2020 FEDERAL TAX UPDATE

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

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These materials summarize important developments in the substantive federal income, estate and gift tax laws affecting individual taxpayers and small businesses using the timeframe of July, 2019, through October, 2020. The materials are organized roughly in order of significance. These materials generally do not discuss developments in the areas of deferred compensation or the taxation of business entities (except to a very limited extent).

I. INFLATION-ADJUSTED FEDERAL INCOME TAX BRACKETS FOR 2021 (Adapted from Rev. Proc. 2020-45)

<table>
<tr><th colspan="2">Taxable Income Exceeding</th><th rowspan="2">Ordinary Income</th><th rowspan="2">Adjusted Net Cap Gain* & Qualified Dividends</th><th rowspan="2">Medicare Surtax on Earned Income**</th><th rowspan="2">Medicare Surtax on Net Investment Income</th></tr>
<tr><th>Single</th><th>Married Filing Jointly</th></tr>
<tr><td>$0</td><td>$0</td><td>10%</td><td rowspan="2">0%</td><td rowspan="5">2.9%</td><td rowspan="5">0%</td></tr>
<tr><td>$9,950</td><td>$19,900</td><td rowspan="2">12%</td></tr>
<tr><td>$40,400</td><td>$80,800</td><td rowspan="6">15%</td></tr>
<tr><td>$40,525</td><td>$81,050</td><td>22%</td></tr>
<tr><td>$86,375</td><td>$172,750</td><td>24%</td></tr>
<tr><td>$164,925</td><td>AGI over $250,000</td><td rowspan="2">32%</td><td></td><td></td></tr>
<tr><td>AGI over $200,000</td><td>$329,850</td><td rowspan="4">3.8%</td><td rowspan="4">3.8%</td></tr>
<tr><td>$209,425</td><td>$418,850</td><td rowspan="2">35%</td></tr>
<tr><td>$445,850</td><td>$501,600</td><td rowspan="2">20%</td></tr>
<tr><td>$523,600</td><td>$628,300</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 2021
(Adapted from Rev. Proc. 2020-45)

<table>
<tr><th>Taxable Income Exceeding</th><th>Ordinary Income</th><th>Adjusted Net Cap Gain* & Qualified Dividends</th><th>Medicare Surtax on Net Investment Income</th></tr>
<tr><td>$0</td><td>10%</td><td rowspan="2">0%</td><td rowspan="5">0%</td></tr>
<tr><td>$2,650</td><td rowspan="2">24%</td></tr>
<tr><td>$2,700</td><td rowspan="3">15%</td></tr>
<tr><td>$9,550</td><td>35%</td></tr>
<tr><td>$13,050</td><td rowspan="2">37%</td></tr>
<tr><td>$13,250</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. ADJUSTED BASIC EXCLUSION AMOUNT FOR FEDERAL WEALTH TRANSFER TAXES

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 new, “chained-CPI” method. The 2017 Act provides that the basic exclusion amount will revert to $5 million (adjusted for post-2011 inflation) after 2025. The estimated revenue loss from doubling of the basic exclusion amount is $83 billion over ten years.

For decedents dying in	The basic exclusion amount is
2011	$ 5,000,000
2012	$ 5,120,000
2013	$ 5,250,000
2014	$ 5,340,000
2015	$ 5,430,000
2016	$ 5,450,000
2017	$ 5,490,000
2018	$11,180,000
2019	$11,400,000
2020	$11,580,000
2021	$11,700,000

III. SECURE ACT LEAVES SOME ESTATE PLANNERS FEELING LESS THAN SECURE WHEN ADVISING CLIENTS ABOUT BENEFICIARY DESIGNATIONS (P.L. 116-94, December 20, 2019)

Signed by the President on December 20, 2019, as part of budget appropriation legislation, the Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019 represented the first major piece of federal legislation significantly affecting retirement plans in 13 years.

The SECURE Act makes several sweeping changes, including allowing individuals to use funds in §529 plans to repay student loans, offering greater opportunities for part-time employees to participate in plans, and making it easier for administrators of 401(k) plans to offer annuities. From an estate planning perspective, there are four significant changes.

A. Delayed Start for Required Minimum Distributions

The age for starting required minimum distributions has increased from 70-1/2 to 72. The change is applicable for those born after June 30, 1949 (a person born that day would have turned 70-1/2 on January 1, 2020).

B. Age-Based Limitation on Traditional IRA Contributions Lifted

Prior to the SECURE Act, an individual could not contribute to a traditional IRA starting in the calendar year in which the individual reached age 70-1/2. That age limit has been removed effective for 2020 and later.

C. The Big One: 10-Year Payouts for Most Designated Beneficiaries

In the "good old days" (2019 and earlier), there were two types of beneficiaries, "designated beneficiaries" and "non-designated beneficiaries." Generally, post-death distributions to designated beneficiaries could be "stretched out" over the designated beneficiary's lifetime. Where the designated beneficiary was the participant's adult child, for example, the deferral could be significant. But in the case of non-designated beneficiaries (generally, the participant's estate or a trust not qualifying as a "conduit" or "accumulation" trust), the distributions had to be paid over a five-year period, often resulting in federal income tax being paid at higher rates and over a shorter period.

Starting in 2020 and going forward, there are now three types of beneficiaries, each with their own rules.

1. Eligible Designated Beneficiaries (Stretch Still Possible)

So-called "eligible designated beneficiaries" still qualify for taking distributions over their life expectancies. There are five types of eligible designated beneficiaries: (1) a participant's <u>surviving spouse</u> or a "conduit" trust for that spouse; (2) a participant's <u>minor child</u> or a "conduit" trust for that minor child (but only until the child reaches the age of majority); (3) a <u>disabled beneficiary</u>, a "conduit" trust for that disabled beneficiary, or an "accumulation" trust that meets certain rules; (4) a <u>chronically ill beneficiary</u>, a "conduit" trust for that chronically ill beneficiary, or an "accumulation" trust that meets certain rules; and (5) a <u>beneficiary less than 10 years younger</u> than the participant.

2. Other Designated Beneficiaries (10-Year Payout)

Benefits payable to individuals who are not eligible designated beneficiaries (as well as any "conduit" trusts for such individuals) and all "accumulation" trusts must be paid within ten years of the participant's death. Specifically, all benefits must be paid by December 31 of the year that contains the tenth anniversary of the participant's death. Like the five-year payout rule, distributions do not have to be made at regular intervals; it is sufficient that all funds are withdrawn by the December 31 deadline.

3. Non-designated Beneficiaries (5-Year Payout)

For non-designated beneficiaries (still defined generally to include the participant's estate and a trust not qualifying as a "conduit" trust or "accumulation" trust), the five-year period to withdraw benefits continues to apply.

D. 10-Year Payout Applies on Early Death of Pre-SECURE Act Designated Beneficiary

Suppose an adult child of a participant who died before 2020 dies before the end of the child's life expectancy. Formerly, a successor beneficiary could "step into the shoes" of the child and continue to receive payments over the rest of what would have been the deceased child's life expectancy. Now, the 10-year payout rule applies to the successor beneficiary.

IV. CARES ACT HOPES TO STIMULATE ECONOMY (P.L. 116-136, March 27, 2020)

On March 27, 2020, the President signed the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), the third piece of federal legislation intended to provide economic relief in connection with the Coronavirus outbreak. The following paragraphs summarize the important federal income tax provisions of the CARES Act impacting individuals and small businesses.

A. Credits (in the Form of Rebates) for Individuals

Under new §6428, "eligible individuals" receive a tax credit for the first taxable year beginning in 2020 in the amount of $1,200. The credit, which increases to $2,400 for married couples filing a joint return where both spouses are "eligible individuals," is paid in the form of a rebate check (payments began in April, 2020). Eligible individuals may claim an additional credit of $500 for each "qualifying child" (using the same definition from the child tax credit).

An eligible individual is defined to mean all but two types of individuals: nonresident alien individuals and individuals "with respect to whom a deduction under section 151 is allowable to another taxpayer." Section 151 refers to the (currently suspended) deduction for personal and dependency exemptions. Since no taxpayer may claim a dependency exemption deduction in 2020, this disqualification is not entirely clear. Presumably it means to disqualify an individual who *could* have been claim as another's dependent had the deduction not been suspended.

Furthermore, it is not entirely clear why Congress tied the disallowance to the dependency exemption and not directly to the $500 bonus that limits its scope to a “qualifying child” and not all persons that could have been claimed as a dependent.

New §6428 also makes clear that no credits are available to estates or trusts.

Importantly, the amount of the credit phases out once the eligible individual’s adjusted gross income exceeds a set threshold. Specifically, the credit is reduced by 5 percent of the amount by which the eligible individual’s adjusted gross income exceeds the applicable threshold:

Unmarried	$ 75,000
Head of Household	$112,500
Married filing jointly	$150,000

Because any one taxpayer’s credit amount depends on whether the taxpayer receives one or more $500 bonus credits for each qualifying child, the amount at which the credit reduces to zero will vary. The following table shows some sample phase-out ranges:

	Phase out begins when AGI exceeds	**Credit reduced to zero when AGI reaches**
Unmarried, no kids	$75,000	$99,000
Unmarried, one qualifying child	$75,000	$109,000
Unmarried, two qualifying children	$75,000	$119,000
Head of household, one qualifying child	$112,500	$146,500
Head of household, two qualifying children	$112,500	$156,500
Married filing jointly, no kids	$150,000	$198,000
Married filing jointly, one qualifying child	$150,000	$208,000
Married filing jointly, two qualifying children	$150,000	$218,000

For purposes of computing the amount of the rebate immediately payable to the taxpayer, the Service will use the taxpayer’s 2019 adjusted gross income (or 2018 adjusted gross income if the 2019 return has not yet been filed). If the taxpayer has not filed for 2019 or 2018, the Service will use information for 2019 provided in Form SSA-1099, Social Security Benefit Statement, or Form RRB-1099, Social Security Equivalent Benefit Statement.

Rebates paid in 2020 act as advance payments of the §6428 credit. The exact amount of the credit, then, is a function of the taxpayer’s 2020 adjusted gross income. It is therefore conceivable that the taxpayer receiving a rebate in 2020 might have to pay some of that rebate back in the form of additional 2020 tax if the taxpayer’s 2020 adjusted gross income is higher than the 2019 (or 2018) adjusted gross income. The House version of this rule expressly required the payment of extra tax but the final version of the CARES Act omits express mention of the possibility of extra tax.

B. Special Rules for “Coronavirus-related Distributions” from IRAs and Defined Contribution Plans

The CARES Act offers three significant benefits for “coronavirus-related distributions” from IRAs and defined contribution plans. A “coronavirus-related distribution” is any distribution made in 2020 to an individual who meets either of two tests: (1) the individual, the individual’s spouse, or the individual’s dependent is diagnosed with COVID-19 in a CDC-approved test; or (2) the individual “experiences adverse financial consequences as a result of being quarantined, being furloughed or laid off or having work hours reduced due to such virus or disease, being unable to work due to lack of child care due to such virus or disease, closing or reducing hours of a business owned or operated by the individual due to such virus or disease, or other factors as determined by the Secretary of the Treasury (or the Secretary’s delegate).” For this purpose, plan administrators may rely on an employee’s certification that the employee meets the requirements for a coronavirus-related distribution.

In *Notice 2020-50*, issued on June 19, 2020, the Service accepted the statute’s invitation to identify additional individuals eligible to take a coronavirus-related distribution. The Notice states that “an individual who experiences adverse financial consequences as a result of: the individual having a reduction in pay (or self-employment income) due to COVID-19 or having a job offer rescinded or start date for a job delayed due to COVID-19; the individual’s spouse or a member of the individual’s household being quarantined, being furloughed or laid off, or having work hours reduced due to COVID-19, being unable to work due to lack of childcare due to COVID-19, having a reduction in pay (or self-employment income) due to COVID-19, or having a job offer rescinded or start date for a job delayed due to COVID-19; or closing or reducing hours of a business owned or operated by the individual’s spouse or a member of the individual’s household due to COVID-19.” The Notice defines a member of a household as someone who shares the same principal residence.

Notice 2020-50 also clarified that an individual may take a coronavirus-related distribution from a beneficiary IRA or from the beneficiary account of an employer-sponsored retirement plan. The Notice also identified several distributions that do not qualify as coronavirus-related distributions, including: (1) corrective distributions of elective deferrals and employee contributions returned to the employee, as well as excess elective deferrals under §402(g), excess §401(k) contributions, and excess aggregate §401(m) contributions; (2) dividends paid under §404(k); (3) costs of current life insurance protection; and (4) distributions of premiums for accident or health insurance.

Finally, *Notice 2020-50* provided that “coronavirus-related distributions are permitted without regard to the qualified individual’s need for funds, and the amount of the distribution is not required to correspond to the extent of the adverse financial consequences experienced by the qualified individual.”

1. No Early Distribution Penalty

Section 2202 of the CARES Act provides that §72(t) (the 10-percent penalty on early distributions from qualified plans and individual retirement accounts) does not apply to any coronavirus-related distributions up to $100,000 made in 2020.

2. Three-Year Ratable Inclusion in Gross Income

An individual receiving a coronavirus-related distribution in 2020 may elect to include the distribution in gross income for 2020 under normal rules. Absent an election, however, the default rule is that any amount required to be included in gross income from a coronavirus-related distribution shall be included ratably over the three-taxable-year period beginning with the taxable year of the distribution.

Notice 2020-50 clarified that periodic payments and distributions that would have been required minimum distributions (but for the suspension of required minimum distributions, as discussed below) can be treated as coronavirus-related distributions and thus be eligible for three-year ratable gross income inclusion.

