John Hancock

Central Intelligence

January 2024

This issue includes:

- Mexican green card holder not subject to FBAR penalties
- Taxpayer's Social Security payments were not disability benefits and thus taxable
- Bills in US Senate and House propose additional taxation of wealthy individuals
- Court grants partial summary judgment in enormous FBAR penalty case
- Supreme Court grants writ of certiorari in *Connelly* case

INSURANCE PRODUCTS	MAY LOSE VALUE	NOT A DEPOSIT
NOT BANK GUARANTEED	NOT FDIC INSURED	
NOT INSURED BY ANY GOVERNMENT AGENCY		

LIFE-5115 1/24

Mexican green card holder not subject to FBAR penalties

***Aroeste v. United States,* No. 3:22-CV-00682 (USDC, So. Dist. Calif.), November 20, 2023.**

Facts

We have covered a number of cases in these pages that set forth the requirements of the FBAR ("Foreign Bank and Financial Accounts Report") under 31 USC §5314 and the penalties for not satisfying these requirements. This case deals specifically with which taxpayers are required to comply with the requirements. Taxpayer was born in Mexico and has lived there all his life. He went to school and graduated from college in Mexico, and he and his spouse have remained there for over 60 years. Taxpayer worked in Mexico until he retired prior to 2012. Moreover, he and his spouse have lived in Mexico City for over 50 years. The couple also own a condominium in Florida which they purchased in 1980 and is used for vacation and relaxation. No one lives in the Florida condominium full-time. Taxpayer has also always filed his Mexican tax returns as a resident of Mexico. In 1984, Taxpayer applied for lawful permanent residency status in the United States (i.e., a "green card"), which status he held for the years at issue. His spouse became a naturalized US citizen on November 8, 2011, and was a citizen during the years at issue. The IRS and Taxpayer agreed that because Taxpayer's spouse was a citizen and thus a US person, she was required to file a FBAR for the years at issue. In 2012 and 2013, Taxpayer had a financial interest or signature authority over five accounts in Mexico and the aggregate balance of those accounts exceeded $10,000. With respect to their US tax returns, for the 2012 and 2013 tax years, Taxpayer and spouse filed an individual income tax return as married filing jointly. In 2016, the IRS had begun audits of Taxpayer's returns for the 2012–13 tax years. In 2020, the IRS assessed FBAR penalties against Taxpayer in the amount of $100,000 ($50,000 for each year). Taxpayer paid part of the penalties, but then sued the IRS for a refund of the amounts paid and discharge of its FBAR liability altogether and seeks summary judgment.

Holding

A court may grant summary judgment when it is demonstrated that there exists no genuine dispute as to any material fact, and that the moving party is entitled to judgment as a matter of law. The Taxpayer has the burden in this case of showing that no reasonable trier of fact could find other than for the Taxpayer and also that based on those facts, under the law the court must find for the Taxpayer. The question in this case comes down to whether Taxpayer is a "United States person" and therefore subject to FBAR requirements. For FBAR purposes, US person is defined broadly to include residents and regulations including "resident aliens" under IRC §7701. That section includes green card holders but provides that a taxpayer is no longer considered a lawful permanent resident of the US if the individual commences to be treated under provisions of an applicable tax treaty as a resident of a foreign country. The Court found that the Taxpayer did not waive his treatment as a resident of Mexico under the applicable US-Mexico tax treaty, nor did he do so by filing jointly with his citizen spouse, which would require an election under IRC §6013(g). Ultimately, the Court held that despite the Taxpayer's apparent dual residency in both Mexico and the US, the treaty provisions controlled, and thus the Taxpayer was not a US person for FBAR purposes.

Takeaway

This is new territory (pun unintended but nonetheless appreciated) and should instruct the understanding of clients similarly situated to Taxpayer, and those clients' advisors. Still, the facts, circumstances, and behavior of each client must be carefully examined within the context of the Court's analysis.

Taxpayer's Social Security payments were not disability benefits and thus taxable

Sean Patrick Canavan v. Commissioner, **No. 3621-22S (USTC), November 30, 2023.**

Facts

Taxpayer received seven payments from June through December during 2019 from the Social Security Administration ("SSA"), all in the amount of $2,102 for an aggregate of $14,714. Taxpayer reported that he has a disability and that he has received disability payments from the SSA that were not reportable in his taxable income. However, the SSA determined that Taxpayer did not qualify to receive disability payments (designated as Supplemental Security Income ("SSI") payments) at any time during 2019. The SSA filed a Form 1099-SSA Social Security Benefit Statement with the Internal Revenue Service reporting that Taxpayer received $14,714 during 2019. Taxpayer timely filed his IRS Form 1040 federal individual income tax return for tax year 2019 on which he reported income from an annuity plan but did not report any other income or any benefits from the SSA. As a result, the IRS issued a notice of deficiency claiming taxable income unreported on Taxpayer's 2019 tax return. Taxpayer appealed to the United States Tax Court, claiming that the income in question is neither reportable nor taxable.

