (i) the commutation of the QTIP subtrusts nor (ii) the sale of the company stock was a § 2519 "disposition of all or part of [Ms. Anenberg's] qualifying income interest for life" in her QTIP subtrusts. Alternatively, Ms. Anenberg's estate argued that even if either of the 2012 events was a § 2519 "disposition," there was no gift of the remainder interests to the children because Ms. Anenberg received all of the assets in the QTIP subtrusts, not merely a portion representing her income interests. The Tax Court heard the IRS's and the estate's arguments on cross-motions for partial summary judgment.

The Opinion. The Tax Court's opinion, written by Judge Toro, began by examining § 2519(a), which provides as follows: "For purposes of this chapter [gift tax] and chapter 11 [estate tax], any disposition of all or part of a qualifying income interest for life in any property to which this section applies shall be treated as a transfer of all interests in such property other than the qualifying income interest." Section 2519(b) provides that subsection (a), as quoted above, applies to property subject to the QTIP election permitted by §§ 2056(b)(7) (estate tax) and § 2523(f) (gift tax). Next, Judge Toro's opinion considered whether commutation of the QTIP subtrusts or selling the company stock constituted a "disposition" of Ms. Anenberg's lifetime income interest. Rather than deciding that issue, however, Judge Toro opined that regardless of whether the commutation or sale of company stock was a § 2519 "disposition," Ms. Anenberg could not have made a taxable gift in either instance because she received 100% of the QTIP subtrust assets in the commutation and received fair value (in the form of the promissory note) upon the sale of the company stock to the children. Judge Toro specifically focused upon the above-quoted language of § 2519(a), which states that a "disposition" of a spouse's income interest in QTIP property is a deemed "transfer" (not a gift) of the remainder interest in the QTIP property. A transfer, Judge Toro explained, is not a taxable "gift" (within the meaning of § 2501) unless it is a "gratuitous transfer." Judge Toro's opinion further explains that because Ms. Anenberg received 100% of the QTIP subtrust assets upon the commutation, and received full consideration on the sale of the company stock, "she gave away nothing of value" even assuming either event was § 2519 disposition of her income interest in the QTIP subtrusts. 162 T.C. at ___. Judge Toro rejected the IRS's counter-argument that if § 2519 is triggered, a "gift" of the remainder interest in the spouse's QTIP trust automatically follows. Judge Toro reasoned that if Congress meant to treat a § 2519 "disposition" (whatever that may mean) of a spouse's income interest in a QTIP trust as a taxable gift of the remainder interest under § 2501, then Congress would have used the word "gift" instead of "transfer" in § 2519. Judge Toro also rejected the IRS's argument that the third sentence of Reg. § 25.2519-1(a) controlled the outcome in the case. The third sentence of Reg. § 25.2519-1(a) states in part that if § 2519(a) applies, "the donee spouse is treated as making a *gift* under section 2519 of the entire [QTIP] trust less the qualifying income interest." (Emphasis added.) Citing U.S. Supreme Court precedent, Judge Toro explained that "self-serving regulations never 'justify departing from the statute's clear text.'" Judge Toro also distinguished or dismissed other authorities cited by the IRS as support for its position.

b. Not good for the goslings (because the IRS got smarter): *McDougall*. The facts in *McDougall* are similar to the facts in *Anenberg*. Namely, a surviving spouse was the lifetime beneficiary of a QTIP trust funded in 2011 with a remainder interest benefiting children. (In this case, though, the remainder beneficiaries were the children of both the predeceased spouse and the surviving spouse.) The deceased spouse's assets funding the QTIP trust were valued at approximately $54 million for estate tax purposes but, due to the marital deduction, were not subject to estate tax in 2011. By 2016, the value of the assets in the QTIP trust had more than doubled. For reasons not explained fully in the opinion, the surviving spouse and the children agreed in October 2016 to terminate the QTIP trust via a "Nonjudicial Agreement." The agreement provided that the QTIP trust "shall be commuted and the entire remaining balance of the [QTIP trust] distributed outright and free of trust to [the surviving spouse]." On the same day in October of 2016, the surviving spouse transferred assets he received from the commutation of the QTIP trust to separate trusts established for each of his children. In exchange, the surviving spouse received promissory notes from each trust. The surviving spouse and each of the children filed 2016 gift tax returns (IRS Form 709, U.S. Gift (and Generation-Skipping) Tax Return) reflecting the above-described events. Their gift tax returns presumed that the commutation of the QTIP trust was a "disposition" (within the meaning of § 2519(a)) of the surviving spouse's lifetime interest; however, the 2016 gift tax returns also took the position that no "gift" (within the meaning of § 2501) occurred with respect to the children's remainder interests because all of the QTIP trust assets were distributed to the surviving spouse. Moreover, the promissory notes were full consideration for the surviving spouse's transfer of assets to the children's trusts. (The surviving spouse and the IRS continue to disagree whether the promissory notes were for full and adequate consideration, but that dispute was not material to the Tax Court's decision regarding the gift tax consequences of the commutation of the QTIP trust.) After examination, the IRS issued notices of gift tax deficiency for the 2016 transfers (citing § 2519(a)) <u>but with a wrinkle</u>: the notices of deficiency were issued to the surviving spouse <u>and</u> to each of the children as remainder beneficiaries of the QTIP trust. The IRS's position was that even if the QTIP trust commutation was not a taxable gift of the remainder interest from the surviving spouse to the children via § 2519(a), the children made taxable gifts of their remainder interests to the surviving spouse by virtue of the commutation. *Touché.* The surviving spouse and each of the children filed petitions in Tax Court contesting the notices of deficiency, and the court consolidated the cases for purposes of its decision. The case was heard upon cross-motions for summary judgment.

