2024/2025 FEDERAL TAX UPDATE

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

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These materials summarize important developments in the federal income, estate and gift tax laws affecting individual taxpayers and small businesses in 2024 and 2025, with occasional references to older items where relevant. The materials are organized roughly in order of significance. These materials generally do not discuss developments in deferred compensation or the taxation of business entities (except to a very limited extent).

I. INFLATION-ADJUSTED FEDERAL INCOME TAX BRACKETS FOR 2025 (from Rev. Proc. 2024-40)

<table>
<tr><th colspan="2">Taxable Income Exceeding</th><th rowspan="2">Ordinary Income</th><th rowspan="2">Adjusted Net Cap Gain* & Qualified Dividends</th><th rowspan="2">Medicare Surtax on Earned Income**</th><th rowspan="2">Medicare Surtax on Net Investment Income</th></tr>
<tr><th>Single</th><th>Married Filing Jointly</th></tr>
<tr><td>$0</td><td>$0</td><td>10%</td><td rowspan="2">0%</td><td rowspan="6">2.9%</td><td rowspan="6">0%</td></tr>
<tr><td>$11,925</td><td>$23,850</td><td rowspan="2">12%</td></tr>
<tr><td>$48,350</td><td>$96,700</td><td rowspan="6">15%</td></tr>
<tr><td>$48,475</td><td>$96,950</td><td>22%</td></tr>
<tr><td>$103,350</td><td>$206,700</td><td>24%</td></tr>
<tr><td>$197,300</td><td>AGI over $250,000</td><td rowspan="2">32%</td></tr>
<tr><td>AGI over $200,000</td><td>$394,600</td><td rowspan="4">3.8%</td><td rowspan="4">3.8%</td></tr>
<tr><td>$250,525</td><td>$501,050</td><td rowspan="2">35%</td></tr>
<tr><td>$533,400</td><td>$600,050</td><td rowspan="2">20%</td></tr>
<tr><td>$626,350</td><td>$751,600</td><td>37%</td></tr>
</table>

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

** Includes employer contribution of 1.45% (§3111(b)(6)), individual contribution of 1.45% (§3101(b)(1)), and additional tax of 0.9% for adjusted gross income over $200,000 for an unmarried individual and $250,000 on a joint return (§3101(b)(2), for years after 2012).

FEDERAL INCOME TAX RATES FOR TRUSTS AND ESTATES FOR 2025

(Adapted from Rev. Proc. 2024-40)

<table>
<tr><th>Taxable Income Exceeding</th><th>Ordinary Income</th><th>Adjusted Net Cap Gain* & Qualified Dividends</th><th>Medicare Surtax on Net Investment Income</th></tr>
<tr><td>$0</td><td>10%</td><td rowspan="2">0%</td><td rowspan="5">0%</td></tr>
<tr><td>$3,150</td><td rowspan="2">24%</td></tr>
<tr><td>$3,250</td><td rowspan="3">15%</td></tr>
<tr><td>$11,450</td><td>35%</td></tr>
<tr><td>$15,650</td><td rowspan="2">37%</td></tr>
<tr><td>$15,900</td><td>20%</td><td>3.8%</td></tr>
</table>

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

II. FEDERAL WEALTH TRANSFER TAX ADJUSTMENTS

A. GIFT TAX ANNUAL EXCLUSION

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

Date of gift	Annual exclusion
1997 – 2001	$10,000
2002 – 2005	$11,000
2006 – 2008	$12,000
2009 – 2012	$13,000
2013 – 2017	$14,000
2018 – 2021	$15,000
2022	$16,000
2023	$17,000
2024	$18,000
2025	$19,000

B. BASIC EXCLUSION AMOUNT

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

For decedents dying in	The basic exclusion amount is		For decedents dying in	The basic exclusion amount is
2011	$5,000,000		2018	$11,180,000
2012	$5,120,000		2019	$11,400,000
2013	$5,250,000		2020	$11,580,000
2014	$5,340,000		2021	$11,700,000
2015	$5,430,000		2022	$12,060,000
2016	$5,450,000		2023	$12,920,000
2017	$5,490,000		2024	$13,610,000
			2025	$13,990,000

III. SUPREME COURT CASES OF INTEREST

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

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

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

1. Facts

The decedent, Michael Connelly, and his brother, Thomas Connelly, were the only shareholders of a building materials corporation based in St. Louis. Michael owned 77.18 percent of the company's stock. Michael and Thomas executed a buy-sell agreement that provided that, upon the death of the first of them to die, the surviving brother would have a right to purchase the deceased bother's shares. If the surviving brother did not exercise this option, the company would redeem the deceased brother's shares. The record states that it was always the intention of Michael and Thomas that the company would redeem the deceased brother's shares. To that end, the company purchased $3.5 million of life insurance coverage on each brother.

The buy-sell agreement further provided that the price to be paid for the deceased brother's stock would be determined by a "certificate of agreed value" to be executed each year by the bothers. If they failed to do so (in fact, they never signed any such document at any point), the value of the stock would be determined by reference to at least two appraisals. When Michael died, the company received the $3.5 million death benefit. Without obtaining any appraisals, the company paid $3 million to Michael's estate in redemption of his 77.18-

percent stake in the company. The balance of the proceeds were used in the company's business. Michael's executor (Thomas) determined the value of Michael's interest through an "amicable and expeditious" negotiation with Michael's son, Michael Connelly, Jr.

Michael's estate filed an estate tax return that reported the value of Michael's stock at $3 million, and the estate paid federal estate tax on this amount. The valuation, remember, was determined by a private agreement, and the valuation did not factor in the value of the death benefit from the life insurance policy. On audit, the IRS determined that the estate should have had the stock appraised and that any such appraisal would have included 77.18 percent of the value of the death benefit. As a result, it determined that the value of Michael's stock was about $5.3 million, resulting in a $890,000 deficiency that Michael's estate paid. The estate then brought this refund action, but a federal district court granted summary judgment to the IRS.

2. The Eighth Circuit's Decision

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

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

> An obligation to redeem shares is not a liability in the ordinary business sense. ... Consider the willing buyer at the time of Michael's death. To own [the company] outright, the buyer must obtain all its shares. At that point, he could then extinguish the stock-purchase agreement or redeem the shares *from himself*. This is just like moving money from one pocket to another. There is no liability to

> be considered—the buyer controls the life insurance proceeds. A buyer of [the company] would therefore pay up to $6.86 million, having "taken into account" the life insurance proceeds, and extinguish or redeem as desired. On the flip side, a hypothetical willing seller of [the company] holding all 500 shares would not accept only $3.86 million knowing that the company was about to receive $3 million in life insurance proceeds, even if those proceeds were intended to redeem a portion of *the seller's own shares*. To accept $3.86 million would be to ignore, instead of "take[] into account," the anticipated life insurance proceeds.

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

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

The court thus affirmed summary judgment for the IRS.

3. Supreme Court Affirms

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

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

> would have treated [the corporation's] obligation to redeem Michael's shares at fair market value as a factor that reduced the value of those shares.

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

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

(Emphasis in original.)

4. Observations

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

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

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

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

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

The MRT, enacted as part of the 2017 Tax Cuts and Jobs Act's conversion to a "source-based" system of corporate taxation from a "worldwide" system, was a one-time tax on United States persons owning at least 10 percent of the stock of a controlled foreign corporation ("CFC") in 2017 on the CFC's undistributed post-1986 earnings and profits. While the MRT imposed a one-time tax on what could be a huge amount of undistributed earnings, it did so at favorable rates: cash earnings were taxed at 15.5 percent and other earnings were taxed at 8 percent. The case, then, was not really about the trifle amount of revenue generated by the MRT. Instead, the case was important as a barometer for the Court's current thoughts on the concept of realization and the constitutionality of a proposed wealth tax.

1. Factual Background and Lower Court Analysis

Charles and Kathleen Moore, a married couple residing in Redmond, Washington, owned 11 percent of the stock in KisanKraft, a CFC that supplies tools to farmers in rural India. The company was profitable, but all profits were reinvested in the business. The Moores never received a distribution from the company. Still, by virtue of owning more than 10 percent of the CFC's stock, in 2017 they became liable for MRT on the company's post-1986 retained earnings. They paid a tax of $14,729 and commenced this refund claim, arguing that the MRT was a retroactive tax on past earnings and thus violative of the Due Process Clause of the Fifth Amendment.

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

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

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

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

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

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

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

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

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

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

2. Early Concerns

That the Supreme Court granted the taxpayers' certiorari petition took many by surprise. It's not like lower appellate court were split on the issue, and the Ninth Circuit even refused a rehearing request by the taxpayers. If they could not convince the Ninth Circuit to hear the case *en banc,* why would the Supreme Court have an interest in taking the case? That question provoked speculation the case was not so much about the MRT as it was about testing the constitutionality of a proposed wealth tax. If Congress cannot impose a one-time tax on prior undistributed earnings of a CFC that will never face United States taxation going forward, as with the MRT, then it probably cannot impose a wealth tax that would tax a high-net-worth individual on unrealized wealth. It seems far-fetched that the Court would agree to review a case about the MRT with the ulterior motive of preventing a tax that has only been introduced as legislation but never advanced out of the House Ways and Means Committee. And yet such speculation, normally the fodder of conspiracy theorists, persisted, leading to significant hand-wringing as to how the Court might rule.

3. Much Ado About Nothing, Says the Majority

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

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

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

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

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

Then, in footnote 3, he writes:

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

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

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

4. Other Opinions Tackle Realization Directly

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

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

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

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

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

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

(Emphasis added, citations omitted.)

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

> Sixteenth Amendment "incomes" include only income realized by the taxpayer. The text and history of the Amendment make clear that it requires a distinction between "income" and the "source" from which that income is "derived." And,

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

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

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

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

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

5. Observations

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

Should the Court later decide that realization is a constitutional requirement, it will need to grapple with other Code provisions that impose income taxation absent the actual receipt of some benefit. These provisions might include, for example, §7872 (treating certain below-market loans as deemed transfers between borrowers and lenders despite no actual transfers), the original issue discount rules (treating the holder of original issue discount as receiving deemed payments on the instrument despite receiving no actual payment), and §475 (requiring certain dealers in securities to use the mark-to-market method of accounting despite not yet realizing the appreciation in value of those securities).

Justice Thomas endorsed the view of the Moores that the MRT "tagged" a CFC shareholder with income even if he or she purchased the shares in 2017, long after the corporation earned the sums being taxed. The claim has intuitive appeal, but it does not really apply to them: the Moores were shareholders at all times their CFC had earnings. If they were being taxed on earnings attributable to years in which they were not shareholders, this argument might have persuaded more than only Justices Thomas and Gorsuch.

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

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

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

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

In simplest terms, *Chevron* deference requires that a court defer to an agency's interpretation of a statute that is either silent or ambiguous as to a particular matter as long as that interpretation "is based on a permissible construction of the statute." In other words, a court may not second-guess or substitute its own, "better" interpretation of a statute as long as the agency's interpretation is a reasonable one. The case was decided in the heyday of the Reagan Administration's deregulation campaign. At the time, it was viewed as a modest victory for conservatives who controlled federal agencies focused on implementing rules that reduced government oversight.

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

1. The Majority Opinion

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

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

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

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

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

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

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

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

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

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

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

Id. at 35.

2. The Concurring Opinions

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

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

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

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

3. The Dissent

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

> Congress knows that it does not—in fact cannot—write perfectly complete regulatory statutes. It knows that those statutes will inevitably contain ambiguities that some other actor will have to resolve, and gaps that some other

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

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

4. Observations

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

IV. DISTRIBUTION OF QTIP TO SURVIVING SPOUSE DOES NOT TRIGGER DEEMED GIFT OF REMAINDER INTEREST, BUT COULD TRIGER GIFT BY REMAINDER BENEFICIARIES (*Estate of Anenberg v. Commissioner*, 162 T.C. No. 9, May 20, 2024, and *McDougall v. Commissioner*, 163 T.C. No. 5, September 17, 2024), NOT TO MENTION INCOME TAX CONSEQUENCES (*Private Letter Ruling 202509010*, February 28, 2025)

In two unanimous opinions, the Tax Court held that a surviving spouse did not make a gift under §2519 upon the termination of two marital trusts holding "qualified terminable interest property" ("QTIP") because the surviving spouse received all of the trust assets upon termination. The court in both cases also held that the surviving spouse's subsequent installment sale of the assets formerly held in the marital trusts likewise did not trigger a deemed gift under §2519. Finally, in one of the cases the court held that the terminating distribution to the surviving spouse was a gift by the remainder beneficiaries of their vested remainder interests in the trust.

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

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

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

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

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

B. *Estate of Anenberg*

1. Facts

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

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

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

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

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

2. No Deemed Gift Upon Termination of Marital Trusts

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

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

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

3. No Deemed Gift on Subsequent Sale

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

> When the Superior Court terminated the Marital Trusts, the property interest Sally received was outright ownership of the … shares, not an income interest. And because the Marital Trusts terminated, the property interest Sally received was unencumbered by any restrictions that were placed on it while it was in the Trusts, including restrictions that would have limited distributions to individuals

> other than Sally. For these reasons, Sally no longer held a qualifying income interest for life as defined by section 2056(b)(7)(B)(ii), Consequently, her sale of the … shares for promissory notes could not trigger section 2519.

4. The IRS Misapplies Rules and Precedent

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

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

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

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

5. What About the Remainder Beneficiaries?

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

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

It seems the IRS will not repeat the mistake, as seen in the next case.

C. *McDougall*

1. Facts

Clotilde McDougall died in 2011 with a gross estate of nearly $60 million, survived by her husband, Bruce, and her two adult children, Linda and Peter. She left the bulk of her estate in trust for the benefit of Bruce and the kids. The trust required the trustee to pay annual income to Bruce, together with any principal needed for his health, maintenance and support. At Bruce's death, the kids will take whatever is left in trust in shares determined by Bruce through exercise of a testamentary limited power of appointment. In his capacity as Clotilde's executor, Bruce made a QTIP election with respect to the property passing to the trust, enabling her estate to claim a marital deduction for the value of that property.

Whoever invested the trust assets earned a good fee: by 2016, the value of the trust assets had more than doubled. At that time, Bruce and the kids entered into a nonjudicial agreement pursuant to which the trust would terminate and the assets would be distributed outright and free of trust to Bruce. On the same day he received the trust assets, Bruce sold them to trusts established for the benefit of Linda, Peter, and their descendants in exchange for promissory notes.

On their federal gift tax returns, the parties took a unique position. They claimed that the termination of the QTIP trust resulted in a deemed gift by Bruce of the remainder interest in the trust under IRC §2519, but because Bruce received all of the trust assets, Linda and Peter made offsetting gifts of their remainder interests to Bruce. Because each party "gave what they got," they claimed, no taxable gifts resulted. The IRS disagreed, issuing deficiency notices to Bruce, Linda, and Peter.

2. *Anenberg* Applies, But Does Not Completely Answer All Questions

As the Tax Court observed, this case is eerily like *Anenberg*. Sticking to that decision, the court held that, just as Sally Anenberg made no gifts to her kids when she received all of the assets from her husband's QTIP trust and then sold those assets to trusts for her children, Bruce made no gifts when he received the assets from Clotilde's QTIP trust and then sold them to trusts for his Linda and Peter. But in this case, unlike *Anenberg*, the IRS also claimed that the remainder beneficiaries made gifts back to the surviving spouse. And on this point, the IRS prevailed. As the court explains:

> Linda and Peter plainly made gratuitous transfers. Before the implementation of the Nonjudicial Agreement, they held valuable rights, i.e., the remainder interests in the QTIP. After the implementation of that agreement, which required their consent, Linda and Peter had given up those valuable rights by agreeing that all of the Residuary Trust assets would be transferred to Bruce. And they received nothing in return. By giving up something for nothing, Linda and Peter engaged in quintessential gratuitous transfers and are therefore subject to gift tax under sections 2501 and 2511.

While the "QTIP fiction" of IRC §2519 applies "for the limited purpose of determining [a surviving spouse's] transfer tax liability when marital assets leave the marital unit," it does not apply for purposes of allowing remainder beneficiaries "to escape transfer tax on their own transactions."

The court also rejected the contention that Bruce and the kids made offsetting reciprocal gifts. Because Bruce did not make an actual or deemed gift through the termination of the trust and the subsequent sale of the trust assets, there is nothing to offset the "very real gifts from Linda and Peter to Bruce."

As noted, the decision was unanimous. Still, Judge Halpern contributed a concurring opinion in which he offers "an alternative analysis" that he dubs "a sounder basis for the Court's conclusions." He takes the position that when the trust terminates and Bruce receives all of the assets, he does not make a "disposition" of his qualifying income interest. Because he owns the assets, he still has the income interest from those assets. Thus, in his view, IRC §2519 has no application here. This leads to the same result, but in a way that avoids employment of a legal fiction. As he explains:

> If section 2519(a) did not apply, we would have no occasion to impose asymmetrical treatment on a single exchange, treating Linda's and Peter's constructive transfers to Bruce as, simultaneously, (1) adequate and full consideration to him for a deemed transfer by him to Linda and Peter, and (2) wholly gratuitous, and thus taxable gifts by them to him. If Bruce made no deemed transfer under section 2519(a) to Linda and Peter, then, as the majority

concludes, he made no taxable gifts to them, and their "very real" transfers to him stand alone as taxable gifts.

3. Observations

The court did not decide the value of gifts Linda and Peter made to Bruce, as it was ruling on cross-motions for summary judgment. Future proceedings will have to determine the value of their gifts. For now, it's safe to say the gifts are large.

McDougall answers the question left open in *Anenberg* as to whether the termination of a QTIP trust through a nonjudicial settlement agreement represents a gift by the remainder beneficiaries. Still, at least one other question remains: suppose a court had ordered termination of the trust over the objection of Linda and Peter, or that the trustee decanted the trust in a manner such that Bruce had easier access to the trust's assets. If Linda and Peter do not consent to the effective termination or limitation of their remainder interests, are they still making a gift? Assuming a gift requires the free and voluntary act of the transferor, there is an argument that, in such cases, the remainder beneficiaries are not making gift transfers. But the validity of that argument is an issue for another day.

D. *Private Letter Ruling 202509010*

And then there are the federal *income* tax issues related to the early termination of a trust. In *Private Letter Ruling 202509010*, the IRS considered the income, gift, and generation-skipping transfer (GST) tax consequences stemming from the court-approved termination of a trust. The trust, created before 1985, provided for the payment of an annual annuity to the grantor's grandchild for that grandchild's life. At the grandchild's death, the annuity amount would be divided among the grandchild's issue *per stirpes*. The trust would terminate upon the last to die of ten listed individuals (including the grandchild), at which point the corpus would be paid to the grandchild's issue *per stirpes*.

The trustee, the grandchild, all of the current remainder beneficiaries, and a special representative appointed to represent minor and unborn beneficiaries have all agreed to terminate the trust pending a favorable ruling from the IRS. If the termination occurs, each beneficiary would receive an amount equal to the actuarial value of the beneficiary's interest in the trust. A court with jurisdiction over the trust has approved of the proposed early termination.

The IRS ruled that the early termination of the trust would not cause the trust to lose its GST tax-exempt status because the termination:

> will neither cause a beneficial interest to be shifted to a beneficiary who occupies a generation lower than the beneficiaries who held the interests prior to the termination, nor extend the time for vesting of any beneficial interest in Trust beyond the period provided for in the original Trust, as long as the actuarial

values of the trust accurately represent the actuarial value of each beneficiary's interest.

The IRS further ruled that the termination will not be treated as a gift by any beneficiary because each will receive an amount that matches the actuarial value of that beneficiary's interest.

But the IRS also ruled that for federal income tax purposes, the termination will be treated as a sale of the grandchild's life interest to the grandchild's children *and* as a sale by the issue who would take at the trust's natural termination of their rights to receive a potential distribution on termination to the grandchild's children. Furthermore, because every beneficiary has a zero basis in their interest, the entire amount received by each beneficiary in the transaction constitutes a long-term capital gain.

As always, keep in mind that a private ruling is binding only as to the taxpayer that requested it; it may not be cited as precedent before the Tax Court, and readers may not rely on it as it is not otherwise binding on the IRS. The IRS can, and often does, change its mind on any given issue examined in a private ruling. Still, professionals can gain insight into the IRS's current stance on relevant and interesting issues by reviewing a private ruling.

Note too that this ruling has been met with skepticism by some commentators. They wonder how a beneficiary who receives an amount equal to the value of his or her actuarial interest could be seen as selling to exchanging anything with any of the other beneficiaries. They claim that the commutation of a trust should not been seen as an exchange of beneficial interests. Indeed, in the gift tax context the IRS says as much when it concludes, "assuming the actuarial values accurately represent each beneficiary's interest, we conclude that *no transfer of property will be deemed to occur* as a result of the termination and the Proposed Distribution." (Emphasis added.) Despite the concern with the reasoning, practitioners might well be concerned that the ruling signals a potential litigation position the IRS may take in other cases. For a thorough and helpful guide to the tax aspects of trust termination, see Boyle, Zaritsky, and Wallace, *The Uniform Basis Rules and Terminating Interests in Trusts Early*, 55 Real Prop. Tr. & Est. L. J. 1 (2020).