Holding

The Court begins by enunciating the long-standing general principle that determinations by the IRS in a notice of deficiency are presumed correct, and thus the taxpayer bears the burden of proving that the IRS determinations are erroneous. However, in cases involving unreported income, the IRS must establish an evidentiary foundation connecting the taxpayer to the income-producing activity or demonstrate that the taxpayer actually received the income claimed unreported. In attempting to do so, the IRS may not rely exclusively on a third-party report of income if the taxpayer raises a reasonable dispute concerning the accuracy of the report. Once the IRS meets this threshold requirement, the burden shifts to the taxpayer to prove, by a preponderance of the evidence, that the IRS determinations are arbitrary or erroneous. The Court finds that documentation provided by the SSA demonstrates that Taxpayer actually received the payments in dispute and Taxpayer has not raised a challenge to that showing. The Court repeated the fundamental tax principle under IRC §61, that gross income is defined as "all income from whatever source derived" unless specifically exempted by a provision of the Code. Under IRC §86, the extent to which Social Security benefits are includible in taxable income for federal income tax purposes is determined by a formula set forth in the statute that considers total income, filing status, proportion of benefits, among other factors. At trial, the IRS agreed that SSI payments would not be includible in taxable income but provided evidence that the benefits received by Taxpayer from SSA during 2019 were not designated as SSI disability payments. For these reasons, the Court sustained the IRS determination of deficiency.

Takeaway

The Court's holding primarily underscores the principle of IRC §61: all income from whatever source, any accretion to a taxpayer's wealth, is includible in the taxpayer's gross income for federal income tax purposes unless the taxpayer can point to a provision of the IRC that specifically exempts it. Even if the income appears to resemble past income that was excludible, care must be taken to examine the authority for the exclusion to establish that it in fact applies to the current income.

Bills in US Senate and House propose additional taxation of wealthy individuals

e.g., Billionaires Income Tax Act (S 3367), Billionaire Minimum Income Tax (HR 6498), November 30, 2023.

Facts

Bills in both the US House and Senate were introduced recently that would impose new additional taxes based on a taxpayer's annual income and/or asset value. For example, the so-encaptioned Billionaires Income Tax Act (S 3367) was introduced on November 30, 2023, by Senator Ron Wyden (D-OR) and co-sponsored by 15 other senators. Senator Wyden is Chairman of the Senate Finance Committee. This bill would use a mark-to-market system to impose additional taxation on taxpayers having greater than $100 million in gross income annually or more than $1 billion in assets over three consecutive years. In committee meetings, it seems clear that some of these bills — and certainly S 3367 — are targeting what is understood to be a technique of the wealthy to pay less tax in both nominal and real terms than the average American taxpayer, colloquially known as "buy/borrow/die." In simple terms, this method involves investing heavily in appreciating assets such as stocks, real estate, etc. ("buy"), then borrowing against these assets to fund at least a part of living expenses ("borrow"), and then liquidating the assets to pay the outstanding loans at death ("die"). Practitioners of the technique thus escape tax on the appreciation in the assets due to the step up in basis on the assets liquidated at death, and likewise pay no income tax on the loan proceeds secured by the assets during life. Under S 3367, wealthy taxpayers' asset values will be marked to market annually, and gains will be taxed, and deductions will be allowed on losses, whether the asset is sold or retained. Under certain circumstances, a taxpayer will be allowed to carry forward losses up to three years. Some asset sales would also be subject to a "deferral recapture amount," capturing the interest deferred during the ownership of the asset. At the same time, Representatives Steve Cohen (D-TN) and Don Beyer (D-VA) introduced a similar bill in the US House of Representatives, the so-encaptioned Billionaire Minimum Income Tax (HR 6498).

Takeaway

These bills face challenges, especially in an election year when political capital is jealously guarded and legislators' powder is kept very dry, all the more so in legislative chambers that are so evenly balanced. But the bills enjoy broad support both with Democrat legislators and with voters. Even if these bills fail, we can expect to see more like them in the coming years.