3. Three-Year Period to Recontribute

Under the CARES Act, the recipient of a coronavirus-related distribution may (but is not required to) re-contribute all or any portion of a coronavirus-related distribution back to the qualified plan or IRA during that same three-taxable-year period without regard to the typical limits on rollovers and plan contributions. *Notice 2020-50* clarified that "only a coronavirus-related distribution that is eligible for tax-free rollover treatment under §402(c), 403(a)(4), 403(b)(8), 408(d)(3), or 457(e)(16) is permitted to be recontributed to an eligible retirement plan, and that recontribution will be treated as having been made in a trustee-to-trustee transfer to that eligible retirement plan. Any coronavirus-related distribution (whether from an employer retirement plan or an IRA) paid to a qualified individual as a beneficiary of an employee or IRA owner (other than the surviving spouse of the employee or IRA owner) cannot be recontributed."

C. Suspension of Required Minimum Distributions for 2020

New §401(a)(9)(I) provides that the so-called "minimum distribution rules" applicable to defined contribution plans and IRAs shall not apply for the 2020 calendar year. (The suspension of the minimum distribution rules does not apply to defined benefit plans or to §457 plans administered by non-governmental tax-exempt employers.) The suspension applies both to plan participants and their beneficiaries.

The suspension specifically includes distributions from 2019 that would have been required by April 1, 2020, due to the participant's attaining age 70-1/2 in 2019.

A participant who already took all or part of the required minimum distribution for 2020 may re-contribute the distribution back to the IRA or defined contribution plan. This same opportunity is generally available to beneficiaries who already received part or all of the 2020 minimum distribution. The CARES Act originally contained a 60-day deadline for re-contributions, but *Notice 2020-51*, issued on June 23, 2020, provided that the deadline for re-contributions would be no earlier than August 31, 2020. The Notice also clarified that the repayment is not subject to the "one rollover per 12-month period" limit nor the restriction on rollovers for inherited IRAs.

D. Above-the-line Deduction for Charitable Contributions

New §62(a)(22) provides that for 2020 only, up to $300 in "qualified charitable contributions" made by an "eligible individual" may be deducted in computing adjusted gross income. Under prior law, all charitable contributions were "below-the-line," itemized deductions; a taxpayer could only deduct charitable contributions by foregoing the standard deduction. Now, up to $300 in donations may be taken "above the line" in determining adjusted gross income, meaning a taxpayer can claim both the standard deduction *and* up to $300 in charitable contributions for 2020.

New §62(f)(2) defines a qualified charitable contribution as one made in **cash** in 2020 to a public charity and not to a supporting organization or donor advised fund. It does not include carryover deduction amounts from donations made in prior years. Importantly, a qualified charitable contribution does not require any connection between the coronavirus and either the charity or the use to which the donation is put. And new §62(f)(1) defined an eligible individual as "any individual who does not elect to itemize deductions." So if the taxpayer itemizes, the entire donation is taken below the line as an itemized deduction.

The statute does not specify whether married couples filing a joint return may claim a maximum above-the-line deduction of $600 (one per spouse) or $300. The Joint Committee on Taxation explains that "[t]he $300 limit applies to the tax-filing unit. Thus, for example, married taxpayers who file a joint return and do not elect to itemize deductions are allowed to deduct up to a total of $300 in qualified charitable contributions on the joint return." Staff of the Joint Committee on Taxation, 116th Cong., 2d Sess., *Description of the Tax Provisions of Public Law 116-136, The Coronavirus Aid, Relief, and Economic Security (CARES") Act* 22, n. 76 (April 23, 2020).

E. Other Provisions Related to the Deduction for Charitable Contributions

Under prior law, the total itemized deduction a taxpayer could claim for cash contributions in any one taxable year was limited to 60 percent of the taxpayer's "contribution base," generally defined to mean the taxpayer's adjusted gross income with some modifications. For 2020 only, this limitation on cash contributions does not apply at all to "qualified charitable contributions," meaning an individual who itemizes may deduct qualified charitable contributions up to 100 percent of the taxpayer's contribution base.

Prior law also limited the total charitable contribution deduction for corporations generally to 10 percent of the corporation's modified taxable income. For qualifying contributions made in 2020, the limit is raised to 25 percent of the corporation's modified taxable income. No connection between the contributions and COVID-19 activities is required.

Finally, the limits in connection with contributions of food inventory are eased for donations made in 2020. Under prior law, the deduction was limited to 15 percent of taxable income in the case of C corporation donors and to 15 percent of the net aggregate income from all business from which the contributions were made in the case of all other taxpayers. For 2020 only, both limitations increase from 15 percent to 25 percent.

F. Provisions Related to Health Savings Accounts

Section 223 permits eligible individuals with high-deductible health plans to deduct contributions made to health savings accounts. The CARES Act provides that for years prior to 2021, a health plan will not fail to qualify as a high-deductible health plan if the plan pays for tele-health and other **remote medical care services** without imposing a deductible, and an eligible individual will not lose status as an eligible individual just because the plan pays for such services without imposing a deductible.

Section 223 requires that a health savings account be used exclusively for paying the "qualified medical expenses" of the account beneficiary. The statute defines an account beneficiary's qualified medical expenses as amounts (not compensated for by insurance or otherwise) paid for medical care for themselves, their spouses, and their dependents. But the statute expressly excludes from the definition of qualified medical expenses amounts paid for medicine or drugs that are not prescribed. The CARES Act removes the prohibition against **nonprescription medicine or drugs** and also provides that the definition includes amounts paid for "**menstrual care products**." Menstrual care products are defined as a tampon, pad, liner, cup, sponge, or similar product used by individuals with respect to menstruation or other genital-tract secretions. These changes are effective for 2020 and beyond.

G. Provisions Related to Student Loans

The CARES Act makes two important modifications impacting student loans. First, the CARES Act **suspends federal student loan payments** (both principal and interest) through September 30, 2020, without penalty to the borrower, and no interest will accrue on these loans during this period.

Second, §127 now provides that "the **payment by an employer**, whether paid to the employee or to a lender, of principal or interest on any **qualified education loan** (as defined in section 221(d)(1)) incurred by the employee for education of the employee" will be treated as an **education assistance payment** (and thus eligible for an exclusion of up to $5,250 from the employee's gross income) in the case of payments made between March 27, 2020, and

December 31, 2020. To avoid a double benefit, the statute makes clear that an employee may not also claim a deduction for any student loan interest paid by an employer that is excluded under this new rule.

H. Paycheck Protection Program Loans and Loan Cancelations

A signature feature of the CARES Act is the creation of Paycheck Protection Program loans. Under this initiative, any lender approved to make Small Business Administration "§7(a) loans" and certain other regulated lenders may loan up to $10 million to a small business. A business is eligible for this program if it: (1) is a small business, nonprofit organization, veterans organization, or tribal business concern with 500 or fewer employees; (2) was in operation on February 15, 2020; (3) had employees to whom it paid salaries and payroll taxes or independent contractors that it paid; and (4) was substantially impacted by the coronavirus. Sole proprietors, independent contractors and many self-employed individuals meeting these criteria are expressly eligible for a loan. Note that some small businesses with more than 500 employees can also qualify if they satisfy the definition of a "small business concern" under §3 of the Small Business Act.

Although a Paycheck Protection Program loan is intended to be used to pay compensation, such amounts should not be used to pay cash compensation to an individual employee making more than $100,000 in annual salary (but funds can be used to meet employer contributions to retirement plans benefitting such employees, to provide health insurance coverage to such employees, and to pay state and local taxes on compensation paid to such employees). Loans also should not be used to pay compensation to an employee whose principal place of residence is outside of the United States.

Importantly, the loans are nonrecourse unless the proceeds are used for an unauthorized purpose. In addition, small business owner need give no personal guarantee or collateral. During the "covered period," defined to mean February 15, 2020, through June 30, 2020, a loan shall bear interest at a rate not to exceed 4 percent, and any payments on the loan may be deferred for up to 12 months. (The SBA website states a Paycheck Protection Program loan "has a maturity of 2 years and an interest rate of 1%." It also provides that "[l]oan payments will … be deferred for six months." An information sheet prepared by the United States Treasury Department explaining the terms and conditions of Paycheck Protection Program loans to prospective borrowers appears in the Appendix of this document.)

Even more importantly, a Paycheck Protection Program loan will be forgiven to the extent the proceeds are used for payroll costs, mortgage interest, rent, and utilities during the "covered period." Generally, the covered period is the eight-week period starting with the date of receipt of the loan proceeds. The Paycheck Protection Program Flexibility Act of 2020, signed on June 5, 2020 (the "Flexibility Act"), extended the covered period for loan forgiveness from eight weeks after the date of loan disbursement to 24 weeks after the date of loan disbursement (but not later than December 31, 2020). The 24-week period applies to all borrowers, but borrowers that received a loan before June 5, 2020, still have the option to use an eight-week period.

The CARES Act originally provided that at least 75 percent of the loan proceeds have to be used for payroll costs in order to qualify for any forgiveness. The Flexibility Act lowered the required payroll amount to 60 percent of the loan proceeds.

Any forgiven amount will be reduced proportionally if: (1) full-time employee headcount declines compared to the prior year; or (2) the salary and wages of any employee declines by more than 25 percent of the employee's compensation from the prior year. The CARES Act originally provided that borrowers that re-hired workers previously laid off by June 30, 2020, would not be penalized for having a reduced payroll at the beginning of the period. The Flexibility Act extended the deadline to restore full-time employee headcount to December 31, 2020. The Flexibility Act also states that if a borrower can document that it was unable to rehire former employees and could not fill such positions with similarly qualified individuals, the amount of forgiveness will not be reduced. Likewise, no reduction in loan forgiveness will occur where the borrower can document that it has been unable to return to the same level of business activity as before February 15, 2020, due to compliance with requirements or guidance issued by the Department of Health and Human Services, the Centers for Disease Control and Prevention, or the Occupational Safety and Health Administration "related to the maintenance of standards for sanitation, social distancing, or any other worker or customer safety requirement related to COVID-19."

From an income tax perspective, the most important feature of the program is that **any indebtedness cancelled will not be included in the borrower's gross income**. Some commentators have suggested it is unclear whether the exclusion of debt discharge income from forgiven loans affects the ability of business owners to deduct expenses paid for with the proceeds from the forgiven loan. There are reasonable arguments in support of both answers. The argument in favor of a deduction works by analogy. Suppose a taxpayer borrows $1 million from a bank and uses the loan proceeds to pay $1 million in compensation to employees. The taxpayer can deduct the $1 million compensation paid, no questions asked. Now suppose the bank cancels the loan. We know that the taxpayer very likely has gross income under §61(a)(12) because there has been a discharge of indebtedness. But this has no effect on the taxpayer's compensation deduction. The fact that the compensation was paid for using loan proceeds that were eventually canceled does not unwind the claimed deduction.

Section 108 of the Code identifies a handful of situations where otherwise includible debt discharge income is excluded from gross income, like when the discharge occurs in a bankruptcy case or when the taxpayer is insolvent. Admittedly, §108 requires a taxpayer to "pay" for forgiveness by requiring reductions to tax attributes in a total amount equal to the amount discharged. But that atonement mechanism only applies to amounts excluded under §108. The Paycheck Protection Program exclusion is not part of §108, so there is no requirement for a taxpayer to have to reduce tax attributes at all. Even if there was, the mechanism does not serve to disallow otherwise allowable deductions like the payment of compensation. In short, because Congress does not provide for an atonement mechanism under the Paycheck Protection Program, there is no authority for denying the compensation deduction to the taxpayer.

But there's also a pretty good argument that the taxpayer should not get a deduction for the compensation paid. Section 265 of the Code prevents taxpayers from deducting expenses paid in connection with income that is exempt from tax. The theory behind this rule is that it's a double benefit for a taxpayer both to deduct compensation paid and exclude the source of the funds used to pay that compensation. This is the same provision that prevents, for example, a taxpayer from deducting premiums paid for life insurance since the death benefit is excluded under §101. Likewise, one can argue that the compensation paid to employees using Paycheck Protection Program loan proceeds is an expense incurred in connection with obtaining tax-free forgiveness of the loan and is thus an expense incurred in connection with income that is exempt from tax. Indeed, that's the reasoning of the Service in Notice 2020-32, issued on April 30, 2020. The Notice cites a Tax Court case from 1982 in which a taxpayer had flight-training courses 90-percent paid for by an education assistance reimbursement program operated by the Veterans Administration. Federal law provided that the payments were not includible in the taxpayer's gross income, but the taxpayer tried to deduct all of the costs for the flight-training courses. The Tax Court held that §265 applied so the costs related to the reimbursed expenses were not deductible. Using that authority, the IRS states in the Notice that "where tax exempt income is earmarked for a specific purpose, and deductions are incurred in carrying out that purpose, section 265(a) applies because such deductions are allocable to the tax-exempt income."

That seems to be a powerful argument against a deduction. But correspondence from members of Congress to IRS officials indicates that it was not the intent of Congress to disallow deductions for the compensation and other authorized expenses paid with a Paycheck Protection Program loan. Future legislation might make clear that the authorized expenses paid for with forgiven loan proceeds would still be deductible.

I. Changes to Rules on Loss Limits

The CARES Act eases two loss limitation rules introduced by the 2017 Tax Cuts and Jobs Act.

The first limitation relates to **net operating losses**. Prior to the 2017 Act, a taxpayer could deduct net operating loss carryovers to the taxable year plus any net operating loss carrybacks to such year. The 2017 Act capped this deduction to 80 percent of taxable income (computed without regard to the net operating loss deduction). It also repealed the two-year carryback of net operating losses except in the case of certain losses incurred by farmers. Similarly, the net operating losses of a property and casualty insurance company could be carried back two years and carried forward 20 years. Finally, the 2017 Act allowed for indefinite carryforwards of net operating losses, as opposed to the 20-year limit that was in place under prior law (with the exception for property and casualty insurance companies described above).

The CARES Act provides that for net operating losses arising in 2018, 2019, and 2020, the taxpayer may carry the loss back five years, although a taxpayer may make an irrevocable election to relinquish the carryback. The CARES Act also provides that the 80 percent of taxable income cap does not apply until 2021. That means net operating loss carryovers from 2019 and earlier years are fully deductible against 2020 income. Taxpayers that were subject to the 80 percent cap on their 2018 returns may amend the prior return to claim the additional deduction associated with repeal of the 80 percent cap.

