Advanced Markets

Central Intelligence

July 2021

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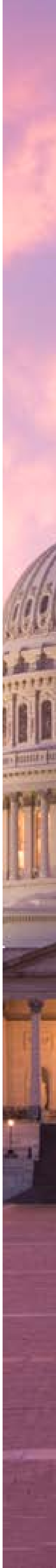
President Biden releases his budget for fiscal year 2022, including Green Book proposals, March 4, 2021.

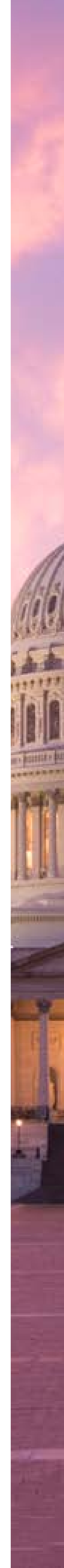
As happens every year, the President releases the budget for the coming fiscal year of the federal government, including what might be best called a "wish list" of tax and legal proposals that affect the budget and federal revenue. The proposals would, if enacted, either raise/create new revenues or spend revenues. The list always contains some proposals that may be enacted and many that stand very little chance, and there are some that show up almost every year. This year's 72-page budget is no departure from the norm, although there are several items that we have not seen before. Below is a short summary a few of the items that we feel will be of interest to our readers.

- Increase the federal income tax rate on C corporations from 21% to 28% effective for tax years after 2021.
- New 15% minimum tax on book earnings of corporations with book income exceeding $2 billion annually.
- Top marginal federal income tax-rate revert to 39.6% for income that exceeds $509,300 (joint filers) and $452,700 (individual filers) beginning in 2022. The bracket thresholds would be adjusted for inflation annually.
- For individuals with adjusted gross income more than $1 million, capital gains taxed at ordinary income rates. The $1 million threshold would be adjusted for inflation annually after 2022.
- Donors and decedents would recognize capital gain on the value in excess of basis of assets gifted during lifetime and at death. (This has been widely referred in the press as the repeal of the step-up in basis, although this proposal does much more than just repeal IRC §1014.)
- Gain on unrealized appreciation also would be recognized by a trust, partnership, or other noncorporate entity that is the owner of property if that property has not been the subject of a recognition event within the prior 90 years, with such testing period beginning on January 1, 1940. The first possible recognition event for any taxpayer under this provision would thus be December 31, 2030.
- Limit the tax deferral of gain on certain "like-kind" exchanges under IRC §1031 that defer annual gains of less than $500,000 individual/$1 million married filing jointly.
- Create a 10% tax credit for certain expenses incurred in moving a "trade or business" from outside to inside the US.
- Provide $13.2 billion in funding for the IRS in 2022, which would be a 10.4% increase over the 2021 funding.

Takeaway
Remember, these are proposals only, which are not solely by inclusion in the proposed budget even before the federal legislature for consideration. The likelihood of any one of the dozens of proposals in the budget being considered and ultimately enacted as law depends on the individual proposal and the political climate into which it is launched. Given the highly polarized political climate in the current federal legislature and the almost even split in control by the two major political parties, more controversial proposals will be difficult to pass into law. For information on the Capital Gains proposal **click here to read our blog.** Notably, while the Green Book proposals are silent on estate taxes and exemption, silence does not necessarily mean they aren't part of the agenda, for more information on other proposals **click here to read our blog.**



Tax Court denies distribution treatment of economic benefits received by S corporation owner as compensation, *Ruben De Los Santos, et ux. v. Commissioner,* 156 T.C. No. 9, April 12, 2021.