Judge Toro's Opinion. Again, Judge Toro wrote the opinion for the Tax Court. As you might expect, the IRS argued, as it had in *Anenberg*, that the QTIP commutation was a "disposition" of the surviving spouse's income interest in the QTIP trust resulting in a taxable gift to the children as remaindermen. Relying upon the Tax Court's decision in *Anenberg*, however, Judge Toro concluded that no "gift" (within the meaning of § 2501) to the children occurred due to the commutation of the QTIP trust. Just as he did in *Anenberg*, Judge Toro reasoned that because the surviving spouse received all of the assets of the QTIP trust as part of the agreed-upon commutation, no "gratuitous transfer" of the remainder interest passed from the surviving spouse to the children notwithstanding § 2519(a). With respect to the gift tax consequences to the children, though, Judge Toro agreed with the IRS. Specifically, even if no "gift" of the remainder interest in the QTIP trust passed from the surviving spouse to the children by virtue of the commutation and § 2519(a), the children made taxable gifts of their QTIP remainder interests to the surviving spouse due to the commutation. The children argued that, according to Judge Toro's opinion in *Anenberg*, the QTIP election regime under either § 2056(b)(7) or §2523(f) creates the "legal fiction" of 100% ownership of QTIP trust property by the surviving spouse. Therefore, there can be no "gift" of the QTIP remainder interest from the children to the surviving spouse because the QTIP regime treats the surviving spouse as already owning the remainder interest. Nonetheless, Judge Toro did not buy the children's argument. Instead, Judge Toro explained that the children took the "QTIP fiction" too far: "We have already recognized that the QTIP fiction does not apply for all purposes." 163 T.C. at ____. In further support, Judge Toro cited *Estate of Mellinger v. Commissioner*, 112 T.C. 26, 36–37 (1999) ("Neither section 2044 nor the legislative history

indicates that decedent should be treated as the owner of QTIP property for [purposes of aggregating stock ownership in connection with valuing the stock].”). Moreover, Judge Toro clarified that the QTIP regime focuses on the transfer of assets outside the marital unit. The QTIP statutes “say nothing about, and do not apply to, transactions that transferees outside the marital unit, such as [the children as remainderman beneficiaries], may undertake with respect to their own interests in QTIP.” 163 T.C. at ___. Judge Toro also rejected the children’s “reciprocal gift” argument—i.e., that the § 2519(a) deemed transfer of the remainder interest from the surviving spouse to the children was offset by the commutation of the QTIP remainder interest back to the surviving spouse. Judge Toro responded by relying upon the Tax Court’s reasoning in *Anenberg*: “[T]here are no deemed gifts from [the surviving spouse to the children] to offset the very real gifts from [the children to the surviving spouse].” Judge Toro concluded his opinion by (i) granting partial summary judgment to the surviving spouse (because he made no taxable gift by virtue of the commutation) but also (ii) granting partial summary judgment to the IRS with respect to the children’s taxable gifts of their QTIP remainder interests to the surviving spouse (due to the commutation). Judge Toro also noted, though, that the value of the children’s gifts was a factual issue yet to be determined. 163 T.C. at ____ footnote 7.

Judge Halpern’s Concurring Opinion. Judge Halpern concurred in the result, but wrote separately to express how his analysis would have differed from the rest of the Tax Court. Instead of declining to address whether the QTIP commutation was a § 2519(a) “disposition” of the surviving spouse’s lifetime income interest, Judge Halpern (who for some reason did not join in or write separately in the Tax Court’s *Anenberg* decision) would have addressed the issue directly. Judge Halpern would have decided that the commutation of the QTIP trust in this case was not a § 2519(a) “disposition.” Nevertheless, Judge Halpern agreed that the children made a gift of their QTIP remainder interests to the surviving spouse by virtue of the commutation (because the surviving spouse received the entirety of the QTIP trust’s assets). Judge Halpern wrote: “Concluding that the [agreed-upon commutation of the QTIP trust] did not effect a disposition of the [surviving spouse’s] qualifying income interest provides a more straightforward justification for the conclusion that [the surviving spouse] did not make a taxable gift but [the children] made taxable gifts to [the surviving spouse].” 163 T.C. at ____.

D. Trusts