The second limitation relates to so-called "**excess business loss**." The 2017 Tax Cuts and Jobs Act introduced new §461(l), set to expire at the end of 2025, which disallows a noncorporate taxpayer's excess business loss for the taxable year and treats it as a net operating loss carryover to the next taxable year. "Excess business loss" is defined as the amount by which the taxpayer's aggregate deductions attributable to all trades or businesses exceeds the sum of the taxpayer's aggregate gross income attributable to all such trades or businesses plus $250,000 (or $500,000 in the case of joint filers).

The CARES Act effectively delays implementation of the limitation on excess business loss until 2021. It also makes some clarifying amendments, like specifying that only net capital gains are considered in computing excess business losses (and not any net capital loss) and that excess business loss is to be determined without regard to any net operating loss deduction or qualified business income deduction. The Act also changes the rule to provide that instead of treating the disallowed excess business loss as a net operating loss carryover to the next taxable year, the disallowed loss is to be treated as a net operating loss for the taxable year for purposes of determining any net operating loss carryover for subsequent taxable years. In other words, the disallowed excess business loss does not automatically carry over to the next taxable year; it does so only to the extent the disallowed excess business loss adds to (or, presumably, creates) a net operating loss.

J. Eased Limitations on Deduction for Active Business Interest

The 2017 Tax Cuts and Jobs Act provided that the deduction for "business interest" in the case of a taxpayer with average annual gross receipts of $25 million or more over the past three years is limited to an amount equal to the sum of: (1) the taxpayer's "business interest income;" plus (2) 30 percent of the taxpayer's "adjusted taxable income;" plus (3) where applicable, the taxpayer's "floor plan financing interest." Any business interest not allowed as a deduction under this rule carries over the next taxable year.

The CARES Act permits a taxpayer to increase the deduction limit from 30 percent of adjusted taxable income to 50 percent of adjusted taxable income for 2019 and 2020. Even better, a taxpayer may use the adjusted taxable income from 2019 in calculating the 2020 limitation.

K. Retroactive Treatment for Qualified Improvement Property

The 2017 Tax Cuts and Jobs Act consolidated the separate rules and depreciation limits for "qualified improvement property," "qualified leasehold improvements," "qualified restaurant property," and "qualified retail improvement property" by eliminating the last three categories so those assets generally become qualified improvement property. Section 168(e)(6) defines qualified improvement property as "any improvement to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service."

Congress intended to make qualified improvement property eligible for a 15-year recovery period instead of the normal 39-year period. This would not only speed up the timeframe for depreciation deductions but would also make qualified improvement property eligible for the 100% bonus depreciation election temporarily in effect. But Congress forgot to give qualified improvement property the shorter recovery period. Oops.

The CARES Act fixes this by technical correction, enacting a rule retroactive to 2018 that qualified improvement property qualifies for a 15-year recovery period. Thus, a taxpayer that incurred qualified improvement property costs in 2018 should amend the 2018 federal income tax return, as the deduction related to the qualified improvement property will no doubt be significantly higher.

V. FORMULA GIFT CLAUSES STILL WORK, JUST NOT THIS ONE (*Nelson v. Commissioner*, T.C. Memo. 2020-81, June 10, 2020).

When making inter-vivos gifts, some taxpayers want to make full use of the federal gift tax annual exclusion and/or the applicable exclusion amount. When the gifted property is difficult to value—like fractional interests in real estate, works of art, or interests in closely-held businesses—there is a risk that a gift intended not to trigger gift tax liability might do so if the Service successfully asserts that the value of the gifted property is higher than the value claimed by the taxpayer. But in *Wandry v. Commissioner*, T.C. Memo. 2012-88, the Tax Court approved the use of a gifting formula that made reference to the *value* of the gifted property rather than the property itself. In that case, the taxpayers gave interests in a limited liability company to their children and grandchildren according to a formula that read as follows:

> I hereby assign and transfer as gifts, effective as of January 1, 2004, a sufficient number of my Units [in the LLC] so that the fair market value of such Units for federal gift tax purposes shall be as follows:

Name	Gift Amount
Kenneth D. Wandry	$261,000
Cynthia A. Wandry	261,000
Jason K. Wandry	261,000
Jared S. Wandry	261,000

Grandchild A	11,000
Grandchild B	11,000
Grandchild C	11,000
Grandchild D	11,000
Grandchild E	11,000
	1,099,000

> Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service ("IRS"). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless, if, after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law.

The Service argued that the language created an invalid savings clause, but the court upheld the language as a valid formula clause. Practitioners have relied on *Wandry* in utilizing similar formula gift clauses to minimize the risk of liability for gift tax based on a valuation adjustment.

In this case, the taxpayers, a married couple, created a limited partnership that owned a 27-percent in a closely-held equipment business and about $675,000 in investment assets. They were the 1-pecrent general partners and Mrs. Nelson owned a nearly 94-percent limited partner interest. The remaining interests were held by UTMA accounts and trusts established for their children. On December 31, 2008, Mrs. Nelson signed an assignment instrument stating that she:

> * * * desires to make a gift and assign to *** [a trust for the benefit of herself and her daughters] her right, title, and interest in a limited partner interest having a fair market value of TWO MILLION NINETY-SIX THOUSAND AND NO/100THS DOLLARS ($2,096,000.00) as of December 31, 2008 * * *, as determined by a qualified appraiser within ninety (90) days of the effective date of this Assignment.

On January 2, 2009, she then sold "a limited partner interest having a fair market value of TWENTY MILLION AND NO/100THS DOLLARS ($20,000,000.00) as of January 2, 2009 * * *, as determined by a qualified appraiser within one hundred eighty (180) days of the effective date of this Assignment." A subsequent appraisal determined the value of a 1-percent limited partner interest was $341,000. If the formulas in the gift and sale documents worked, that meant Mrs. Nelson gifted a 6.14-percent limited partner interest and sold a 58.65-percent limited partner interest. The partnership then recorded transfers of percentage interests consistent with the appraisal.

On their 2008 federal gift tax returns, the taxpayers split Mrs. Nelson's gift, meaning each had gifted $1,048,000, an amount that utilized (but did not exceed) four annual exclusions and the applicable exclusion amount. In 2013, the Service determined that the value of each gift was $1,761,009, not $1,048,000. The Service also determined that the property transferred in the $20 million sale was really worth just over $33.6 million, meaning each taxpayer had made a 2009 gift of just over $6.8 million.

The taxpayers argued that the language in their assignment documents used valid formula clauses consistent with that approved in *Wandry*, but the Tax Court observed that the gifted and sold interests "are expressed in the transfer instruments as an interest having a fair market value of a specified amount as determined by an appraiser within a fixed period. The clauses hang on the determination by an appraiser within a fixed period; value is not qualified further, for example, as that determined for Federal estate tax purposes." So because the transfers were based on the value as determined by the appraisal and not on the finally determined gift tax value, the taxpayers were stuck with the percentage interests reflected on the gift tax return. The Tax Court then went on to address the value of the transferred interests, holding that the taxpayers made combined gifts of about $2.5 million in 2008 and about $4.1 million in 2009. From the perspective of the taxpayers, this was a better result than the Service's initial determination, but the result likely still stings.

If they had a mulligan, one suspects the taxpayers would omit the "as determined by a qualified appraisal…" clauses from the gift and sale instruments. Indeed, had there been transfers simply of interests with a fixed "fair market value" or a fixed "fair market value as finally determined for federal gift tax purposes," the results likely would have been different. In the end, then, this case signals that well-drafted formula gift clauses still work.

VI. AN OPINION TEN YEARS IN THE MAKING THAT TAKES ALMOST THAT LONG TO EXPLAIN (*Estate of Moore v. Commissioner*, T.C. Memo. 2020-40, April 7, 2020)

The decedent may have had an eighth-grade education, but he had a Ph.D. in grit. Starting work as a land leveler and often paid with the land he leveled, the decedent started a farming operation that became quite successful. In September 2004, at the age of 88, the decedent began negotiating the sale of his farm. In December, with negotiations still underway, the decedent suffered a heart attack so severe that a doctor feared he had only months to live. At that time, the decedent began more aggressive estate planning.

Acting on the advice of counsel, the decedent established three trusts and a family limited partnership. The first trust was a standard revocable living trust, to which the decedent transferred all of his real property and intangible personal property. The living trust provided that upon the decedent's death, property remaining after the payment of debts and expenses would be allocated between a charitable lead annuity trust (CLAT) and a trust for the benefit of the decedent's four children. The share allocable to the CLAT was defined as "the smallest amount which … will result in the least possible federal estate tax being payable as a result of my death after allowing for the applicable exclusion amount … as finally determined for federal estate tax purposes." The balance would pass to the trust for the children. Why a CLAT? It looks like the decedent saw the CLAT as a route to rebuild relations between his children. Because the beneficiary of the CLAT was a foundation established by the decedent, the decedent hoped this gift would force the children, as the foundation's directors, to meet periodically and make decisions about what charities best promote the values of the family.

The second trust was an irrevocable "family management trust" for the benefit of the decedent. It named two of the children as trustees. The management trust was designed solely to be the 1-percent general partner of the family limited partnership. Speaking of which, let's talk about that partnership. Funded with an initial combined contribution of $10,000, the partnership started with six partners: the management trust (the 1-percent general partner), the living trust (a 95-percent limited partner), and each of the decedent's four children (each a 1-percent limited partner). The living trust then contributed a four-fifths interest (not 80-percent, mind you, but four-fifths) in the farmland to the partnership. Testimony from the children revealed that the purpose of the partnership was to "protect against liabilities, creditors, and bad marriages." Apparently, there was a perceived risk from the use of pesticides. The kids also testified that the partnership was also designed to help bring the family together. The partnership agreement required unanimous consent from all partners for the transfer of any partnership interest.

The third trust was an irrevocable trust for the benefit of the decedent's children. The decedent did not retain any direct beneficial interest in the trust or control over its assets, but the trust instrument did instruct the trustee to "distribute an amount equal to the value of any asset of this trust which is includible in [the decedent's] gross estate for federal estate tax purposes" to the living trust. Thus, this distribution would happen only if the Service successfully determined that at least some portion of this trust's assets was includible in the decedent's gross estate.

Within five days of the transfer of the four-fifths interest to the partnership, the farmland was under contract at a purchase price of just over $16.5 million. The decedent alone completed negotiations and signed the deal. The sale closed in February of 2005. Following the sale, the decedent continued to live on the property *and operate the farm*. When cash payments from the sale started coming in, the decedent paid $220,000 in legal fees to the lawyer who designed this structure, 80-percent of which came from the partnership and 20-percent of which came from the trust. In addition, the decedent had the partnership pay $500,000 to each child in exchange for a promissory note requiring repayment (plus 3.6 percent annual interest) five years later. None of the children ever made payments on these notes; indeed the lawyer who designed the transactions specifically told them no payments were required. Finally, the decedent directed the partnership to pay $2 million to the living trust, all but $144,000 of which was used to pay the decedent's federal and state income taxes in connection with the sale of the farm. Days later, the decedent gifted $500,000 cash from the living trust to the irrevocable trust.

In March of 2005, the living trust sold its entire limited partner interest to the irrevocable trust for $500,000 cash and a promissory note in the amount of $4.8 million. The note required the payment of annual interest at 4.5 percent and a balloon payment of principal five years later. The decedent died about three weeks later. The living trust paid many of the decedent's final expenses, including another $475,000 to the lawyer for administration of the estate.

The decedent's federal estate tax return included the management trust's 1-percent interest in the partnership and the $4.8 million note from the irrevocable trust. The return claimed a $4.8 million charitable contribution deduction for the amount passing to the CLAT and a $475,000 deduction for the attorney fees in administration. The estate also filed a federal gift return for 2005 that reported the gift of the $500,000 to the irrevocable trust as four gifts of $125,000 to each child.

When the IRS determined an estate tax deficiency of almost $6.4 million and a gift tax deficiency of more than $1.3 million, the estate ran to Tax Court. The court determined it had to answer five questions:

1. Does §2036 require inclusion of the value of the farm in the decedent's gross estate even though it was sold through the partnership prior to his death? The court held that §2036 did require inclusion of the full value of the farmland. The court concluded the transfer of the four-fifths interest in the land to the partnership was not a bona fide sale because there was no legitimate and significant nontax reason for the creation of the partnership and the transfer of assets to it. The court rejected the proffered reasons for the entity's formation, finding that since there was no business for the family to run, "building family harmony" was a bogus justification for the arrangement. It also rejected the claim that the partnership protected against creditors since there was no credible evidence that anyone in the family had a legitimate concern as to possible creditor claims. The fact that all of this planning occurred following the decedent's heart attack "strongly supports a finding that the [partnership] was … part of an attempt to avoid federal gift and estate taxes." The court also did not like the fact that the decedent ran the whole show without input from other family members:

> We also can't ignore the testamentary essence of the whole plan. This was very far from a deal, even a deal within a family: There was no bargaining, no negotiating, not even any questioning. Instead, Moore unilaterally set up the [partnership]. He alone created the restrictions in the [partnership] agreement. None of Moore's children sought legal advice on the terms or so much as negotiated their percentage of shares. Moore's children each joined the [partnership] because Moore told them to--they did not have their own reasons. Moore's unilateral decision making tends to contradict any assertion of a bona fide sale.

Moreover, reasoned the court, the decedent retained possession and enjoyment of the farm after the transfer to the partnership (not to mention after the sale to the unrelated buyer). The decedent "continued to live on the property and continued to operate [the farm] as his own—he made all the decisions." Furthermore, the decedent "scooped into [partnership] assets to pay personal expenses" like the distribution to the living trust to pay federal and state income taxes and the distributions made to the children. The fact that two kids were trustees of the management trust made no difference, for the children "typically did things because [the decedent] asked them to, and giving them nominal 'power' was no different from [the decedent's] keeping that power."