Facts

During 2011 and 2012 the Taxpayer, a doctor, was the sole shareholder of a medical practice organized as an S corporation that employed him and his Spouse (the Couple). The Spouse served as the office manager for the practice. The S corporation adopted a multiple-employee welfare benefit plan under IRC §419(A)(f)(6) that provided benefits to the Taxpayer, Spouse and four other employees. Under the plan as adopted by the S corporation, the Couple were entitled to a $12.5 million death benefit, and the four rank-and-file employees were each entitled to a $10,000 death benefit and certain flexible benefits. The Couple received these benefits in their capacity as employees. In fact, to be eligible to receive benefits under the plan, a person was required to provide services to "an Employer." The Couple were "eligible employees" under the plan, because they provided services to the S corporation. (In an earlier ruling, the Court ruled that the benefit plan, insofar as it afforded life insurance protection to the Couple, constituted a compensatory "split-dollar" life insurance arrangement under Treasury Reg. §1.61-22.) The Couple are thus taxable on the economic benefits they realized by participating in the plan. In a notice of deficiency issued to Couple, the IRS determined that these economic benefits are taxable to the Couple as ordinary compensation income. The Couple filed a motion for a partial summary judgment contending that because the Taxpayer is a shareholder of the S corporation, the economic benefits he realized under the plan are taxable to him as a distribution under IRC §301 (governing the treatment of distributions of property to owners of a corporation). Of course, a distribution of property from a corporation to an owner may be characterized as a dividend, as a tax-free return of the owner's basis, as capital gain, or even as a combination of two or more alternatives. The Couple contend that the economic benefits received by a shareholder pursuant to a split-dollar life insurance arrangement constitute a distribution under IRC §301, regardless of whether a taxpayer receives the benefits in his capacity as an employee or as a shareholder. In support of this position, the Couple relied on *Machacek v. Commissioner,* 906 F.3d 429, 122 AFTR 2d 2018-6268 (6th Cir. 2018), which we summarized in the September 2018 edition of *John Hancock Central Intelligence.*

Holding

After discussing the differences between purely compensatory split-dollar arrangements and shareholder split-dollar arrangements, the Court did not find the Taxpayer's argument persuasive. Because the compensatory split-dollar life insurance arrangement afforded benefits to the Taxpayer in his capacity as an employee of the S corporation, such benefits may not be characterized as a distribution "by a corporation to a shareholder with respect to its stock." The Court disagreed with the *Machacek* Court's' interpretation of IRC §301 and, because the decisions of that court are appealable to an appeals court of a different circuit, it is not bound by the former's decision. The Court finishes by taking a slightly more complicated path through the S corporation rule (specifically IRC §1372) to arrive at the same destination that the IRS sought, holding that the value of the economic benefits enjoyed by the Couple under the plan must be included for federal income tax purposes in their gross income as ordinary income.

Takeaway

The Sixth Circuit court's interpretation of the regulations under IRC §301 in *Machacek* has been troubling to many practitioners since it was handed down in 2018 and this Tax Court's opinion now provides what many will find a more reasonable interpretation that is consistent with the clear language of the underlying statute. We will continue to follow this case to see, if appealed, whether the Court's reasoning ultimately prevails.

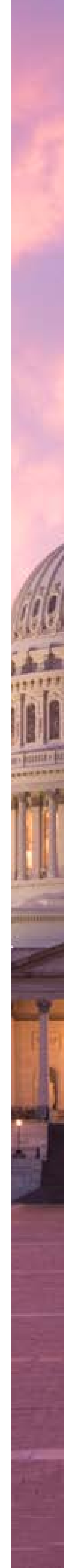
District Court upholds IRS finding that benefit plan is a listed transaction requiring notice of participation, *Mann Construction, Inc. v. IRS,* 126 AFTR 2d 2020-6790 (DC MI), November 11, 2020.

Facts

Plaintiffs are Michigan residents and co-owners and key employees of S Corp, a construction company organized as a Michigan subchapter S corporation. In 2013, S Corp established a Benefit Plan that included an irrevocable restricted property trust (RPT). The stated purpose of this RPT in the Benefit Plan is "to provide the employee an appreciating property interest, namely a beneficial interest in the RPT, that is subject to a substantial risk of forfeiture, in consideration for employee's continued provision of valuable services to S Corp." The RPT was intended to and did own life insurance policies insuring the lives of the Plaintiffs and certain other employees. S Corp agreed to contribute premiums to the RPT on behalf of a participant in the Benefit Plan so long as (1) that participant continued to be an employee of S Corp and (2) so long as S Corp had "sufficient available cash" to afford such payment. If RPT did not receive a premium payment from S Corp on behalf of a participant, the policy insuring that participant would lapse, and any value remaining in the RPT from that policy would be contributed to a stated charity. Although purportedly subject to a substantial risk of forfeiture, participants would include the economic benefit value of the Benefit Plan in income each year for federal income tax purposes by making an election to do so under IRC §83(b). S Corp relied on these elections to take a deduction for the aggregate amounts included in the income of participants who made such elections. The participants reported the full premium amounts in the elections and S Corp took a deduction for the aggregate amounts of the elections. Neither S Corp nor any participant has any ownership interest or current access rights to the policies, which remain the sole property of the RPT; the beneficial owners of the policy values are either the participants or the specified charity. After five years, if the policy is still in force, it is transferred outright to the participant. According to the Plaintiffs' own description of the Benefit Plan, at the time of this transfer, the participant "shall include in gross income the value of the life insurance policy received, less any amounts previously included in gross income pursuant to any elections made by such employee under IRC Section 83(b)." S Corp reported the contributions to the Benefit Plan in 2013 and claimed a deduction for the contribution. In 2019 the IRS issued a proposed adjustment disallowing the deductions for contributions to the Benefit Plan, which increased the income and tax liability of Plaintiffs and separately imposed penalties on Plaintiffs and S Corp for failure to report participation in a listed transaction. Plaintiffs and S Corp filed this action in appeal with the U.S. District Court for the Eastern District of Michigan.