V. VALUE OF QUALIFIED TERMINABLE INTEREST PROPERTY IS NOT REDUCED BY AMOUNTS DISTRIBUTABLE TO SURVIVING SPOUSE'S ESTATE (*Estate of Kalikow v. Commissioner*, No. 23-7957 (2d Cir. March 4, 2025)

In *Estate of Kalikow v. Commissioner*, No. 23-7957 (2d Cir. March 4, 2025), the Second Circuit Court of Appeals affirmed the Tax Court's determination that a decedent's gross estate included the value of assets held in a trust created under the will of the decedent's spouse for which the spouse's executors had made a qualified terminable interest property ("QTIP") election under IRC §2056(b)(7), without diminution for the amount that the trustees must pay to the decedent's estate in settlement of the estate's claim for undistributed income. It thus sustained a $32.7 million estate tax deficiency. The appellate court also confirmed that the settlement amount could be not deducted under IRC §2053(b) as an administration expense.

A. Facts of the Case

When Pearl Kalikow's husband, Sidney, died in 1990, his will devised the residue of his estate to a trust for the benefit of Pearl. The will provided that upon Pearl's death, the trust would terminate, with the remainder passing in equal shares to two separate trusts, one for each of Sidney and Pearl's two children and their issue. The executors of Sidney's estate properly elected to treat this trust as a QTIP trust under IRC §2056(b)(7), thus enabling his estate to claim an estate tax marital deduction for the value of the assets passing to the trust.

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

While that would appear to be the end of the matter, there is more to the story. When one of Pearl's grandchildren petitioned the trustees for an accounting, the co-trustees filed competing accounts. One of the reports showed Pearl did not receive some $16.9 million in income to which she was entitled. Under a QTIP trust, remember, a surviving spouse must receive all of the trust's net income at least annually. The report from the other co-trustee, on the other hand, concluded that Pearl had received nearly $3.3 million *too much* from the trust.

The $20 million difference led to litigation that lasted a decade. In 2019, a settlement was reached under which the trust would pay $9.2 million to Pearl's estate. Of this amount, about $6.5 million represented undistributed income that should have been paid to Pearl while she was alive. Pearl's will left her entire estate to a foundation she created, so the undistributed income payable under the settlement agreement would ultimately pass to charity. The balance of the settlement agreement represented legal fees and trustee commissions.

B. Tax Court Decision

The estate tax return filed by Pearl's estate reduced the amount of the QTIP trust includible in her gross estate by the $6.5 million settlement payable to her estate. But the Tax Court rejected this position, noting that the parties had already stipulated to the value of the partnership interest. *Estate of Kalikow v. Commissioner*, T.C. Memo. 2023-21. The settlement agreement imposes liability for the settlement payment jointly on the QTIP trust and the two trusts that will receive the remainder of the QTIP trust. Importantly, the partnership itself is not liable for any portion of the payment. “Consequently,” said the court, “there is no basis to conclude that this liability would affect the date-of-death fair market value of the [partnership interest], i.e., the liability would not affect the price of this partnership interest as determined between a hypothetical willing buyer and seller as of the date of the decedent’s death.” The court rejected the estate’s argument that the decision has the effect of imposing estate tax on $6.5 million that will ultimately pass to charity. “Inclusion of the [QTIP] trust assets in decedent’s gross estate will give rise to neither double taxation nor any estate tax on any charitable bequest but rather will merely give effect to the provisions of section 2044(a).”

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

C. Second Circuit Affirms

In a summary order, which may be cited although it does not have “precedential effect,” the Second Circuit affirmed both of the Tax Court’s conclusions. The Second Circuit observed that “a liability that belongs to the Trust but does not affect the value of the underlying assets would not alter the value of the gross estate.” Here, the settlement liability did not affect the assets of the trust, for, as the appellate court noted, “[a] hypothetical purchaser of the largest asset in the [QTIP] Trust—the [family limited] partnership [interest]—would not accede to the liability and therefore would not regard the liability as affecting the price of the asset.” The court found it telling that the estate and the co-trustees “knew of the undistributed income claim at the time they stipulated to” the $54.5 million value of the partnership interest, and that the settlement agreement itself stated that the payment could be made from “readily available funds” from the trust without having to liquidate any of the properties held by the partnership. “Thus,” ruled the court, “there is no basis upon which to diminish the value of the assets included in the gross estate by the amount of the undistributed income claim.”

As for the claimed deduction under IRC §2053(b), the Second Circuit agreed with the Tax Court that the liability belonged to the trust and not to the estate. Because IRC §2053(b) only offers a deduction for claims against the estate, it would be improper to permit a deduction for the trust’s liability payable to the estate. The court also rejected the estate’s claim of double taxation, noting that the settlement payment, as part of Pearl’s residuary estate, will be paid to a charitable foundation, giving the estate a charitable contribution deduction for the amount of the settlement payment.

D. Observation

The court observed that the Tax Court "appropriately declined" to decide whether the QTIP trust would be entitled to a deduction on its own federal income tax return for the settlement payment. On this point it is important to note that the settlement was paid in 2019. Even where costs incurred in defense of a claim related to the administration of a trust are deductible under normal rules, those costs are "miscellaneous itemized deductions." As a result, the deduction would be suspended (effectively, disallowed) under IRC §67(g). Section 67(e), which effectively exempts certain expenses of estates and trusts from this rule, see Reg. §1.67-4, would not apply because settlement payments are not unique to estates and trusts.

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

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

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

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

Among other things, the SECURE Act created a distinction between "designated beneficiaries" and "eligible designated beneficiaries." Prior to the SECURE Act, there were only "designated beneficiaries," generally defined as individuals and most see-through trusts for the benefit of individuals. Under the old rules, a designated beneficiary was required to withdraw the funds from a deceased participant's plan or individual retirement account over the designated beneficiary's remaining life expectancy. After the SECURE Act, the opportunity for this "lifetime stretch-out" is limited to "eligible designated beneficiaries." The Act established only four types of eligible designated beneficiaries: surviving spouses, minor children (but only until they reach the age of majority), disabled and chronically ill beneficiaries, and any individual less than ten years younger than the plan participant. §401(a)(9)(E)(ii). For all other designated beneficiaries (like adult children, for example), the SECURE Act imposed a new ten-year payout period. §401(a)(9)(H)(i). Under this rule, an adult child named as the beneficiary of a retirement plan or IRA has ten years to withdraw the funds from the participant's account, regardless of that adult child's own life expectancy. Planners have come to call this the "10-year rule."

The conventional wisdom was that the 10-year rule would operate like the five-year rule long in effect where, for example, trusts are named as beneficiaries of the decedent's IRA or retirement plan. Under the five-year rule, the custodian must make sure funds are fully distributed by the end of the fifth year after the decedent's year of death, but there is no requirement that a minimum distribution be made in any one year. Indeed, a custodian may make a one-time distribution of the entire account balance to the trustee at or near the end of the fifth year following the year of the participant's death.

But in the 2022 proposed regulations, the IRS announced that where: (1) the 10-year rule applies to an IRA or a qualified plan; and (2) the participant had started taking annual RMDs prior to death, RMDs must likewise be taken by the designated beneficiary starting the year after the year of death of the employee, with a full and final distribution required by the end of the tenth calendar year after the year of the employee's death. In other words, heirs and beneficiaries cannot wait until the end of the ten-year period to make one lump sum distribution like they could under the five-year regime.

Since this rule was not in the statute and was only first announced in the 2022 proposed regulations, the heirs and beneficiaries of employees who died in 2020 after starting RMDs very likely did not take an RMD in 2021 and were unsure whether they had to take an RMD in 2022. This very much matters because §4974 imposes a penalty for failure to take an RMD equal to 25 percent of the amount by which the amount actually distributed falls short of the RMD amount. In their comments to the proposed regulations, some of these individuals who would otherwise face a penalty for not taking RMDs in 2021 and 2022 asked that, if the final regulations adopt the interpretation of the 10-year rule contained in the proposed regulations, the IRS provide transition relief.

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

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

> beneficiary who is a designated beneficiary of an employee who died in 2020, 2021, 2022, or 2023, and after the employee's required beginning date, provided that the beneficiary was not an eligible designated beneficiary who used the lifetime or life expectancy payments exception under section 401(a)(9)(B)(iii). Those notices also provided comparable relief for the case in which an eligible designated beneficiary who was taking annual life expectancy payments died in 2020, 2021, 2022, or 2023, and that beneficiary's successor beneficiary failed to take a distribution in 2021, 2022, 2023, or 2024.

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

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

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

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

Id. at 58896-58897.

The following chart, adapted from a slide presented by Steven Siegel, gives an overview of how post-death distributions work under the legislation and regulations.

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

B. Accompanying Proposed Regulations

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

1. Surviving Spouse Election to be Treated as Participant

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

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

2. Corrective Distributions to Reduce Penalty

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

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

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

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

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

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

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

A. Guidance on Emergency Personal Expense Distributions

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

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

B. Guidance on Domestic Abuse Victim Distributions

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

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

C. Observations

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

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

VIII. DEATHBED PARTNERSHIP FAILS, SO ASSETS INCLUDED IN GROSS ESTATE (*Estate of Fields v. Commissioner,* T.C. Memo. 2024-90, September 26, 2024)

The Tax Court has held that assets transferred shortly before the decedent's death to a family limited partnership by the decedent's agent under a durable power of attorney are includible in the decedent's gross estate, denying valuation discounts claimed by the estate and, thus, increasing the amount of federal estate tax due.

The decedent, Anne Milner Fields, inherited an oil business from her husband in the 1960s. Under her leadership, the oil business did … well. (Oil? Well? Get it?) According to the court, "She took a particular interest in her great nephew, Bryan Milner, educating him, mentoring him, and designating him as the successor to her wealth." She appointed Milner as the agent of a broad durable power of attorney, which proved an important component of some last-minute estate planning implemented about one month before her death.

Following a bad fall in May, 2016, the decedent's health began its downward spiral. That same month, Milner, on the advice of counsel, formed a family limited partnership, designating an LLC that he owned as the general partner and the decedent as limited partner. Milner transferred $1,000 to the partnership on behalf of the general partner. Then, acting as the decedent's agent under the power of attorney, Milner transferred to the partnership some $17 million in assets belonging to the decedent. Following the transfers, then, Milner's LLC was the 0.0059% general partner and the decedent was the 99.9941% limited partner. By the time the decedent's largest single asset was transferred to the partnership, the decedent had been diagnosed with end-stage Alzheimer's. Ten days after the last transfer, the decedent died.

Milner hired an expert to appraise the value of the decedent's limited partner interest. Applying a 15% minority interest discount and a 25% discount for lack of marketability, the appraiser set the value of the limited partner interest at about $10.8 million. Milner, as the decedent's executor, reported this value on the decedent's federal estate tax return.

The IRS determined that the partnership should be disregarded and that the value of the assets contributed to the partnership on behalf of the decedent should be included in the decedent's gross estate. In the alternative, should a court determine that the partnership entity is to be respected, the IRS determined that the value of the decedent's partnership interest was $15.388 million. The IRS also determined a negligence penalty should apply on these facts.

A. Inclusion of the Partnership Assets Under §2036(a)

Where a decedent transferred property during life but retained certain rights or interests in the property that were not relinquished before death, §2036(a) requires the property to be included in the decedent's gross estate for federal estate tax purposes. The parties stipulated that the decedent, through the actions of Milner acting as her agent, transferred assets to the partnership. They disagreed as to whether the decedent retained any rights or interests in the transferred property and as to whether the exception for "a bona fide sale for adequate and full consideration" applied.

The Tax Court agreed with the IRS that the decedent both retained possession or enjoyment of the transferred property (which causes inclusion under §2036(a)(1)) and retained the right to designate who shall possess or enjoy the transferred property (which causes inclusion under §2036(a)(2)).

Applying §2036(a)(1), the court observed that, following the transfers, the decedent was left with only $2.15 million of assets outside the partnership, yet her will provided for bequests totaling $1.45 million when a "substantial estate tax liability was foreseeable." That proved "an implicit agreement between Mr. Milner and [the decedent] that he, as manager of [the] general partner, would make distributions from the partnership to satisfy her expenses, debts, and bequests if and when necessary." Noting that "Virtually nothing beyond formal title changed in decedent's relationship to [her] assets," the court concluded, "The use of a significant portion of partnership assets to discharge obligations of a decedent's estate is evidence of a retained interest in the assets transferred to the partnership."

Applying §2036(a)(2), the court pointed to a provision in the partnership agreement giving the decedent the power, exercisable with Milner, to liquidate the partnership, sell its assets, and distribute the cash proceeds to the partners in accordance with their capital accounts. This power, said the court, gave the decedent the right "to at any time acquire outright all income from the transferred assets and then designate its disposition," giving her the power to control beneficial enjoyment of the assets. "We emphasize," the court concluded, "that here there was essentially no pooling of assets in the partnership, which accordingly functioned not as a joint investment vehicle but rather only as a vehicle to reduce estate tax."

B. The Bona Fide Sale Exception Does Not Apply

By its terms, §2036(a) does not apply to a transfer otherwise within its scope where the transfer is a "bona fide sale for an adequate and full consideration in money or money's worth." Precedent indicates that a transfer is a "bona fide sale" where it is "objectively likely to serve a substantial nontax purpose." *Strangi v. Commissioner*, 417 F.3d 468 (5th Cir. 2005). Any nontax reason must be "a significant factor that motivated the partnership's creation. A significant purpose must be an actual motivation, not a theoretical justification." *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005). The court also noted that "we may consider the decedent's age and health at the time of the transfer" in determining the bona fides of a sale or exchange.

The decedent's estate asserted four significant and legitimate nontax purposes for the partnership arrangement, but the Tax Court rejected them all. The estate first claimed the partnership would protect the decedent from financial elder abuse, citing events where the decedent had been preyed upon by manipulative caregivers. But the court noted that those instances incurred years before the formation of the partnership and that there was no evidence showing any likelihood that these events would be ongoing, especially given the decedent's health condition at the time of formation.

The estate then claimed the partnership facilitated "succession management of assets," effectively giving Milner the chance to name a successor to manage the partnership, a power he lacked under the power of attorney. But the court found no evidence to support this claim. Instead, the court found evidence that the only reason for formation of the partnership was to enhance applicable valuation discounts for estate tax purposes.

The third nontax purpose claimed by the estate was that the partnership "resolved the problem of third parties, such as banks, refusing to honor the general [power of attorney]." That might have had some legs were it not for the fact that the entity was formed only after the decedent's health began its rapid decline, meaning that no one expected the power of attorney to last for much longer.

Finally, the estate argued that the partnership allowed for "consolidated and streamlined management of assets." The court found the only evidence to support this was Milner's own testimony, which had little probative value given a slew of other, unfavorable facts: all the transfers happened as the decedent's health was in "precipitous decline;" the assets transferred "were of a disparate character, promised no obvious synergies with each other, and came almost exclusively from" the decedent; none of the assets transferred were business interests requiring active management; and the decedent "was not herself involved in any of the partnership planning or management."

Thus, the transfers to the partnership were not "bona fide sales," and because the decedent retained rights to (and control over) possession and enjoyment of the assets, the assets themselves are includible in her gross estate.

C. Valuation of the Amount Included in the Gross Estate and Application of the Penalty

Rather than simply hold that the decedent's estate includes the date-of-death value of the assets Milner transferred to the partnership on her behalf, the court insisted on following the cumbersome formula approach from *Estate of Moore v. Commissioner*. T.C. Memo. 2020-40. Under that formula:

$$V_{included} = C_d + FMV_d - C_t$$

$V_{included}$ is the value that must be included in the gross estate. C_d is the date-of-death value of the consideration received by the decedent from the transfers that remains in her estate under IRC §2033. FMV_d is the fair market value of the property transferred to the partnership that is included in the gross estate under IRC §2036 as of the date of death. Finally, C_t is the value of the consideration, if any, received by the decedent as the time of the transfer, which must be subtracted under IRC §2043(a).

The court reasoned that because C_d and C_t are only 27 days apart, and because there is no evidence that the value of the assets changed over this time period, the two components cancel each other out, leaving only the date-of-death value of the assets as the amount included in the decedent's estate.

Why, oh why, must the Tax Court insist on using this formula in cases involving "deathbed formations" of a family partnership or LLC? The whole point of disregarding the partnership is to include the value of the assets held by the partnership instead of the value of the partnership interest. Unless a court finds actual consideration paid upon transfer, the formula offers little help and abundant complexity.

That brings us to the issue of valuation. At trial, the parties disputed only the valuation of one asset: some 89,000 shares of stock in North Dallas Bank & Trust. The estate's expert applied a 10% blockage discount to shares representing about 3.5% of the company's total stock, but the Tax Court noted there was no evidence or explanation given by the expert supporting the application of this discount. The court instead accepted the valuation of the IRS's expert, which valued the stock with a net asset value of $5.43 million at just over $5.1 million thanks to the application of a more modest 5.7% blockage discount supported by analysis from 32 comparable transactions. That meant the total amount included in the decedent's estate came to just over $17 million, nearly $6.2 million more than the amount shown on the estate tax return.

The IRS asserted a 20% negligence penalty in this case, which the estate resisted by claiming there was "reasonable cause" for its reporting position on the estate tax return. But the Tax Court found that "a reduction of approximately $6.2 million in the Estate's reportable assets thanks to the seemingly inconsequential interposition of a limited partner interest between [the decedent] and her assets on the eve of her death would strike a reasonable person in Mr. Milner's position as very possibly too good to be true." Finding also that there was no evidence that Milner reasonably relied on professional tax advice, the court upheld the application of the negligence penalty.

D. Final Thoughts

Once upon a time, valuation cases involving transfers to family limited partnerships and LLCs were commonplace. Over time, planners have learned to avoid the common traps that apply to this technique, leaving fewer cases on court dockets. At the same time, the surge in the basic exclusion amount since 2017 has made it so only the largest estates find family limited partnerships and LLCs helpful in reducing the amount subject to estate tax. Generally, advisors for those largest estates are quite savvy in designing and implementing these plans, minimizing exposure to deficiency determinations.

IX. GIFT LOAN IS NOT A GIFT WHERE ADEQUATE INTEREST IS STATED AND PAID (*Estate of Galli v. Commissioner*, No. 7003-20, U.S. Tax Court, March 5, 2025)

The Tax Court has held that a loan arrangement between parent and child did not result in a taxable gift by the parent because the child agreed to pay (and in fact did pay) interest at a rate equal to the applicable federal rate (AFR) in effect in the month the loan was made.

In February, 2013, Barbara Galli, then age 79, transferred $2.3 million to her son, Stephen. They both signed a promissory note under which the balance would be repaid in no more than nine years with interest at a rate 1.01 percent, the mid-term AFR for February, 2013. Barbara did not file a federal gift tax return reporting this transaction.

After Stephen made three annual payments of interest, Barbara died in 2016. Pursuant to her estate plan, the note was distributed to Stephen, effectively resulting in the note's cancelation. Barbara's estate tax return included in the gross estate an amount equal to the unpaid portion of the loan. But the IRS determined that the transaction was a gift. In support of its conclusion, the notice of deficiency noted the following additional facts:

> The loan was unsecured and the note lacked provisions necessary to create a legally enforceable right to repayment reasonably comparable to the loans made between unrelated persons in the commercial marketplace. It has not been shown that the borrower had the ability or intent to repay the loan. It has not been shown that the decedent had the intent to create a legally enforceable loan, or that she expected repayment. … For estate tax purposes, the estate valued the note at $1,624,000. The difference between the amount lent and the fair market value of the note then determined by the IRS is $869,000.

Stephen challenged the IRS's determination, arguing that the deficiency notice in essence treats the transfer not as a gift in its entirety but rather as a "gift loan." That is important, because under IRC §§7872(c)(1)(A), (d)(2), (e)(1), and (f)(3), a "gift loan" is not a taxable gift for gift tax purposes as long as interest on the loan is payable at a rate at least equal to the AFR as of the day on which the loan was made. Thus it would not matter that Barbara did not report the transaction on a gift tax return, and the estate should not be tagged on the estate tax return with having a previously unreported gift on which no gift tax was paid.

The Tax Court (Judge Holmes) agreed. While it found the IRS's position not entirely clear, the court determined that the IRS is contending that the loan was a partial gift, not that the entire transaction was some kind of sham or disguised gift. Stephen had proof that the transaction was a loan: the note, Barbara's income tax returns including the interest paid, and bank statements proving the amounts were paid. The IRS, meanwhile, had only a theory based on the fact Barbara never filed a gift tax return. So if the IRS's position is that the transaction was a gift loan and not a gift in its entirety, Stephen is exactly right that under IRC §7872 there is no taxable gift for gift tax purposes in this case because Stephen was charged (and paid) AFR interest. The court thus granted the estate's motion for summary judgment.

Judge Holmes was right to grant the motion, as the proof of the loan and interest payments was clear. The IRS's description of the transaction in the deficiency notice reads as if it was pasted from another deficiency. It claims there was no evidence Barbara ever expected repayment, yet Stephen made all required payments on a timely basis. Had Stephen and Barbara been sloppy in following the formalities, the result may have changed. But here, the IRS just looks bad.

X. FINAL REGULATIONS (AT LONG LAST) IMPLEMENT BASIS REPORTING AND DUTY OF CONSISTENCY RULES (T.D. 9991, September 17, 2024)

The IRS has unveiled final regulations related to the so-called "duty of consistency," a statutory requirement that a recipient's basis in certain property acquired from a decedent must be consistent with the value of the property as finally determined for federal estate tax purposes, as well as the corollary duty to report information related to basis both to recipients and to the IRS. The final regulations, effective as of September 17, 2024, implement regulations first proposed in 2016.