It is interesting to note that the court required gross estate inclusion of the full value of the farmland and not just the four-fifths portion transferred to the partnership. Steve Akers and Ron Aucutt explain:

> **Treating Sale of Decedent's Retained One-Fifth of Farm as §2036 Transfer; Use of Farm Property**. We are all very familiar with treating property contributed to an FLP or LLC as a §2036 transfer, with the transferred property (undiscounted) being included in the gross estate. In this case 4/5ths of the farm was contributed to the FLP and included in the gross estate under §2036(a)(1). But somewhat surprisingly, the remaining 1/5th interest that Mr. Moore retained in his Living Trust until the sale was treated as a transfer with retained enjoyment. Note — a sale to an unrelated party was treated as a §2036 transfer! The use of the sale proceeds could not have been the reason for that; sales to third parties typically are not considered as §2036 transfers no matter what the seller does with the sale proceeds. Typically the bona fide sale for full consideration exception would apply to third party sales. Clearly, there was a legitimate and significant nontax reason for selling the farm to a third party – it was to dispose of the farm. What was unusual in this case was that the decedent apparently contracted to continue living on the property, and to be in charge of making farm operations decisions, for the remainder of his very short life expectancy. (He lived about three months after the sale.) But even if that was treated as retained enjoyment, that would not explain why the bona fide sale for full consideration exception did not apply. Perhaps a small concession was made on the purchase price for the short period of time that the buyers agreed to allow their elderly neighbor to continue living on the property (though that seems unlikely and the court's opinion gives no hint of that). If such a price concession was made, that may have kept the full consideration requirement from being satisfied. But the court did not discuss why the bona fide sale for full consideration exception did not apply to the sale of the decedent's retained 1/5th interest in the farm.

Steve R. Akers and Ronald D. Aucutt, *Estate of Howard Moore v. Commissioner, T.C. Memo. 2020-40*, Bessemer Trust Advisor Insights (April 2020) at 12.

2. Did the living trust's transfer of its limited partnership interest to the irrevocable trust do anything to remove the value of the farm from the decedent's gross estate? Section 2043(a) requires the value of property included in the gross estate by §2036 to be reduced by "the

value of the consideration received therefor by the decedent." The court stated the operation of §2043(a) in formula form, which can be simplified even further to this:

Fair market value of the property included under §2036
Plus Date-of-death value of consideration received by decedent remaining in the gross estate
Minus Consideration received by decedent at the time of transfer
Equals Amount included in gross estate

The court holds that the fair market value of the property included under §2036 is the same as the sale price to the unrelated buyer given the sale occurred so close to death. The court then holds that the "consideration received by decedent at the time of transfer" is both the one-fifth value of the farm and the value of the decedent's partnership interest following the transfer of the four-fifths interest of the land to the partnership. Because there was such little time between the transfer and the decedent's death, though, the only difference between the consideration received at the time of transfer and the consideration remaining at death would be reflected in amounts paid by the living trust between the date of sale and the date of death. So the court ultimately simplified the formula even further:

Fair market value of the property included under §2036
Minus Money that left the estate between the date of sale and the date of death
Equals Amount included in gross estate

The court then left it to the parties to figure out the exact numbers, noting only that "We have no doubt that computations will be difficult."

3. May the estate claim a charitable contribution deduction for the amount the irrevocable trust might have to pay to the living trust in the future? Remember—though it was pages ago—the irrevocable trust is supposed to reimburse the living trust for any extra estate tax due as a result of the inclusion of the irrevocable trust's assets in the decedent's gross estate. The estate says that this provision has been triggered now that the court has held the farmland includible in the decedent's gross estate. And since a portion of the reimbursement from the irrevocable trust will be allocated to the CLAT, the estate wants a charitable contribution deduction for that amount.

The Tax Court rejected this argument, observing that the reimbursement clause is triggered only where an asset of the irrevocable trust is included in the decedent's gross estate—yet the farmland was not an asset of the irrevocable trust. But there's a bigger problem, notes the court: it is well established that an estate may not claim a deduction for a donation that turns upon the action of a beneficiary or fiduciary. The charitable donation must be made "by the decedent during his lifetime or by will," which was not the case here. Whether the irrevocable trust makes a transfer to the living trust and thus to the CLAT is not ascertainable at the decedent's death. It requires a successful determination by the IRS that more tax is due. The estate tried to argue that this was a charitable formula clause that has been approved in other cases, but the court easily distinguished a valid formula clause that gives some fixed transfer of unknown value to charity from the clause at issue here which gives a transfer to charity only upon the occurrence of a condition subsequent.

4. May the estate deduct the $475,000 in attorney fees? To be deductible, fees for administration must be reasonable. Here, there was a flat fee. There was never an accounting by the lawyer as to the time spent or the nature of the work performed in administration. At trial, the lawyer vaguely testified that “his work continues to this day.” There was no evidence of claims that would have to be settled in administration, and so much of the estate was already held by the living trust. “Absent any evidence that [the] fees were necessarily incurred in the administration of the estate, or if they were, why they were so high, we won’ allow the estate to deduct them.”

5. Were the $500,000 transfers made by the decedent to each child gifts or loans? The court initially says this issue does not matter much. “If the transfers were gifts, they would fall out of [the decedent’s] gross estate but would still be subject to gift tax. If they were true loans, they would be assets of the estate subject to estate tax, but not gift tax.” But the court goes on to hold that “more likely than not … these were gifts.” The notes were unsecured and had no payment schedules, the kids never paid any interest, and there was no evidence the kids had the resources to repay the loans. Accordingly, the Service was right to treat these transfers as additional gifts. Moreover, because those gifts were made within three years of death, and gift tax paid on those gifts will be included in the decedent’s gross estate under §2035(b).

Ultimately, then, the near-death planning did not work. What could have saved this plan, besides the decedent living longer? It likely would have helped if the decedent did not control every aspect of the land and its operations following the transfers. Legitimate partnership meetings and prudent decisions made by the trustees of the management trust would have helped. It certainly would have helped for the decedent to pay rent for the right to occupy the farm, and if the decedent wanted to keep farming it perhaps he should have done so as a salaried employee under an employment agreement negotiated at arms’ length.

VII. DECEDENT’S REVOCABLE TRUST WAS A SUBSTITUTE LIMITED PARTNER AND NO MERE ASSIGNEE (*Estate of Streightoff v. Commissioner*, 5th Circuit, March 31, 2020).

Acting under a power of attorney, the decedent’s daughter formed a Texas limited partnership. The general partner was a limited liability company managed by the daughter, and the limited partners were the decedent, his children, and an ex-daughter-in-law (she and the kids took their interests by gifts from the decedent). The partnership was funded in 2008 with marketable securities and fixed-income investment assets. On the same day, the decedent created a revocable living trust that named the daughter as sole trustee. The daughter then transferred the decedent’s 88.99% limited partner interest to the trust.

The decedent died in 2011. The estate’s federal estate tax return reported the partnership interest and valued it at nearly $4.59 million using the alternate valuation date election and applying a 37.2% blended discount for lack of marketability, control, and liquidity. The Service determined that the discount should have been limited to 18% instead, thus leading to a deficiency just under $500,000 that's at the heart of this case.

At the Tax Court, the estate took the position that the decedent's interest should be valued as an *assignee* interest rather than as a *limited partner* interest. Texas law provides that the assignee of a limited partner interest is entitled to distributions but cannot become or exercise the rights and powers of a partner. Texas law also states an assignee has no rights to information or accountings from the partnership. According to the estate, this justifies a larger discount. The Tax Court rejected this argument, finding that the interest transferred in this case was not a mere assignee interest. The partnership agreement provided that an assignee could become a substitute limited partner if (1) the general partner consents to the transferee's admission, (2) the transferee acquires the interest by means of a permitted transfer, and (3) the transferee agrees to be bound by the partnership agreement. The court observed that all three requirements were met here: the daughter signed the agreement as manager of the LLC-general partner, thus consenting to its terms, and the daughter, as trustee of the revocable trust, signed the assignment document which specifically stated that the trust agreed to abide by the terms of the partnership agreement. Thus the revocable trust was a limited partner and not a mere assignee.

The Tax Court then held that there should be no discount for lack of control since the decedent's 88.99% interest was sufficient to remove the general partner and, thus, dissolve the partnership. As to the marketability discount, the court adopted the analysis of the Service's expert concluding an 18% discount was appropriate.

On appeal, the Fifth Circuit affirmed the analysis of the Tax Court. It also observed that in this particular case there was no real difference between being an assignee and being a substitute limited partner. "Other than [the decedent's daughter], there is no record of [the partnership's] limited partners, the decedent's children, exercising their partnership rights or responsibilities. For example, this partnership held no meetings or votes, nor was there any attempt to remove [the general partner]. Without genuine nontax circumstances present, the Assignment is the functional equivalent of a transfer of limited partnership interest." The estate also argued that the deficiency notice was defective for inadequate notice of the reason for deficiency, but the Fifth Circuit rejected the argument, citing precedent that the notice need only inform the taxpayer that a deficiency exists and the amount of the deficiency.

VIII. CAN YOU KILL SOMETHING THAT NEVER EXSITED? FINAL ANTI-CLAWBACK REGULATIONS (Prop. Reg. §20.2010-1(c), November 26, 2019)

The basic exclusion amount for federal wealth transfer tax purposes is set to revert from $10 million (adjusted for post-2011 inflation) to $5 million (adjusted for post-2011 inflation) in 2026. If a client makes a taxable gift of, say, $9 million in 2019, and if Congress takes no other action, will that mean that the client must pay gift tax in 2026 on the amount in excess of the reduced basic exclusion amount applicable that year? Alternatively, will the client's estate have to pay estate tax on that excess amount if the client dies in 2026? The answer to both of these questions has always been "no." More precisely, the answers *should be* "no," but some planners worried that the statute was not entirely clear on this point.

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

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

Note that the statute tells us to use the *rates* of tax in effect at death rather than the *rates* in effect at the time of the gift. It does not say to use the *exemption amounts* in effect at death. That's what led some planners to conclude that there could be "clawback," the scary-sounding term for gift or estate tax attributable to a prior taxable gift. The 2017 Tax Cuts and Jobs Act addressed this concern by enacting §2001(g)(2):

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

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

A. Proposed and Final Regulations

On November 23, 2018, Treasury published proposed regulations implementing the Congressional mandate. Here is the text of the proposed regulations:

> **§20.2010-1 Unified credit again estate tax; in general.**
>
> * * *
>
> (c) *Special rule in the case of a difference between the basic exclusion amount applicable to gifts and that applicable at the donor's date of death—*

> (1) *Rule.* Changes in the basic exclusion amount that occur between the date of a donor's gift and the date of the donor's death may cause the basic exclusion amount allowable on the date of a gift to exceed that allowable on the date of death. If the total of the amounts allowable as a credit in computing the gift tax payable on the decedent's post-1976 gifts, within the meaning of section 2001(b)(2), to the extent such credits are based solely on the basic exclusion amount as defined and adjusted in section 2010(c)(3), exceeds the credit allowable within the meaning of section 2010(a) in computing the estate tax, again only to the extent such credit is based solely on such basic exclusion amount, in each case by applying the tax rates in effect at the decedent's death, then the portion of the credit allowable in computing the estate tax on the decedent's taxable estate that is attributable to the basic exclusion amount is the sum of the amounts attributable to the basic exclusion amount allowable as a credit in computing the gift tax payable on the decedent's post-1976 gifts. The amount allowable as a credit in computing gift tax payable for any year may not exceed the tentative tax on the gifts made during that year, and the amount allowable as a credit in computing the estate tax may not exceed the net tentative tax on the taxable estate. Sections 2505(c) and 2010(d).
>
> (2) *Example.* Individual A (never married) made cumulative post-1976 taxable gifts of $9 million, all of which were sheltered from gift tax by the cumulative total of $10 million in basic exclusion amount allowable on the dates of the gifts. A dies after 2025 and the basic exclusion amount on A's date of death is $5 million. A was not eligible for any restored exclusion amount pursuant to Notice 2017-15. Because the total of the amounts allowable as a credit in computing the gift tax payable on A's post-1976 gifts (based on the $9 million basic exclusion amount used to determine those credits) exceeds the credit based on the $5 million basic exclusion amount applicable on the decedent's date of death, under paragraph (c)(1) of this section, the credit to be applied for purposes of computing the estate tax is based on a basic exclusion amount of $9 million, the amount used to determine the credits allowable in computing the gift tax payable on the post-1976 gifts made by A.

Looking for an easy way to state this rule? Treasury's news release, issued the same day as the proposed regulations, offers one: "the proposed regulations provide a special rule that allows the estate to compute its estate tax credit using the higher of the [basic exclusion amount] applicable to gifts made during life or the [basic exclusion amount] applicable on the date of death."

The proposed regulations were finalized on November 26, 2019 in T.D. 9884. The final regulations are largely the same as the proposed regulations, but they contain more examples. Here are two of them:

> *Example 1.* Individual A (never married) made cumulative post-1976 taxable gifts of $9 million, all of which were sheltered from gift tax by the cumulative total of

$11.4 million in basic exclusion amount allowable on the dates of the gifts. The basic exclusion amount on A's date of death is $6.8 million. A was not eligible for any restored exclusion amount pursuant to Notice 2017-15. Because the total of the amounts allowable as a credit in computing the gift tax payable on A's post-1976 gifts (based on the $9 million of basic exclusion amount used to determine those credits) exceeds the credit based on the $6.8 million basic exclusion amount allowable on A's date of death, * * * the credit for purposes of computing A's estate tax is based on a basic exclusion amount of $9 million, the amount used to determine the credits allowable in computing the gift tax payable on A's post-1976 gifts.

Example 2. Assume that the facts are the same as in *Example 1* * * * except that A made cumulative post-1976 taxable gifts of $4 million. * * * The credit to be applied for purposes of computing A's estate tax is based on the $6.8 million basic exclusion amount as of A's date of death, subject to the limitation of section 2010(d).