Holding

On November 5, 2007, the IRS published a revenue notice entitled "Abusive Trust Arrangements Utilizing Cash Value Life Insurance Policies Purportedly to Provide Welfare Benefits," (the "Notice"). The Notice explains that the IRS is aware of certain trust arrangements claiming to be welfare benefit funds and involving cash value life insurance policies that are being promoted to and used by taxpayers to improperly claim federal income and employment tax benefits. The Notice informs taxpayers that the tax benefits claimed for these arrangements are not allowable for federal tax purposes. The Notice also alerts taxpayers that these transactions are considered "tax avoidance transactions" and identifies certain transactions and substantially similar transactions, including so-called restricted property trusts, as "listed transactions" under the IRC. The Notice further notifies taxpayers of their duty to report their participation in a "listed transaction" or "substantially similar" transaction by filing a Form 8886. Plaintiffs argued from several directions that either (a) their Benefit Trust was not substantially similar to a listed transaction in the Notice or (b) that the Notice did not really mean what it says; but the Court was not even slightly swayed by these arguments. Instead, the Court found that the Benefit Plan was a listed transaction and therefore granted summary judgment to the IRS, holding that Plaintiffs underreported their income and tax and failed to report participation in a listed transaction.



Takeaway

If you play with fire, you risk being burned, perhaps badly. The Notice identifying restricted property trusts as a listed transaction was out for almost six years before Plaintiffs entered into their "welfare benefit plan," and yet they forged ahead. Don't let this happen to you.

Tax Court upholds reduction in value of charitable tax deduction based on discounts for lack of control/marketability, *In re Trust Created by McGregor,* 308 Neb. 405, March 4, 2021.

Facts

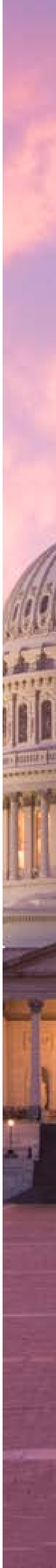
Decedent died in 2014 owning 100% of an LLC. The value of the LLC was included in the Decedent's estate for federal estate-tax purposes and valued at the time of the Decedent's death at $25,14,695. The Decedent left 75% of the LLC to Charity1 and the other 25% of LLC to Charity2, both charities being charitable organizations under IRC §501(c)(3). The Decedent's estate claimed a charitable deduction on the Decedent's federal estate-tax return in the amounts of $19.2 million for the bequest to Charity1 and $6.4 million for the bequest to Charity2, with those figures representing the corresponding proportions that each bequest value bore to the total value of LLC. The IRS audited the Decedent's estate in 2018 and issued a notice that showed an estate-tax deficiency. This deficiency resulted from two primary sources: (1) the IRS increased the value of the LLC in the Decedent's estate based on the increased market value of property owned by the LLC and (2) the IRS reduced the total charitable deductions for the contributions to the charities from the $25.6 million claimed to slightly more than $21.4 million due to discounts in the value received by each charity for lack of control and marketability. The value of the deduction for the 25% LLC interest was reduced more than that of the 75% LLC interest because the minority interest afforded even less control. These adjustments resulted in unreported value and unpaid estate tax of $368,452 plus penalties. The Decedent's estate filed timely petitions challenging the deficiency on the basis of both the increases in the LLC value and the reductions of the charitable deduction based on discounts in the hands of the charities. The Tax Court heard the case in 2019.

