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

III. INVESTMENT GAIN AND INCOME

IV. COMPENSATION ISSUES

A. Fringe Benefits

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

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

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

B. Qualified Deferred Compensation Plans

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

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

Section 1042. Section 1042(a) of the Code generally (subject to conditions and limitations) permits a taxpayer to elect to defer gain recognition on the sale of "qualified securities" to an ESOP if sufficient "qualified replacement property" is timely acquired. In particular, and relevant to the Tax Court's decision in this case, the flush language of § 1042(a) provides that (if the taxpayer so elects) the gain "*which would be recognized* as long-term capital gain [upon the sale of qualified securities to the ESOP] shall be recognized only to the extent that the amount realized on such sale exceeds the cost to the taxpayer of . . . qualified replacement property." § 1042(a) (emphasis added). Under § 1042(c)(3), the qualified replacement property must be acquired within the "replacement period," which extends from three months before to twelve months after the sale to the ESOP. Thus, in a typical transaction, a taxpayer sells stock ("qualified securities") in a C corporation the taxpayer controls to an ESOP sponsored by the taxpayer's corporation and elects under § 1042(a) to defer reporting (a/k/a "roll over") gain from the sale. Next, to comply with § 1042(a), the taxpayer later (but within twelve months) acquires "qualified replacement property" at a cost equal to or greater than the *amount realized* upon the sale of the qualified securities to the ESOP. Accordingly, under § 1042(d), the taxpayer's cost basis in the qualified replacement property is adjusted downward by the gain "rolled over" from the sale of stock to the ESOP. If, however, the taxpayer subsequently disposes of the qualified replacement property, then (and relevant to the Tax Court's decision in this case) § 1042(e) provides that, "*notwithstanding any other provision of this title*, gain (if any) shall be recognized to the extent of the gain which was not recognized under [§ 1042(a)] by reason of the acquisition by such taxpayer of such qualified replacement property." § 1042(e)(1) (emphasis added).

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

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

The 2003 facts. On October 22, 2003, the taxpayers purchased "qualified replacement property" (as defined in § 1042).[1] The qualified replacement property consisted of floating rate notes and was acquired within the period allowed by § 1042(c)(3). The taxpayers used cash and margin debt to acquire the floating rate notes. A day later, on October 23, 2003, the taxpayers transferred the floating rate notes and margin debt to Bancroft Ventures, Ltd., an affiliate of Derivium Capital LLC, in 90-percent loan transactions. The IRS asserted and the taxpayers ultimately conceded that the 90-percent loan transactions were in substance sales of their qualified replacement property. The next day, on October 24, 2003, Bancroft Ventures sold the floating rate notes, satisfied the margin debt, retained a 10 percent fee, and paid the net balance remaining from the disguised sales to the taxpayers. Also in 2003, and important to the Tax Court's analysis, the ESOP paid roughly $900,000 of principal on the installment notes issued to the taxpayers in connection with the 2002 sale of stock to the ESOP. With respect to the foregoing transactions, the taxpayers reported no income, either in the form of § 1042(e) recapture or § 453 installment sales gain, on their 2003 federal income tax returns.

The 2004 facts. In 2004, the taxpayers received further principal payments of approximately $100,000 on their ESOP installment sale notes. Again, the taxpayers reported no income on their

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

2004 federal income tax returns, either in the form of § 1042(e) recapture or § 453 installment sales gain.

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

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

Judge Gale's Analysis. After considering but dismissing certain other arguments by the taxpayers seeking to invalidate their irrevocable election to defer gain from their sale of stock under § 1042,[2] Judge Gale proceeded to analyze the interplay between §§ 453(a) and 1042(e). The IRS's position, of course, was that the taxpayers' irrevocable election under § 1042(a) to roll over approximately $8 million in ESOP-sale gain for 2002, and their corresponding purchase (under § 1042(c)(3)) and disguised sale (ala Derivium 90-percent loan) of qualified replacement property in 2003, meant that § 1042(e) was triggered, thereby recapturing $8 million in gain deferred from the 2022 ESOP sale. More specifically, the IRS argued that § 1042(e) is the <u>exclusive</u> means for determining and reporting the $8 million of roll over gain from the ESOP sale because the subsection states in relevant part, "notwithstanding any other provision of this title." The taxpayers posited that, in the unique circumstances of this case, § 453(a) applied in 2002 to determine the gain from their ESOP sale. Because the taxpayers received no installment payments in 2002, there was no roll over gain from that year to recapture under § 1042(e) despite the 2003 disposition of the qualified replacement property. As support, the taxpayers pointed not to §1042(e) but to the language in § 1042(a) regarding the deferral of gain "*which would be recognized*" but for the