These examples confirm that the higher basic exclusion amount is a "use it or lose it" proposition: if a client fails to utilize the client's entire basic exclusion amount before it drops, only the basic exclusion amount at death will apply.

B. Clawback's Kissing Cousin, Disappearing DSUE, Also Not a Thing

Suppose one spouse dies in 2020, never having made a taxable gift, leaving the entire estate to the survivor. If the deceased spouse's executor timely files a federal estate tax return, the deceased spouse's unused $11.58 million exclusion is added to the surviving spouse's basic exclusion amount. If the surviving spouse has likewise never made a taxable gift, the surviving spouse would have an applicable exclusion amount equal to $23.16 million: the survivor's own $11.58 million basic exclusion amount and the "deceased spousal unused exclusion amount" (what the so-called "portability" regulations call the "DSUE amount") of $11.58 million. While the surviving spouse's basic exclusion amount continues to grow, the DSUE amount is fixed. For example, if the basic exclusion amount in 2020 grows to, say, $12 million, the surviving spouse's applicable exclusion amount would be $23.58 million: $12 million of basic exclusion amount plus the $11.58 million DSUE amount. On this much there is no dispute.

Suppose further, however, that the surviving spouse is still alive in 2026, and that the basic exclusion amount in that year is only $6 million, as might be the result under current law. Does the DSUE amount stay at $11.58 million or does it too shrink to $6 million? The applicable statute, §2010(c)(4), provides as follows:

(4) DECEASED SPOUSAL UNUSED EXCLUSION AMOUNT - For purposes of this subsection, with respect to a surviving spouse of a deceased spouse dying after December 31, 2010, the term "deceased spousal unused exclusion amount" means the lesser of—

(A) the basic exclusion amount, or
(B) the excess of—
(i) the applicable exclusion amount of the last such deceased spouse of such surviving spouse, over
(ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse.

Section 2010(c)(4)(A) is not clear whether the "basic exclusion amount" refers to the amount at the time of the deceased spouse's death or the time of the surviving spouse's death. If it refers to the basic exclusion amount at the death of the first spouse to die, the DSUE amount would never shrink even though the survivor's basic exclusion amount might. But if it refers to the basic exclusion amount at the survivor's death, the DSUE amount could shrink. This creates the risk of the "disappearing DSUE," as explained by Mike Jones and DeeAnn Thompson in their article, *Jones and Thompson on the Disappearing BEA*, appearing in *Leimberg Estate Planning Newsletter #2708* (March 14, 2019).

Happily, the portability regulations already take the position that there is no "disappearing DSUE." Here is the language of Regulation §20.2010-2(c)(1) (with emphasis added):

(c) Computation of the DSUE amount -
(1) General rule. Subject to paragraphs (c)(2) through (4) of this section, the DSUE amount of a decedent with a surviving spouse is the lesser of the following amounts -
(i) The basic exclusion amount *<u>in effect in the year of the death of the decedent</u>*; or
(ii) The excess of -
(A) The decedent's applicable exclusion amount; over
(B) The sum of the amount of the taxable estate and the amount of the adjusted taxable gifts of the decedent, which together is the amount on which the tentative tax on the decedent's estate is determined under section 2001(b)(1).

Unwilling to let that settle the matter, some practitioners warn that the regulation pre-dates the scheduled reduction to the basic exclusion amount implemented by the 2017 Tax Cuts and Jobs Act. They argue that the emphasized language from the regulation intends only to make clear that the DSUE amount does not adjust for inflation like the basic exclusion amount. Perhaps this concern prompted the AICPA to recommend to Treasury that it issue guidance making clear that there is no disappearing DSUE.

In any case, the final anti-clawback regulations make clear that the DSUE amount does not shrink. Here's how the relevant example from the final regulations makes this clear:

Example 3. Individual B's predeceased spouse, C, died before 2026, at a time when the basic exclusion amount was $11.4 million. C had made no taxable gifts and had no taxable estate. C's executor elected, pursuant to § 20.2010-2, to allow B to take into account C's $11.4 million DSUE amount. B made no taxable gifts and did not remarry. The basic exclusion amount on B's date of death is $6.8 million. * * * The credit to be applied for purposes of computing B's estate tax is based on B's $18.2 million applicable exclusion amount, consisting of the $6.8 million basic exclusion amount on B's date of death plus the $11.4 million DSUE amount, subject to the limitation of section 2010(d).

IX. PROPOSED REGULATIONS CLARIFY ITEMIZED DEDUCTIONS FOR ESTATES AND TRUSTS (Proposed Regulation §§1.67-4 and 1.642(h)-2, May 11, 2020)

Section 67(g), added by the 2017 Tax Cuts and Jobs Act, prohibits individuals from taking "miscellaneous itemized deductions" until 2026. Section 67(e), in effect before the 2017 Tax Cuts and Jobs Act, provides that deductions for costs paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such estate or trust are to be treated as above-the-line deductions and not as itemized deductions or miscellaneous itemized deductions. Section 67(e) likewise treats the deductions allowable under §642(b) (the personal exemption of an estate or nongrantor trust) and §§651 and 661 (the deductions for trust distributions of current and accumulated income) as above-the-line deductions.

Treasury has now issued proposed regulations clarifying that §67(g) does not affect the above-the-line status of the deductions described in §67(e) for an estate or nongrantor trust, including the so-called "S portion" of an electing small business trust. The proposed regulations expressly provide that such deductions are not "miscellaneous itemized deductions" and thus not suspended for estates and nongrantor trusts. They also make clear, however, that costs paid by estates and nongrantor trusts that "commonly or customarily would be incurred by a hypothetical individual holding the same property" are treated as "miscellaneous itemized deductions" and would be subject to §67(a)

At the same time, Treasury issued proposed regulations under §642(h). That section provides that if an estate or trust has, upon its termination: (1) a net operating loss carryover; (2) a capital loss carryover; or (3) deductions (other than the personal exemption and charitable contributions) in excess of gross income for its last year, then such carryover or excess shall be allowed as a deduction to the beneficiaries receiving the assets of the estate or trust at termination. Preexisting regulations make clear that the beneficiaries can take "inherited" NOL and capital loss carryovers as above-the-line deductions.

But preexisting regulations also state that the excess deductions upon termination of an estate or trust are treated as a single miscellaneous itemized deduction of the beneficiary, and thus are subject to temporary disallowance under §67(g). That's not entirely fair, though, because this single deduction can theoretically consist of many different expenses that would otherwise be above-the-line deductions, regular itemized deductions, and miscellaneous itemized deductions. Accordingly, the proposed regulations offer a new regime under which each deduction comprising the §642(h)(2) excess deduction retains its separate character as either an above-the-line deduction, a regular itemized deduction, or a miscellaneous itemized deduction. The proposed regulations require that a fiduciary separately identify deductions that may be limited when claimed by the beneficiary as provided in the instructions to the Form 1041*. The proposed regulations also explain how the new separation regime works where* deductions are not directly attributable to a specific class of income, together with a new example.

The proposed regulations will apply to taxable years beginning after the date they are finalized, but estates, nongrantor trusts, and their beneficiaries may rely on the proposed regulations for taxable years beginning after 2017.

X. DON'T LEAVE BLANK BLANKS IN AN APPRAISAL SUMMARY (*Loube v. Commissioner*, T.C. Memo. 2020-3, January 8, 2020)

In 2013, the taxpayers, a married couple, purchased a single-family home in Potomac, Maryland. They planned to demolish the existing home and build their dream house in its place. About two weeks after buying the property, the taxpayers donated the existing improvements, buildings, and fixtures on the land to Second Chance, Inc., a charitable organization dedicated to teaching marketable skills to persons facing barriers to employment through the deconstruction of homes and buildings. The taxpayers also agreed to donate $27,500 to Second Chance to cover the costs of deconstruction.

The taxpayers obtained an appraisal of the property that estimated the value of the deconstructed house to be $297,000. Accordingly, on their 2013 joint return, the taxpayers claimed a noncash charitable contribution deduction of $297,000, claiming this was the value of the improvements and fixtures that Second Chance would remove and keep for sale. They attached an appraisal summary to the return, but the summary omitted several items of requested information, including the date the donated property was acquired and the donor's cost basis in the property. The Service disallowed the deduction, claiming the taxpayers failed to comply with the requirements of furnishing all needed information. Alternatively, the Service concluded that the appraisal fails because it valued the entire house and not the several items of tangible personal property acquired by Second Chance.

The Tax Court held that the taxpayers did not substantially comply with the applicable substantiation requirements, and thus were not entitled to a deduction for the value of the donated improvements and fixtures. Citing two recent cases, the court held that "a failure to provide the 'cost or adjusted basis' on an appraisal summary is a failure to substantially comply" (sic) with the substantiation regulations, in part because "if cost basis is not explicity disclosed where it is required to be disclosed, the Commissioner will be handicapped in identifying suspicious charitable deductions and deterring taxpayers from 'continu[ing] to play the 'audit lottery.''"

XI. FULL INCLUSION REQUIRED WHERE GRAT ANNUITANT FAILS TO SURVIVE (*Badgley v. United States*, 9th Circuit, April 28, 2020)

In 1998, the decedent created a grantor-retained annuity trust ("GRAT") funded with her one-half interest in a family partnership and three parcels of rental property. The trust instrument provided that the decedent would receive annual annuity payments for 15 years or her prior death (payable quarterly) equal to 12.5% of the date-of-gift value of the property transferred to the GRAT. The trust instrument provided that upon termination of the decedent's annuity rights, the trust corpus would pass to her two daughters. Between 2002 and 2012, the GRAT's share of partnership income was larger than the annuity obligation owed to the decedent. The partnership made cash distributions to the GRAT during this time, all payable to a bank account in the name of the GRAT. The decedent controlled the account and used it to make the quarterly annuity payments to her personal accounts. The decedent transferred the excess funds to other investment accounts.

The decedent died late in 2012, before the expiration of her annuity interest. Her federal estate tax return originally reported a total gross estate of about $36.8 million, a figure that included the value of the assets held in the GRAT. But the executor then filed a $3.8 million refund claim, maintaining that the full value of the GRAT was not includible in the decedent's estate. When the Service took no action on the claim, the executor brought a refund suit.

The executor first argued that §2036(a) did not apply because the statute is limited to cases where the decedent retained the right to "income" (or possession or use or enjoyment) from gifted property. The executor argued that there is a difference between "a fixed annuity payment payable out of transferred property" on the one hand, and the retention of a "right to income" on the other. Income fluctuates, but a fixed annuity payment does not. Moreover, the decedent's annuity could have been satisfied from principal instead of income, meaning the two concepts are distinct. The Service replied that §2036(a) applied, both because the decedent died with rights to (or control over) income through her right to annual annuity payments from the GRAT, and because she possessed and enjoyed the property through her "other interests and powers" in the family partnership.

In a 2018 decision, the federal district court sided with the Service. The decedent's annuity, it concluded, comprised some possession, enjoyment, or right to income from the transferred property. There was no evidence that any of the three rental properties were ever sold to fund the annuity. Thus, the annuity necessarily drew either from the GRAT's current or accumulated income.

The executor then argued that the regulation requiring full inclusion in the decedent's gross estate was invalid. The district court upheld the regulation after performing the two-part *Chevron* test. The regulation's approach was a reasonable interpretation of an issue not clearly answered by Congress. The lower court thus denied the estate's refund claim, granting the Service's motion for summary judgment.

On appeal, the Ninth Circuit affirmed. Just because §2036(a) refers to "income" and not to an "annuity" does not mean that decedents escape gross estate inclusion through a GRAT. "The fact that §2036(a)(1) does not include the term 'annuity' does not exclude annuities from its ambit. This is consistent with the decisions of the Supreme Court and our sibling circuits, which have concluded that interests such as reversionary interests, the power of appointment, and rent – also not listed in §2036(a) – nevertheless fall into one of the three categories," i.e., "possession, enjoyment, or a right to income therefrom." No matter whether the decedent's annuity was paid from current income, accumulated income, or other principal, the decedent "enjoyed" the benefit of the GRAT assets for life, enough to warrant full inclusion of the GRAT assets in her gross estate.

XII. THE YEAR IN CONSERVATION EASEMENTS

Conservation easements continue to be a popular method for generating large charitable contribution deductions at little to no real cost to the donor. In the typical case, a landowner grants a "conservation easement" to a charitable organization related to environmental or historical preservation. The easement is effectively a covenant whereby the existing use of the underlying real property cannot change without the consent of the easement holder.

The amount of the charitable contribution deduction equals the difference between the value of the underlying real property without the easement and value of such real property with the easement attached. Because this value is determined by appraisals, litigation over the amount of the deduction often ensues. In some cases, the Service disallows a deduction altogether when it concludes that some of the requirements for the deduction are not met. For example, the Service has successfully disallowed deductions where the underlying real property is subject to a mortgage and the lienholder has not agreed to subordinate its interest to the charity's easement. The Service has also disallowed deductions where the parties have failed to ensure that the easement will last in perpetuity.

Several cases involving conservation easements have worked their way through the courts, and here is a summary of some of the more significant and interesting decisions.

***Carter v. Commissioner*, T.C. Memo. 2020-21 (February 3, 2020) – Retained Right to Build in Area to be Designated.** Through their partnership, the taxpayers, a married couple, donated a conservation easement to the North American Land Trust that prohibited the construction or occupancy of any dwellings. But the taxpayers retained the right to build single-family dwellings in specified "building areas" that would be determined later with the consent of the North American Land Trust. The Tax Court agreed with the Service that this arrangement is "antithetical to the easement's conservation purposes." It held the taxpayers could claim no deduction at all.