Holding

The Court heard from expert witnesses from both parties on the issue of the fair market value of the LLC in the hands of the Decedent's estate and of the value of the LLC interests in the hands of each charity. The Decedent's estate claimed that the full fair market value of the LLC in the Decedent's hands was the proper value of the combined total charitable deduction because that was the value that she donated to charitable causes. The IRS countered that the value of the deduction must reflect only the benefit received by each charity. The Decedent's estate also argued that to reduce the value would subvert the public policy of motivating charitable donations. The Court disagreed. Citing precedent, the Court stated "[t]here is nothing in the statutes or in the case law that suggests that valuation of the gross estate should take into account that the assets will come to rest in several hands rather than one." But when property is split as part of a charitable contribution, a testator may only be allowed a deduction for estate-tax purposes for what is actually received by the charity. In short, the Court stated, "when valuing charitable contributions, we do not value what an estate contributed; we value what the charitable organizations received." The Court held for the IRS.

Takeaway

This is an important one to keep in mind when a taxable estate will be relying on charitable deductions to reduce the total estate tax. The determining factor of the value of the charitable deduction is what the charity receives without regard to the value in the hands of the decedent's estate. Where an asset passes to more than one party, the value received by the charitable beneficiary may likely be less than thought.



Bankruptcy Court finds inherited 401(k) not included in bankruptcy estate despite being inherited before bankruptcy filing, *In re: Chris D. Dockins, Holly R. Corbell-Dockins, Debtors,* No. Chapter 7, 2021 BL 208970, (Bankr. W.D.N.C.) June 4, 2021.

Facts

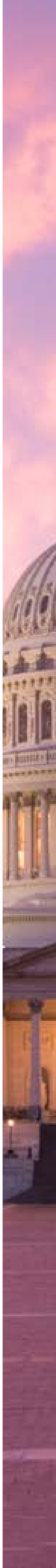
Debtors H and W , a married couple living in North Carolina, filed for Chapter 7 Bankruptcy on April 2, 2020. Several years before, Debtor W had been involved in a relationship with the Decedent in Idaho and, for this reason, the Decedent had at the time designated Debtor W as the beneficiary of his 401(k). However, the relationship did not work out. Debtor W subsequently married Debtor H and the couple moved to Idaho. The Decedent never changed the beneficiary designation on his 401(k) and died less than two months before the Debtors filed for bankruptcy. The plan fiduciary, the Decedent's employer, notified Debtor W that the Decedent had passed away and that she was the designated beneficiary of his 401(k) and requested that she provide a copy of the death certificate so that the 401(k) rolled over to her name. Debtor W, with the help of a friend, produced a scan of the certificate. Although the Debtors informed the bankruptcy trustee of the inherited 401(k) account twice, on advice of counsel they did not report it among their assets for purposes of the bankruptcy proceedings. The bankruptcy trustee not surprisingly disagrees. The Court heard arguments from the parties at a hearing on the issue.