A. Background

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 created two new income tax provisions as revenue raisers. First, IRC §6035(a)(1) requires executors of estates required to file a federal estate tax return to provide "a statement identifying the value of each interest in" property included in the decedent's gross estate. The statement must be furnished to the IRS and to "each person acquiring any interest" in such property within 30 days of the date on which the estate tax return is filed or due (including extensions), whichever is earlier. Of relevance, IRC §6035(b) authorizes legislative regulations to enforce this "basis reporting" requirement, and it directs Treasury and the IRS to consider, among other things, the application of this requirement to cases where no estate tax return is required to be filed. A conforming amendment to IRC §6724(d)(1) makes the failure to furnish this statement subject to a $250 penalty.

Second, IRC §1014(f) provides that the basis in property acquired from a decedent cannot exceed the final value that has been "determined" for federal estate tax purposes. Where there has not yet been a "determination" of the property's value, the basis cannot exceed the amount provided in the IRC §6035 statement. Basis is "determined" for federal estate tax purposes where the value is shown on the federal estate tax return and the IRS does not contest it before expiration of the statute of limitations. If the IRS does timely contest the value and the executor relents, the basis of the property will be "determined" as the value set by the IRS. Of course, basis can also be "determined" by a court or through a settlement agreement between the IRS and the executor.

These rules, which effectively prohibit claiming property has a lower value for estate tax valuation purposes and a higher value for income tax basis purposes, are applicable to property "with respect to which an estate tax return is filed" after July 31, 2015, some two weeks after enactment. That gave Treasury little time to implement the new regime.

In *Notice 2015-57*, 2015-36 I.R.B. 24, the IRS indicated that for IRC §6035 statements required to filed or furnished to a beneficiary before February 29, 2016, the due date would be postponed to February 29, 2016. This would give the IRS time to issue guidance implementing the basis reporting and consistency rules and, ideally, a form. Indeed, the notice told executors and others required to furnish IRC §6035 statements not to do so "until the issuance of forms or further guidance by the Treasury."

B. Form 8971

On January 29, 2016, Treasury released the final version of Form 8971, Information Regarding Beneficiaries Acquiring Property From a Decedent, together with instructions. The Form asks for general information about the decedent and executor, as well as the name, taxpayer identification number, and address of each beneficiary. The Form includes a Schedule A, the page to be furnished to each beneficiary of the estate. The schedule must provide a "description of property acquired from the decedent," along with an indication of where the item is reported on the estate's Form 706. The schedule must indicate whether the asset increased estate tax liability, the valuation date for the asset, and the "estate tax value (in U.S. dollars)." The Schedule A includes this notice to beneficiaries:

> You have received this schedule to inform you of the value of property you received from the estate of the decedent named above. Retain this schedule for tax reporting purposes. If the property increased the estate tax liability, Internal Revenue Code section 1014(f) applies, requiring the consistent reporting of basis information. For more information on determining basis, see IRC section 1014 and/or consult a tax professional.

Instructions accompanying the form indicate that if final distributions have not been made by the time the Form 8971 is due, "the executor must list 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. (This means that the same property may be reflected on more than one Schedule A.) A supplemental Form 8971 and corresponding Schedule(s) A should be then filed once the distribution to each such beneficiary has been made." As Steve Akers observed in a March, 2016 report:

> This [will] cause real heartburn for some estates. Executors may be reluctant to provide full information about all estate assets to beneficiaries who are only

> entitled to receive a general bequest that may represent a fairly small portion of the estate. Furthermore, it will be burdensome. In effect, *each* beneficiary who has not already been funded by the 30 day due date will receive a report that may be about as long as the Form 706–including a list of all assets listed on the return that have not yet been sold or distributed and that could be distributed to the beneficiary.

Steve R. Akers, *Basis Consistency Temporary and Proposed Regulations* at 9 (Mar. 25, 2016).

In *Notice 2016-19*, 2016-9 I.R.B. 362, the IRS extended the first deadline for IRC §6035 statements (Forms 8971) from February 29, 2016, to March 31, 2016. Then, in *Notice 2016-27*, 2016-15 I.R.B. 576, the IRS again extended the deadline for Form 8971 filings to June 30, 2016.

C. Proposed (and Now Final) Regulations

On March 4, 2016, the IRS issued proposed regulations offering guidance on the application of IRC §§1014(f) and 6035. The proposed regulations offered a number of clarifications, the vast majority of which survived in the final regulations. First, the proposed regulations stated that while IRC §1014(f) caps the initial basis a beneficiary takes in property, **subsequent adjustments** to basis for improvements, depreciation, and the like will still be allowed. The final regulations retain this rule and further clarify that where the property is subject to recourse or nonrecourse debt, the beneficiary's initial basis will be the gross value of the property without any reduction for the amount of debt, regardless of whether the estate reports the net equity value of the property or separately reports the gross value of the property and claims an estate tax deduction for the amount of the outstanding debt. Reg. §1.1014-10(b)(3)(i).

Second, the proposed regulations provided that because IRC §1014(f) applies to property the inclusion of which in the decedent's gross estate actually increases the estate's liability for federal estate taxes, **property eligible for the marital and charitable deductions is exempted** from IRC §1014(f), as is any tangible personal property for which an appraisal is not already required under the estate tax regulations (the final regulations refer to this as "**household and personal effects**"). But all other property included in the gross estate is subject to IRC §1014(f) if any federal estate tax liability is incurred. The final regulations retain this rule, further clarifying that the exclusion does not apply to property qualifying for only a partial marital or charitable deduction. Reg. §1.1014-10(c)(2)(xi). This means, for example, that property passing to a charitable remainder trust or a charitable lead trust is still subject to the duty of consistency, as is property passing to a trust to which a only partial QTIP election has been made.

Third, the proposed regulations addressed property discovered after the filing of the Form 706 and property omitted from the Form 706 (herein, "**omitted property**"). If the omitted property is reported before the expiration of the statute of limitations on the assessment of estate tax, the regular rules for determining the final value of property would apply. But if the omitted property is reported after expiration of the statute of limitations, it would have a final value of zero. Likewise, if no estate tax return is ever filed, the final value of all property includible in the gross estate that is subject to IRC §1014(f) would be deemed to be zero.

To the surprise of no one, the IRS received a lot of comments on this "zero basis rule." The preamble to the final regulations notes that comments either challenged the IRS's authority to implement a zero basis rule or decried the zero basis rule as "onerous, unduly harsh, and unfair." While claiming it absolutely had authority to implement the zero basis rule, the IRS recognized that it affects only the recipients of omitted property, many of whom will have no knowledge of the omission or any involvement in the failure to report the property. Accordingly, the final regulations abandon the zero basis rule. Comforted by the fact that intentional omission of property will trigger criminal liability, the final regulations clarify that the basis consistency rule only applies to property included in the value of the decedent's gross estate. Reg. §§1.1014-10(c)(1)(i); 1.1014-1(d)(4).

Fourth, the proposed regulations clarified that the IRC §6035 reporting requirement does not apply where an estate tax return is filed solely for purposes of making a **portability election** or a **generation-skipping transfer tax exemption allocation**. The final regulations retain this rule.

Fifth, the proposed regulations **exempted the following assets** from IRC §6035 reporting: cash (narrowed in the final regulations to only United States dollars but also broadened to include any cash equivalent payable in United States dollars, like life insurance proceeds), income in respect of a decedent (specifically including retirement plans, per the final regulations), items of tangible personal property for which an appraisal is not required under the estate tax regulations (again referred to in the final regulations as "household and personal effects"), and property that will not be distributed to a beneficiary because it has been sold or otherwise disposed of by the estate in a taxable transaction. The final regulations retain this rule, subject to the modifications described above.

Sixth, the proposed regulations made clear that **where an individual executor is also a beneficiary**, the executor must still furnish a Schedule A to Form 8971 to himself or herself. If the beneficiary is an estate, trust, or business entity, the notice is to be delivered to the entity and not its beneficiaries or owners. If the executor cannot locate a beneficiary in time, the Form 8971 is to explain the efforts taken to locate the beneficiary. The final regulations retain this rule, deleting a requirement from the proposed regulations that would require an executor to use "reasonable due diligence" to locate a missing beneficiary.

Finally, the proposed regulations provided that where the recipient of property reported on the Form 8971 **transfers** all or any portion of the property to a related party, the transferor must file a supplemental Form 8971 documenting the new ownership if the transferee's basis is to be determined with reference to the transferor's basis. Realizing this rule "is too heavy a burden to impose on individual beneficiaries who, as a practical matter, may have no way of knowing the existence of, or of how to comply with, this subsequent reporting requirement," the final regulations narrow the rule to apply only to "trustees of beneficiary trusts making a distribution of property that was reported on a Statement furnished to those trustees, or of any other property the basis of which is determined, in whole or in part, by reference to the basis of this property." Reg. §1.6035-1(h)(1).

D. Worth the Wait?

The preamble to the final regulations offers no explanation or apology for the eight-year gap between the issuance of the proposed regulations and the final regulations. Still, to the extent the final regulations eliminate the zero basis rule and the requirement that recipients report carryover basis transfers to third parties—rules that most generated the most objections from commentators—many practitioners will likely consider the final regulations worth the wait.

XI. DEVELOPMENTS IN REPORTING FOREIGN BANK ACCOUNTS

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

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

A. Penalties Survive the Decedent (*United States v. Hendler*, S.D. N.Y., September 17, 2024)

A federal district court held that a $70,000 penalty for negligently failing to report the existence of foreign bank accounts over a seven-year period does not abate upon the death of the account holder. It thus granted the federal government's motion for summary judgment on the issue. The decision is consistent with that of other federal courts, all of which have found that because the penalty is "remedial" rather than "penal," liability for the penalty continues after death.

In this case, David Benishai, a United States citizen, had signatory authority over nine Israeli bank accounts. For the years at issue (2004 through 2010), he did not timely file FBARs. The IRS began an examination in late 2015, when Benishai finally filed FBARs for the years at issue. The examination did not conclude until 2021, but Benishai and his agents agreed in writing several times to extend the deadline by which the IRS had to assess penalties. The last extension agreement reflected a deadline of June 30, 2021. The IRS assessed initial penalties of $250,000 against Benishai in April, 2021—before the stipulated deadline. The only wrinkle: Benishai died three months earlier, in January, 2021. In 2023, the IRS, in response to the Supreme Court's holding in *Bittner v. United States*, 598 U.S. 85, that the $10,000 penalty for negligent failure to file FBARs applies on a per-report basis and not a per-account basis, reduced the penalty to $70,000 (i.e., one $10,000 penalty for each of the seven years).

On behalf of his estate, Benshai's spouse and daughter, Hanna Hendler and Danielle Benishai (hereafter "Hendler"), resisted the reduced penalty, arguing that penalties cannot be asserted against a decedent. Hendler claimed that because the IRS did not assert the penalty until after Benishai's death, it was too late. But the district court rejected this argument, noting that other courts have concluded that liability for an FBAR penalty accrues on the date the form is due, not on the date of assessment.

Hendler then argued that even if the penalty applied, it was extinguished at Benishai's death. The court observed that under federal common law, a penalty that is "penal" abates at death, but penalties that are "remedial" survive the decedent and are enforceable against the decedent's estate. Citing *Kahr v. Commissioner*, 414 F.2d 621 (2d Cir. 1969) as controlling precedent, the court concluded that because one purpose of the FBAR negligence penalty is to "protect the tax revenue and to reimburse the Government for the public funds which must be expended in the investigation and uncovering of taxpayer tax evasions activities," the penalty is remedial and not penal. The court noted that this conclusion was in accord with cases from federal district courts in Florida. Indeed, it found no cases holding otherwise.

Hendler also argued that the statute of limitations for collecting on a penalty that accrued from 2004 through 2010 had long ago expired, but the court cited several cases confirming that agreements to extend the IRS's time for assessment are valid. The court went on to reject Hendler's constitutional arguments related to due process and the Excessive Fines Clause of the Eighth Amendment, favorably citing *United States v. Toth*, 33 F.4th 1 (1st Cir. 2022), for the proposition that the Excessive Fines Clause does not apply because the penalty is remedial and not penal.

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

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

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

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

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

C. Eleventh Circuit Holds FBAR Penalties Can Violate Excessive Fines Clause, Creating Circuit Split (*United States v. Schwarzbaum*, 11th Cir., August 30, 2024)

The Eleventh Circuit Court of Appeals has held that the penalty for willful failure to file an FBAR is a "fine" and thus subject to the Excessive Fines Clause of the Eighth Amendment. The court went on to hold that three $100,000 penalties imposed against the defendant were excessive, reducing a penalty of over $12.55 million to just over $12.25 million. The case is important because the result is contrary to that reached by the First Circuit on similar facts in *United States v. Toth*, 33 F.4th 1 (1st Cir. 2022), creating a split amount the circuits that could prompt Supreme Court review.

German-born Isac Schwarzbaum became a citizen of the United States in 2000. During the years at issue (2007, 2008, and 2009), he lived in Switzerland. During those years, he had dozens of bank accounts in Switzerland and Costa Rica. His accountant prepared an FBAR for 2007, but it only disclosed a single account. Schwarzbaum then filed his own returns for 2008 and 2009, including his own FBARs; one of the FBARs disclosed a single account, and the other disclosed just three accounts.

The IRS determined that Schwarzbaum's failure to list all of the accounts was "reckless," and, therefore, "willful," triggering the application of the higher penalty. Under the Bank Secrecy Act, recall, the penalty for willful failure to file an FBAR is the greater of $100,000 or half the balance of the bank account as of the date the FBAR was originally due. The IRS initially determined a penalty of $35.4 million. Finding this amount too high, the IRS, on its own initiative, reduced the penalty to about $13.7 million. When Schwarzbaum failed to pay the penalty, it instituted this proceeding in federal district court. The district court agreed that Schwarzbaum's failure to file was willful, but concluded the IRS miscalculated the penalty amount, entering judgment that Schwarzbaum was liable for a penalty of just over $12.9 million. In a prior ruling, the Eleventh Circuit held that the district court should have remanded the penalty determination back to the IRS instead of computing the penalty itself. *United States v. Schwarzbaum*, 24 F.4th 1355 (11th Cir. 2022). The lower court did as instructed, but Schwarzbaum is back again at the Eleventh Circuit, this time arguing the penalty violates the Excessive Fines Clause.

As any good criminal defense lawyer will tell you (from memory), the Eighth Amendment provides: "Excessive bail shall not be required, nor excessive fines imposed, nor cruel and unusual punishments inflicted." In *Austin v. United States*, 509 U.S. 602 (1993), the Supreme Court held that the Excessive Fines Clause applies to civil penalties that constitute "punishment." It further held that in order to fall outside the scope of the Excessive Fines Clause, a penalty must "fairly be said solely to serve a remedial purpose." Later, in *United States v. Bajakajian*, 524 U.S. 321 (1998), the Supreme Court clarified that the Excessive Fines Clause applies to any penalty that "is designed to punish the offender" and thus serves as "punishment even in part."

Against this framework, the Eleventh Circuit determined that the purpose of the FBAR penalty on willful failure to file "is—at least in part—punishment," and therefore subject to the Excessive Fines Clause. It rejected the IRS's argument that the penalty is remedial because it remedies its investigation and enforcement expenses associated with FBAR violations:

> 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. … A willful violation of the FBAR statute thus has a ceiling limited only by the size of the violator's bank account, regardless of the corresponding tax liability or cost spent by the Government remediating the problem.

Further, observed the court, the willfulness penalty requires a culpable state of mind "equivalent to that of a criminal under the same statute," underscoring the punishment aspect of the penalty. The court also tossed in excerpts from Treasury explanations of the 2004 legislation that toughened the penalty for willful violations indicating that the purpose of the tougher penalties was to improve compliance and deter violations of the reporting requirement. Penalties designed to deter behavior are punitive (or "penal") in nature, the court reasoned, and thus subject to the Excessive Fines Clause.

The court acknowledged that its conclusion is contrary to that reached by the First Circuit in *Toth*, *supra*. The First Circuit determined that the penalty was remedial based on earlier Supreme Court precedent that the Eleventh Circuit says is “no longer applicable in the Excessive Fines context.” The Eleventh Circuit also pointed to Justice Gorsuch’s dissent from the denial of certiorari in *Toth*, in which he argues that the First Circuit’s analysis “is difficult to reconcile with our precedents” and that a penalty that “serves even ‘in part to punish’ is subject to analysis under the Excessive Fines Clause.”

The Eleventh Circuit then proceeded to determine whether the penalty was excessive. This required the court to examine not whether the total aggregate penalty amount was excessive but, rather, whether any of the 23 penalties imposed on each of the accounts for the years at issue was excessive. The court reasoned it had to perform a detailed, account-by-account analysis because the statute characterizes each willful failure to report an account as a separate violation.

In the end, the Eleventh Circuit determined that three of the $100,000 penalties imposed were excessive. Those three penalties all related to a single account that never had a relevant balance in excess of $16,000. “A $100,000 penalty for an account holding comparatively small amounts of currency strikes us as being ‘grossly disproportional to the gravity of the defendant’s offense.’” Accordingly, it reduced the total penalty by $300,000.

Justice Gorsuch’s dissent from the denial of certiorari in *Toth* was a clear signal that, in his mind, the First Circuit was wrong. If his goal in dissenting was to invite another circuit to reach a different result, it seems the Eleventh Circuit was happy to oblige. Note too: it appears the Excessive Fines Clause applies only to the willfulness penalty. The $10,000 penalty for negligent failure to file FBARs does not require a particular mental state, and to date every court that has considered the issue has found the negligence penalty “remedial” rather than “penal.”

D. District Court Agrees Penalties Survive Decedent But Collecting from Spouse or Beneficiary Violates the Eighth Amendment (*United States v. Leeds*, No. 1:22-CV-00379, D. Idaho, March 7, 2025)

A federal district court has held that while a decedent’s liability for penalties in connection with willfully failing to disclose foreign bank accounts survived the decedent’s death, the Excessive Fines Clause of the Eight Amendment applies to willful penalties. This proved important, for while the penalties applied to the decedent did not violate the Eighth Amendment, the penalties *do* violate the Eighth Amendment “to the extent the Government seeks to recover the penalties against” the decedent’s spouse, who was also his executor. It thus granted the government’s summary judgment motion against the decedent’s estate but denied the motion to the extent the government sought to collect from the decedent’s spouse personally.

Richard and Patricia Leeds, United States citizens, were married in 1955. An expert in satellite communications, Richard worked for an international architectural engineering firm providing services under government contracts. Through his work, Richard met and interacted with top military and political figures in other countries. As Patricia tells it, he also worked for the CIA, though she did not learn of this until well after his retirement. While on a business trip to Saudi Arabia in 1984, Richard's plan was hijacked and forced to land in Iran, where he was questioned extensively for several hours. The experience led Richard to set up two foreign bank accounts so he would have "readily available cash" to pay future ransoms if needed.

During the years at issue (2006 through 2012), Richard did not disclose these accounts to the IRS, even though he was required to do so by the Bank Secrecy Act. In each of the years, Richard's tax preparer, a CPA, asked him whether he had any foreign bank accounts. Each year, Richard said he did not. By the end of 2011, the bank that maintained both accounts informed Richard that in order for the bank to comply with the Foreign Account Tax Compliance Act, all United States clients were no longer welcome and that he would need "to find a solution for his assets." He then bought more than $1.45 million in precious metals using account funds and then withdrew (and later sold) the remaining foreign currency.

In 2014, the bank urged Richard to participate in the Offshore Voluntary Disclosure Program (OVDP) to reduce his risk for prosecution and monetary penalties. He followed up with questions about how far back the bank would disclose information about his accounts and whether closed accounts would be reported, but took no further action. When the IRS started an investigation, Richard applied for participation in the OVDP but then opted out nearly two years later. That led the government to assess willful FBAR penalties against Richard totaling over $1.5 million in 2020.

When Richard died in November, 2021, the government sought to collect over $2 million in penalties, late fees, and interest from Patricia in her capacities as beneficiary of Richard's estate and as his personal representative. Once discovery was complete, the government moved for summary judgment against the estate, the motion giving rise to this decision.

The court first determined that Richard's failure to file FBARs for the years at issue was willful. Under *United States v. Hughes*, 113 F.4th 1158 (9th Cir. 2024), discussed *supra*, "willfulness can be shown by proof of objective recklessness as well as subjective intent." Under this test, the same as that employed by "every other Court of Appeals to have considered the question," the court found Richard's conduct was willful. He acted to conceal the existence of his accounts from the government by lying to his preparer about the existence of the accounts, using pseudonyms for the accounts that allowed him to sign using fake names, and having the bank hold his mail so that he could only collect it in person. "Based on the undisputed facts," said the court, "Richard should have known about the FBAR requirements and that there was a grave risk he was not complying with his filing requirements despite being positioned to easily discover his tax obligations." Accordingly, the court determined the government was entitled to "maximum penalties" in this case.

That raises the issue of the penalty amount. Patricia argued the penalty imposed by the government violated the Excessive Fines Clause of the Eighth Amendment. That again raises the conflicting cases of *Toth* and *Schwarzbaum*, *supra.* An appeal in this case would go to the Ninth Circuit, which has not taken a side in this debate. The court, thus free to go with what it found the better rule, decided that the Eleventh Circuit's analysis in *Schwarzbaum* was "more well-reasoned." It thus held that the FBAR penalty is a "fine" for purposes of the Eighth Amendment.