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

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

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

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

163 T.C. at ___ (emphasis added). Judge Gale also wrote in a footnote that the taxpayers' failures to report gains consistent with the installment method on their 2002, 2003, and 2004 returns "have no impact on the applicability of the installment method of reporting the gain on the sale of their ESOP stock." 163 T.C. at ___ note 34. Judge Gale then determined that rather than $8 million in gain for 2003 as urged by the IRS, the taxpayers need only report installment sales gain of approximately $900,000 for 2003 and $100,000 for 2004 due to the installment payments received from the ESOP during those years. Finally, in accordance with § 1042(d), the taxpayers were required in 2003 to adjust their basis in the qualified replacement property downward (from an initial cost basis of around $8.3 million) by roughly $900,000 of recognized installment sales gain. Therefore, after the downward adjustment in basis, the taxpayers had another $60,000 (approximately) of gain from the disguised sale of the qualified replacement property to Bancroft Ventures (a Derivium affiliate) in 2003. With respect to 2004 (as noted above), the taxpayers must recognize about $100,000 of gain from their 2002 installment sale of stock to the ESOP due to the 2004 installment payment of $100,000 of principal. The court did not, however, address whether and how this 2004 recognized gain might result in a downward adjustment to any remaining qualified replacement property retained by the taxpayers after 2003.[3]

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

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

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

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

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

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

D. Individual Retirement Accounts

V. PERSONAL INCOME AND DEDUCTIONS

VI. CORPORATIONS

A. Entity and Formation

B. Distributions and Redemptions

1. A new excise tax of 1% on redemptions of stock by publicly-traded U.S. corporations. The Inflation Reduction Act, § 138102, adds new Code § 4501, which imposes a 1 percent excise tax on the value of stock "repurchased" by a "covered corporation" (generally, a U.S. publicly-traded corporation) during the corporation's taxable year. The term "repurchase" is defined as a redemption within the meaning of Code § 317(b) plus any other "economically similar" transaction as determined by the Secretary of Treasury. The amount subject to the new 1 percent excise tax is the fair market value of stock redeemed during the year reduced by (i) the value of any new stock issued to the public for the year and (ii) the value of stock issued to the employees of the corporation for the year. A subsidiary of a publicly-traded U.S. corporation that performs the buyback for its parent or a U.S. subsidiary of a foreign corporation that buys back its parent's stock is subject to the excise tax. The provision also excludes certain repurchases from the excise tax, as explained further below. Section 4501 applies to repurchases of stock after December 31, 2022.

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

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

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

The proposed regulations (REG-115710-22 cited above) address computational matters concerning the § 4501 excise tax and may be found at Prop. Reg. §§ 58.4501-1 through -7. The computational matters addressed concern the types of transactions subject to the § 4501 excise tax (including transactions that are "economically similar" to § 317(b) stock redemptions) and stock issuances that reduce the amount otherwise subject to the § 4501 tax (the "netting rule"). Generally, the proposed regulations are consistent with guidance published in Notice 2023-2. In particular, the proposed regulations republish and clarify numerous examples that were originally announced in Notice 2023-2. A total of 40 examples are provided in the proposed regulations, such as:

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

- Pro rata stock dividend. *See* Prop. Reg. § 58.4501-5 Ex. 5.

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

C. Liquidations

D. S Corporations

1. Disproportionate distributions from an S Corporation do not create a second class of stock and do not terminate an S election. Maggard v. Commissioner, T.C. Memo 2024-77 (8/7/24). The taxpayer and his business associate formed a corporation under California law and elected to have it classified for federal tax purposes as a subchapter S corporation. The taxpayer and his business associate each received equal shares of the S corporation's common stock. Under California corporate law, owners of common stock are entitled to a pro rata share of dividends, distributions, and liquidation proceeds. See Cal. Corp. Code §§ 159, 400(b). The taxpayer's business associate sold his shares to the taxpayer, who in turn sold 60 percent of his interest to two other individual shareholders (40 percent to one individual and 20 percent to the other). These two individual shareholders (Two Shareholders) caused the corporation to make substantially disproportionate distributions to themselves. When the taxpayer confronted them about their alleged looting of the corporation, they cut the taxpayer off from the corporation's accounting records and did not allow the taxpayer to attend company meetings. The taxpayer prepared his federal income tax returns for 2014 through 2016 without having received a Schedule K-1 from the S corporation. When the taxpayer requested this information through an attorney, he received a single figure on a cocktail napkin. This figure was $300,000 for 2014 and $50,000 for 2015. These figures allegedly represented the taxpayer's shares of losses of the S corporation for these years. After the taxpayer filed his returns, the S corporation issued Schedules K-1 showing that the taxpayer had a share of income for each year. Upon audit, the IRS disallowed the loses reported by the taxpayer and determined that the taxpayer had failed to report his allocable share of the S corporation's income correctly in the years audited. The taxpayer argued that the corporation's S election terminated prior to the years being audited because the Two Shareholders caused the S corporation to make disproportionate distributions to themselves. The taxpayer maintained that the disproportionate distributions violated the requirement that an S corporation have only a single class of stock. *See* § 1361(b)(1)(D). Because the S corporation allegedly had violated the single class of stock requirement, he argued, its S election had terminated and therefore the corporation's income no longer passed through to the shareholders under the regime of subchapter S. The Tax Court (Judge Holmes) disagreed and held that the disproportionate distributions did not terminate the corporation's S election. The court acknowledged that an S corporation can only have one class of stock. Relevant Treasury regulations provide that the one class of stock requirement is met if all outstanding shares of the S corporation confer identical rights to distribution and liquidation proceeds. Reg. § 1.1361-1(*l*)(1). The regulations further provide that