Court grants partial summary judgment in enormous FBAR penalty case

***United States of America v. Francis Burga, et al.*, 132 AFTR 2d 2023-6551 (DC CA), November 27, 2023.**

Facts

Yet another FBAR case, this time testing just how large an FBAR penalty can be assessed and enforced and to a lesser extent, whether reliance on an advisor can be asserted as a defense. Married Taxpayers (F and M) are residents and citizens of the US residing in California at all relevant times, and were apparently enormously talented and enterprising, together and each in their individual professions. Each was quite successful in the computing and data storage industries before they met and married, and this success continued. Taxpayers amassed a sizable fortune via their joint business ventures. M created a new company to coordinate their international businesses, of which company F worked as a vice president of manufacturing and sales and ultimately, after M's death, as president controlling all operations. During the years in question here, 2004–2009, M created Structure, comprising 3 foreign foundations in Liechtenstein which owned 25 foreign entities across 10 countries, and operated 271 foreign bank accounts. The groundwork for Structure was begun in 1995 and F was not heavily involved in its creation and development over the first 10 years. Over the years, however, Taxpayers used Structure funds to purchase property that the Taxpayers freely used as their own, and ultimately used Structure funds to pay personal expenses including their two children's private boarding school tuition. Proceeds from Structure were used to purchase a multimillion-dollar home, an Italian vineyard, a Swiss investment company, a luxury tile business, and other items of value. The IRS detected evidence that Taxpayers were treating accounts as their own, despite being owned in the name of foundations, and began to investigate Structure in 2007. M's health declined and F took over increasing responsibilities for the governance of their businesses and Structure. M died in 2010. Taxpayers did not file FBARs for 2004–2008. The IRS brought this action in US District Court seeking unpaid taxes plus interest and penalties attributable to unreported income and $120 million in FBAR penalties for failure to file. The IRS filed a motion for summary judgment on all issues.

Holding

F claims that she was not aware of Structure or its use to avoid federal income tax and FBAR reporting until she discovered it in IRS letters addressed to her husband that she found after his death. F testified that she signed documents without reviewing them because M would become publicly abusive and derisive if she asked questions, despite F being an officer of their company and involved in its operation. F filed a FBAR in 2010 on behalf of M's estate after M's death, but only reported 85 accounts and omitted at least 62 foreign accounts. Furthermore, F did not file an FBAR on her personal joint tax return for 2009 (final return for M). Taxpayers concede that they are subject to FBAR, and that Structure held accounts of the size and kind that were required to be reported. Taxpayers, however, question whether they had sufficient authority over or interest in the accounts to be responsible for reporting the accounts under FBAR. The Court spent little time in establishing that Structure treated the accounts as belonging to Taxpayers and Taxpayers had the expectation of enjoying the benefit of the assets held therein. Having established Taxpayers' interest in the accounts, the Court turned its attention to whether the Taxpayers' failure to file was willful. It found abundant evidence to show that M was fully aware of FBAR, that the accounts were reportable thereunder, and that Structure was designed to facilitate avoidance of his FBAR reporting obligations. F, on the other hand, claimed that she was deliberately kept in the dark and

punished for asking too many questions. F claims that she should be exempted from responsibility to report because she was actively prevented from knowing the facts. The Court, however, found that F had access to company and Structure accountants and attorneys that she could have turned to for information, and had a duty as an officer to seek out such information. At any rate, as M's health declined and F took over complete operation of their business endeavors, nothing could have prevented F from learning the truth if she was interested in learning it. The Court granted summary judgment to the IRS with respect to most accounts and for willful failure to file against F for 2009, but not for all accounts. The Court will hear evidence on F's willful failure to file for years 2004–2008 and render a decision thereafter.

Takeaway

Perhaps in the larger sense, Taxpayers were victims of their own success in that they wound up with too many lies to manage successfully. The true lesson here, though, seems to have nothing to do with Taxpayers' crimes, which were bald-faced and are indefensible. But one gets the sense that perhaps F was at one point truly an innocent spouse. If her testimony was accurate, her greatest failure might have been, for whatever reason, to try to continue a fraud and crime begun by someone who could have treated her with more respect.

Supreme Court grants writ of certiorari in *Connelly* case

***Connelly v. Internal Revenue Service* 23-146, December 13, 2023.**

Facts

The United States Supreme Court granted a writ of certiorari in *Connelly v. United States* on December 13, 2023. The lower courts included the proceeds of a life insurance policy when valuing the deceased owner's shares in a closely held corporation for purposes of the federal estate tax, disregarding the corporation's obligation to use those proceeds to purchase the deceased owner's shares in the corporation. We covered the decision by the Eighth Circuit Court of Appeals in the *Connelly* case in our **June 2023 edition** and discussed the Connelly estate's petition to the Supreme Court in our **September 2023 edition**.