The court then had to determine whether the "fines" imposed by the government were "excessive." Under *United States v. Bajakajian*, 524 U.S. 321 (1998), a fine is excessive if is "grossly disproportional" to the gravity of the offense. In determining the "disproportionality" of an offense, a court is to consider the nature of the conduct, the resulting harm, and whether other penalties may be imposed. The burden of proof is on the party subject to the fine.

Applying this test, the court first determined that the FBAR penalties in this case are grossly disproportionate as applied to Patricia. The IRS countered that she misunderstands the case because the government is not suing her personally but only in her capacity as executor of Richard's estate. But the court found that "the Government's allegations are less than clear how it intends to recover the FBAR penalties and that it does not intend to recover the FBAR assessments against Patricia personally." After all, the caption to the case names Patricia both as Richard's personal representative and in her personal capacity. So if there's a chance the government could go after assets in which Patricia has a personal interest, the court wants to be on record that any penalty applied to her would be excessive. "Patricia had no access to [the] Accounts and no knowledge about them until the IRS began its investigation into Richard after he had closed the Accounts."

While Patricia met the burden of showing that penalties applied against her would be excessive, she was unsuccessful in claiming that the fine applied to Richard's estate was excessive due to his willful failure to file FBAR reports. So Patricia then argued that Richard's liability for willful negligence died with him. But the court, citing a consistent string of opinions from other federal district courts, held that FBAR penalties are remedial for purposes of survival, meaning the FBAR penalties here survived Richard's death.

While it seems inconsistent to say an FBAR penalty is "a fine and not a remedy" for purposes of the Excessive Fines Clause but "a remedy and not a fine" for purposes of determining whether the penalty survives the offender, the court in footnote 9 reconciles these seemingly contradictory positions:

> This conclusion [that FBAR penalties survive the decedent] is not inconsistent with the conclusion that the Excessive Fines Clause applies to the penalties because "the test in the Excessive Fines context remains whether the purpose of the penalty is solely compensatory." *United States v. Schwarzbaum*, 127 F.4th 259, 275 (11th Cir. 2025); see also *United States v. Green*, 457 F. Supp. 3d 1262, 1272 (S.D. Fla. 2020) ("[T]he FBAR penalty is the proverbial square peg in the round hole; it fits perfectly in neither of the round holes of the remedial-penal

dichotomy. Rather, the FBAR penalty is primarily remedial with incidental penal effects.”).

Whether the explanation is convincing is left to the reader. Of greater interest, if the government appeals this decision to the Ninth Circuit, we could see a third opinion in the debate over the applicability of the Excessive Fines Clause, setting the stage for possible resolution by the Supreme Court. Stay tuned.

XIII. CONSERVATION EASEMENT DEVELOPMENTS

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

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

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

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

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

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

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

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

The proposed regulations explained how an owner's modified basis should be computed for purposes of this rule. The final rule, Reg. §1.170A-14(l)(2), now provides for five adjustments to be made in this order:

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

- Second, adjust this figure to reflect any **partnership interests acquired or disposed of** between the start of the entity's taxable year to the moment immediately prior to the qualified conservation contribution. For example, if the owner acquired additional interests in the partnership, the amount would be increased by the owner's basis in those additional interests.

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

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

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

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

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

89 F.R. 54284 at 54289.

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

The statute provides three exceptions from the application of the 2.5 times rule. The first exception covers contributions of property held at least three years. In the typical syndicated conservation easement scheme, the entity purchases the subject land and immediately places an easement on the property. But under §170(h)(7)(C), the 2.5 times rule will not apply where the entity donates the easement at least three years after the entity acquired the subject property (or, if later, three years after the date in which any owner acquired any interest in the entity). While the statute does not define the phrase "acquired any interest," the regulations provide that, in the case of an S corporation, it refers to "any transfer, issuance, redemption, or other disposition of stock in the S corporation" except for any proportionate issuance or redemption. Prop. Reg. §1.170A-14(n)(2)(iii). In the case of a partnership, any "variation" within the meaning of Regulation §1.706-4(a)(1) will suffice. The preamble to the proposed regulations explained that variations include acquisitions, partial dispositions, and complete dispositions. Rather than re-invent the wheel, the IRS found it simpler to incorporate those rules by reference. The final regulations made no change to this approach.

The second exception relates to "family partnerships." Under §170(h)(7)(D)(i), the disallowance rule in §170(h)(7)(A) does not apply where "substantially all of the … interests in [the entity] are held, directly or indirectly, by an individual and members of the family of such individual." The statute defines "family" as one's spouse and dependents, but it does not define when "substantially all" of the entity interests are held by one family. The regulations fill this gap, stating that "substantially all" means at least 90-percent ownership. Reg. §1.170A-14(n)(3)(i). In the case of a partnership, the family must own 90 percent of the interests in capital and profits. Reg. §1.170A-14(n)(3)(ii)(A). In the case of an S corporation, the family must own 90 percent of the voting power and value of the stock. Reg. §1.170A-14(n)(3)(ii)(B). The regulations include anti-abuse rules under which the family must have held the subject real property for at least one year and the family must be allocated at least 90 percent of the resulting charitable contribution deduction. Reg. §1.170A-14(n)(3)(iv)(A). This latter rule prevents a partnership from allocating most of the deduction to a non-family member.

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

B. Final Regulations Identify Syndicated Conservation Easements as Listed Transactions (T.D. 10007, October 8, 2024)

Treasury has finalized regulations proposed in December, 2022, that identify a "syndicated conservation easement transaction" as a "listed transaction" for purposes of §§6011, 6662A, and 6707A. The proposed regulations were issued in response to the Tax Court's decision in *Green Valley Investors, LLC v. Commissioner*, 159 T.C. No. 5 (2022), in which the court, in a 15-2 decision, held that the IRS's prior identification of syndicated conservation easement transactions as listed transactions in *Notice 2017-10*, 2017-4 I.R.B. 544 (2016), violated the notice-and-comment procedures for legislative rules under the Administrative Procedure Act ("the APA") and was therefore invalid. The final rule, Reg. §1.6011-9, should ensure that syndicated conservation easement transactions are subject to the rules of §§6011, 6662A, and 6707A. The final regulations are effective as of October 8, 2024.

1. Background on Reportable Transactions

Section 6011(a) generally provides that taxpayers must include information identified in regulations when they file their federal income tax returns. Pursuant to this rule, Reg. §1.6011-4(a) provides that where a taxpayer participates in a "reportable transaction," the taxpayer must file a disclosure statement (currently Form 8886) with the taxpayer's federal income tax return. A copy of the Form 8886 must also be sent to the IRS's Office of Tax Shelter Analysis. Reportable transactions come in five forms: confidential transactions, transactions with contractual protection, loss transactions, transactions of interest, and, most importantly for immediate purposes, "listed transactions." A listed transaction is one that is the same or substantially similar to one that the IRS determines to be a tax avoidance transaction "identified by notice, regulation, or other form of published guidance." Reg. §1.6011-4(b)(2).

A number of Code provisions police the reporting of (and participation in) reportable transactions, with stiffer sanctions often applicable to those reportable transactions that are listed transactions. For example, §6707A imposes a penalty generally equal to 75 percent of the decrease in tax shown on the taxpayer's return as a result of the reportable transaction for failing to disclose the transaction.

In addition, §6662A imposes another 20-percent accuracy-related penalty on any understatement attributable to a reportable transaction; if the taxpayer did not properly disclose the transaction, the penalty increases to 30 percent of the understatement. Furthermore, IRC §6111 and Reg. §301.6111-3(a) require that a "material advisor" with respect to a reportable transaction must file a disclosure statement (currently Form 8918) with the Office of Tax Shelter Analysis, with IRC §6707 imposing penalties on a material advisor that fails to file a timely disclosure or files an incomplete or false disclosure.

2. The Need for Regulations in Light of Adverse Case Law

The APA generally requires a federal agency to publish a notice about a proposed rule, allow for public comment, consider submitted comments, make appropriate revisions, and provide a concise general statement of the basis and purpose of the final rule adopted. These steps apply any time an agency promulgates a "legislative rule," one that announces a new law or a change in the law. The notice-and-comment procedure is not required for an "interpretive rule," one that identifies how the agency construes a statute.

Historically, the IRS identified listed transactions and other reportable transaction by publishing a notice in the Internal Revenue Bulletin. Notices traditionally did not undergo the notice-and-comment procedures required by the APA. This proved problematic when parties challenged the identification of reportable transactions and listed transactions by notice. In *Mann Construction, Inc. v. United States*, 27 F.4th 1138 (6th Cir. 2022), the Sixth Circuit Court of Appeals held that *Notice 2007-83*, 2007-45 I.R.B. 960, in which the IRS designated certain employee-benefit plans featuring cash-value life insurance policies as listed transactions, was void because the notice was a legislative rule that did not undergo notice and comment.

Federal district courts within the Sixth Circuit, citing *Mann Construction*, invalidated other notices on similar grounds. See, e.g., *CIC Services v. IRS*, 592 F.Supp.3d 677 (E.D. Tenn. 2022) (setting aside *Notice 2016-66*, 2016-47 IRB 745, which identified micro-captive insurance arrangements as listed transactions); *GBX Associates, LLC v. Commissioner*, 130 A.F.T.R. 2d 2022-6440 (N.D. Ohio 2022) (invalidating *Notice 2017-10*, which identified syndicated conservation easements as listed transactions, on similar grounds). Then, in *Green Valley Investors*, *supra*, the Tax Court likewise invalidated *Notice 2017-10*.

If the decisions in the foregoing cases are correct, every notice that identified reportable transactions is void, as none of the notices has undergone the APA's notice and comment procedures. That in turn means that none of the statutory penalties applicable to participation in reportable transactions (or the failure to fully and timely disclose them) would apply to any taxpayer. Faced with such high stakes, the IRS decided to issue proposed regulations in connection with syndicated conservation easement transactions. As Treasury stated in the preamble to the proposed regulations:

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

3. A Change in the Statute

Just 15 days after issuing the proposed regulations, Congress passed the SECURE 2.0 Act of 2022. Section 605 of the Act added §170(h)(7)(A), which provides that a contribution by a partnership is not treated as a qualified conservation contribution if the amount of the contribution exceeds 2.5 times the sum of each partner's relevant basis in the partnership. This new rule applies to contributions made on or after December 30, 2022. Regulations implementing this new rule were finalized in June, 2024, as explained above.

With the addition of §170(h)(7)(A), Congress effectively killed syndicated conservation easement transactions, as there is now little benefit at best from engaging in them. Still, the IRS found it necessary to finalize the proposed regulations identifying syndicated conservation easement transactions as listed transactions. For one thing, §170(h)(7)(A) does not apply to transactions involving contributions before December 30, 2022. For another, §170(h)(7)(A) does not automatically disallow all contributions made via syndicated conservation easement transactions. And finally, the IRS is aware that, in some syndicated conservation easement transactions, the partnership substitutes the contribution of a fee simple interest in real property for contribution of a conservation easement.

4. Overview of the Final Regulations

The final regulations make only a few changes to the proposed regulations. Regulation §1.6011-9(a) provides that "Transactions that are the same as, or substantially similar to, a transaction described in paragraph (b) of this section are identified as listed transactions…." Regulation §1.6011-9(b) then states that:

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

(emphasis added). Of these elements, the "2.5 times rule" in Regulation §1.6011-9(b)(1) garnered the most attention from commenters. For purposes of the 2.5 times rule, "promotional materials" are any written or oral communications provided to investors, specifically including:

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

Reg. §1.6011-9(c)(4). In addition, if the promotional materials suggest or imply a range of potential charitable deduction amounts, the highest suggested or implied deduction amount will be used to determine if the 2.5 times rule is met. Reg. §1.6011-9(d)(2). In fact, the proposed regulations presume the 2.5 times rule is met where:

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

Reg. §1.6011-9(d)(3). The preamble to the final regulations state that many commenters objected both to this rebuttable presumption and to the 2.5 times rule generally, arguing the threshold was arbitrary and that the proposed regulations offered no guidance for overcoming the presumption. The IRS declined to offer such guidance formally, but the preamble suggests that:

> a taxpayer may be able to rebut the presumption by establishing that the partnership was not open to other investors (and thus the only promotional materials were documents needed to execute the transaction) or that similar properties in the same area had increased significantly in value in the period between the time the taxpayer invested in the partnership and the date the conservation easement was contributed.

Note that where promotional materials tout a pass-through deduction *equal to* 2.5 times the taxpayer's investment, the transaction is still a listed transaction even though the amount of the deduction would not be disallowed under §170(h)(7)(A) because the deduction does not *exceed* 2.5 times the taxpayer's investment. The preamble to the final regulations states this is not an oversight.

Anticipating that investors could easily avoid the 2.5 times rule by contributing other investment assets to the pass-through entity in addition to the amounts used to purchase a share of the real property on which the conservation easement will be placed, the regulations contain an "anti-stuffing rule" under which only the investor's contribution attributable to the portion of the real property on which the easement is placed is considered in determining whether the 2.5 times rule is met. Reg. §1.6011-9(d)(4).

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

These regulations had more bite before the enactment of §170(h)(7)(A). A syndicated conservation easement transaction is a good investment only where the investor will receive a pass-through deduction in an amount that at least 2.5 times the amount of investment. If an investor in the 37-percent tax bracket contributes $100,000 to participate in a syndicated conservation easement transaction, a pass-through deduction of $250,000 would save the investor $92,500 of tax (37% x $250,000). That's not a great return on investment. But now that a deduction larger than $250,000 in this example would be *completely* disallowed by the statute, the transaction is an unattractive investment across the board.

C. Conservation Easement Deduction Denied on Two Grounds, and with Either of Two Penalties (*Oconee Landing Property, LLC v. Commissioner*, T.C. Memo. 2024-25, February 21, 2024, and *Oconee Landing Property, LLC v. Commissioner*, T.C. Memo. 2024-73, July 17, 2024)

The Tax Court has held that a syndicated conservation easement transaction resulted in no charitable contribution deduction, both because the taxpayer did not attach a qualified appraisal of the contributed property and because the taxpayer did not prove that its basis in the ordinary income property donated to charity exceeded zero. The court went on to uphold a substantial understatement penalty. In the first decision (*Oconee I*), the court did not consider whether a negligence penalty also applies. But in the second case (*Oconee II*, logically enough), the court ruled that a negligence penalty could apply, although any single owner of the taxpayer would face liability for either negligence or the substantial understatement, not both.

1. Facts

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

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

2. Donative Intent

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

3. Qualified Appraisal

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

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

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

4. Ordinary Income Property

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

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

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

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

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

Thus, under §170(e)(1), the amount of the deduction was limited to the taxpayer's basis. The taxpayer's completed Form 8283 stated that the basis of the property was about $3.3 million, derived from the contributing partner's 2014 tax return. But there was no evidence substantiating this claimed amount, and the court noted that "An entry on a tax return simply states the taxpayer's position as to an item; it does not constitute evidence." And when the court says there is no evidence, it means there is *no evidence*: nothing about the original price paid by the developers, nothing about the costs of any improvements, and nothing to support a claim that any purchase price should be apportioned equally among each individual acre. And where a taxpayer cannot prove that basis exceeds zero, the basis is treated as zero. Accordingly, the taxpayer is entitled to a deduction of zero.

5. Valuation of the Easement and Penalties

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

But the taxpayer, remember, claimed the value of the easement was $20.67 million, an amount over four times the value computed by the court. Since the value claimed on the return was more than double the correct amount, the 40-percent substantial understatement penalty applies. While the IRS also argued that a negligence penalty would apply, the *Oconee I* court did not decide whether the taxpayer was negligent because of its interpretation of the so-called "no-stacking rule." The *Oconee I* court described the rule as follows:

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

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

But the *Oconee II* court disagreed:

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

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

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

6. Observation

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

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

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

1. Background

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

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

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

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

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

2. Prior Cases Disagreed on Regulation's Validity

In *Oakbrook Land Holdings, LLC v. Commissioner*, 154 T.C. 180 (2020), *aff'd*, 28 F.4th 700 (6th Cir. 2022) (*Oakbrook I*), the Tax Court held in a 16 – 1 decision that the proceeds regulation was properly promulgated under the APA and that the IRS's interpretation of the statute's perpetuity requirement as reflected in the provision on extinguishment was entitled to "*Chevron* deference." The taxpayer in that case acquired a 143-acre parcel outside Chattanooga, Tennessee, in December, 2007, for $1.7 million. With the intent to develop the property, the taxpayer made some improvements to the land, including building a bridge, installing a sewer-pump station, and rezoning the property. After conveying 37 acres to various related entities in December, 2008, the taxpayer then placed a conservation easement for the benefit of the Southeast Regional Land Conservancy on the remaining 106 acres. Based on an appraisal, the taxpayer claimed a $9.545 million charitable contribution deduction on its 2008 return.

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

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

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

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

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

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

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

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

> the statutory text and the legislative history that Treasury contemplated in promulgating Treas. Reg. §1.170A-14(g)(6)(ii) illuminate the regulation's basis and purpose: to provide an administrable mechanism that would ensure that an easement's conservation purpose as per §170(h)(5)(A) continued to be protected should the interest be extinguished. That the regulation allots the proceeds in a

> manner more favorable to the donees than to donors merely demonstrates Treasury's acute awareness of Congress's decision to concern itself with the welfare of one entity over the other once the donation was made. Because we can discern this from the information that Treasury provided during the rulemaking, its concise statement suffices.

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

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

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

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

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

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

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

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

3. The Tax Court's Change of Heart

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

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

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

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

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

4. Other Opinions

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

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

> I am concerned that the Court's reversing a prior position taken only four years ago and without compelling new legal argument will result in instability of the law in the area of conservation easements. Additionally, the opinion of the Court may result in challenges to regulations that have been relied upon for over 40 years.

5. Observations

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

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

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

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

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

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

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

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

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

29 start date was not fatal to New LLC's deduction since, as explained, that date was chosen just to get the IRS's filing system to accept the return.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

> Where the asserted [highest and best use] of property is the extraction of minerals, the proponent must show the presence of minerals in commercially exploitable volumes and the existence of a market "that would justify [mineral] extraction in the reasonably foreseeable future." "There must be some objective support for the future demand, including volume and duration. Mere physical adaptability to a use does not establish a market."

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

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

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

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

The Eleventh Circuit Court of Appeals has held that *Notice 2017-10*, 2017-4 I.R.B. 544 (December 23, 2016), in which the IRS announced that a “syndicated conservation easement transaction” is a “listed transaction” for purposes of §6707A (and, thus, for purposes of the penalty in §6662A), is invalid under the Administrative Procedure Act (the “APA”). The court’s ruling is consistent with decisions from the Tax Court, *Green Valley Investors, LLC v. Commissioner*, 159 T.C. 80 (2022), and the Northern District of Ohio, *GBX Associates LLC v. United States*, 1:22cv401 (N.D. Ohio 2022). Ultimately, in *A.O.D. 2024-01*, 2024-52 I.R.B. 1354 (December 23, 2024), the IRS Chief Counsel office announced that the IRS will no longer defend any guidance identifying “reportable transactions” after the enactment of the American Jobs Creation Act of 2004 (the “AJCA”) unless such guidance underwent notice-and-comment rulemaking procedures set forth in the Administrative Procedure Act (the “APA”).

1. Statutory Background

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

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

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

2. Notice 2017-10

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

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

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

3. Eleventh Circuit Agrees the Notice is Invalid

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

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

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

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

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

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

(Emphasis added, citations omitted.)

4. IRS Concedes the Issue: *A.O.D. 2024-01*, 2024-52 I.R.B. 1354 (December 23, 2024)

In *A.O.D. 2024-01*, Chief Counsel expressly disagrees with the results in these cases, but recognizes both that the IRS has consistently lost on this point and that "the reasoning of this adverse precedent applies to all existing post-AJCA reportable transaction notices." Thus, Chief Counsel announces a new policy:

> The Service will follow the Sixth and Eleventh Circuit and the Tax Court decisions in all circuits and will no longer defend post-AJCA reportable transaction notices. The Service will not enforce the disclosure and reporting requirements set forth in those notices and will not assert penalties under sections 6662A, 6707, 6707A, and 6708 resulting from identification of reportable transactions pursuant to post-AJCA guidance that did not go through notice-and-comment rulemaking procedures.

Chief Counsel also announced that the IRS will concede or abate penalties asserted under the Code provisions listed above in pending cases "resulting from identification of reportable transactions pursuant to post-AJCA notices that did not go through notice-and-comment rulemaking procedures." Chief Counsel also made clear that "[t]his AOD does not apply to pre-AJCA notices."

5. Waning Impact

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

I. Conservation Easement Deduction Was "Just" 178 Times Actual Value, But Negligence Penalty Still Applies (*J L Minerals, LLC v. Commissioner*, T.C. Memo. 2024-93, October 8, 2024)

The Tax Court has held that the donation of a conservation easement in nearly 65 acres of land in rural Georgia yielded a federal income tax deduction of $93,690. But because the taxpayer claimed a deduction of $16,745,000 for the donation, the court upheld the determination of a deficiency plus an accompanying accuracy-related penalty.

In December, 2015, two real estate professionals purchased 645 acres of land in rural Georgia for $1.6 million though an LLC they formed for this purpose. That same day, they conveyed about 65 acres of that land to a separate LLC (the "Easement LLC") they owned. Those 65 acres had previously been subject to a 10-year mineral lease that gave a mining company the right to find and extract kaolin, a mineral abundant in the area. The mining company never engaged in any activity on the land despite having this leasehold.