***Railroad Holdings, LLC v. Commissioner*, T.C. Memo. 2020-22 (February 5, 2020) – Charity Not Assured Proportionate Value Upon Extinguishment.** The taxpayer, a Georgia limited liability company, donated a conservation easement on 454 acres of land in Aiken County, South Carolina, to the Southeast Regional Land Conservancy, a charitable organization. The deed conveying the easement stated that if changed circumstances made the easement impossible or impractical, the easement could only be extinguished by a court. The deed further provided that if the subject property was ever sold, exchanged, or involuntarily converted as a result, the proceeds would be divided in such a way that the charity would receive an amount "at least equal to the fair market value of the Conservation Easement … as of the date of this Conservation Easement." The Service claimed that the taxpayer could not claim a charitable contribution deduction because there was no assurance the charity would be entitled to a proportionate share of any sale proceeds. The deed language only guaranteed that the charity would receive an amount equal to the current value of the easement and not its value at the time of extinguishment. The Tax Court agreed, holding this language effectively violated the "protected in perpetuity" requirement in that it did not guarantee the charity a proportionate share of the proceeds based on date-of-sale values instead of date-of-donation values.

The court explained the flaw in the deed's language with an example:

> If the easement contributed by [the taxpayer] were, at the time of the contribution, worth 10% of the value of a $10 million property, then the "proportionate value" of the easement (as the deed uses that term) would be $1 million, and that dollar value – rather than the fraction of value it did represent – "shall remain constant." Thus, if a court extinguished the easement many years later after the property had appreciated to $20 million, the donee's share of extinguishment proceeds would be not 10% of $20 million (i.e., … $2 million) but rather the "constant" $1 million. [Regulation §1.170A-14(g)(6)(ii)] requires that the donee "must be entitled to a portion of the proceeds at least equal to that proportionate value" (in this example, 10% of $20 million, or $2 million), … but [the taxpayer]'s deed would give the donee only "at least" a constant 10% of the $10 million value "as of the date of" the contribution, or $1 million.

***Oakbrook Land Holdings, LLC v. Commissioner*, T.C. Memo. 2020-54 (May 12, 2020) – Charity Not Assured Proportionate Value Upon Extinguishment—Again.** The taxpayer acquired a 143-acre parcel outside Chattanooga in December, 2007, for $1.7 million. With the intent to develop the property, the taxpayer made some improvements to the land, including building a bridge, installing a sewer-pump station, and rezoning the property. After conveying 37 acres to various related entities in December, 2008, the taxpayer then placed a conservation easement for the benefit of the Southeast Regional Land Conservancy on the remaining 106 acres. Based on an appraisal, the taxpayer claimed a $9.545 million charitable contribution deduction on its 2008 return. The Service disallowed the deduction, pointing to a provision in the deed granting the easement that if the easement is extinguished by judicial proceeding, the Conservancy would receive "a portion of the proceeds equal to the fair market value of the Conservation Easement." The deed also provided that the amount payable to the Conservancy would be reduced by the value of any improvements made by taxpayer after the date of the gift.

Regulation §1.170A-14(g)(6)(ii) requires that upon judicial extinguishment and sale of the underlying property, the charity "must be entitled to a portion of the proceeds at least equal to [the] proportionate value of the conservation restriction." A 2019 case interpreted this language to mean that a charity's share upon extinguishment is that percentage determined by a fraction, the numerator of which is the value of the conservation easement *on the date of the gift* and the denominator of which is the value of the whole property *on the date of the gift*. 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 the percentage required by the regulation, the deed violates the regulation and thus the deduction is disallowed entirely. The IRS also challenged the language reducing the amount payable to the charity by the value of post-contribution improvements made by the taxpayer.

In this Memorandum decision, the Tax Court agreed with the IRS, finding that it does not matter that the fixed value provided for in the deed would almost certainly be more than the percentage of proceeds to which the Conservancy would be entitled under the regulation. But the court also held that the taxpayer was not liable for a substantial understatement penalty since the taxpayer's manager reasonably relied on language pulled from a favorable private ruling in crafting the deed.

***Oakbrook Land Holdings, LLC v. Commissioner*, 154 T.C. No. 10 (May 12, 2020) – And That Regulation is Valid.** So the taxpayer in the last case argued that the regulation is invalid. In a reviewed opinion, the Tax Court (16-1) upheld the regulation's validity, finding it was properly promulgated under the Administrative Procedure Act (the "APA") and that the regulation's interpretation of the statute was entitled to "*Chevron* deference."

The majority concludes that the regulation at issue is a legislative regulation because it imposes a requirement not expressly stated in the statute, namely that the charity and the donor agree to a proportionate division of proceeds following judicial extinguishment of an easement. The taxpayer argued that when Treasury issued the regulation in final form, it failed to provide a "concise general statement of [the] basis and purpose" for the new rule. But the majority observed that "No court has ever construed the APA to mandate that an agency explain the basis and purpose of each individual component of a regulation separately." The provision at issue here was one "of a regulation project consisting of 10 paragraphs, 23 subparagraphs, 30 subdivisions, and 21 examples." Since Treasury adequately stated the general purpose of the substantiation regulations for conservation easements, the regulation was properly enacted.

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

The dissent (Judge Holmes, the judge who tried the case and issued the Memorandum decision described above) concludes that the majority's decision means "the Treasury Department can get by with the administrative-state equivalent of a quiet shrug, a knowing wink, and a silent fleeting glance from across a crowded room." Judge Holmes observed that a number of commentators expressed concern with the regulation related to the perpetuity requirement and judicial extinguishments in its proposed form, but neither the final regulation nor its preamble addressed these concerns. "What we hear is the chirping of crickets." The dissent contends it is not enough that Treasury states "After consideration of all the comments, the proposed regulations are adopted as amended." He argues this is simply form language that can't be used to excuse oversight of significant issues raised during the notice-and-comment phase of rulemaking.

***Woodland Property Holdings, LLC v. Commissioner*, T.C. Memo. 2020-55 (May 13, 2020) – Court follows *Oakbrook Land Holdings* in Summary Judgment Motion.** In December, 2012, the taxpayer acquired 980 acres in South Carolina. Eight days later, it gave a conservation easement on the land to the Southeast Regional Land Conservancy. Here too the deed provided that upon judicial extinguishment of the easement, the Conservancy would be entitled to "at least" the value of the easement as of the date of the gift. The taxpayer claimed an $8.7 million deduction on its 2012 return, which the IRS disallowed. Following the precedents explained above, the Tax Court upheld the IRS's summary judgment motion, concluding that the taxpayer could not claim a deduction because the deed failed to give the charity a proportionate share of the proceeds following extinguishment and sale.

***Johnson v. Commissioner*, T.C. Memo. 2020-79 (June 8, 2020) – Battle of the Experts.** The taxpayer purchased a vacant lot in Colorado for $200,000 in 2002 and turned it into a ranch. In 2007, the taxpayer granted a conservation easement on the property to Colorado Open Lands and claimed a $610,000 charitable contribution deduction on his federal income tax return. Because the taxpayer could not deduct the entire amount of the donation on the 2007 return, the taxpayer carried the deduction over to 2008, 2009, 2010, 2011, 2012, 2013, and 2014.

The IRS did not contest the merits of the deduction but claimed that the taxpayer had already deducted more than the value of the easement by the time it got to the years at issue in the case (2012, 2013, and 2014). So the case turned on the value of the donated easement. As the Tax Court explained, the value of a conservation easement is equal to the amount of the difference between the fair market value of the underlying real property immediately before donation of the easement and such property's fair market value immediately after the easement's donation. The taxpayer's expert concluded that the value of the property before the donation was $1.15 million and the value of the property after the easement was $565,000, resulting in a difference of $585,000. Thus, said the taxpayer's expert, the value of the easement was $585,000. The IRS's expert concluded that the pre-easement value of the property was only $840,000 and that the post-easement value of the property was $555,000, resulting in a difference (and deduction) of $285,000.

The Tax Court was not especially enamored with the approach used by either expert. The IRS's expert eschewed reliance on sales of comparable properties, finding the market data was too inconsistent to be reliable. Instead, the IRS's expert used a "qualitative approach" that took account of the relative superiority or inferiority of the comparables and not just their sale prices. But the Tax Court held that the market data was not nearly as unreliable as the IRS's expert claimed. The court cited other decisions involving properties in neighboring counties. In those cases, sales of comparable properties were sufficient to determine the values of the subject properties. Ultimately, the court determined that the value of the ranch before the donation of the easement was $1.022 million.

The parties were not far apart in their valuation of the now-encumbered ranch. Nonetheless, the court used the average of the discounts claimed by the parties' experts to reach its own conclusion that the value of the ranch with the easement immediately after donation was $649,000. This resulted in a value for the conservation easement in the amount of $373,000, a number ultimately closer to the value determined by the IRS.

***Hewitt v. Commissioner*, T.C. Memo. 2020-89 (June 17, 2020) – Stop Me If You've Heard This Before: Charity Not Assured Proportionate Value Upon Extinguishment.** The taxpayer in 2012 donated to the Atlantic Coast Conservancy a conservation easement on a portion of farmland that has been in the family for almost 60 years. The taxpayer claimed a $2.8 million charitable contribution deduction on the 2012 federal income tax return and carried it over to 2013 and 2014.

The IRS did not challenge the 2012 return but disallowed the carryover deductions on the 2013 and 2014 returns. Before the Tax Court, the IRS argued that the easement granted to the Conservancy failed the regulatory requirement that the easement be "protected in perpetuity" because the deed granting the easement provides that upon judicial extinguishment of the easement and resulting sale of the property the Conservancy will only receive an amount equal to the value of the easement at contribution. The taxpayer argued for an interpretation of the regulations that would support the taxpayer's claim that a charity need only be entitled to an amount equal to the value of the easement at contribution, but the court quickly and easily dispensed with the argument, citing a number of precedents.

The taxpayer tried to rely on a favorable private ruling from 2008, but the court said the ruling "is neither persuasive nor relevant." The ruling did not expressly consider the validity of the easement deed that subtracted the value of post-easement appreciation from extinguishment proceeds, so it does not have any bearing on the issue posed here.

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

***Plateau Holdings, LLC v. Commissioner*, T.C. Memo. 2020-93 (June 23, 2020) – This is Getting Old: Charity Not Assured Proportionate Value Upon Extinguishment.** The taxpayer in 2012 donated to the Foothills Land Conservancy conservation easements on two separate 1,000+-acre parcels of Tennessee property that had previously been used for mining. The two nearly identical deeds conveying the easements provided that following judicial extinguishment of the easements, the Conservancy would be entitled to a fixed amount of the proceeds equal to the percentage of the easement's value *at the time of the donation* relative to the value of the subject properties *at the time of donation*. The deeds expressly state that the charity's share is to be determined without regard to any post-easement improvements made to the property. This violates the perpetuity requirement identified above because it does not give the charity a proportionate share of the proceeds based on the values at the time of extinguishment. But that did not stop the taxpayer from claiming a combined charitable contribution deduction in excess of $25.4 million.

Unsurprisingly (if you've read the case summaries before this), the Tax Court upheld the IRS's disallowance of the deduction. The charity's share of extinguishment proceeds is improperly reduced by the appreciation in value of improvements existing at the time of the donation and by the value of any improvements made by donor after the donation. The taxpayer argued that the deeds contained a savings clause, providing that the charity's share of extinguishment proceeds shall be determined in accordance with the formula discussed above "or Section 1.170A-14, if different." But the court noted that this "constitutes a 'condition subsequent' saving clause that we and other courts have consistently declined to enforce" because it would require a tribunal to hold first that the formula contained in the deed was noncompliant before it could ever take effect. Perhaps if the deed provided that the amount payable to the charity was "the greater of" the formula amount or the amount required under the regulation, the result would have been different.

The court went on to uphold the application of penalties too, finding that the claimed value of the easement on one parcel was 852% of its correct value and the claimed value of the easement on the other parcel was 1,031% of its correct value (gulp).

***Lumpkin One Five Six, LLC v. Commissioner*, T.C. Memo. 2020-94 (June 23, 2020), and *Lumpkin HC, LLC v. Commissioner*, T.C. Memo. 2020-95 (June 23, 2020) – Attack of the Clones: Charity Not Assured Proportionate Value Upon Extinguishment.** These two cases, decided by the same judge on the same day in opinions that are nearly verbatim, involve the perpetuity requirement yet again. The cases involved conservation easements on two parcels of Georgia real property and combined deductions of over $10.7 million. Both deeds contained the now-infamous formula provision for dividing extinguishment proceeds:

> [T]his Easement shall have at the time of Extinguishment a fair market value determined by multiplying the then fair market value of the Easement Area 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 Easement Area, without deduction for the value of the Easement, at the time of this grant.

As we have seen from the earlier cases, this is fatal because the formula provides that the portion of the proceeds required to be paid to the charity upon extinguishment is to be reduced by the value of improvements to the property made by the taxpayer after grant of the easement. The taxpayers tried to argue the regulation's rule on extinguishments was invalid, but the court rejected the argument, citing *Oakbrook Land Holdings*.

***Village at Effingham, LLC v. Commissioner*, T.C. Memo. 2020-102 (July 9, 2020), *Riverside Place, LLC v. Commissioner*, T.C. Memo. 2020-103 (July 9, 2020), *Maple Landing, LLC v. Commissioner*, T.C. Memo. 2020-104 (July 9, 2020), and *Englewood Place, LLC v. Commissioner*, T.C. Memo. 2020-105 (July 9, 2020) – These Clones are Growing Exponentially: Charity Not Assured Proportionate Value Upon Extinguishment.** Here we have four cases tried by the same judge with near-verbatim opinions issued on the same day, each involving yet another botched conservation easement because of deed language that violates the perpetuity requirement discussed above. The cases involved conservation easements on various parcels of Georgia real property and combined deductions of over $20.7 million.

In addition to holding that the deeds violated the regulatory requirement ensuring that the charity would receive a proportionate share of the value of the whole property at the time of extinguishment, the court also held that the deduction is disallowed for lack of substantial compliance with the substantiation requirements. In each case, the taxpayer failed to disclose the basis of the donated property, claiming in an attachment to the return that such information would not be provided "because of the fact that the basis of the property is not taken into consideration when computing the amount of the deduction." Yeah, good luck with that.