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

Reg. § 1.1361-1(*l*)(2)(1). In Rev. Proc. 2022-19, § 3.02, 2022-41 I.R.B. 282, the IRS indicated that it will not treat any actual disproportionate distributions as violating the one class of stock rule if the distribution provisions in the governing documents provide for identical distribution rights. Based on this authority and the court's own precedent, the court held that the disproportionate distributions in this case did not violate the one class of stock rule. The court noted that it had reached a similar conclusion in prior cases. *See Mowry v. Commissioner*, T.C. Memo. 2018-105;

Minton v. Commissioner, T.C. Memo. 2007-372, *aff'd*, 562 F.3d 730 (5th Cir. 2009).Accordingly, the court held that the S corporation's election had not terminated and that the corporation's income from the audited years passed through to the taxpayer.

E. Mergers, Acquisitions and Reorganizations

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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 challenged this determination by filing a petition in the Tax Court. The Tax Court (Judge Marvel) agreed with the taxpayer and held that there is no statutory authority for the IRS to assess § 6038 penalties. The IRS argued that § 6201(a), which authorizes the Secretary of the Treasury to make the "assessments of all taxes (including interest, additional amounts, additions to the tax, and assessable penalties) imposed by this title" authorizes assessment of penalties imposed by § 6038. The court disagreed, however, and reasoned that the term "assessable penalties" in § 6201(a) does not automatically apply to all penalties in the Code. The court observed that (1) §§ 6671(a) and 6665(a)(1) provide that penalties imposed by specified Code sections shall be assessed and collected in the same manner as taxes and (2) Code sections other than those specified by §§ 6671(a) and 6665(a)(1) commonly provide that the penalty is a tax or assessable penalty for purposes of collection or are expressly covered by (or contain a cross-reference to) one of the specified Code sections. In contrast, the court explained, § 6038 is not one of the Code sections specified by §§ 6671(a) and 6665(a)(1) and contains only a cross-reference to a criminal penalty provision. The court also rejected the IRS's argument that § 6038 penalties are "taxes" within the meaning of § 6201(a) and therefore subject to assessment. In short, the court held, although § 6038(b) provides penalties for failure to provide the information required by § 6038(a), there is no statutory authority for assessment of those penalties and the IRS therefore is unable to collect those penalties through a levy.

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

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

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

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

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

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

After the IRS issued a final notice of intent to levy and a notice of federal tax lien, the taxpayer requested a collection due process (CDP) hearing. Based on the IRS's estimate of the taxpayer's reasonable collection potential, the Settlement Officer who conducted the CDP hearing rejected the taxpayer's alternative requests for an installment agreement or an offer-in-compromise. The Settlement Officer issued a notice of determination sustaining the collection action and the taxpayer responded by filing a petition in the Tax Court.

In the Tax Court, the taxpayer argued principally that (1) the IRS had violated his Fifth Amendment due process rights because the Settlement Officer was not independent, (2) the Settlement Officer had abused his discretion in rejecting the taxpayer's offer-in-compromise, and (3) the foreign reporting penalties imposed by §§ 6038(b) and 6677 violate the Excessive Fines

Clause of the Eighth Amendment. The Tax Court (Judge Greaves) efficiently disposed of the taxpayer's first two arguments and, because they are highly fact-specific, this discussion will not address those arguments. The significance of the Tax Court's opinion is its holding regarding the third argument.

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

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

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

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

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

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

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

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

B. Discovery: Summonses and FOIA

C. Litigation Costs

D. Statutory Notice of Deficiency

E. Statute of Limitations

F. Liens and Collections

G. Innocent Spouse

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

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

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

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

H. Miscellaneous

XI. WITHHOLDING AND EXCISE TAXES

XII. TAX LEGISLATION

XIII. TRUSTS, ESTATES & GIFTS