In January, 2016, a timber company bought a 98-percent interest in the Easement LLC. In December, 2017, the Easement LLC donated a conservation easement in the 65 acres to a qualified charitable organization. On its federal income tax return for 2017, the Easement LLC claimed a federal income tax charitable contribution deduction of $16,475,000. The IRS disallowed the deduction in its entirety, and the resulting deficiency and imposition of penalties lead to this lawsuit.

The IRS argued that the Easement LLC lacked donative intent, thus disqualifying it from the deduction. But the Tax Court, citing *Mill Road 36 Henry, LLC v. Commissioner*, T.C. Memo. 2023-129, and other cases, rejected this argument, observing that "a donor motivated by guilt, or by the hope of being admired, or by the desire for a tax benefit, may still deduct his contribution." Congress created the federal income tax deduction for charitable contributions in part to spur donations, so a taxpayer should not be punished for taking advantage of the incentive.

The IRS then claimed the donation was not made exclusively for conservation purposes, as required by §170(h)(4)(A). The court held that the deed in this case satisfies the requirement that the easement protect "a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem." The land subject to the easement will not be developed even if all the parcels surrounding it are, one day, developed. That is sufficient to satisfy the statutory requirement, said the court. Although the deed did reserve certain rights to the donor to engage in limited agriculture and forestry, it prohibited commercial forestry and imposed no-cut zones in areas covering about two-thirds of the subject land. The deed allowed the LLC to borrow pits for limited specific uses, but it prohibited any activity that would change the topography of the land except as consistent with IRS regulations.

The IRS also claimed the Easement LLC failed to secure a "qualified appraisal," as required by §170(f)(11). Specifically, it alleged that the appraiser was not qualified because the

LLC's owners knew or should have known that the appraiser would falsely overstate the value. The court rejected this argument, finding from the evidence that the back-and-forth between the appraiser and the Easement LLC's owners in this case was normal. The court held that a reasonable person with the knowledge of the Easement LLC's owners would not expect the appraiser to overstate the value of the easement, and there was no evidence that the appraiser and the owners had a "meeting of the minds on a predetermined result." Accordingly, said the court, the appraiser was qualified.

Having found a conservation easement deduction was proper, the court turned its focus to the amount of the deduction (i.e., the value of the easement). Here the Easement LLC did not fare well. The Easement LLC's expert said the "highest and best use" of the subject property was as a kaolin mine, but the court rejected that claim. "To put it bluntly," said the court, "multiple kaolin processors had taken a close look at the easement property and, in at least two cases …, decided that it was not worth mining or even keeping it as part of a long-term reserve."

The court also expressed "considerable skepticism" in the credibility of the Easement LLC's expert:

> [O]n at least eight occasions to our knowledge [the expert] concluded that a property in rural Georgia had an extremely large kaolin deposit (ranging between 3.6 and 6.4 million tons of kaolin), which was later used to support a very large charitable contribution deduction (between $14.6 and $22 million dollars (sic)). If [the expert] were correct, the entire kaolin industry failed to appreciate hundreds of millions of dollars of valuable kaolin right under its feet, despite decades of drilling and testing and buying and selling. Occa,'s razor suggests a different result: [the expert] repeatedly overstated the amount of commercial-grade kaolin in its reports.

The court instead agreed with the IRS's expert that the highest and best use of the subject property was its current use: "agricultural/residential/recreation use with knowledge that some mineral exists on the site."

The court found it relevant that the timber company that bought a 98-percent interest in the Easement LLC paid a purchase price that translates to $2,647 per acre. It also found the IRS expert's evidence about comparable sales of nearby parcels to be probative. It ultimately concluded that the value of the land before the easement's conveyance was $2,700 per acre, or $174,690. It then applied the lowest value of the land after the easement's conveyance indicated by the IRS's expert. That value was $81,000. Thus, the proper deduction amount was $93,690.

Because the value claimed on the Easement LLC's tax return was more than 200 percent of the correct amount (heck, it was about 17,800 percent more than the correct amount!), the IRS determined that the Easement LLC was liable for the 40-percent gross misstatement penalty. The Easement LLC resisted this too, but the court held that the "deduction claimed in this case, however ‘does not pass any reasonable smell test.’ JL Minerals and its coterie of advisors took Congress’s attempt to promote conservation and cynically used it as a cover to fleece the public fisc to the tune of nearly $17 million in baseless deductions.” It thus upheld the imposition of the penalty.

J. Conservation Easement Deduction Proved Not So Gneiss (*Jackson Crossroads, LLC v. Commissioner*, T.C. Memo. 2024-111, December 19, 2024)

The Tax Court has held that although two related limited liability companies were entitled to conservation easement deductions, the deduction amounts were far lower than what they claimed on their federal income tax returns, leading to the application of gross valuation misstatement penalties. While the taxpayers prevailed against IRS attacks on the bona fides of the deductions, they lost on the all-important issue of valuation.

Our story begins in 2015, when a couple of college pals who made it big in real estate formed an LLC that acquired title to two adjoining parcels of real property, both straddling Walton and Morgan Counties in Georgia, from unrelated sellers. This LLC paid a combined $5.2 million for the two parcels, which totaled about 925 acres. In 2016, the LLC subdivided the 925 acres into four separate lots. It then assigned one parcel containing nearly 230 acres to one of the taxpayers in this case, a new subsidiary. A second parcel consisting of nearly 310 acres was assigned to a second new subsidiary LLC, the second taxpayer in this case. Thus, the taxpayers are subsidiaries of a master LLC owned by the two real estate moguls.

The taxpayers then, late in 2016, conveyed conservation easements in their parcels to the Oconee River Land Trust. The first taxpayer claimed a charitable contribution deduction of about $23.1 million, while the other taxpayer claimed a charitable contribution deduction of about $13.8 million. (For those struggling in math, the total deduction amount for the taxpayers—both subsidiaries of a master LLC with two owners, remember—is about $36.9 million.) When the IRS disallowed both deductions, each LLC ran to Tax Court. The court consolidated the two matters into this one case.

1. Adequate Substantiation

Where a taxpayer claims a charitable contribution deduction greater than $500,000, the taxpayer must attach a “qualified appraisal” of the contributed property. IRC §170(f)(11). Regulations set forth the elements of a qualified appraisal, and one of the elements is that the appraisal must be “prepared, signed, and dated by a qualified appraiser.” Reg. §1.170A-13(c)(3)(i)(B). A qualified appraiser, in turn, is one who meets certain requirements, mostly related to the appraiser’s credential and experience. The requirement at issue here, however, is the one set forth in the so-called “knowledge regulation,” Reg. §170A-13(c)(5)(ii). That regulation states in part that:

> An individual is not a qualified appraiser with respect to a particular donation … if the donor had knowledge of facts that would cause a reasonable person to expect the appraiser falsely to overstate the value of the donated property.

That seems odd: an *appraiser* is not qualified if a reasonable *donor* would expect the appraiser would falsely overstate the value of the donated property. As the Tax Court observed, this has nothing to do with the appraiser's credentials, but instead turns on whether the donor "held specific knowledge of facts that would cause it to expect [the appraiser's] opinion of value to be falsely overstated."

Based on the record, the Tax Court found no evidence that a reasonable donor in the taxpayer's position would know any such facts. Though the real estate developers who formed the entities in this case did hire the appraiser for multiple projects, the court found that the relationship between the founders and the appraiser:

> could also be read as a relatively normal back-and-forth between client and appraiser. The client first retains someone who has experience and skill with real property valuations and then gives samples of what the client has found appropriate in the past. The client trusts the appraiser to pick an acceptable method and believes that the income method makes sense given the uniqueness of the property. The appraiser, although responsive to feedback, explicitly aims to stay within the bounds of reasonableness.

The court went on to determine that the appraisals submitted by the taxpayers met all of the other requirements of a qualified appraisal.

2. Capital Assets or Inventory?

The IRS then argued that the subject lots were inventory in the hands of the taxpayers. If so, then the deductions of the taxpayers would be limited to their adjusted bases in the properties under IRC §170(e)(1)(A). Given the master LLC paid only $5.2 million for all 925 acres, this would significantly curtail the amount of the deduction.

But the Tax Court determined that the properties were capital assets to both taxpayers. As an appeal would be heard in the Eleventh Circuit, the court applied the test from *Sanders v. United States*, 740 F.2d 886 (11th Cir. 1984). Under that test, the question of whether a given asset is inventory:

> involves three subsidiary inquiries: (1) whether the taxpayer was engaged in a trade or business; (2) whether the taxpayer held the property primarily for sale in that business; and (3) whether the sales thus contemplated were "ordinary" in the course of that business.

Here, the focus was on the second inquiry. The taxpayers argued they acquired the lots primarily for conservation purposes and not for sale to customers, while the IRS said that the properties were inventory because the founders frequently and continuously acquired land for the purpose of claiming conservation easement deductions.

The Tax Court decided that the focus should not be on the actions of the founders but on the actions of the LLCs. The LLCs showed the properties as "land" on their balance sheets (not as "inventory"). Further, none of the traditional indicia of inventory—like efforts to sell the property or the use of a business office to market it—were present here. Thus, said the court, the properties were capital assets.

3. Valuation of the Deduction

This brought the court to the valuation of the contributions. The value of a conservation easement is measured as the difference between the value of the property at its highest and best use and the value of the property following the restriction imposed by the easement. Here, the parties disagreed as to the highest and best use of the properties and as to the method that should be used to determine the value of that highest and best use.

The taxpayers claimed that the properties could be developed, one into a granitic gneiss mine and the other into an industrial warehousing or manufacturing site. The Tax Court concluded that while the first property could be used for mining, both the demand for the gneiss and the output capacity were overstated by the taxpayer, to the point that mining was not the highest and best use of the land. The court also concluded that there was no sustainable demand for the industrial site. It thus determined that the highest and best use of each property was its current use as agricultural, residential, and recreational land.

In valuing the properties, the taxpayer used an approach based on income and comparable sales. The court, however, found more probative the fact that all 925 acres had been purchased the year before for just $5.2 million, or $5,600 per acre. The court then consulted evidence of comparable sales from three other experts, concluding that the "before value" for each property would be $7,000 per acre, a total of about $3.7 million. While the parties disagreed as to the "after value" of the lots, the court ultimately found the taxpayer's average price per acre to be the better-reasoned conclusion. That resulted in a combined "after value" of about $1 million. Accordingly, the proper deduction amount was about $2.7 million.

4. Penalties

But the combined deductions claimed by the taxpayers came to about $36.9 million. Because this amount exceeds twice the correct deduction amount (heck, it's more than *13 times* the correct amount!), the 40 percent "gross valuation misstatement" penalty of IRC §6662(h) applies. The taxpayers argued they had reasonable cause for the understatement, but the court observed that this exception does not apply to "gross" understatements. Thus, it sustained the 40-percent penalties imposed by the IRS.

5. Observation

The case is a helpful reminder that there is no "reasonable cause" exception to the gross valuation misstatement penalty. It also represents the recent reemergence of valuation as the core issue in conservation easements. For a few years, the IRS relied on regulations to disallow the deductions in full unless hyper-technical requirements were followed to the letter. But following decisions from the Tax Court and one federal circuit court of appeals invalidating those regulations, the IRS must once again wage war on the valuation front.

K. Façade Easement Deduction Fails for Want of Certification of Historic Structure Status (*Capitol Places II Owner, LLC v. Commissioner*, 164 T.C. No. 1, January 2, 2025)

The Tax Court has held that the donation of a building façade easement was not deductible because the taxpayer did not establish a "qualifying conservation purpose" for the contribution. The court thus granted summary judgment to the IRS, finding no genuine issue of material fact remaining to be decided.

In 2014, the taxpayer acquired ownership of the Manson Building, a three-story masonry building in Columbia, South Carolina, designed by a prominent local architect, James Urquhart. Built in the early 20th century, the building underwent a "fair share of alterations and remodeling," including the addition of a stucco façade to the top two floors in the 1960s.

Back in 2000, the then-owner of the building applied with the National Park Service to get the building listed in the National Register of Historic Places. The NPS denied the application, finding the building "has lost important character-defining features" and that much of the first-floor retail space had been altered.

In 2014, the Historic Columbia Foundation applied to get the "Columbia Commercial Historic District" listed in the National Register of Historic Places. The application listed 36 buildings within the district, including the Manson Building, as "contributing" to the area's local significance. The application was approved, though in that process there was never a determination that the Manson Building itself was of historical significance to the district.

On December 17, 2014, the taxpayer granted a façade easement in the Manson Building to the Historic Columbia Foundation. On its short-year 2014 federal income tax return, the taxpayer claimed a charitable contribution deduction of $23.9 million for the donation of the façade easement. The IRS disallowed the deduction, bringing the parties to the Tax Court.

1. A Little Ditty About Façade Easements

Section 170(f)(3)(A) generally prohibits a deduction for the charitable contribution of anything less than the donor's entire interest in the donated property. Thus, for example, a taxpayer who owns all rights to a parcel of improved land may not deduct the value of an income interest donated to charity. There are a limited number of exceptions to this rule, the relevant one here being §170(f)(3)(B)(iii), which permits a deduction for a "qualified conservation contribution." Under §170(h)(1)(C), only a contribution "exclusively for conservation purposes" can be a qualified conservation contribution.

Section 170(h)(4) then sets forth a number of qualifying conservation purposes, the relevant one here being "the preservation of an historically important land area or a certified historic structure." §170(h)(4)(A)(iv). Section 170(h)(4)(C) explains that a "certified historic structure," for this purpose, means either:

> (i) any building, structure, or land area which is listed in the National Register, or
>
> (ii) any building which is located in a registered historic district ... and is certified by the Secretary of the Interior to the Secretary as being of historic significance to the district.

The Tax Court granted summary judgment to the IRS, finding first that the Manson Building was not listed in the National Register of Historic Places. The taxpayer argued it was sufficient that the Manson Building was within the Columbia Commercial Historic District, but the court rejected this argument. If it is enough that a building is within the boundaries of an area listed in the National Register, then the statute would not need to contain the second method for qualifying as a certified historic structure. The court refused to read the first method in a way that renders the second method superfluous. As the court concludes:

> [T]he text and context of section 170(h)(4)(C)(i) establishes that the phrase "listed in the National Register" refers to a building, structure, or land area individually listed in the National Register and not merely one located in a registered historic district.

Furthermore, observed the court, there was never a certification from the Department of the Interior that the Manson Building was of historic significance to the district. The taxpayer at no point even applied for this certification. The taxpayer claimed it was sufficient that the building was listed as "contributing" to the historical significance of the area in the district's application for listing in the National Register, but even though a building "might conceivably qualify" for certification by reason of being a resource "contributing to" a registered historic district, certification is, nonetheless, still required.

The taxpayer then claimed that even if the Manson Building was not a certified historic structure, the façade easement protects "an historically important land area." The court had little patience for this alternative argument, finding it suspicious that this other claimed purpose was not listed in the deed. Indeed (no pun intended, but what the heck), the easement deed specifically preserves a building and not a land area. As the court notes, "[a] single façade easement protecting a single building is insufficient."

Because the taxpayer could not prove that the easement protected a qualifying conservation purpose, the court found that the taxpayer could not claim a charitable contribution deduction for the donated façade easement. But the failure of the deduction does not undo the easement: the taxpayer still owns the Manson Building and lacks any power to change the building's façade without the consent of the Historic Columbia Foundation. While the taxpayer may not be as much as $23.9 million poorer as a result of the donation, without question it now owns property worth less than its original value. The case underscores that taxpayers with visions of tax savings dancing in their heads should proceed carefully, as the transaction is not without genuine risk.

L. Conservation Easement Generated $4.7 Million Deduction, Not the $32.5 Million Claimed by the Taxpayer (*Seabrook Property, LLC v. Commissioner*, T.C. Memo. 2025-6, January 21, 2025)

The Tax Court has held that a syndicated conservation easement transaction resulted in a federal income tax deduction, but in an amount far less than the taxpayer claimed on its 2017 tax return. The easement covered roughly 620 acres in rural Liberty County, Georgia, land near the Florida-Georgia line that's about a 45-minute drive from Savannah.

Some 250 acres of the property is marshland, but the remainder, while undeveloped, is prime for residential development. At least that's what the taxpayer's appraiser concluded, leading the taxpayer to claim a deduction of over $32.5 million for the donation of the easement. The IRS agreed that residential development was possible, but at a much more modest level given the property's remote rural location and lack of nearby grocery stores, schools, restaurants, and hospitals.

But the IRS led with the argument that the taxpayer should get no deduction at all for lack of "donative intent." The argument goes that the LLC was only in it for the deduction, thus there was no "gift" to Southern Conservation Trust, Inc., the charitable recipient of the easement. The Tax Court rejected this argument, as it did in four cases from 2023 and 2024: *J L Minerals, LLC v. Commissioner*, T.C. Memo. 2024-93; *Buckelew Farm, LLC v. Commissioner*, T.C. Memo. 2024-52; *Mill Road 36 Henry, LLC v. Commissioner*, T.C. Memo. 2023-129; and *Oconee Landing Property, LLC v. Commissioner*, T.C. Memo. 2024-25. As the court (once again) reasoned, any "*quid pro quo*" in the form of a tax deduction is coming from Congress and not from the charity. In the court's view, it is enough that the taxpayer donated property to charity and received nothing back *from the charity*, or at least nothing more in value than what was given to the charity.

The IRS then argued that the appraisal attached to the 2017 tax return did not substantially comply with the requirements for a "qualified appraisal," as required by Reg. §1.170A-13(c). The IRS pointed to all kinds of nitpicky faults, none of which swayed the court into finding that the appraisal did not substantially comply with the requirements of the regulation. First, the IRS claimed the appraisal did not adequately describe the property, but the court found it contained enough information to alert the IRS as to the property to which the easement relates. Second, the IRS pointed out the appraisal did not state the date of donation, but the court felt it was enough that the donation date was specified on the Form 8283 and that the date of the appraisal was close to the donation date. Finally, the IRS griped that the appraisal made no mention of Georgia Forest Land Protection Act (FLPA) covenants related to the property, violation of which could result in a $50,000 penalty. The court reasoned that because the penalty amounted to 0.14% of the appraised value of the land, the failure to mention or discuss the impact of the covenants on the appraised property value was of no import.

On the valuation of the property itself, though, the IRS prevailed. The court ultimately determined that the value of the easement was just over $4.718 million, and because the amount of the claimed deduction ($32.5 million, remember) was more than double that amount, the taxpayer was liable for a 40-percent gross valuation misstatement penalty under §6662. In reaching its conclusion, the court was more persuaded by evidence of comparable sales offered by the IRS's expert. Those sales reflected values ranging from $7,000 to $10,000 per acre. It found the taxpayer's expert less persuasive, faulting his report because it "ignores real estate's oldest adage: 'Location, location, location.'" While the property may be pretty, it also pretty remote.

M. An Even Bigger Valuation Error (*Green Valley Investors, LLC v. Commissioner*, T.C. Memo. 2025-15, February 11, 2025)

The Tax Court has determined that the value of a conservation easement on about 140 acres in Chatham County, North Carolina, donated at the end of 2014 was roughly $1.15 million. Alas, the taxpayer claimed a charitable contribution deduction of nearly $22.6 million from the donation, so here too the taxpayer was liable for a gross valuation misstatement penalty under §6662.

This case was consolidated with three other cases involving related parties. In each case, the taxpayer, a limited liability company, purchased land and then donated a conservation easement to the Triangle Land Conservancy in either 2014 or 2015. If the taxpayer's name rings a bell, that may be because it and the other three taxpayers already appeared in Tax Court regarding these very donations. In the prior case, *Green Valley Investors, LLC v. Commissioner*, 159 T.C. 80 (2022), the IRS disallowed the deductions on the grounds that the donated easements violated the statutory requirement that they be given in perpetuity. And because the disallowed deductions resulted in understatements from syndicated conservation easement transactions, the IRS asserted §6662A penalties. The Tax Court held that these penalties could not apply because the IRS did not properly identify syndicated conservation easement transactions as "listed transactions" for purposes of this penalty. Importantly, though, that decision only rejected the application of the penalty applicable to listed transactions. It saved for another day the computation of the allowable deduction amount and whether other penalties might apply.

That day has now come. The taxpayer claimed that the subject property could be used as a crushed stone aggregate quarry. But the Tax Court held that while such an activity "is a physical and legal possibility," the actual development of the property for such a use is not financially feasible. Rather, said the court, the "highest and best use of the Green Valley property remains its current agricultural/residential/recreational use with knowledge of minerals on the site." From that lens, the size of the deduction was bound to be smaller.

Indeed it was. Considering that the taxpayer's predecessor in interest bought the land in 2011 for about $3,700 per acre and that same year sold about 180 acres of it for about $41,361 per acre, the taxpayer's claim that the easement was worth $161,000 per acre seemed…a stretch. That led the court to its determination that the pre-easement value of the property was roughly $1.4 million. Subtract the $250,000 "after-easement" value stipulated by the parties, and you get the court's conclusion that the easement was worth about $1.15 million. Because the deduction claimed by the taxpayer was nearly 20 times that amount, the 40-percent gross valuation misstatement applied. The court then applied a second, 20-percent accuracy-related penalty under §6662 applicable to that portion of the taxpayer's underpayment not attributable to a gross valuation misstatement.

A little over two years earlier, Green Valley left the Tax Court with a victory under its belt. This time, the IRS emerged triumphant. While in the prior case the IRS hoped the Tax Court would disallow the deduction completely, this time the Tax Court disallowed the bulk of the claimed deduction, and the penalties in connection with the understatement will far exceed the tax savings from the deduction amount that was allowed.

