RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

By

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I. ACCOUNTING

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

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

The facts: The taxpayers, a married couple, invested $40,000 in 2006 to acquire stock in a non-U.S. corporation conducting business in India. The taxpayers owned 13 percent of the corporation's outstanding stock. The taxpayers' investment was profitable. By 2017, the taxpayers' share of the foreign corporation's undistributed earnings and profits was approximately $508,000. Also in 2017, as part of the Tax Cuts and Jobs Act, Congress added the Mandatory Repatriation Tax ("MRT") to subpart F of the Code. *See* IRC § 965(a)(1), (c), (d). Subpart F applies to "controlled foreign corporations," commonly referred to as CFCs. Under § 957(a), a CFC generally is a non-U.S. corporation if, on any day during the corporation's taxable year, "United States shareholders" own stock possessing more than 50 percent of either the total voting power of all classes of stock entitled to vote or the total value of the corporation's stock. Pursuant to § 957(b), a "United States shareholder" is a "United States person" (see § 7701(a)(30)) who owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote (before 2018) or 10 percent or more of the total value of shares of all classes of stock of the foreign corporation (after 2017). In the Court's words, the MRT imposes "a one-time pass-through tax" that is "backward-looking" on the accumulated but undistributed income of "American-controlled foreign corporations." 144 S. Ct. at 1686. Put differently, and subject to conditions and limitations not applicable to the taxpayers in this case, the MRT effectuates a deemed repatriation (in tax parlance, "phantom income") of earnings and profits to U.S. shareholders holding 10 percent or more of the controlled foreign corporation's stock. Longstanding provisions of subpart F have operated the same way for decades, but before the MRT, subpart F mainly applied to passive income.[1] Thus, after certain adjustments, the MRT required the taxpayers to report $132,512 of undistributed income in 2017 from their shareholdings in a foreign corporation, resulting in a *whopping* $14,729 federal income tax liability with respect to their shares.[2] The taxpayers paid the tax and then sued for a refund on the grounds that the MRT is unconstitutional. The U.S. District Court held for the government, the U.S. Court of Appeals for the Ninth Circuit affirmed the district court, and the Supreme Court granted certiorari.

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

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

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

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

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

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

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

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

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

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

144 S. Ct. at 1696-1697.

- Justice Jackson agreed with the majority but would have gone further than the Court was willing, writing in a separate, concurring opinion: "[B]oth before and after the Sixteenth Amendment was adopted, the term 'income' was widely recognized as flexible enough to include both realized and *unrealized* gains." 144 S. Ct. at 1698 (emphasis added).

- Justices Barrett and Alito disagreed with Justice Kavanaugh's opinion, including his reasoning and interpretation of precedent; however, they nevertheless concurred in the result in favor of the government, stating:

  > Congress's power to attribute the income of closely held corporations to their shareholders is a difficult question — and unfortunately, the parties barely addressed it. Without focused briefing on the attribution question,[3] I would not resolve it. Subpart F and the MRT *may or may not be constitutional*, nonarbitrary attributions of closely held foreign corporations' income to their shareholders. In this litigation, however, the [taxpayers] have conceded that subpart F is constitutional. And I agree with the Court that subpart F is not meaningfully different from the MRT in how it attributes corporate income to shareholders. Taxpayers generally bear the burden to show they are entitled to a refund. Given the [taxpayers'] concession, they have not met that burden here. For that reason, I concur in the Court's judgment affirming the judgment below.

144 S. Ct. at 1709.

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

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

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

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

For example, what about the Court's decision in *Commissioner v. Tufts*, 461 U.S. 300 (1983), which sanctions the determination of amount realized and gain on the disposition of property encumbered by a nonrecourse liability by taking into account the entire outstanding principal balance of the debt notwithstanding the property's lower fair market value? *See also* § 7701(g). Is unrealized *Tufts* gain unconstitutional? What about the taxation of built-in gain and passive investment income of subchapter S corporations? Sections 1374 and 1375 impose federal income

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

taxes on the S corporation itself even though S corporation's shareholders also pay federal income tax on their allocable shares of such income. *See* §§ 1366, 1374, 1375. Are sections 1374 and 1375 taxes "on both the entity and the shareholders" as described by Justice Kavanaugh in the above-quoted footnote? Finally, what about the federal estate tax, which taxes the unrealized but appreciated value of a decedent's property (and grants a corresponding basis step-up)? *See* §§ 1014, 2001. Is the estate tax a questionable "wealth tax" as footnoted by Justice Kavanaugh? The Court upheld the constitutionality of the federal estate tax over 100 years ago in *New York Trust Company v. Eisner*, 256 U.S. 345 (1921), but does *Moore* change the analysis? We're certain there are numerous other examples of the taxation of "unrealized" appreciation.