***Smith Lake, LLC v. Commissioner*, T.C. Memo. 2020-107 (July 13, 2020) – You Guessed It, Charity Not Assured Proportionate Value Upon Extinguishment.** The taxpayers conveyed a conservation easement on a 21.89-acre parcel of real property located in Alabama to a subsidiary of Atlantic Coast Conservancy and claimed a charitable contribution deduction in excess of $6.5 million representing the value of the easement. The deed granting the easement contained language nearly identical to the ones quoted above in earlier cases regarding the disposition of sale proceeds following judicial extinguishment of the easement. When the IRS disallowed the deduction, the taxpayer made the same arguments as those discussed above, including that the regulation requiring a proportionate division of the sale proceeds is invalid. Unsurprisingly, the Tax Court stuck to its newly-established guns in upholding the regulation's validity and denying the taxpayer's deduction.

***Belair Woods, LLC v. Commissioner*, T.C. Memo. 2020-112 (July 22, 2020) – IRS Not Bound by Concession Regarding Extinguishment Clause in Unrelated Case.** The taxpayer purchased 145 acres of Georgia real property in 2008 for just over $382,000. The next year, the taxpayer donated a conservation easement on 141 acres of the land to the Georgia Land Trust. The taxpayer claimed a $4.7 million charitable contribution deduction for its contribution. Sadly, the deed conveying the easement stated that upon judicial extinguishment, the share of sale proceeds allocable to the Georgia Land Trust would be determined by subtracting all claims against the property (and not just a share of those claims), as well as the value of any improvements made by the taxpayer after contribution of the easement.

Consistent with all the cases already described, the Tax Court upheld the Service's disallowance of the deduction because the purpose of the easement was not protected "in perpetuity" because the charity was not assured of its proportionate share of any extinguishment proceeds. The taxpayer pointed out that in a 2016 case from the Federal District of Arizona, the IRS stipulated that a deed containing a similar extinguishment clause satisfied the regulation. Thus said the taxpayer, the IRS was judicially estopped from challenging the extinguishment clause here. The Tax Court rejected this argument, noting that the IRS's position in the prior case was simply a tactical concession made so that the IRS could pursue another theory on a summary judgment motion.

XIII. TAX COURT ALLOWS TAX-AFFECTING IN VALUING PASSTHROUGH ENTITY INTEREST (*Estate of Jones v. Commissioner*, T.C. Memo. 2019-101, August 19, 2019)

The decedent opened a sawmill in Eugene, Oregon, in 1954. As the business grew, the decedent needed to assure his business would have a steady supply of timber. In 1992, the decedent formed a limited partnership to acquire and hold timberland that the sawmill would use for inventory. The sawmill was the general partner and the decedent was the limited partner with the largest interest (his three daughters held smaller limited partner interests thanks to prior gifts not at issue here).

In 2009, the decedent made gifts of nonvoting stock in the sawmill and limited partner interests in the partnership to various trusts established for his children and their descendants. The decedent's 2009 federal gift tax return claimed the decedent gifted about $3.6 million in stock and $3.6 million in limited partner interests. The Service determined the gifted stock was worth $15.3 million and the gifted limited partner interests were worth $25.8 million. Throw on some interest and you have a total deficiency in excess of $44.9 million.

So the case is one of valuation. The estate's expert, one who "has performed approximately 100 business valuations of sawmills and timber product companies," determined the value of the gifted stock was about $4.3 million and the value of the gifted partnership interests was about $3.9 million. The Service's expert, who "has performed several privately held business valuations," determined the value of the gifted partnership interests was just under $26 million. (No mention is made of any determination by an expert for the Service as to the value of the gifted stock, indicating the real fight was about the valuation of the limited partner interests.)

The Service made several attacks against the report produced by the estate's expert. It first argued that the expert wrongly used an income-based approach instead of a net-asset-value-based approach in valuing the partnership. But the Tax Court held that the partnership should be valued as an operating company using the income-based approach. The timber was used to service the inventory needs of the sawmill and was thus part of the sawmill business. This means the partnership was not an ordinary holding company but instead part of a going concern, making use of an income-based approach more appropriate.

The Service also argued that it was improper for the estate's expert to use midyear revenue projections from 2009 in determining the value of the partnership interests. Due to the subprime mortgage crisis that year, the sawmill's management team commissioned midyear financial projections using the same process used for regular, yearly financial projections. Those midyear projections were considerably more pessimistic. The Service found it awfully convenient that those projections were used by the estate's expert in valuing the interests gifted, but the Tax Court concluded it was certainly proper, as they were the most recent set of financial reports available at the time of the gift.

The Service next argued that it was wrong for the estate's expert to "tax-affect" the businesses. If you're new to tax-affecting, the concept was explained masterfully by Lou Harrison in his 2013 article, *Throwing Darts at the S Corporation Tax Affecting Valuation Dartboard – After Years of Tax Court Abuse, Do We Finally Know How to Hit a Bull's-eye?*:

> In valuing minority interests in C corporations, appraisers will typically start with a variable related to earnings on an after tax basis. C corporations pay tax at the entity level.
>
> With S corporations, there is no corporate level tax. Earnings for S corporations will then always start off with a before tax number. In valuing minority interests in S corporations, appraisers will seek to "tax affect" S corporation earnings.
>
> "Tax affecting" takes a variable in the S corporation valuation, like net earnings, and fictitiously reduces its value by C Corporation taxes. This could have the affect (sic) of reducing the overall valuation by 35% (the [then-

applicable] C corporation tax rate). This is a substantial reduction, and every bit as important as the marketability and minority discounts.

The Service argued that tax-affecting was disallowed by the Tax Court in a 1999 case, *Gross v. Commissioner*. Thus, it contended, the estate's expert should have assumed a zero-percent tax rate instead of the 38-percent blended federal and state income tax rate actually employed. But here the court concluded that *Gross* was not intended to be read so broadly:

> In *Gross …*, we concluded that "the principal benefit that shareholders expect from an S corporation election is a reduction in the total tax burden imposed on the enterprise. The owners expect to save money, and we see no reason why that savings ought to be ignored as a matter of course in valuing the S corporation." We then concluded that, on the record in that case, a zero-percent corporate tax rate properly reflected those tax savings, rejecting the expert's offered justifications. More recently, in *Estate of Gallagher v. Commissioner*, T.C. Memo. 2011-148, … we again rejected tax-affecting because the taxpayer's expert did not justify it but again acknowledged that the benefit of a reduction in the total tax burden borne by S corporation owners should be considered when valuing an S corporation. And in *Estate of Giustina v. Commissioner*, [T.C. Memo. 2011-141] we rejected tax-affecting in the valuation of a partnership because we found the taxpayer's expert's method to be faulty: He used a pretax discount rate to present value post-tax cash flow. The question in those cases, as here, was not whether to take into account the tax benefits inuring to a flowthrough entity but how.

And here, said the court, the estate's expert more accurately reflected the tax consequences of the partnership's passthrough status. Among other things, the estate's expert reduced the estimated tax burden by benefit of avoiding a second tax on distribution to the owners. As the court concluded, the approach of the estate's expert in tax-affecting "may not be exact, but it is more complete and more convincing than respondent's zero tax rate."

The Service then argued that intercompany loans between the sawmill and the partnership were improperly reflected in the report from the estate's expert, but the court quickly rejected this argument. It likewise rejected another argument that the claimed marketability discount (35 percent) was unreasonably high. As a result, the court ended up accepting the valuation of the estate's expert in full, resulting in a big win for the estate.

XIV. LIFETIME LOAN TRANSFERS BECOME GIFTS WHEN CONVERTED TO ADVANCEMENTS (*Estate of Bolles v. Commissioner*, T.C. Memo. 2020-71, June 1, 2020)

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 is 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. 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 court's conclusion means that the estate lost over $1 million of applicable exclusion amount through the lifetime taxable gifts. But it also means 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, the estate might have been happy to lose this one.

XV. TAXPAYER PREVAILS IN BATTLE OF THE EXPERTS OVER VALUATION OF NONVOTING LLC INTERESTS (*Grieve v. Commissioner*, T.C. Memo. 2020-28, March 2, 2020)

In 2013 the taxpayer made two gift transfers. The first was a transfer of a 99.8-percent nonvoting interest in Rabbit LLC, an entity that owned just over $9.1 million in cash and marketable securities, to a two-year grantor-retained annuity trust (GRAT). The second was a transfer of a 99.8-percent nonvoting interest in Angus LLC, a different entity that owned over $31.9 million in cash and marketable securities, to an irrevocable trust in exchange for a private annuity worth just over $8 million.

On his 2013 federal gift tax return, the taxpayer reported a taxable gift of zero for the transfer of Rabbit units and a taxable gift of nearly $10 million for the transfer of Angus units. These numbers were based on appraisals that valued the nonvoting units in Rabbit at just over $5.9 million and the nonvoting interests in Angus at nearly $20.9 million. But the Service determined that the nonvoting interests in Rabbit were worth just over $9 million and the nonvoting interests in Angus were worth nearly $31.9 million.

The valuation adjustment for the Rabbit units was no big deal since the Service agreed that no gift tax would be due if the size of the annuity payments from the GRAT is adjusted to reflect the higher valuation. But the valuation adjustment to the Angus units changed the value of the net gift from nearly $10 million to about $17.8 million.

The taxpayer challenged this determination in the United States Tax Court. Both sides came equipped with new and improved appraisals at their sides. The taxpayer's expert concluded the value of the transferred Rabbit interest was in fact only $5.88 million and the value of the transferred Angus interest was $19.85 million. But the Service's expert claimed the value of the transferred Rabbit interest was $8.9 million and the value of the transferred Angus interest was just over $31.4 million. It was thus up to the court to figure out the "true" values.

The Tax Court did not like the reasoning of the Service's expert that a willing buyer of a 99.8-percent nonvoting interest would necessarily also purchase the 0.2-percent voting interest in order to protect the investment in the large nonvoting interest. The court believed testimony from the taxpayer's daughter, the sole shareholder and manager of the corporation that owned the voting interests in each entity, that she has no plan to sell her interest and that if she ever did she would demand a substantial premium. She also testified that if the nonvoting interests were ever sold outside the family, she would demand a fee for managing the entities. The court held it was thus improper to factor in the value of the 0.2-percent voting interest. It went on to find that the taxpayer's expert used an appropriate valuation method that had been approved in prior cases and that the discount ranges used by the taxpayer's expert were also in line with those used by the court in earlier cases. It thus adopted the valuations reported by the taxpayer's expert.

XVI. EYEGLASS DONATION SCHEME LACKED FOCUS (*Campbell v. Commissioner*, T.C. Memo. 2020-41, April 7, 2020)

The taxpayer's accountant recommended that the taxpayer participate in a scheme operated by ZD Products, Inc. (ZD). For reasons unexplained, ZD had over 170,000 designer eyeglass frames in its possession. ZD packaged the frames into units of about 3,400 frames each and then sold each unit for $50,000 to buyers. Here's the gimmick: a buyer would hold the 3,4,00 eyeglasses for over one year, donate them to a charitable organization (Lions in Sight was the preferred one), then claim a charitable contribution deduction for the fair market value of the frames. The taxpayer bought a unit of frames on December 22, 2006, and the frames were donated to Lions in Sight on December 28, 2007. An appraisal concluded that the value of some 349,629 frames donated to Lions in Sight was just over $24 million.

Using this figure, the taxpayer's 2007 return showed a charitable contribution deduction of just over $225,000. Since the taxpayer also had a net operating loss carryforward of over $897,000, though, the taxpayer carried the donation over to 2008. In its examination of the 2008 return, the Service disallowed the carryforward on a variety of grounds. It concluded the contribution lacked donative intent, the appraisal was not a "qualified appraisal," and the letter received by the taxpayer from Lions in Sight was not a proper contemporaneous written acknowledgment.

The Tax Court held that the taxpayer did not comply with the substantiation requirements, so it did address the arguments regarding donative intent. The court observed that the appraisal related to 349,629 eyeglass frames and not the 3,400 frames donated by the taxpayer. Although the frames donated by the taxpayer were included in the aggregate appraisal, "we (and the IRS) have no way to determine whether what he alone contributed was overvalued." Given that the individual frames had values between $37 and $80, there was no way to determine the value of the taxpayer's donation with any degree of confidence. The taxpayer argued he contributed a fractional share of the 349,629 frames, but the court rejected the argument, finding "the record unmistakably belies this." The taxpayer purchased a block of frames, not a share of a larger lot.

The court also held that the letter furnished by the charity was not a contemporaneous written acknowledgment. "The letter merely acknowledged his 'generous gift of prescription eyeware (sic)' and how his contribution would assist Lions in Sight; it made no mention of whether Lions in Sight provided any goods or services in consideration for [the taxpayer's] contribution." The taxpayer argued there was substantial compliance with the substantiation rules, but the court concluded that the defects in the documents "are not (in the words of [the taxpayer]) 'ridiculously trivial and inconsequential.'"

XVII. THERE'S NO DISPUTE THERE WAS NEVER A DISPUTE OVER THE LAWYER'S PORTION OF A SETTLEMENT AWARD (*Isaacson v. Commissioner*, T.C. Memo. 2020-17, January 23, 2020)

Before he was disbarred in 2013, the taxpayer was a litigator. In 2007, the taxpayer represented four individuals who had been sexually abused as children by Catholic priests. When the Archdiocese of Los Angeles offered over $660 million to resolve all pending cases, the taxpayer appeared at an informal settlement conference and secured a total settlement of $12.75 million for his four clients. The taxpayer charged the clients a 60-percent contingent fee, which two of the four clients accepted. But the other two clients claimed the taxpayer's share should have been closer to 40-percent or 50-percent. Still, those objecting clients never made a formal request for arbitration, as provided in their fee agreements.