XIII. CASES INVOLVING SUBSTANTIATION OF CONTRIBUTIONS

A. Appraisal of Bargain Sale of Furniture Factory Was Lazy, Boy (*Leo v. Commissioner*, T.C. Memo. 2025-9, January 29, 2025)

The Tax Court has determined that the 2013 bargain sale of 136 acres in Union County, Mississippi, containing a furniture factory resulted in a charitable contribution of just over $4 million, not the $12.425 million amount deducted on the taxpayer's return. The taxpayer argued that the appraisal obtained in connection with the bargain sale transaction should be binding in the computation of the deduction amount, but the court observed that it was not bound by the appraisal. Indeed, the report contained many inaccuracies, including a statement that the factory was in "average condition and well maintained." In fact, the property was in poor shape. Furthermore, and likely even more damning, there was evidence the appraiser had precommitted to value the property at an amount of at least $15 million before conducting any inspection. As the court notes, "this precommitment impaired his objectivity in evaluating the condition of the … property."

The taxpayer submitted an appraisal from another expert, but the court rejected that one too, finding the appraiser did not conduct a thorough independent investigation but simply relied on much of the information from the prior appraisal. The second appraisal used an income-based approach, but the court concluded that the assumed $1.50 per square foot rental value was far in excess of the 48-cent and 45-cent per square foot rental rates in effect under prior lease agreements in effect shortly before the donation.

Instead, the court found the report of the IRS's expert to be more credible. The IRS's expert used a comparable-sales-based approach, then adjusting it for the relatively poor condition of the subject property. Importantly, the IRS's expert performed an inspection of the property, interviewed its former tenants, and accounted for the fact that much of the property was not suitable for rental in its then-present state. The court rewarded the extra legwork by adopting the IRS expert's report. Oh, and there was this: the property itself was later sold by the charity in May 2015—just 17 months after the bargain sale transaction—for a total of $1.13 million. That suggests the IRS's determination of value is more credible than the valuation offered by the taxpayer.

Because the taxpayer's deduction was more than double the correct value, the court upheld the imposition of a 40-percent gross valuation misstatement penalty under §6662.

B. Forms 8283 are Not Qualified Appraisals, so Taxpayers Lose Charitable Contribution Deduction (*Cade v. Commissioner*, T.C. Memo. 2025-20, March 10, 2025)

The Tax Court has granted the IRS's motion for summary judgment as to whether a married couple had obtained a "qualified appraisal" of the items they allegedly donated to charity. The taxpayers argued the appraisal summary they attached to an amended return was sufficient for this purpose, but the IRS and the Tax Court concluded otherwise. The case reminds us that an "appraisal summary" is not the same thing as a "qualified appraisal."

William and Mary Cade, a married couple, originally filed a federal income tax return for 2019 showing a balance due of $89,013. The taxpayers did not include any payment with the return. They then filed an amended return claiming to have made a charitable contribution in December, 2019, to their church of various "surplus items" they did not need in their real estate business, including over 2,200 jackets and over 1,200 short sleeve coveralls. (You know, because realtors need lots of jackets.) They also claimed to have donated some $89,100 in cobblestones as well as over 9,600 pieces of commercial vinyl tile and ten four-gallon tubs of floor-tile adhesive. Completed Forms 8283, Noncash Charitable Contributions, were attached to the amended return. If allowed, the resulting federal income deduction from the donations would—wait for it—eliminate any liability for additional tax and even result in a modest refund. The IRS disallowed the deduction on the grounds that the donations were not adequately substantiated, leading the taxpayers to seek redetermination in Tax Court.

But the Tax Court largely held in favor of the IRS. It agreed with the IRS that the taxpayers had not obtained a contemporaneous written acknowledgment from the church, as required by IRC §170(f)(8). The taxpayers initially argued the Forms 8283 doubled as an acknowledgment from the church, but the court found that argument “does not hold water,” because the acknowledgement must include a statement as to whether the recipient provided any goods or services in consideration for the gift, and the Forms 8283 contained no statement to that effect. The taxpayers then claimed to have discovered a receipt from the church, “ostensibly dated” on the claimed donation date, but the court found the timing of this discovery “arouses suspicion.” The taxpayers “found” the receipt many months after the IRS kept requesting copies of it. “If petitioners or their return preparer had this document in their files, it seems odd that it was no provided sooner.”

On top of that, the receipt itself “has other questionable features,” including illegible signatures, no indication of the signatory’s name or title, and inconsistent addresses for the church. “Given that the documents were ostensibly executed on the same day, these seeming discrepancies require explanation.” Given the many factual questions about the authenticity of the receipt, the court denied the IRS’s motion for summary judgment to the extent it was based on the failure to secure a contemporaneous written acknowledgment.

The Tax Court also rejected the argument of the taxpayers that the Forms 8283 could constitute “qualified appraisals,” calling the argument “a non-starter.” While the Form 8283 qualifies as an “appraisal summary,” that is not the same as a “qualified appraisal.” The requirements for a qualified appraisal are set forth at Reg. §§1.170A-13(c)(3) and 1.170A-17(a), and the regulations make clear that an appraisal summary and a qualified appraisal are two different documents. The taxpayers then claimed that statements they obtained from three experts more than three years after the donation could constitute qualified appraisals, but the court had none of it, finding the statements were too short to be complete and were prepared more than two years after the taxpayers filed their amended return. (The regulations provide that a donor must receive the qualified appraisal before the return is filed. See Reg. §§1.170A-13(c)(3)(iv)(B) and 1.170A-17(a)(4)(iii).)

The court went on to hold that even if the statements were considered to be timely appraisals, the three experts who supplied them were not “qualified appraisers,” as required by IRC §170(f)(11)(E)(ii). None of the three individuals regularly perform appraisals for money, and none had indicated successful completion of professional or college-level coursework in valuing the type of property appraised. So the court granted the IRS’s motion for summary judgment to the extent it disallows the deduction for lacking substantiation from a qualified appraisal by a qualified appraiser.

The court made no decision regarding whether the taxpayers had reasonable cause for failing to meet the substantial requirements, finding this defense “typically raises factual questions illsuited [sic] to summary adjudication.”

XIV. AUTO-GENERATED ONLINE TAX COURT PETITIONS ARE DEEMED TO BE SIGNED BY THE TAXPAYER (*Donlan v. Commissioner*, 164 T.C. No. 3, February 19, 2025)

The Tax Court has held that a married couple timely petitioned the court for redetermination of an alleged federal income tax deficiency through the use of an electronic filing available to pro se taxpayers (that is, taxpayers who represent themselves before the Tax Court). The IRS moved to dismiss the matter for lack of jurisdiction because the petition did not contain the handwritten signatures of the taxpayers or facsimiles of handwritten signatures. Instead, the forms uploaded by the taxpayers contained their typed names and contact information on the form's signature blocks.

In a unanimous opinion, the Tax Court held that an electronic filing without a handwritten signature is proper. It thus denied the IRS's motion to dismiss. The court confirmed that it released an online petition generator for pro se taxpayers on July 31, 2024. That generator allows a taxpayer to answer a series of questions, which the tax Court's e-filing system them uses to generate a completed petition that the taxpayer can file by uploading. While the computer-generated petition contains a signature block, the court sagely observed that "a taxpayer cannot place a handwritten signature on a petition created with the online petition generator."

So how is a taxpayer supposed to comply with the signature requirement when using the online petition generator? This looks like a job for Tax Court Rule 23(a)(3), which states: "A person's name on a signature block on a paper that the person authorized to be filed electronically, and that is so filed, constitutes the person's signature." So there you go. When a pro se taxpayer uses the electronic petition option, then, the auto-generated signature block on the petition serves as the taxpayer's signature. The taxpayers here used the court's online petition generator, so their petition is deemed to have been signed by both of them.

Ever get the feeling you're reading a case from 2005 only to discover that it's in fact a case from 2025? It's remarkable (or maybe more accurately, "appalling") that the IRS would move to dismiss a case because an auto-generated e-filed petition did not contain a handwritten signature. Wait until the IRS learns that Tax Court filing fees can be paid by credit card!

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

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

A. Background on QDOTs

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

B. Items to be Updated

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

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

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

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

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

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

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

Prop. Reg. §20.2056-2(d)(1)(iii).

C. Observation

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

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

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

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

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

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

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

XVII. RETURN OF THE TAX PROTESTORS? (*Christiansen v. Commissioner*, T.C. Memo. 2025-21, March 10, 2025)

The Tax Court has rejected claims that married couples were not required to pay federal income tax and that "voluntary self-assessment" means that federal income taxes are optional "gifts" to the federal government. The case is included here largely for schadenfreude but also as an alert that tax protestors may be rising from their recent slumber.

The taxpayers, a married couple, had gross income from wages and unemployment compensation for each of the years at issue (2015, 2016, 2017, and 2018) but did not file federal income tax returns for those years until January of 2022. On those returns, they reported no gross income and no tax liability. On the lines for wages and other compensation, the couple wrote "26 C.F.R. §1.61-2" and "Control No. 1545-0771," apparently under the theory that the regulation was not approved by the federal Office of Management and Budge (OMB) control No. 1545-0074, and therefore they were not required to report their gross income on their tax returns. The IRS issued a notice of deficiency for each of the years at issue based on the Forms W-2 and 1099-G it received and also determined that the couple was liable for penalties.

Before the Tax Court, the couple argued they owed no taxed based on a four-pronged attack. They argued that (1) the federal income tax based on "voluntary self-assessment;" (2) there is no federal statute that requires them to pay tax; (3) the IRS failed to obtain OMB approval requiring them to report wage information and unemployment compensation as gross income; and (4) OMB approval is required before the IRS can use information reported on Forms W-2 to determine their tax liability. Citing a long line of cases, the Tax Court rejected these arguments as "frivolous." The court also upheld penalties for late filing, even adding:

> The Court has discretionary authority to impose a penalty payable to the United States of not more than $25,000 on taxpayers whenever it appears that their position in a proceeding is "frivolous or groundless." See §6673(a)(1)(B). We

caution petitioners that a penalty may be imposed in any future case before this Court should they continue to pursue their misguided positions.

About a decade or so ago, it was all the rage for tax protestors to pursue their claims in Tax Court. The number of petitions filed by protestors has, thankfully, declined significantly. One hopes the past trend is not coming back in style.

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

The District of Columbia Circuit Court of Appeals has reversed a decision of the Tax Court treating $6.5 million of the proceeds from the sale of a partnership interest by a nonresident alien individual attributable to inventory items of the partnership as United States-source income on which the individual would owe federal income tax. The appellate court determined that the inventory gain was sourced outside the United States, shielding the taxpayer from federal income tax on that portion of the gain from the sale of the partnership interest. The case offers a helpful primer on the intersection of partnership taxation and the United States taxation of international transactions.

The taxpayer owned a 30-percent interest in a limited liability company that manufactures and sells a variety of consumer products including 5-hour Energy drinks. She sold her interest in 2008 for a 20-year promissory note with a face amount of $438 million. (Gulp!) At the time of the sale, according to a stipulation between the taxpayer and the IRS, the taxpayer's share of inventory items held by the LLC was $6.5 million.

The taxpayer argued that no portion of this "inventory gain" from the sale should be treated as a sale of inventory since she did not sell any inventory—she sold a partnership interest. But the Tax Court ruled a different result was required by IRC §751(a)(2), which provides that the portion of the proceeds from the sale of a partnership interest attributable to inventory items must be treated as sold separately from the partnership interest. *Rawat v. Commissioner*, T.C. Memo. 2023-14. The Tax Court took that to mean that the inventory gain must be treated as income from the sale of inventory, which could have a United States source.

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

Note that under current law, the taxpayer's inventory gain would have a United States source. Part of the 2017 Tax Cuts and Jobs Act provides that the sale of an interest in a United

States partnership has a United States source. The sale in this case took place in 2008, well before the current sourcing rule took effect.

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

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

A. Background on Relevant Statutes

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

Specifically, §6048(a) requires the United States grantor of a foreign trust (or, where applicable, a "United States transferor" or the executor of a United States decedent) to report the creation of any foreign trust, the transfer of any money or property to a foreign trust that is not a sale for fair market value, and the death of any United States person treated as the owner of any portion of a foreign trust (or whose gross estate includes any portion of a foreign trust). This is done on Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts.* In addition, §6677 imposes a penalty for failing to report the information required under §6048 absent reasonable cause. The penalty amount is equal to the greater of $10,000 or 35 percent of the gross amount reportable. If, after the IRS mails notification of the failure to report, the failure continues for more than 90 days, an additional $10,000 penalty is imposed, and successive $10,000 penalties continue every 30 days (or portion thereof) thereafter.

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

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

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

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

Proposed Regulation §1.643(i)-2 then lists four exceptions to the deemed distribution rule in Proposed Regulation §1.643(i)-1. First, there is no deed distribution in the case of any loan made in exchange for a "qualified obligation," defined generally as a written debt instrument with a term of not more than five years requiring all payments to be made in United States dollars and with interest payable at a fixed rate. Further, all stated interest on the obligation must be "qualified stated interest" as defined in the rules related to original issue discount, and the yield to maturity on the obligation must not be less than the applicable federal rate of interest in effect on the day the debt instrument is issued, nor more than 130 percent of such applicable federal rate of interest. Second, there is no deemed distribution from a foreign corporation to a United States beneficiary where the total amount of all loans made to the beneficiary does not exceed the foreign corporation's undistributed earnings and profits that are or have been included in the beneficiary's gross income under subpart F.

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

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

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

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

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

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

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

Proposed Regulation §1.6677-1 explains the application of civil penalties applicable for failing to comply with the rules of Proposed Regulations §§ 1.6048-2 through 1.6048-4. Notably, this proposed regulation takes the position that the §6677 penalty applies separately to each of the §6048 reporting requirements (the requirements to report transactions under Proposed

Regulation §1.6048-2, to report certain trust activities and operations under Proposed Regulation §1.6048-3, and to report distributions from foreign trusts in accordance with Proposed Regulation §1.6048-4). In explaining the reasonable cause exception to the §6677 penalty, the proposed regulation states that the determination of whether a failure to file a complete Form 3520 is due to reasonable cause and not due to willful neglect will be made "on a case-by-case basis, taking into account all pertinent facts and circumstances." According to the proposed regulation, the fact that a foreign jurisdiction would impose a civil or criminal penalty for disclosing the required information is not reasonable cause, nor is a foreign trustee's refusal to provide information.

XX. CLAIMS COURT ALLOWS TREATY-BASED FOREIGN TAX CREDITS AGAINST NET INVESTMENT INCOME SURCHARGE (*Buryea v. United States*, ___ Fed. Cl. ___, December 5, 2024)

The Court of Federal Claims has held that a United States citizen could use the foreign tax credit under the United States-Canada income tax treaty (the "Canada Treaty") to offset liability for net investment income tax ("NIIT") under IRC §1411. The case offers new hope to taxpayers, as at least one prior attempt to use treaty-based credits against NIIT liability proved unsuccessful.

A. Background on the Canada Treaty and the NIIT

Article XXIV of the Canada Treaty, entitled "Elimination of Double Taxation," states in Paragraph 4 that:

> Where a United States citizen is a resident of Canada, the following rules shall apply:
>
> (a) Canada shall allow a deduction from the Canadian tax in respect of income tax paid or accrued to the United States in respect of profits, income or gains which arise (within the meaning of paragraph 3) in the United States, except that such deduction need not exceed the amount of the tax that would be paid to the United States if the resident were not a United States citizen; and
>
> (b) For the purposes of computing the United States tax, the United States shall allow as a credit against United States tax the income tax paid or accrued to Canada after the deduction referred to in subparagraph (a). The credit so allowed shall not; reduce that portion of the United States tax that is deductible from Canadian tax in accordance with subparagraph (a).

The Canada Treaty defines "United States tax" in Article II as taxes "imposed on income by the United States" and "irrespective of the manner in which they are levied." Anticipating future changes to the Code, Article II also provides that the Canada Treaty applies to "any taxes identical or substantively similar" to the taxes described elsewhere in the Article.

Section 1411 is the lone provision of Chapter 2A of the Code ("Unearned Income Medicare Contribution"). It imposes a 3.8-percent surcharge on a taxpayer's "net investment income" for the taxable year (or, if less, the amount by which the taxpayer's "modified adjusted gross income" for the year exceeds the "threshold amount"). The "threshold amount" is $250,000 for married couples filing a joint return, $125,000 for a married individual filing separately, and $200,000 for everyone else. IRC §1411(b). For trusts and estates, the threshold amount effectively is the dollar amount at which the highest ordinary income tax bracket in IRC §1(e) begins. IRC §1411(a)(2). Generally, a taxpayer's net investment income" is the sum of gross income from interest, dividends, annuities, royalties, rents, and passive activities minus the deductions allocable to such income. IRC §1411(c)(1).

B. Facts of the Case

The taxpayer, a United States citizen residing in British Columbia, recognized a substantial capital gain in 2015. He paid almost $2 million in tax to Canada on that gain and claimed a United States foreign tax credit of nearly $1.4 million to offset his United States tax liability. The gain also gave rise to NIIT liability, but, for reasons undisclosed, the taxpayer did not claim a foreign tax credit with respect to this additional liability. Late in 2016, he filed an amended federal income tax return, this time claiming a refund of more than $263,000 thanks to applying a foreign tax credit to offset the NIIT liability. The IRS rejected the refund claim, finding that the Code does not allow a foreign tax credit against the NIIT and that the Canada Treaty did not provide an independent basis for such a credit. This ultimately led to the present lawsuit in which the taxpayer sought the refund he claimed.

C. Taxpayer Victory

The Claims Court granted the taxpayer's motion for partial summary judgment on the issue of entitlement to a foreign tax credit against the NIIT under the Canada Treaty. Although the foregoing provisions of the Canada Treaty would suggest that the taxpayer is entitled to a foreign tax credit to reduce NIIT liability, the IRS argued that under the "U.S. Law Limitation Clause" of the Canada Treaty, Article XXIV Paragraph 1(2), any treaty-based credit must be "in accordance with the provisions … of the law of the United States." This Clause, the IRS argued, means that a treaty-based credit cannot exist independently of the Code. The IRS then argued that IRC §27 provides a foreign tax credit "against the tax imposed by this chapter" (i.e., Chapter 1, the federal income tax) to the extent provided in IRC §901. The NIIT, recall, sits in Chapter 2A. Thus, claimed the IRS, because the Code does not authorize a foreign tax credit for the NIIT, the Canada Treaty cannot authorize one.

The Claims Court rejected the IRS's attempt to elevate the U.S. Law Limitation Clause over the treaty-based credit:

> More significantly, the government's interpretation has a glaring consistency problem: ***the government takes an ad-hoc approach to the U.S. Law Limitation***.

> The government interprets the U.S. Law Limitation differently when applied to different paragraphs within Article XXIV. In fact, as the Court details below, the government concedes that there are Treaty provisions that the government must follow even though they are inconsistent with the I.R.C. That is a powerful concession in Mr. Bruyea's favor because if there are such Treaty provisions, how does the U.S. Law Limitation work? How can the government ask this Court to read the U.S. Law Limitation to apply to some paragraphs of Article XXIV but not others? On the other hand, Mr. Bruyea must contend with the meaning of the U.S. Law Limitation. (Emphasis in original.)

In fact, the court continued, the Canada Treaty:

> will give way to the [Code] in only two circumstances. The first is where a later-enacted statutory provision "directly" conflicts with the Treaty. That "last-in-time rule" is a background, bedrock legal principle of treaty interpretation. The second circumstance is where the Treaty, by its terms, defers to the [Code].

Considering the last-in-time rule, the court determined that nothing in the language of the NIIT contradicted the existence of a treaty-based foreign tax credit. It rejected the IRS's position that the placement of the NIIT in Chapter 2A rather than Chapter 1 mattered because the Canada Treaty "guarantees that any future amendment to United States law will not change the general principle" of the Treaty. The Claims Court reasoned that the Canada Treaty (like any treaty) will give way to the Code only where a later-enacted statutory provision "directly" conflicts with the Treaty or where the Treaty, by its terms, defers to the Code.

The court then held that the U.S. Law Limitation Clause does not preclude the taxpayer from claiming the treaty-based credit to offset the NIIT, finding the NIIT was "substantively similar" to the taxes to which the Canada Treaty clearly applies. Indeed, the Technical Explanation to the Canada Treaty states that Paragraph 1 of Article XXIV "provides a credit for these specified taxes whether or not they qualify as creditable under Code section 901 or 903." Notice the Technical Explanation says it is the *Treaty* that "provides a credit" even though the Code does not. The Claims Court found this excerpt from the Technical Explanation to be powerful evidence in support of the taxpayer's claim.

D. Observation

The decision in *Bruyea* stands in contrast to the Tax Court's holding in *Toulouse v. Commissioner*, 157 T.C. 49 (2021). In *Toulouse*, the Tax Court rejected the taxpayer's claim that the United States-France Income Tax Treaty allows a foreign tax credit against the NIIT. Unlike the Claims Court, the Tax Court found it important that the NIIT was in Chapter 2A of the Code and not in Chapter 1. As the court observed, "The enactment of a 3.8% net investment income tax as part of chapter 2A is a clear expression of congressional intent that credits against section 1 not apply against the section 1411 tax."