B. Deductible Expenses versus Capitalization

C. Reasonable Compensation

D. Miscellaneous Deductions

E. Depreciation & Amortization

F. Credits

G. Natural Resources Deductions & Credits

H. Loss Transactions, Bad Debts, and NOLs

I. At-Risk and Passive Activity Losses

III. INVESTMENT GAIN AND INCOME

IV. COMPENSATION ISSUES

A. Fringe Benefits

B. Qualified Deferred Compensation Plans

1. Proposed regulations on required minimum distributions. REG-105954-20, Required Minimum Distributions, 87 F.R. 10504 (2/24/22). Treasury and the IRS have issued proposed regulations that address required minimum distributions (RMDs) from qualified retirement plans and annuity contracts and related matters. The proposed regulations would update existing regulations to reflect a number of statutory changes. The most significant of these statutory changes were made by the SECURE Act, enacted on December 20, 2019, as Division O of the 2020 Further Consolidated Appropriations Act.

2. Among other changes, the SECURE Act amended Code § 401(a)(9)(E) to modify the RMD rules for inherited retirement accounts (defined contribution plans and IRAs). The proposed regulations are lengthy and address these and a number of other issues. This outline will focus on only the guidance provided by the proposed regulations on the change made by the SECURE Act to RMDs for inherited retirement accounts. Readers should consult the proposed regulations for additional guidance.

The SECURE Act changes to RMDs from inherited retirement accounts. A provision of the SECURE Act, Division O, Title IV, § 401 of the 2020 Further Consolidated Appropriations Act, amended Code § 401(a)(9)(E) to modify the required minimum distribution (RMD) rules for inherited retirement accounts (defined contribution plans and IRAs). The amendments require all funds to be distributed by the end of the 10th calendar year following the year of death (the "10-year rule"). The statute contains no requirement to withdraw any minimum amount before that date. Section 401(a)(9)(H)(i)(II), as also amended by the SECURE Act, provides that this rule applies whether or not RMDs to the employee or IRA owner have begun. The current rules, which permit taking RMDs over life expectancy, continue to apply to a designated beneficiary who is an "eligible designated beneficiary," which is any of the following: (1) a surviving spouse, (2) a child of the participant who has not reached the age of majority, (3) disabled within the meaning of

§ 72(m)(7), (4) a chronically ill individual within the meaning of § 7702B(c)(2) with some modifications, or (5) an individual not in any of the preceding categories who is not more than 10 years younger than the deceased individual. These changes generally apply to distributions with respect to those who die after December 31, 2019.

The proposed regulations' interpretation of the SECURE Act. The proposed regulations adopt an interpretation of the 10-year rule that appears to differ from the plain language of the statute and from the interpretation of the legislation of most advisors. The statute provides that, when the designated beneficiary is *not* an eligible designated beneficiary, all funds must be distributed by the end of the 10th calendar year following the year of death and that this rule applies whether or not RMDs to the employee or IRA owner have begun. There appears to be no requirement to withdraw any minimum amount before that date. The preamble to the proposed regulations, however, explains that the proposed regulations distinguish between situations in which the employee or IRA owner dies before the required beginning date for distributions, and situations in which death occurs after such date. When the employee or IRA owner dies *before* the required beginning date for distributions, the proposed regulations provide that no distribution is required before the 10th calendar year following the year of death. However, in situations in which the employee or IRA owner dies *after* the required beginning date for distributions, the proposed regulations provide that a designated beneficiary who is *not* an eligible designated beneficiary must take RMDs before the 10th calendar year following the year of death:

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

87 F.R. 10514. This interpretation differs not only from the plain language of the statute and from the interpretation of the legislation of most advisors, but also from IRS Publication 590-B, which was issued for 2021. IRS Publication 590-B (page 11) provides:

> The 10-year rule requires the IRA beneficiaries who are not taking life expectancy payments to withdraw the entire balance of the IRA by December 31 of the year containing the 10th anniversary of the owner's death. For example, if the owner died in 2021, the beneficiary would have to fully distribute the IRA by December 31, 2031. The beneficiary is allowed, but not required, to take distributions prior to that date.
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> The 10-year rule applies if (1) the beneficiary is an eligible designated beneficiary who elects the 10-year rule, if the owner died before reaching his or her required beginning date; or (2) the beneficiary is a designated beneficiary who is not an eligible designated beneficiary, regardless of whether the owner died before reaching his or her required beginning date.

Many of the comments on the proposed regulations urge the IRS to change its interpretation or at least to delay the effective date of the interpretation because many beneficiaries subject to the 10-year rule did not take distributions in 2021.

a. The IRS will not assert that the 50% excise tax of § 4974 is due from those who failed to take certain RMDs from inherited retirement accounts in 2021 or 2022. Notice 2022-53, 2022-45 I.R.B. 437 (10/7/22). This notice announces that, when the proposed regulations described above become final, the final regulations will apply no earlier than the 2023 distribution calendar year. The notice also addresses the tax treatment of individuals who failed to take RMDs in 2021 or 2022 under the interpretation of the 10-year rule set forth in the proposed regulations. Section 4974 provides that, if the amount distributed from a qualified retirement plan during the year is less than the RMD for that year, then an excise tax is imposed equal to 50 percent of the amount by which the RMD exceeds the amount actually distributed. The notice provides that the IRS will not assert that an excise tax is due under § 4974 from an individual who did not take a "specified RMD." It also provides that, if an individual paid an excise tax for a missed RMD in 2021 that constitutes a specified RMD, the taxpayer can request a refund of the excise tax paid. A "specified RMD" is defined as any distribution required to be made in 2021 or 2022 under a defined contribution plan or IRA if the payment would be required to be made to (1) a designated beneficiary of an employee or IRA owner who died in 2020 or 2021 and on or after the employee or IRA owner's required beginning date, and (2) the designated beneficiary is not taking lifetime or life expectancy payments as required by § 401(a)(9)(B)(iii). In other words, the IRS will not assert that the excise tax of § 4974 is due from a beneficiary who (1) is not an eligible designated beneficiary (and who therefore is subject to the 10-year rule), (2) inherited the retirement account from an employee or IRA owner who died in 2020 or 2021 and on or after the required beginning date of distributions, and (3) were required to take RMDs in 2021 or 2022 under the interpretation of the 10-year rule in the proposed regulations but failed to do so. The notice provides the same relief to beneficiaries of eligible designated beneficiaries if the eligible designated beneficiary died in 2020 or 2021 and was taking lifetime or life expectancy distributions.

- The notice does not explicitly address what RMD must occur in 2023. The issue is whether, in 2023, a beneficiary who failed to take an RMD in 2021 or 2022 must take the 2023 RMD and also any RMDs previously missed. The notice does not explicitly require missed RMDs to be withdrawn. The notice provides only that the IRS will not assert that an excise tax is due from those who failed to take RMDs in 2021 or 2022 under the interpretation of the 10-year rule in the proposed regulations. In the authors' view, the notice implies that, in 2023, only the 2023 RMD must be withdrawn. For example, if an employee or IRA owner died in 2021 with a designated beneficiary who was not an eligible designated beneficiary, that beneficiary should have begun taking RMDS in 2022, which should continue through 2030 (the ninth year after the employee or IRA owner's death), and the remaining balance of the account should be fully withdrawn in 2031. The authors' interpretation is that the beneficiary in this example should simply begin taking RMDs in 2023 (calculated as if they had begun in 2022), which should continue through 2030, and the remaining balance of the account should be fully withdrawn in 2031. The final regulations may provide further guidance on this question.