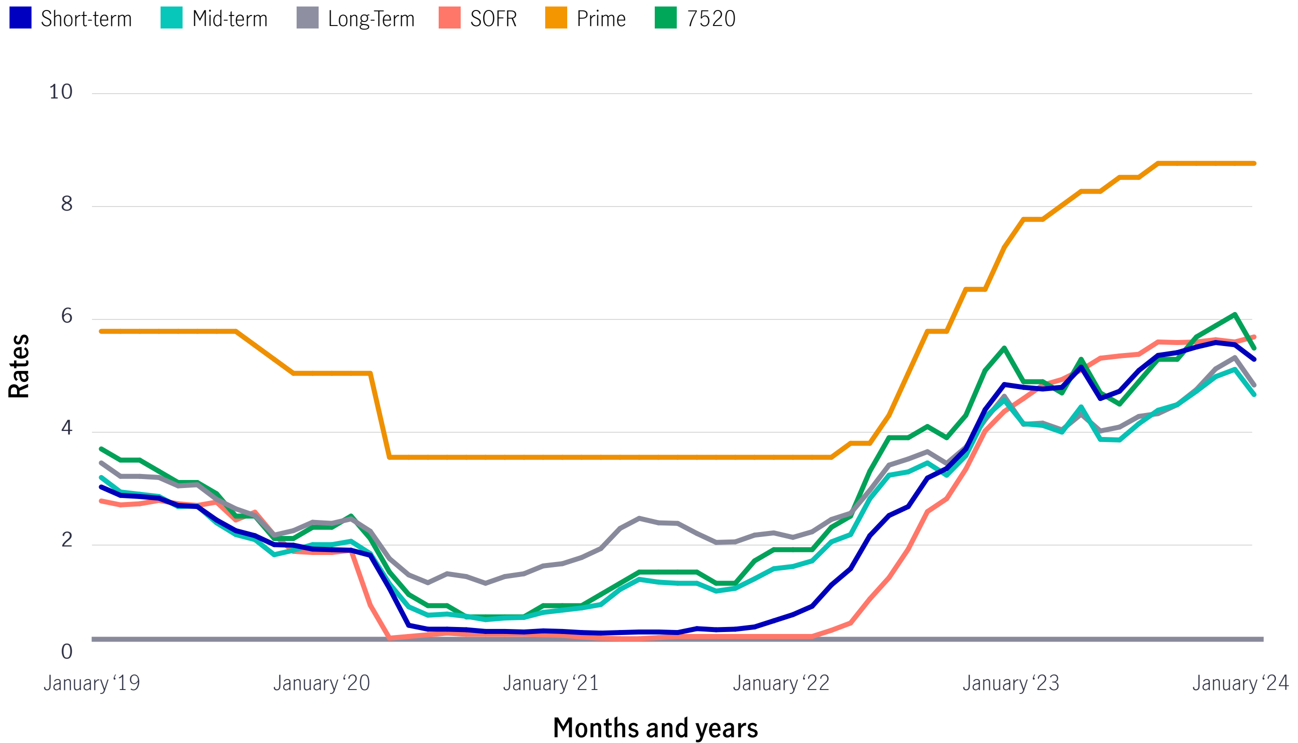
The Supreme Court accepts very few cases, particularly in the area of estate taxes. The Connelly estate put forth several reasons for the Court to accept this case, including the conflict among the circuit courts of appeals that this decision creates and the need for uniform valuation principles for closely held businesses, which comprise the majority of American companies. The government responded that there was no real conflict among the circuits and there are other ways to structure buy-sell agreements to avoid this issue. Both parties also reasserted the arguments they made in the lower courts.

Each side approached the question presented differently. The Court adopted the Connelly estate's framing: "Whether the proceeds of a life-insurance policy taken out by a closely held corporation on a shareholder in order to facilitate the redemption of the shareholder's stock should be considered a corporate asset when calculating the value of the shareholder's shares for purposes of the federal estate tax."

While the Court adopted the Connelly estate's framing of the issue, it is important to remember that the case itself was filled with "bad facts," including the parties' own failure to follow the buy-sell agreement that the estate now wants to be considered enforceable. Regardless of the ultimate result for the Connelly estate, the scope of the Court's ruling could have considerable repercussions for business owners and their advisors.

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

Short, Mid, Long Term Applicable Federal Rate (AFR), 7520, SOFR, Prime Rates from January 2019 – January 2024



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

	Short-term AFR	Mid-term AFR	Long-term AFR	7520	SOFR	Prime
January 2024	5.00%	4.37%	4.54%	5.20%	5.40%	8.50%
December 2023	5.26%	4.82%	5.03%	5.80%	5.31%	8.50%

*For more information on these rates, please visit https://www.irs.gov/applicable-federal-rates

This material does not constitute tax, legal, investment or accounting advice and is not intended for use by a taxpayer for the purposes of avoiding any IRS penalty.

Comments on taxation are based on tax law current as of the time we produced the material. All information and materials provided by John Hancock are to support the marketing and sale of our products and services, and are not intended to be impartial advice or recommendations. John Hancock and its representatives will receive compensation from such sales or services. Anyone interested in these transactions or topics may want to seek advice based on his or her particular circumstances from independent professionals. Insurance products are issued by: John Hancock Life Insurance Company (U.S.A.), Boston, MA 02116 (not licensed in New York) and John Hancock Life Insurance Company of New York, Valhalla, NY 10595.

© 2024 John Hancock. All rights reserved.

MLINY010324583-1