XXI. TAX COURT INSISTS ONLY TRUE LIMITED PARTNERS QUALIFY FOR EXEMPTIONS FROM SELF-EMPLOYMENT TAX (*Denham Capital Management LP v. Commissioner*, T.C. Memo. 2024-114, December 23, 2024)

The Tax Court has held that individual partners in an investment firm were not "limited partners, as such" for self-employment tax purposes because of their active involvement in the partnership's management. As a result, their distributive shares were subject to self-employment tax for the years at issue. In reaching this decision, the court affirmed its commitment to a rule announced in 2023 that the exemption from self-employment tax for "limited partners, as such" does not apply to individuals who are limited partners in name only.

The taxpayer is a Delaware limited partnership that "offers investment advisory and management services to affiliated private equity funds that invest in the energy sector, specifically oil and gas, mining, and power." It has five limited partners, all individuals, and one general partner, a Delaware LLC (the formal petitioner in the case). Only the LLC had management authority, but the limited partners were the LLC's voting members. Each of the limited partners had roles and responsibilities beyond those spelled out in the partnership agreement, including leading various industry groups within the partnership. So important were the services performed by each limited partner, "investors had the right to withdraw their investments early if one or more of the Partners died, became disabled, or could no longer devote substantially all business time to the funds."

During the years at issue (2016 and 2017), the partnership generated revenues of $69.9 million and $61.2 million. The partnership made guaranteed payments and distributions to the limited partners, but only the guaranteed payments were reported as net earnings from self-employment. Perhaps unsurprisingly, the distributions to each limited partner were much larger than the guaranteed payments; in some cases, the distributions were as much as 20 times the amount of the guaranteed payments. The partnership claimed total net earnings from self-employment of about $1.7 million for 2016 and $1.4 million for 2017. The IRS, on the other hand, determined that the net earnings from self-employment were about $29.2 million for 2016 and $24.3 million for 2017.

Under §1401, individuals must pay a tax on "the net earnings derived from self-employment" during the year. Section 1402(a) states in part that:

> The term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member….

Thus, under this definition, an individual's distributive share of a partnership's ordinary business income is included as net earnings from self-employment. But §1402(a)(13) provides that:

> there shall be excluded the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.

In *Soroban Capital Partners LP v. Commissioner*, 161 T.C. No. 12 (2023), the Tax Court held that the exception from self-employment taxes for distributive shares allocable to "limited partners, as such" only applies to distributive shares allocable to those actually functioning as limited partners and not to the shares allocable to those acting as limited partners in name only. The court also held that the determination of whether a partner is truly a limited partner or one acting in name only is a partnership-level determination over which the Tax Court has jurisdiction in a partnership-level proceeding. In this case, the taxpayer challenged both of these holdings, but the court remained steadfast:

> Petitioner contends that *Soroban* missed the mark because therein the Court did not consider a third element of the definition of partnership items — that the item must affect the entire partnership, not just the partners individually. The Court adheres to the doctrine of stare decisis and thus affords precedential weight to its prior reviewed and division opinions. … We revisit our prior decisions only when presented with a special justification to do so. … We see no special justification to revisit *Soroban*'s reasoning.

After affirming its commitment to the *Soroban* holdings, the Tax Court then applied them to the present case. The court first analyzed the roles and responsibilities of the limited partners to determine whether they were more like those of passive investors or employees. The facts strongly supported the conclusion that the limited partners were more like employees. Each of the partners devoted substantially their full-time efforts to the partnership. They treated their work for the partnership as their full-time employment. Their expertise and judgment were important to investors, as evidenced by an investor's ability to withdraw upon a limited partner's death, retirement, or withdrawal. The limited partners had control over personnel matters in a "substantial and active business operation" that paid over $23 million in employee compensation in 2017 alone.

In sum, concluded the court, the partners here were not "limited partners, as such" under §1402(a)(13). Accordingly, it upheld the IRS's determination that the distributive shares of the partners were subject to self-employment tax.

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

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

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

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

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

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

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

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

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

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

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

XXIII. SHERIFF WHO WITHDREW GOVERNMENT FUNDS IN PONZI SCHEME DID NOT HAVE EMBEZZLEMENT INCOME (*Franklin v. Commissioner*, T.C. Memo. 2025-8, January 22, 2025)

The Tax Court has held that a former county sheriff did not embezzle funds from a bank account dedicated to feeding inmates held in the county jail when she withdrew funds from the account and loaned them to a car dealership business with the promise of making big profits over just 30 days. Although the court determined the former sheriff did not commit embezzlement, it upheld a penalty against the sheriff for failing to file a federal income tax return and also denied a deduction for legal and accounting fees incurred in connection with the alleged embezzlement activity.

Ana Franklin was elected Sheriff of Morgan County, Alabama, in 2010. She served two terms, stepping down from the post in 2019. Franklin's job description included, among other things, "an obligation to see that the inmates in the county jail were properly fed." The State paid $1.75 per inmate per day along with other occasional allowances for this purpose. For federal inmates, the United States supplied a feeding allowance of $5 per day. If these funds fell short, the sheriff was on the hook to cover the difference. But on the other hand, Alabama statutes provide that a sheriff may retain any surplus funds remaining after feeding prisoners and use the surplus funds for any police-related purpose.

When Franklin started the job, she set up accounts with various food vendors and established a line of credit, all in her own name and using her Social Security number. She also obtained signatory authority over the checking account into which government funds for jail food were deposited. Throughout her first term, Franklin and her staff managed to feed inmates with funds provided by the government. By the start of 2015 (the end of Franklin's first term), the balance in the account was over $224,000. But shortly after her second term as sheriff commenced, the amount spent on jail food exceeded the allowances received from the government. Franklin thus had a problem: funds were draining, and she didn't want to pony up her own cash for feeding prisoners.

Enter Franklin's boyfriend (who was also a Morgan County police officer at the time, but let's not focus on the conflict of interest just now). At his recommendation, Franklin withdrew $150,000 from the jail food account and loaned it to "a local used car dealership and title-pawn lending service" with the expectation that the funds would be repaid in 30 days with 17 percent interest. After all, the boyfriend had invested in the business, and he saw this as a great chance for recouping some of the losses on the jail food account. He even agreed to serve as guarantor for the loan.

Go figure, after 30 days the borrower had paid neither the principal nor any interest. The borrower's owner ghosted Franklin. She eventually learned that the whole arrangement was a Ponzi scheme (the opposite of a Fonzie scheme, which is cool). After the borrower filed for bankruptcy, the boyfriend did the upright thing and paid $150,000 to Franklin, which she deposited into the jail food account in late 2016.

The IRS claimed that Franklin had $150,000 of gross income from embezzling the funds from the jail food account, but the Tax Court held that because the loan was bona fide, Franklin had not made personal use of the money. As the court observed:

> Although petitioner's withdrawal of the funds failed to adhere to certain formalities as a written instrument, the lack of such formalities is not by itself conclusive. Petitioner credibly testified, and her testimony was corroborated by that of [the boyfriend] and others, that she was concerned about the long-term viability of the jail food money account. On the promise of a 17% return within 30 days, petitioner withdrew the funds from the jail food money account by

> cashier's check and immediately signed the cashier's check over to [the borrower]. Other members of the Morgan County Sheriff's staff had access to the jail food money account, yet there is no indication that petitioner undertook any effort to hide the withdrawal of the funds from them or otherwise conceal her actions. Petitioner may have exhibited poor business judgment, both in withdrawing the funds and in lending them to [the borrower], but petitioner's poor judgment is not a factor in determining her intent.

(Citations omitted.) In essence, said the court, this was an "an unauthorized loan and not embezzlement income."

It doesn't quite end there. On her 2018 federal income tax return, Franklin deducted nearly $45,000 in legal and accounting services in connection with criminal tax charges stemming from the late filing of her 2015 federal income tax return. Those are miscellaneous itemized deductions, of course, and as of 2018 such deductions were suspended under what was then the new §67(g). So Franklin pivoted, claiming that managing the jail food account had become a trade or business activity, which would support the deduction of the legal and accounting fees as business expenses rather than personal expenses.

The Tax Court didn't buy it. Managing the account was part of her employment duties as sheriff, said the court; it was not a separate trade or business activity. Thus, the expenses were unreimbursed employee business expenses, a type of miscellaneous itemized deduction suspended under §67(g). On top of losing the deduction on the 2018 return, the court upheld a failure to file penalty under §6651(a)(1) with respect to her 2015 return.

XXIV. FINAL REGULATIONS ACCOUNT FOR OVERLAPPING ECONOMIC RISK OF LOSS IN ALLOCATION OF PARTNERSHIP RECOURSE LIABILITIES (T.D. 10014, December 2, 2024)

Treasury and the IRS have issued final regulations relating to the allocation of recourse liabilities of a partnership along with special rules for related persons. The regulations generally apply to partnership recourse liabilities incurred or assumed on or after December 2, 2024.

Section 752(a) treats an increase in a partner's share of partnership liabilities as a deemed cash contribution to the partnership, increasing the partner's "outside basis" (that is, the partner's basis in the partnership interest). Likewise, IRC §752(b) treats a decrease in a partner's share of partnership liabilities as a deemed cash distribution to the partner, which will be taxable to the extent the amount of the deemed cash distribution exceeds the recipient's outside basis. Regulations under IRC §752 set forth the rules for determining a partner's share of partnership liabilities for purposes of these rules. These regulations distinguish between recourse liabilities (where one or more partners, or a person related to one or more partners, bears the "economic risk of loss") and nonrecourse liabilities (where no partner or related person bears the economic risk of loss).

Under existing rules, a partner generally bears the economic risk of loss for a partnership liability:

> to the extent that, if the partnership constructively liquidated, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner.

Reg. §1.752-2(b)(1). Back in December, 2013, the IRS and Treasury issued proposed regulations to amend the existing rules for the allocation of recourse liabilities. Only now are the regulations being finalized, though luckily, according to the preamble, "no intervening legislative changes regarding allocations of partnership of liabilities have been made, no subsequent changes to regulatory rules concerning allocations of partnership liabilities address the issues in the proposed regulations, and the issues raised by the [two] commenters continue to remain relevant."

A. Proportionality Rule for Overlapping Economic Risk of Loss Retained

The proposed regulations provided a "proportionality rule" to determine how partners share a partnership liability when multiple partners bear the economic risk of loss for the same liability (what the regulations call "overlapping economic risk of loss"). Under this proportionality rule, the economic risk of loss borne by a partner is the amount of the partnership liability (or portion thereof) multiplied by a fraction obtained by dividing the amount of economic risk of loss borne by the partner by the sum of the economic risk of loss borne by all partners with respect to that liability. The rule is retained in the final regulations. Reg. §1.752-2(a)(2). The final regulations illustrate the proportionality rule with an example:

> (i) A and B are unrelated equal members of limited liability company, AB. AB is treated as a partnership for Federal tax purposes. AB borrows $1,000 from Bank. A guarantees payment for the entire amount of AB's $1,000 liability and B guarantees payment of up to $500 of the liability, if any amount of the full $1,000 liability is not recovered by Bank. Under paragraph (b)(1) of this section, A bears $1,000 of economic risk of loss for AB's liability and B bears $500 of economic risk of lo when ss for AB's liability. A and B have not entered into a loss-sharing agreement addressing their status as co-guarantors, and local law does not clearly establish responsibility as between them for the liability.
>
> (ii) Because the aggregate amount of A's and B's economic risk of loss under paragraph (a)(1) of this section ($1,500) exceeds the amount of AB's liability ($1,000), the economic risk of loss borne by each of A and B is determined under paragraph (a)(2) of this section. Under paragraph (a)(2) of this section, A's economic risk of loss equals $1,000 multiplied by $1,000/$1,500, or $667, and B's economic risk of loss equals $1,000 multiplied by $500/$1,500, or $333.

Reg. §1.752-2(f)(9) Example 9.

B. Changes to Rules in Determining Whether a Person is Related to a Partner

Adopting the proposed regulations with only minor tweaks, the final regulations make three significant changes to the "related person rules" at play in determining a partner's economic risk of loss. First, they modify the attribution rules used to determine if a person is related to a partner. The regulations already provided that a person is related to a partner if they have a relationship described in IRC §267(b) or IRC §707(b)(1), as modified. Reg. §1.752-4(b)(1). Normally the stock attribution rules in IRC §267(c)(1) would be used for this purpose, but the regulations now provide that IRC §267(c)(1) will be disregarded in determining whether stock owned by a partnership is treated as owned proportionately by its partners when the corporation directly bears the economic risk of loss. Reg. §1.752-4(b)(1)(iv)(A). The corporate stock attribution rules will also be disregarded in determining whether an interest in a lower-tier partnership owned by an upper-tier partnership is considered as owned proportionately by the partners of the upper-tier partnership when the lower-tier partnership directly bears the economic risk of loss. Reg. §1.752-4(b)(1)(iV)(B).

Second, the regulations introduce a "related partner exception" providing that:

> if a person who owns … an interest in a partnership directly bears the economic risk of loss … for a partnership liability, or portion thereof, then other persons owning interests … in that partnership are not treated as related to that person for purposes of determining the economic risk of loss borne by each of them for such partnership liability, or portion thereof.

Reg. §1.752-4(b)(2).

Finally, the regulations contain a "multiple partner rule" that states when a person who directly bears the economic risk of loss for a liability is related to more than one partner, each partner related to such person is considered to bear the economic risk of loss for the liability in proportion to the partner's interest in partnership profits. The preamble to the final regulations uses this example to illustrate the need for the rule:

> For example, corporations X, Y, and Z are partners in an entity treated as a partnership for Federal tax purposes. The partnership agreement provides that the partners share equally in all items of income, gain, loss, deduction, and credit of XYZ partnership. A, an individual, wholly owns X and Y. Z is an unrelated third party. Partnership borrows $1,000 from a bank and A and Z both guarantee the entire amount of the liability. Without the multiple partner rule, each of X and Y has $1,000 of EROL from A's $1,000 guarantee and Z has $1,000 of EROL from its guarantee. Each would be allocated one-third of the liability under the proportionality rule. In contrast, by applying the multiple partner rule, each of X

and Y has $500 of EROL. When the proportionality rule is applied, X and Y are each allocated one-fourth of the liability and Z is allocated one-half of the liability. This is the correct result because there is one guarantee from A's related group and one guarantee by Z.

The final regulations also provide a helpful ordering rule for clarifying how these three new rules interact. Reg. §1.752-4(e). First, assuming at least one partner bears the economic risk of loss for a partnership liability, one first applies the related party exception. Then, the multiple partner rule is applied before finally applying the proportionality rule to determine the amount of economic risk of loss each partner bears when the amount borne by multiple partners exceeds the amount of the liability. The regulations contain an elaborate example illustrating the application of the ordering rule. Reg. §1.752-4(f).

C. Effective Date

While the final regulations apply to any liability incurred or assumed by a partnership on or after December 2, 2024, a taxpayer can elect to apply the final regulations to all partnership liabilities with respect to all returns filed after December 2, 2024. Treasury and the IRS justify this rule providing greater certainty for partnerships with respect to older liabilities. Reg. §1.752-5(a).

XXV. FINAL REGS IMPLEMENT TAX ON GIFTS AND BEQUESTS FROM CERTAIN EXPATRIATES (T.D. 10027, January 14, 2025)

Treasury and the IRS have issued final regulations relating to taxpayers who owe taxes on gifts or bequests received from certain individuals who gave up their United States citizenship or residency. Although these regulations come nearly 17 years after Congress enacted the tax, there remains no method for reporting transfers subject to the tax or the computation of the tax owed. For the most part, the final regulations are effective as of January 1, 2025, though some provisions are applicable as of January 14, 2025, the date of publication in the Federal Register.

A. Statutory Background

Section 2801 was added to the Code by the Heroes Earnings Assistance and Relief Tax Act of 2008. (Note the Act's cutesy acronym.) It imposes a tax at the highest applicable gift or estate tax rate on “covered gifts” and “covered bequests” received by a United States citizen or resident from a “covered expatriate.” See §2801(a). The Code defines a covered gift as any property acquired directly or indirectly by gift from a covered expatriate. Likewise, a covered bequest is property acquired by reason of the death of a covered expatriate. See §2801(e)(1). Any tax imposed is to be paid by the recipient. See §2801(b).

While the federal wealth transfer taxes (the federal estate, gift, and generation-skipping transfer taxes) are excises imposed on a transferor, the IRC §2801 tax is imposed on the recipient. There appears to be no mechanism by which a covered expatriate has a duty to inform the recipient that a transfer of property is subject to this tax, nor anything requiring the executor of a covered expatriate's estate to inform a beneficiary that a bequest or devise triggers the tax.

Section 877A(g)(1) defines a covered expatriate as an individual who expatriates on or after June 17, 2008, provided that, on the expatriation date, the individual: (1) has an average annual net income tax liability for the previous five tax years in excess of $124,000 (an amount adjusted for inflation); (2) has a net worth of at least $2 million; and (3) fails to certify compliance with all United States tax obligations for the previous five tax years.

B. 17 Years Later, We Have Regulations … But No Form

Proposed regulations implementing this new tax were published in 2015, seven years after the enactment of §2801. Now, nearly ten years later, those proposed regulations have been finalized. The final regulations make several changes to the proposed regulations in response to the 16 comments submitted by taxpayers. Two of those changes are summarized here.

The first change relates to the definition of a covered bequest. Under Prop. Reg. §28.2801-2(f), any property acquired directly or indirectly by reason of the death of a covered expatriate, regardless of the situs of the property and whether the property was acquired by the covered expatriate before or after expatriation from the United States would be treated as a covered bequest. A comment submitted to the IRS observed this definition was too broad, in that Congress's apparent intent was to limit the §2801 tax to property that would have been included in the covered expatriate's gross estate had such person been a United States citizen at death. For example, property passing to an expatriate's child from a trust created by the expatriate's parent after the expatriate's death would be subject to the §2801 tax under the proposed rule even though it would not be includible in the expatriate's gross estate had the expatriate retained United States citizenship.

To correct this problem, the final regulations identify three categories of property included in the definition of a covered bequest: (1) property acquired by a recipient on or after June 17, 2008, directly or indirectly by reason of the death of a covered expatriate, that would have been included in the covered expatriate's gross estate if the covered expatriate had been a United States citizen immediately before death; (2) property received from a covered expatriate that would have been included in the covered expatriate's estate, even if not acquired directly or indirectly by reason of the death of a covered expatriate (this would include, for example, property includible under IRC §2035); and (3) distributions made by reason of the death of a covered expatriate from a non-electing foreign trust to the extent the distributions are attributable to covered gifts and covered bequests made to the foreign trust on or after June 17, 2008. Reg. §28.2801-2(f).

In addition, the final regulations modify the definition of "indirect" property acquisitions. Under Prop. Reg. §28.2801-2(i), property is indirectly acquired where it is: (1) acquired through ownership of an interest in a corporation or other entity, (2) acquired through one or more foreign trusts, entities, or persons not subject to the §2801 tax, (3) paid in satisfaction of a debt or liability, (4) acquired through a power of appointment over property not in trust granted by a covered expatriate to one who is not a covered expatriate, and (5) acquired as a result of "any other indirect transfer." Among other things, commenters groused that items (2) and (5) were overbroad as written.

In response to these concerns, the final regulations more generally provide that an indirect transfer occurs where property is gratuitously passes from or by the covered expatriate through another person or entity. The final regulations also convert the five-part list from the proposed regulations to a nonexclusive list of four examples describing the application of the general definition of an indirect transfer. Reg. §28.2801-2(i).

The regulations contemplate that the §2801 tax will be computed on Form 708, *United States Return of Tax for Gifts and Bequests Received from Covered Expatriates*. Frustratingly, however, the form has yet to be released. Apparently, a United States recipient will use the form to report covered gifts and covered bequests received during a calendar year. Stay tuned for further developments…but maybe don't hold your breath. It seems these things take time.

XXVI. PRINCIPAL IN PONZI SCHEME PARTNERSHIP CANNOT DEDUCT ATTORNEY FEES OR ALLEGED THEFT LOSS (*Shaut v. Commissioner*, T.C. Memo. 2024-103 (November 6, 2024)

The Tax Court has held that a taxpayer could not deduct his legal expenses after a company he managed was sued for fraud, rejecting claims that the fees were deductible either as a theft loss or as a business expense. The court also disallowed a claimed theft loss for the taxpayer's own investments in the activity, finding a lack of documentation both for the amounts invested and the amounts not recovered.

In 2014, the taxpayer, an environmental lawyer, invested $250,000 in a partnership that supposedly would be engaged in developing patentable technology. In short order, the taxpayer became the partnership's president, though only for about six months. Following another investment, the taxpayer became a managing director of the partnership. In that position, he recruited many others to make million-dollar investments in the partnership.

In 2016, some investors determined that some of the partnership principals were engaged in misrepresentation and mismanagement. This led to around 17 separate lawsuits in which the taxpayer was named as a defendant. Most of the suits were resolved by 2018. Two of the principals were prosecuted and imprisoned in 2019 for their roles in what proved to be a Ponzi scheme.

In defending his good name, the taxpayer claims to have spent about $600,000 in legal fees in addition to losing some $720,000 invested in the enterprise. On his amended return for 2019, the taxpayer claimed a fraud loss deduction of $1,320,000, though the taxpayer could only substantiate legal bills of about $539,000 and lacked documentation for some of the claimed investments in the partnership. The IRS did not accept the amended return.