The taxpayer included no portion of the fee in his gross income for 2007. When his return was selected for examination, he argued that the bank charged with holding the funds invested them without his authorization. This proved to be inaccurate. Before the Tax Court, he claimed that the funds were not gross income because two of his clients disputed the fee. As a result, he said, rules of professional conduct prohibited him from claiming any rights to the funds until the dispute resolved itself. But the court applied the doctrine of judicial estoppel to defeat his position. "Petitioner argues that he could not recognize income from the clergy lawsuit settlement because clients disputed his fees and [because] he was barred from disbursing his fee until that fee dispute was resolved. In prior proceedings, however, petitioner took precisely the opposite track; he repeatedly represented, and earlier tribunals accepted as true, that no fee dispute existed between him and his clients."

Furthermore, said the Tax Court, even if two of the clients had disputed the fee, there was no dispute as to the taxpayer's portion of the award made to the other two clients—so at least that amount would have been gross income to the taxpayer in 2007. Moreover, the court held, the taxpayer exercised dominion and control over the entire settlement amount through his improper investing of those funds. It is inconsistent for the taxpayer to argue only now that there was a restriction on his use of the funds when in fact no such restriction was ever in place. The court upheld a 75-percent fraud penalty on top of the understatement.

XVIII. A LITTLE ADMINISTRATIVE LAW AND CONSTITUTIONAL LAW IN YOUR TAX LAW SOUP: REDUCED DONOR DISCLOSURE REQUIREMENT INVALIDATED (*Bullock v. Internal Revenue Service*, D. Mont., July 30, 2019)

For many years, the Service required most exempt organizations to report on their Forms 990 the names and addresses of donors who contributed $5,000 or more during the taxable year. A duty to disclose information about donors who contributed more than $1,000 applied to certain social clubs and fraternities where such amounts were used for charitable purposes. In *Revenue Procedure 2018-38*, issued on July 16, 2018, the Service, citing its discretionary authority under §6033(a)(3)(B) to relieve any exempt organization from the requirement to file an information return, announced that exempt organizations other than those described in §501(c)(3) were no longer required to provide donor information, effective for taxable years ending on or after December 31, 2018. Organizations benefitting from this new policy included the AARP and the NRA, as well as the Democratic Socialists of America and the conservative Americans for Prosperity. These groups can engage in political activity as long as they do not spend more than half of their budgets on political campaigns.

The governors of Montana and New Jersey sued the Service, claiming the revenue procedure was invalid under the Administrative Procedure Act ("APA"). The APA requires federal agencies to follow certain procedures in the implementation of legislative and interpretive rules. Legislative rules, those with the force and effect of law thanks to a congressional delegation of express rulemaking authority, must undergo a "notice and comment" process under which the agency publishes notice of a proposed rule in the Federal Register and provides a set period of time for public comment before finalization. Interpretive rules, those promulgated under general authority to prescribe rules that interpret congressional acts so as to implement and enforce them, need not undergo notice and comment since interpretive rules merely explain the law and do not create new law.

Montana and New Jersey claim to have standing in the matter because donor disclosures are shared with state governments, and state governments use that information to track suspicious activity and to award state-level tax exemptions to the reporting organizations. The Service argued that this was not enough of an interest for the states to have standing to contest the revenue procedure, but the district court disagreed. It found that depriving states of the information that used to be required forced the states to come up with their own, separate enforcement mechanisms. The added cost of enforcement represented a sufficient injury so as to say the states had standing.

The Service then tried to convince the court that the states had no power to contest the revenue procedure because §6033(a)(3)(B) expressly gives the Service the power to relieve an organization from the obligation of providing information on a return. The court observed that while that interpretation of the tax statute is correct, it is irrelevant since the states contested the revenue procedure only for failure to comply with the APA. The states were not challenging the substance of the revenue procedure or the Service's authority to issue it under the Internal Revenue Code. They are instead claiming the revenue procedure is invalid because it was not properly issued.

So the key question became whether the revenue procedure was a legislative rule that required notice and comment or whether it was an interpretive rule that the Service could issue without such process. The court concluded the revenue procedure was no mere interpretation of what information has to be provided. Instead, it is a reversal of a 50-year practice of requiring information about large donors. Effectively, then, it is an amendment to the existing rule, making it a legislative rule that required notice and comment.

XIX. BEWARE OF SPECIAL ALLOCATIONS WHEN LLC ELECTS S CORPORATION STATUS (*Private Letter Ruling 201930023*, July 26, 2019)

A limited liability company validly elected to be taxed as an S corporation. Thereafter, the founding members of the LLC entered into an operating agreement. The agreement stated that all distributions would be made to the members in proportion to their respective membership interests, including upon liquidation. Subsequent to this, though, the members amended the agreement to provide that, upon liquidation, distributions would be paid to members with positive capital accounts in accordance with their respective positive capital account balances. This, of course, is common for entities taxed as partnerships, for the ability to make special allocations of income, gain, loss, deduction, and credit is usually conditioned on (among other things) such an agreement between the partners. But this is fatal to a subchapter S election since an S corporation must made all distributions (including liquidating distributions) on a *pro rata* basis.

The Service ruled that the amendment terminated the S election since liquidating distributions would not necessarily be made on a *pro rata* basis. But the Service also ruled that the termination was inadvertent and not motivated by tax avoidance. The members quickly agreed to a second amendment to the operating agreement which corrected the liquidating distribution language and provided for distributions on a *pro rata* basis in accordance with membership ownership percentages. Accordingly, the Service granted inadvertent termination relief, meaning the LLC kept its tax status as an S corporation without interruption. Ultimately, things turned out fine for the LLC, though it cost the members some anxiety and the price of a private ruling.

XX. PORTION OF 23ANDME TESTING MAY BE DEDUCTIBLE AS A MEDICAL EXPENSE (*Private Letter Ruling 201933005*, August 16, 2019)

23andMe sells genetic tests that provide customers with information about ancestry, wellness, and genetic traits like food-taste preferences. In addition, the company provides health reports with information on whether customers have gene variants that increase their risk for developing certain diseases. As of this writing, customers have two purchase options: an "ancestry service" kit for $99 and a "health and ancestry service" kit for $199. While the report from the ancestry kit is limited to information about a customer's maternal and paternal ancestry, the health and ancestry kit also includes information about whether the customer carries certain genes or genetic predispositions to conditions like cystic fibrosis, sickle cell anemia, and hereditary hearing loss. Customers provide 23andMe with a DNA sample collected through a home-testing kit.

In this private ruling, the Service concluded that the price of the ancestry kit is not deductible as a medical expense. But "if the taxpayer also purchases the health services, the price of the DNA collection kit must be allocated between the ancestry services and the health services using a percentage (cost of health services / total cost of ancestry plus health services). For this purpose, explained the Service, "the taxpayer may use a reasonable method to value and allocate the cost of the health services between services that are medical care (such as the testing at the laboratory) and non-medical services or items (such as the reports that provide general information on a test result)." 23andMe reports that the ruling means a customer can deduct up to $117.74 of the $199 cost of the health and ancestry service kit.

Two observations about the ruling: First, to the extent the cost qualifies as a medical expense, that means a taxpayer may use a healthcare flexible spending account or health savings account to cover that portion of the cost. Second, one wonders whether this ruling might open the door to taxpayers claiming medical expense deductions for other mixed-use costs, like Apple Watches used in part to track diet and exercise regimens.

APPENDIX

The following was published by the United States Treasury Department on April 3, 2020

PAYCHECK PROTECTION PROGRAM (PPP) INFORMATION SHEET:

BORROWERS

The Paycheck Protection Program ("PPP") authorizes up to $349 billion in forgivable loans to small businesses to pay their employees during the COVID-19 crisis. ***All loan terms will be the same for everyone.***

The loan amounts will be forgiven as long as:

- The loan proceeds are used to cover payroll costs, and most mortgage interest, rent, and utility costs over the 8 week period after the loan is made; and
- Employee and compensation levels are maintained.

Payroll costs are capped at $100,000 on an annualized basis for each employee. Due to likely high subscription, it is anticipated that not more than 25% of the forgiven amount may be for non-payroll costs.

Loan payments will be deferred for 6 months.

When can I apply?

- Starting April 3, 2020, small businesses and sole proprietorships can apply for and receive loans to cover their payroll and other certain expenses through existing SBA lenders.
- Starting April 10, 2020, independent contractors and self-employed individuals can apply for and receive loans to cover their payroll and other certain expenses through existing SBA lenders.
- Other regulated lenders will be available to make these loans as soon as they are approved and enrolled in the program.

Where can I apply? You can apply through any existing SBA lender or through any federally insured depository institution, federally insured credit union, and Farm Credit System institution that is participating. Other regulated lenders will be available to make these loans once they are approved and enrolled in the program. You should consult with your local lender as to whether it is participating. Visit www.sba.gov for a list of SBA lenders.

Who can apply? All businesses – including nonprofits, veterans organizations, Tribal business concerns, sole proprietorships, self-employed individuals, and independent contractors – with

500 or fewer employees can apply. Businesses in certain industries can have more than 500 employees if they meet applicable SBA employee-based size standards for those industries….

For this program, the SBA's affiliation standards are waived for small businesses (1) in the hotel and food services industries …; or (2) that are franchises in the SBA's Franchise Directory …; or (3) that receive financial assistance from small business investment companies licensed by the SBA. Additional guidance may be released as appropriate.

What do I need to apply? You will need to complete the Paycheck Protection Program loan application and submit the application with the required documentation to an approved lender that is available to process your application by June 30, 2020. …

What other documents will I need to include in my application? You will need to provide your lender with payroll documentation.

Do I need to first look for other funds before applying to this program? No. We are waiving the usual SBA requirement that you try to obtain some or all of the loan funds from other sources (i.e., we are waiving the Credit Elsewhere requirement).

How long will this program last? Although the program is open until June 30, 2020, we encourage you to apply as quickly as you can because there is a funding cap and lenders need time to process your loan.

How many loans can I take out under this program? Only one.

What can I use these loans for? You should use the proceeds from these loans on your:

- Payroll costs, including benefits;
- Interest on mortgage obligations, incurred before February 15, 2020;
- Rent, under lease agreements in force before February 15, 2020; and
- Utilities, for which service began before February 15, 2020.

What counts as payroll costs? Payroll costs include:

- Salary, wages, commissions, or tips (capped at $100,000 on an annualized basis for each employee);
- Employee benefits including costs for vacation, parental, family, medical, or sick leave; allowance for separation or dismissal; payments required for the provisions of group health care benefits including insurance premiums; and payment of any retirement benefit;
- State and local taxes assessed on compensation; and
- For a sole proprietor or independent contractor: wages, commissions, income, or net earnings from self-employment, capped at $100,000 on an annualized basis for each employee.

Does the PPP cover paid sick leave?

Yes, the PPP covers payroll costs, which include employee benefits such as costs for parental, family, medical, or sick leave. However, it is worth noting that the CARES Act expressly excludes qualified sick and family leave wages for which a credit is allowed under sections 7001 and 7003 of the Families First Coronavirus Response Act (FFCRA) (Public Law 116–127). …

How large can my loan be? Loans can be for up to two months of your average monthly payroll costs from the last year plus an additional 25% of that amount. That amount is subject to a $10 million cap. If you are a seasonal or new business, you will use different applicable time periods for your calculation. Payroll costs will be capped at $100,000 annualized for each employee.

How much of my loan will be forgiven? You will owe money when your loan is due if you use the loan amount for anything other than payroll costs, mortgage interest, rent, and utilities payments over the 8 weeks after getting the loan. Due to likely high subscription, it is anticipated that not more than 25% of the forgiven amount may be for non-payroll costs.

You will also owe money if you do not maintain your staff and payroll.

- <u>Number of Staff</u>: Your loan forgiveness will be reduced if you decrease your full-time employee headcount.
- <u>Level of Payroll</u>: Your loan forgiveness will also be reduced if you decrease salaries and wages by more than 25% for any employee that made less than $100,000 annualized in 2019.
- <u>Re-Hiring</u>: You have until June 30, 2020 to restore your full-time employment and salary levels for any changes made between February 15, 2020 and April 26, 2020.

How can I request loan forgiveness? You can submit a request to the lender that is servicing the loan. The request will include documents that verify the number of full-time equivalent employees and pay rates, as well as the payments on eligible mortgage, lease, and utility obligations. You must certify that the documents are true and that you used the forgiveness amount to keep employees and make eligible mortgage interest, rent, and utility payments. The lender must make a decision on the forgiveness within 60 days.

What is my interest rate? 1.00% fixed rate.

When do I need to start paying interest on my loan? All payments are deferred for 6 months; however, interest will continue to accrue over this period.

When is my loan due? In 2 years.

Can I pay my loan earlier than 2 years? Yes. There are no prepayment penalties or fees.

Do I need to pledge any collateral for these loans? No. No collateral is required.

Do I need to personally guarantee this loan? No. There is no personal guarantee requirement. ***However, if the proceeds are used for fraudulent purposes, the U.S. government will pursue criminal charges against you.***

What do I need to certify? As part of your application, you need to certify in good faith that:

- Current economic uncertainty makes the loan necessary to support your ongoing operations.
- The funds will be used to retain workers and maintain payroll or to make mortgage, lease, and utility payments.
- You have not and will not receive another loan under this program.
- Y ou will provide to the lender documentation that verifies the number of full-time equivalent employees on payroll and the dollar amounts of payroll costs, covered mortgage interest payments, covered rent payments, and covered utilities for the eight weeks after getting this loan.
- Loan forgiveness will be provided for the sum of documented payroll costs, covered mortgage interest payments, covered rent payments, and covered utilities. Due to likely high subscription, it is anticipated that not more than 25% of the forgiven amount may be for non-payroll costs.
- All the information you provided in your application and in all supporting documents and forms is true and accurate. Knowingly making a false statement to get a loan under this program is punishable by law.
- You acknowledge that the lender will calculate the eligible loan amount using the tax documents you submitted. You affirm that the tax documents are identical to those you submitted to the IRS. And you also understand, acknowledge, and agree that the lender can share the tax information with the SBA's authorized representatives, including authorized representatives of the SBA Office of Inspector General, for the purpose of compliance with SBA Loan Program Requirements and all SBA reviews