Holding

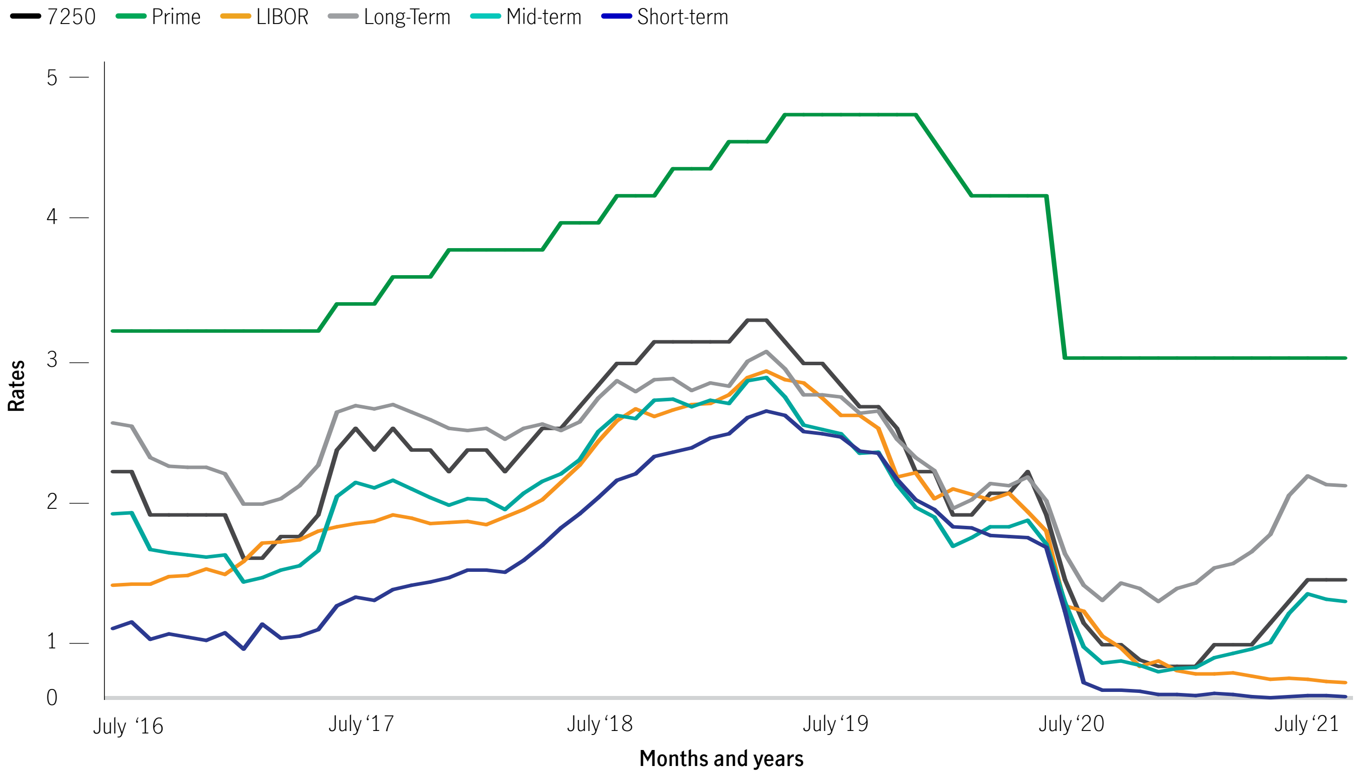
The bankruptcy trustee points out that the inherited 401(k) does not fall into any of the categories under 11 USC §541(b) that defines property not to be included in a bankruptcy. (This section contains 10 paragraphs with several subparagraphs each.) The trustee goes on to argue that the inherited 401(k) is also not specifically exempted under any applicable statute and even cited US Supreme Court case law that an inherited IRA could not be exempt from the bankruptcy estate. That case law turned on whether the inherited account qualified as "retirement funds" under a specific statute, however. Because Debtor W could withdraw funds from her inherited 401(k) at any time without penalty and even must withdraw all funds within 10 years, the trustee argued, the funds could not be exempted. Debtors for their part hang their hat on a specific provision of 11 USC §541(c)(2), viz., "[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable non-bankruptcy law is enforceable in a case under this title." In 1992, the US Supreme Court held that the phrase "applicable non-bankruptcy law" includes ERISA-qualified plans. Debtors argued that the ERISA protections were in effect as of the date of their bankruptcy filing and therefore prevent the inherited 401(k) from being included in the bankruptcy estate. The Court, after extensive comparative analysis, ultimately felt it had to agree with the Debtors. Despite many similarities between 401(k)s and IRAs, they are governed by different statutes with different provisions. For this reason, the case law cited by the trustee did not govern Debtor W's inherited 401(k) but the case law cited by Debtors did. In the end, timing dealt the final blow to the trustee's hopes of including the inherited 401(k) in the bankruptcy estate. Although the rollover account had been set up for Debtor W one day before the Debtors filed for bankruptcy, the 401(k) funds were still in the hands of the plan fiduciary at the time of the filing. For that reason, the Debtor had no access to the funds. The Court holds that the inherited 401(k) balance is not the property of the bankruptcy estate.

Takeaway

This was a case of first impression before the Bankruptcy Court. As it is so often, the outcome of this case rests on very particular statutory provisions, examined closely for proper applicability to very specific facts. The Debtors' counsel in this case is to be admired for not accepting what many might have considered the obvious (opposite) result and for doing the complete analysis to show that what is obvious is sometimes wrong.



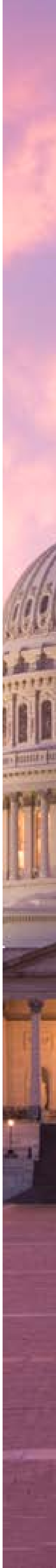
The following are historical graphs of various rates that are commonly used by the Advanced Markets Group.



Take a look at how rates compare this month to last month:

	Short-term AFR	Mid-term AFR	Long-term AFR	7520	LIBOR	Prime
April '21	0.12%	1.00%	2.07%	1.2%	0.25%	3.25%
March '21	0.13%	1.02%	2.08%	1.2%	0.26%	3.25%

To read more and stay up-to-date on the latest industry news, please log on to the *Advanced Market's blog* on *JHSalesHub.com*. We can also be reached at *888-266-7498, option 3* or *option 4.*



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