The Tax Court explained that an uncompensated theft loss is deductible under §165 where the taxpayer proves the existence of a theft, the amount of the deductible loss, and the year in which the theft was discovered. The court held that the taxpayer here did not prove that the loss was discovered in 2019. The taxpayer testified that he made his investments in earlier years and that most of the litigation surrounding the alleged misrepresentation and mismanagement was concluded by 2018. As the court said:

> [I]t is evident that [the taxpayer] knew before 2019 that [the partnership] was a financial failure, that improper activity occurred, and that he would not recover his investment. For these reasons alone, [the taxpayer] failed to carry his burden of demonstrating that his purported theft losses were "discovered" in 2019, thus entitling him to a casualty loss deduction for that year.

Furthermore, the court ruled, the taxpayer did not prove he was a victim of theft. Indeed, the court believes he was in on the scheme, though it does not say so in as many words:

> Although he claims no intimate involvement in the [partnership's] operations after his role as president ended, we find [the taxpayer's] explanation implausible and not credible. [He] has extensive business expertise; he started multiple successful businesses. After his role as the president…, he served the crucial role of raising millions of dollars for [the partnership]. Indeed, he brought on investors who were ultimately victims of the…scheme. His self-serving testimony alleging theft is insufficient in this case to meet his burden of proof.

Even if the taxpayer "was somehow unaware" of the wrongdoing, the court continued, he did not prove that his investments in the partnership "were anything more than a bad business decision." Couple that with the lack of evidence substantiating the claimed loss and the court's decision is easy: the taxpayer does not qualify for a theft loss deduction.

The taxpayer argued he should be allowed to deduct the attorney fees paid in defending himself against wrongdoing as a business expense. The court observed that while it is not entirely clear to which business the legal fees relate, the taxpayer "appears to suggest that his legal fee deduction should be permitted as a business expense for" the partnership.

The problem, though, is that most of the invoices submitted to substantiate the deduction were for years before 2019. Only those business expenses "paid or incurred during the taxable year" are deductible under §162(a). "Even more problematic," the court noted, the taxpayer's claim that the legal fees are a business expense contradicts his claim that "he was merely an individual who helped raise money" for the partnership and that he played no role in day-to-day operations.

When claiming to be both a principal and a victim (an officer and a gentleman?) of an enterprise, one should expect considerable skepticism from the IRS and courts. Inconsistent testimony and incomplete documentation doomed the taxpayer's chances for salvaging a deduction from this scheme.

XXVII. OUTSIDE BASIS ADJUSTMENTS CAN BE MADE EVEN IN YEARS CLOSED BY THE STATUTE OF LIMITATIONS (*Surk, LLC v. Commissioner*, T.C. Memo. 2024-99, October 29, 2024).

The Tax Court has held that even though a taxpayer got away with deducting passthrough losses in excess of the taxpayer's basis in the partnership in years now closed by the statute of limitations, the IRS can still make basis computations for an open taxable year with reference to how those losses should have been reported in the earlier year.

In the name of readability, this summary uses rounded numbers in almost all cases and does not include the effect of matters not relevant to the decision. The taxpayer, a partnership, owned a majority interest in an LLC. In 2014, the taxpayer deducted over $1.1 million as its share of the LLC's net losses for the year, even though the partnership's basis in the LLC interest was just over $540,000. That was improper under IRC §704(d), which limits a partner's deduction for passthrough losses to the partner's basis in the partnership interest (known to partnership tax mavens as a partner's "outside basis"). At most, the taxpayer should have deducted just over $540,000 and carried forward another $600,000 in suspended loss. In any case, the taxpayer's outside basis at the end of 2014 should have been zero:

2014: $1.14 million loss	What **was** reported	What **should have been** reported
Starting Outside Basis	540,000	540,000
Passthrough Loss Deducted	(1,100,000)	(540,000) ← limited by IRC §704(d)
Ending Outside Basis	0	0
Carryover Loss		$600,000

The next year, the taxpayer's share of the LLC's net losses came to over $2.7 million. The taxpayer deducted this amount in full even though its outside basis in the LLC had been reduced to zero in the prior year because of the allowable passthrough deduction. None of this passthrough loss should have been allowed (increasing the suspended loss to $3.3 million), and the taxpayer's correct outside basis as of the end of 2015 was still zero:

2015: $2.7 million loss	What **was** reported	What **should have been** reported
Starting Outside Basis	0	0
Passthrough Loss Deducted	(2,700,000)	0 ← limited by IRC §704(d)
Ending Outside Basis	0	0
Carryover Loss		$3.3 million

Then, in 2016, the taxpayer's outside basis in the LLC grew by over $3.8 million thanks to an election under §754. The taxpayer's share of the LLC's net loss for that year was $3 million, but for some reason the taxpayer computed its outside basis at just $1,730. It thus deducted $1,730 of the passthrough loss and carried forward a roughly $2.999 million loss. But the taxpayer *should* have deducted the entire passthrough loss, as there was enough outside basis to absorb it. Indeed, the taxpayer could then have deducted $800,000 of the $3.3 million suspended loss. That would leave the taxpayer with an outside basis of zero and a remaining suspended loss of $2.5 million:

2016: $3 million loss	What **was** reported	What **should have been** reported
Starting Outside Basis	0	0
IRC §754 Election Adjustment	3,800,000	3,800,000
Passthrough Loss Deducted	(1,730)	(3,800,000) *incl. 800,000 carryover*
Ending Outside Basis	0	0
Carryover Loss	$2.999 million	$2.5 million

In 2017, the fun continued. The taxpayer's share of the LLC's net loss was over $4.9 million, but after calculating its outside basis at $5.3 million(!), the taxpayer deducted the full passthrough loss plus almost $400,000 of the carryforward loss from 2016. Because the taxpayer's basis should have been zero, of course, none of the passthrough loss for 2017 would be deductible that year. Instead, it would add to the suspended loss, raising it from $2.5 million to $7.4 million.

2017: $4.9 million loss	What **was** reported	What **should have been** reported
Starting Outside Basis	5,300,000	0
Passthrough Loss Deducted	(5,300,000) *incl. 400,000 carryover*	0
Ending Outside Basis	0	0
Carryover Loss	$2.599 million	$7.4 million

The IRS determined that the taxpayer lacked outside basis sufficient to deduct its share of the LLC's 2017 loss as well as any portion of the suspended loss. The taxpayer argued that this had the effect of re-opening 2014 and 2015 even though the statute of limitations for those years had passed. But the Tax Court rejected this argument:

> As stated above, under section 705(a) a partner must calculate outside basis annually and must decrease its outside basis for the current-year loss as well as all prior-year losses since the partnership began. Treasury Regulation § 1.704-1(d)(2) adopts the section 705 basis adjustment rules although it limits the negative basis adjustment to allowed losses. Thus, it is immaterial that

> respondent did not issue an FPAA for 2014 and 2015 or that those years are closed. Respondent is calculating [the taxpayer's] outside basis for yearend 2017.
>
> Moreover, respondent is not seeking to make an assessment for a closed year or to disallow the excess loss deductions for 2014 and 2015. The question before the Court is how the excess loss deductions factor into the annual outside basis calculation. Events from non-docketed, prior, closed years may be considered to calculate outside basis for the docketed year.

Although the court determined the IRS was only focusing on the right result for 2017 and not those in any prior year, the court treated the passthrough losses claimed by the taxpayer for 2014 and 2015 as "allowed" for basis purposes because the taxpayer claimed the losses on its tax returns and the IRS did not challenge them.

This case underscores the principle that a taxpayer's adjusted basis is usually computed with reference to how items in prior years *should* have been reported for federal income tax purposes, and not necessarily according to how such transactions *are in fact* reported. While that principle worked in favor of the IRS in this case, it can also benefit the taxpayer. In PLR 9504032, for example, the taxpayer overstated the amount of excluded cancellation of indebtedness ("COD") income resulting from a bankruptcy, which in turn led the taxpayer, in applying IRC §108(b), to reduce its net operating loss carryovers going forward by an amount greater than what should have been the case. The IRS allowed the taxpayer to increase the net operating loss carryover figure based on the correct (and lower) amount of excluded COD income, even though the statute of limitations for the year in which the COD income arose had run.

XXVIII. CASES INVOLVING THE DEDUCTION FOR HOBBY LOSSES

A. Salt Miner Digs Himself Into a Hole Deducting Losses from Hay Farming and Horse Racing (*Bucci v. Commissioner*, 2d Cir., February 23, 2025)

The Second Circuit, in a summary order, has affirmed an oral bench opinion of the Tax Court holding that three activities engaged in by the taxpayer were hobbies. The substantial losses resulting from those activities, then, could not be used to offset the millions in income the taxpayer received from his salt mining business.

Joseph Bucci co-founded (and owns about one-third of the stock in) a corporation that owns the largest salt mine in the United States. He and his wife, Elaine, filed federal income tax returns for 2016 and 2017, the former reporting taxable income of $8.3 million and the latter reporting taxable income of $8.2 million. Those returns reported losses from three separate activities: farming, real estate, and horse racing. The IRS disallowed the losses from these activities under IRC §183, finding they were hobbies.

Section 183(a) generally provides that if an activity engaged in by an individual or an S corporation is "not engaged in for profit, no deduction attributable to such activity shall be allowed" for federal income tax purposes. Section 183(c) then provides that activity is "not engaged in for profit" if the activity is neither a business (with expenses deductible under IRC §162) nor an activity engaged in for profit (the expenses of which are deductible under IRC §212).

Whether a taxpayer engages in activity for profit is a question of fact. To assist in the determination, Reg. §1.183-2(a) lists nine factors that should be used to determine whether a taxpayer entered into the activity with the objective of making a profit, no one of which is determinative. Further, a court has the power to give more weight to some factors than to others, depending on the applicable facts.

Through a bench opinion, Judge Holmes applied the nine factors to each of the three activities after first observing:

> The Seventh Circuit has called this open-ended list of objective factors of subjective intent "goofy" and has chosen not to "wade through the nine factors" but instead take a more holistic approach, *Roberts v. Commissioner*, 820 F.3d 247, 250 – 254 (7th Cir. 2016). This case, though, is appealable to the Second Circuit, so we'll go back to the metaphorical salt mine of a long-standard analysis and address each specific factor as well as any other additional facts we find important to determine if the Buccis ever engaged in any of these activities for profit.

The first activity was Joseph's hay farming. He uses the hay to feed his horses and allows his neighbors to use the rest for their dairy activities. Rather importantly, he sells none of it. But that didn't stop him from claiming a $250,000 loss from hay farming in 2016 and a $200,000 loss in 2017. After methodically applying all nine factors to what was concededly "an easy case," the court determined this was not a for-profit activity and that the losses should be disallowed.

The second activity was Joseph's real estate activity, which he claimed to be an investment activity of buying and selling property. The activity, however, generated no income for 2016 or 2017. It did generate modest losses ($5,000 for 2016 and just under $7,000 for 2017), but after applying the nine factors the court determined this too was a hobby activity.

The third activity was horse racing, specifically, Joseph's dream to enter a horse in the Kentucky Derby. There were modest successes in the years at issue, as Joseph's horses won purses totaling just under $200,000 each year. But even with these victories, the activity generated a net loss of over $600,000 for 2016 and over $400,000 for 2017. This was consistent with other years, where the average net loss was $560,000. "This is not a money-making operation in other words," observed the court. Holistically speaking, horse racing is "simply an expensive, if for him affordable, dream." Still, the court applied the nine factors, finding that the activity is not engaged in for profit. “Mr. Bucci may be the rock salt king of America and horse racing is often called the sport of kings, but it is not on this record the business of kings.”

The Buccis took an appeal to the Second Circuit, but they fared no better in that venue. The court held that the Tax Court applied the correct legal standard and that it was not an error to deny their second request for a continuance in order to obtain counsel because Joseph conceded that retaining a lawyer in the matter was something he “should have got … done maybe earlier.”

The Buccis argued that the IRS conceded to a profit motive for all of the activities in its deficiency notice, but the Second Circuit saw no evidence of this. The couple claimed that because the IRS treated the loss from the sale of horses as capital losses, it was conceding that horse racing was an investment activity. But the Second Circuit observed that the sale of assets used in a hobby can give rise to capital gains and losses too, and the deficiency notice expressly stated the IRS’s determination that the racing activity was a hobby.

The Buccis finally argued that the Tax Court misapplied the nine factors to each activity, but the Second Circuit dismissed this claim as quibbling with the lower court’s fact findings and weighing of the factors. Such quibbles do not satisfy the requirement to show “clear error” by the Tax Court.

B. Fledgling Writer-Researcher Conducts a Hobby, Not a Business (*Mazotti v. Commissioner*, T.C. Memo. 2024-75, July 25, 2024).

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

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

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

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

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

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

C. Lawyer Cannot Deduct Race Car Activity Costs as Advertising Expense (*Avery v. Commissioner*, 10th Cir., December 9, 2024)

The Tenth Circuit Court of Appeals has affirmed the Tax Court's decision in *T.C. Memo. 2023-18* that a lawyer with a solo practice could not deduct some $355,000 in expenses incurred over a six-year period in connection with his race car hobby as "advertising expenses" under IRC §162(a) even though the taxpayer claimed the racing activity promoted his law practice.

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

> Petitioner believed that being involved in car racing might enable him to meet lawyers, doctors, and other professionals who could help his career. Car racing, he said, was a good "conversation starter" with these individuals. But he could identify only two instances in which his car-related activity actually intersected with his law practice. Through one racing connection he met a Pizza Hut franchisee who had a dispute with a vendor; petitioner subsequently "consult[ed]" with that franchisee. Several years previously he had met a surgeon

> who later served as an expert witness in a personal injury case he tried in Denver. But he met that doctor at an Indiana car show, not at a racing event.

On late and amended federal income tax returns for the years 2008 through 2013, the taxpayer claimed a total of $355,000 in "advertising expenses," all related to the car racing. At trial, though, the taxpayer could only substantiate $51,634 of this amount.

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

In this case, fueled by a desire to minimize his tax liability, the taxpayer tried to deduct the cost of the Dodge Viper and parts, but the argument quickly broke down. The Tax Court noted that these costs were "potentially recoverable" as depreciation expenses, but even so, the costs would not be deductible as ordinary and necessary business expenses. As the court observed:

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

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

On appeal, the taxpayer argued it was error for the Tax Court to focus on his enjoyment of car racing in deciding that the costs incurred in connection with the racing activity were not "ordinary and necessary" to his law firm business. But the Tenth Circuit found this argument was a lemon, unsupported by any authorities. What's more, observed the Tenth Circuit, it is not apparent that the Tax Court really considered the taxpayer's enjoyment as a factor affecting the "ordinary and necessary" analysis. But even beyond that, said the appellate court, the taxpayer's personal enjoyment *does* relate to the determination of his primary motive for engaging in the activity. On this point, the court concludes:

> As long as personal enjoyment remains one factor among others, we see no realistic threat of the situation he posits, where the Tax Court disallows otherwise legitimate business expenses related to a work vehicle solely because the owner enjoys driving it. We therefore reject his argument.

The taxpayer also claimed the Tax Court erred in handling posttrial proceedings in violation of his due process rights. But the Tenth Circuit, retracing the procedural history after the Tax Court's decision, revealed that the taxpayer failed to participate in the proceedings following trial. Thus the lower court's entry of a final decision instead of ordering a remand to the Independent Office of Appeals was on the right track.

Finally, the court rejected the taxpayer's last argument that the drag of litigation led to the imposition of more interest and larger penalties, all in violation of his due process rights. The taxpayer cited no authority for this argument, and the appellate court found nothing to support it either. The court thus chose not to address the theory any further.

XXIX. CHANGING STORIES MIDSTREAM RARELY WORKS (*Sehati v. Commissioner*, T.C. Memo. 2025-3, January 15, 2025)

The Tax Court has held that family members diverted income from their jewelry businesses to an undisclosed account, rejecting their claim that the account held funds from the sale of jewelry gifted to them by the family matriarch. The case is a morale boost to those of us that follow the rules: cheaters don't always prosper.

Joseph and Lilly, a married couple, own a company that operates two jewelry kiosks in a California shopping mall. Two of Joseph's brothers own a separate jewelry store located near the mall. The three brothers together own other companies that invest in real estate. In the course of examining their federal income tax returns, the IRS discovered an undisclosed bank account that, during the years at issue (2012 through 2014), received many deposits of unreported income belonging, according to the IRS, partly to Joseph and Lilly and partly to the two brothers. Before the Tax Court, everyone swore that the deposits derived from sales of jewelry given to the three brothers by their mother, and—wouldn't you know—the sales were for amounts at or just below basis. Yet the Tax Court was skeptical:

> Although petitioners' description of the alleged gifts conjures up images of a treasure trove of gold and jewels, petitioners never mentioned this remarkable theory during the examination to respondent's agent, who was instead told by two of them that the income represented loan or inheritance proceeds.

Unsurprisingly, the Tax Court, calling "the gift jewelry story … entirely fanciful," upheld the deficiencies determined by the IRS, as well as fraud and accuracy-related penalties. Specifically, Joseph and Lilly owed a total deficiency of about $1.5 million and fraud penalties of over $1 million, while each of the two brothers owed deficiencies of over $500,000 and fraud penalties ranging from about $300,000 to over $480,000.

The testimony offered from the taxpayers was "inconsistent," "vague," and "simply lacked credibility." Some of the checks deposited into the account refer to watches or wine glasses in the memo line, yet no witness testified that watches or wine glasses were among the items listed. And it was weird how customers of the jewelry stores always paid with credit cards, yet when they bought items from the "gifted" jewelry, they paid by check or in cash. "A more plausible explanation," said the court, "is that [the jewelry businesses] diverted income from cash and check sales in the regular course of business from their operating accounts in an attempt to conceal income."

XXX. PRIVATE RULING ROUNDUP

Readers should keep in mind that a private ruling is binding only as to the taxpayer that requested it; they may not be cited as precedent before the Tax Court, and readers may not rely on them as they are not otherwise binding on the IRS. The IRS can, and often does, change its mind on any given issue examined in a private ruling. Still, professionals can gain insight into the IRS's current stance on relevant and interesting issues by reviewing these rulings.

A. Possible Blueprint for Getting Assets Out of a QTIP Trust

In *Private Letter Ruling 202504006* (released January 24, 2025), the IRS considered the tax consequences stemming from the proposed division of a marital trust for which the decedent's executor made a qualified terminable interest property (QTIP) election. The trustee and all of the beneficiaries agreed to divide the trust into "Trust 1" and "Trust 2." Trust 1 will hold assets with a value not to exceed the surviving spouse's remaining basic exclusion amount, and Trust 2 will hold the balance. The spouse, through an agent, would then disclaim the spouse's interest in Trust 1, causing those assets to be distributed to the remainder beneficiaries. The IRS ruled that: (1) the division of the QTIP trust into Trust 1 and Trust 2 will not cause any of the trusts or their beneficiaries to recognize any income, gain, or loss; (2) after the division, Trust 1 and Trust 2 will continue to be QTIP trusts under §2056(b)(7); (3) the spouse's disclaimer of her interest in Trust 1 will be treated as a gift of all of the assets of Trust 1 under both §§2511 and 2519 (but that's okay because the gift will be covered by the spouse's exclusion amount); (4) the spouse's disclaimer of her interest in Trust 1 will not be treated as a gift of any assets held in Trust 2; (5) the assets of Trust 1 will not be included in Spouse's gross estate under §2044(a); and (6) the spouse's disclaimer of her interest in Trust 1 will not cause her interest in Trust 2 to be valued at zero under §2702. This seems like a helpful blueprint for getting assets out of a QTIP trust during the surviving spouse's life without triggering liability for gift tax.

B. In Vitro Fertilization Costs Not Deductible as Medical Expenses

In *Private Letter Ruling 202505002* (released January 31, 2025), the IRS stuck with its position that costs and fees arising from in vitro fertilization and the use of a gestational surrogate are not deductible medical expenses for a married couple that incurs them, though the IRS did concede that expenses of reproduction technology performed directly on the couple are deductible. The ruling involved a wife diagnosed with conditions requiring medication that is "contraindicated in pregnancy." The couple planned to hire a pregnancy surrogate that would carry a donated egg from a third party fertilized with sperm from the husband. The IRS said that the costs related to the surrogate affected the structure and function of the surrogate's body and not the wife's body; thus, the expenses did not qualify for a deduction under §213.

C. Interesting Plan for Dividing Retirement Accounts Between Charitable and Private Beneficiaries

In *Private Letter Ruling 202506004* (released February 7, 2025), the IRS considered proposed transactions involving a decedent's revocable living trust that was the beneficiary of all of her retirement accounts. The trust instrument provides that upon her death, the trust shall terminate, with a certain percentage of the value of trust assets payable to individual beneficiaries and the remainder to charities selected by the trustee. After the decedent's death, the trustee formed a charitable foundation to select the charities and make the distributions. The ruling states that the trustee proposed to receive a lump sum of cash from the retirement accounts, which the trustee will pay over to the foundation. Any amounts remaining in the retirement accounts after the charitable withdrawal would then pass to inherited IRAs for the individual beneficiaries in a trustee-to-trustee transfer. The IRS ruled that as long as the trustee pays the lump sum to the foundation in the same taxable year as the withdrawal, the trust will qualify for a charitable income tax deduction under §642(c)(1) equal to the amount of gross income received by the trust from the distribution. Interestingly, the IRS also ruled that the transfer (and division) of the remaining retirement accounts via trustee-to-trustee transfers into inherited IRAs for the benefit of the individual beneficiaries "will not result in taxable distributions or payments under §§402(c) or 408(d)(1) to Trust." Note that by citing §402(c), this ruling includes transfers of 401(k) accounts even though the trust is not a designated beneficiary. That seems contrary to the statutory regime, but there it is.