b. The IRS has granted a further reprieve: the Service will not assert that the excise tax of § 4974 is due from those who failed to take certain RMDs from inherited retirement accounts in 2021, 2022, or 2023. Notice 2023-54, 2023-31 I.R.B. 382 (7/14/23). This notice announces that, when the proposed regulations described above become final, the final regulations will apply no earlier than the 2024 calendar year. The notice provides that the IRS will not assert that an excise tax is due under § 4974 from an individual who did not take a "specified RMD." A "specified RMD" is defined as any distribution required to be made in 2021, 2022, or 2023 under a defined contribution plan or IRA if the payment would be required to be made to (1) a designated beneficiary of an employee or IRA owner who died in 2020, 2021, or 2022 and on or after the employee or IRA owner's required beginning date, and (2) the designated beneficiary is not taking lifetime or life expectancy payments as required by § 401(a)(9)(B)(iii). In other words, the IRS will not assert that the excise tax of § 4974 is due from a beneficiary who (1) is not an eligible designated beneficiary (and who therefore is subject to the 10-year rule), (2) inherited the retirement account from an employee or IRA owner who died in 2020, 2021, or 2022 and on or after the required beginning date of distributions, and (3) were required to take RMDs in 2021, 2022, or 2023 under the interpretation of the 10-year rule in the proposed regulations but failed to do so. The notice provides the same relief to beneficiaries of eligible designated beneficiaries if the eligible designated beneficiary died in 2020, 2021, or 2022 and was taking lifetime or life expectancy distributions.

- The notice also grants relief to those who attained age 72 in 2023 and received distributions from January 1 through July 31, 2023, that are mischaracterized as RMDs. Taxpayers who attain age 72 in 2023 are not required to begin taking RMDs for 2023 because Congress increased the age at which RMDs must begin to age 73 for those who attain age 73 after 2022. The Notice gives such taxpayers until September 30, 2023, to deposit such amounts in an eligible retirement plan and treat the deposits as a tax-free rollover. This aspect of the notice is discussed in more detail below in connection with the discussion of the change in the age at which RMDs must begin.

c. The IRS has granted a further reprieve: the Service will not assert that the excise tax of § 4974 is due from those who failed to take certain RMDs from inherited retirement accounts in 2021, 2022, 2023, or 2024. Notice 2024-35, 2024-19 I.R.B. 1051 (4/16/24). This notice announces that, when the proposed regulations described above become final, the final regulations will apply no earlier than the 2025 calendar year. The notice provides that the IRS will not assert that an excise tax is due under § 4974 from an individual who did not take a "specified RMD." A "specified RMD" is defined as any distribution required to be made in 2021, 2022, 2023, or 2024 under a defined contribution plan or IRA if the payment would be required to be made to (1) a designated beneficiary of an employee or IRA owner who died in 2020, 2021, 2022, or 2023 and on or after the employee or IRA owner's required beginning date, and (2) the designated beneficiary is not taking lifetime or life expectancy payments as required by § 401(a)(9)(B)(iii). In other words, the IRS will not assert that the excise tax of § 4974 is due from a beneficiary who (1) is not an eligible designated beneficiary (and who therefore is subject to the 10-year rule), (2) inherited the retirement account from an employee or IRA owner who died in 2020, 2021, 2022, or 2023 and on or after the required beginning date of distributions, and (3) were required to take RMDs in 2021, 2022, 2023, or 2024 under the interpretation of the 10-year rule in the proposed regulations but failed to do so. The notice provides the same relief to beneficiaries of eligible designated beneficiaries if the eligible designated beneficiary died in 2020, 2021, 2022, or 2023 and was taking lifetime or life expectancy distributions.

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

D. Individual Retirement Accounts

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

B. Miscellaneous Income

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

D. Deductions and Credits for Personal Expenses

1. A nonresident alien is entitled to a personal exemption deduction in 2018 through 2025, but the amount of the deduction is zero under the 2017 Tax Cuts and Jobs Act. Bell v. United States, 169 Fed. Cl. 466 (1/25/24). The taxpayer in this case, Mr. Cecil Bell, was a Jamaican citizen and a nonresident alien of the United States.[4] The Court of Federal Claims, in an opinion by Judge Horn, held that, although the taxpayer was entitled to one deduction of the "exemption amount" under § 151(a) and § 151(b), the exemption amount was zero pursuant to § 151(d)(5), as applicable during the years 2018 through 2025. The effect of this holding is that the taxpayer did not receive any reduction in income or the refund he requested.

Section 151(a) and (b) authorize a deduction equal to the "exemption amount" for a taxpayer. The 2017 Tax Cuts and Jobs Act, § 11041, amended Code § 151(d) by adding § 151(d)(5). Section 151(d)(5)(A) reduces the exemption amount to zero for taxable years beginning after 2017 and

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

before 2026. The intended effect of this amendment was to eliminate the deduction for personal exemptions authorized by § 151(a).

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

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

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

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

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

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

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

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

E. Divorce Tax Issues

F. Education

G. Alternative Minimum Tax

VI. CORPORATIONS

VII. PARTNERSHIPS

VIII. TAX SHELTERS

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

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

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

a. The Tax Court got it wrong, says the D.C. Circuit. Despite the absence of explicit language authorizing the assessment of penalties imposed by § 6038(b), the text, structure, and function of § 6038(b) indicate that the penalties it imposes are assessable. Farhy v. Commissioner, 100 F.4th 223 (D.C. Cir. 5/3/24), *rev'g* 160 T.C. No. 6 (4/3/23). In an opinion by Judge Pillard, the U.S. Court of Appeals for the D.C. Circuit has reversed the Tax Court and held that statutory authority exists for the assessment of penalties imposed by § 6038(b) and that the IRS therefore is able to collect those penalties through its administrative collection powers, such as a levy. The court first rejected the parties' competing readings of § 6201(a), which authorizes the Secretary of the Treasury to make the "assessments of all taxes (including interest, additional amounts, additions to the tax, and assessable penalties) imposed by this title." The IRS argued that § 6201(a) authorizes the assessment of all taxes and penalties unless the Code expressly requires a different process for a given exaction. The taxpayer argued that § 6201(a) authorizes the assessment of a penalty only if the penalty is explicitly characterized as a "tax" or designated as assessable. The cout declined to adopt either interpretation of § 6201(a) and instead based its holding on the text, structure, and function of the specific provision at issue, § 6038(b). The court placed primary emphasis on the history and legislative purpose underlying § 6038(b). Congress enacted § 6038 in 1960. As originally enacted, the penalty for failure to file the required informational return regarding a foreign corporation was a 10-percent reduction in the U.S. taxpayer's foreign tax credit. Congress amended § 6038 in the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, Title III, § 338, 96 Stat. 324, 631, commonly known as TEFRA. The 1982 amendments moved the 10-percent reduction of a taxpayer's foreign tax credit to current § 6038(c) and amended § 6038(b) to impose a new, fixed-dollar penalty for failure to file the required informational return. Amended § 6038(c)(3) coordinates the two penalties by providing that the § 6038(c) reduction of a taxpayer's foreign tax credit is reduced by any fixed-dollar penalty imposed by § 6038(b). These changes, the court observed, were intended to bolster and streamline enforcement of the penalty. The parties in this case agreed that the penalty imposed by § 6038(c) is assessable because a reduction of a taxpayer's foreign tax credit has the effect of increasing a taxpayer's tax liability, and § 6201(a) authorizes the assessment of all taxes imposed by the Internal Revenue Code. The remaining question was whether authority exists for the IRS to assess the penalty imposed by § 6038(b). The court emphasized that Congress's purpose in amending § 6038 in 1982 to add the fixed-dollar penalty currently provided by § 6038(b) was to streamline collection of the penalty. Under the interpretation of § 6038 advanced by the taxpayer, the IRS can assess and therefore collect through its administrative collection powers the penalty imposed by § 6038(c) (the 10-percent reduction in a taxpayer's foreign tax credit) but must instead enforce the fixed-dollar penalty imposed by § 6038(b) by bringing legal action against the taxpayer in a United States District Court. Such an interpretation, the court concluded, does not make sense:

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

The court also reasoned that the availability of a reasonable cause defense to the penalty imposed by § 6038(b) suggests that the penalty is assessable. A taxpayer can avoid the penalty imposed by § 6038(b) by showing reasonable cause for the noncompliance. See I.R.C. § 6038(c)(4); Reg. § 1.6038-2(k)(3)(ii). Section 6038(c)(4)(B), the court reasoned, "expressly treats the reasonable cause showing for failure to file the relevant informational returns as within the purview of the

Service." Further, the court observed, "[i]f the subsection (b) penalty were not assessable, there would be no post-assessment administrative process in which the taxpayer could make a reasonable cause showing to the Secretary." The express contemplation of § 6038 that the Secretary of the Treasury will determine the availability of a reasonable cause defense to the penalties imposed by § 6038 supports treating the penalties imposed by both § 6038(b) and § 6038(c) as assessable. Finally, the court, observed, interpreting the § 6038(b) as not being assessable and therefore collectible only through an action in U.S. District Court and the § 6038(c) penalty as being assessable and collectible through the IRS's administrative collection powers with judicial review of the collection process (following a collection due process hearing) in the Tax Court could lead to inconsistent holdings in the two courts for the same taxpayer and would raise other potential issues:

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

B. Discovery: Summonses and FOIA

C. Litigation Costs

D. Statutory Notice of Deficiency

E. Statute of Limitations

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

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

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

Deference to Treas. Regulation §301.7508A-1(g)(1) and (2). Having concluded under the *Chevron* analysis that § 7508A(d) was unambiguous and that the court did not have to accord *Chevron* deference to the regulations, the court also concluded that Reg. § 301.7508A-1(g)(1) and (2) were invalid. The regulations were invalid to the extent that these two subsections limit the non-pension-related "time sensitive acts that are postponed for the mandatory 60-day postponement period…[to] the acts determined to be postponed by the Secretary's exercise of authority under 7508(a)." In so holding, the court stated that the regulation, promulgated after the petition in this case was filed, cannot change the result dictated by an unambiguous statute.

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

F. Liens and Collections

G. Innocent Spouse

H. Miscellaneous

XI. WITHHOLDING AND EXCISE TAXES

XII. TAX LEGISLATION

A. Enacted

XIII. TRUSTS, ESTATES & GIFTS

A. Gross Estate

1. Case results in a clear split between Eighth and Eleventh Circuits concerning inclusion of corporate-owned life insurance proceeds in estate tax value of

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

The Estate's Arguments. The estate of the deceased brother made two arguments that the $3 million redemption price for the decedent's shares was proper for estate tax purposes. The estate's first argument was that the stock purchase agreement complied with § 2703(b) and therefore sets the value of the deceased brother's shares for estate tax purposes. Section 2703(a) generally provides that the estate tax value of property is determined without regard to any agreement restricting the property's sale or setting the property's price at less than fair market value. Section 2703(b), though, provides an exception, thereby potentially allowing an agreement to set the estate tax value of property via agreement if three requirements are met: (i) it is a bona fide business arrangement; (ii) it is not a device to transfer property among family members for less than full and adequate consideration; and (iii) its terms are comparable to arms' length transactions entered into by unrelated persons. The estate's second argument was that the $3 million price set for the deceased bother's shares reflected the stock's fair market value exclusive of the $3.5 million of life insurance proceeds, which is the proper result under *Estate of Blount v. Commissioner*, 428 F.3d 1338 (11th Cir. 2005). The Eleventh Circuit in *Blount* held under similar circumstances that the estate tax value of a decedent's shares subject to a stock purchase agreement at death should not include corporate-owned life insurance proceeds used to redeem the decedent's shares. The Eighth Circuit reasoned that any such life insurance proceeds have no net effect on the value of the redeemed shares because the proceeds received by the corporation are offset by a concomitant liability to purchase the decedent's stock. The Eighth Circuit stated in *Blount*, "To suggest that a reasonably competent business person, interested in acquiring a company, would ignore a $3 million liability strains credulity and defies any sensible construct of fair market value." 428 F.3d at 1346. *See also Estate of Cartwright v. Commissioner*, 183 F.3d 1034 (9th Cir. 1999).

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

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

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

> To further see the illogic of the estate's position, consider the resulting windfall to [the surviving brother]. If we accept the estate's view and look to Crown's value exclusive of the life insurance proceeds intended for redemption, then upon [the

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

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

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

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

144 S. Ct. at 1411-1412. Importantly, however, Justice Thomas clarified in a footnote that the Court's holding in *Connelly* does not mean a redemption obligation can never decrease a corporation's value for estate tax purposes. "A redemption obligation could, for instance, require a corporation to liquidate operating assets to pay for the shares, thereby decreasing its future earning capacity. We simply reject [the estate's] position that all redemption obligations reduce a

corporation’s net value. Because that is all this case requires, we decide no more.” 144 S. Ct. at 1413 note 2.

B. Deductions

C. Gifts

D. Trusts