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LIFE-5115 2/24

Tax Court upholds denial of innocent spouse relief for blogging widow

Sydney Ann Chaney Thomas v. Commissioner, 162 T.C. No. 2, January 30, 2024.

Facts

Taxpayer and her husband were married in 1994. Throughout most of their marriage, Taxpayer and her husband, and their two daughters, enjoyed success and a relatively lavish lifestyle. They owned a large home in an affluent suburb of San Francisco and built a second home in the Lake Tahoe ski resort area. Taxpayer's husband bought a five-carat diamond ring for Taxpayer that she owned at the time of these proceedings. The couple began having financial and marital problems around 2007 when Taxpayer's husband suffered a reduction of income as a result of the global financial crisis and ultimately left his job. They began to default on mortgage and credit card obligations and took early distributions from their qualified plans to make ends meet. For tax years 2012–2014, the couple paid less than the full amount of federal income tax they reported on their returns. Taxpayer was aware of the underpayments at the time and even wrote the IRS individually to have the outstanding liability reduced due to lack of funds. However, Taxpayer continued her accustomed lifestyle, taking trips to Hawaii and Paris with her daughters and purchasing expensive automobiles. In 2016, Taxpayer's husband passed away naming Taxpayer as the sole beneficiary of his estate, comprising the two homes subject to high mortgage balances and two luxury cars. Taxpayer still continued her usual lifestyle and, notably, maintained a blog detailing her travels and lifestyle, designer bags, and luxury real estate. In late 2018, Taxpayer filed for bankruptcy, but the case was dismissed. In 2019, Taxpayer filed a Request for Innocent Spouse Relief with the IRS under IRC §6015 seeking, in relevant part, relief from her unpaid tax liabilities for the 2012, 2013, and 2014 tax years. The IRS denied the request. Taxpayer appealed the denial with the Tax Court.

Holding

The Court upheld the IRS denial of innocent spouse relief under IRC §6015. The Court begins by enunciating the general rule that married taxpayers may elect to file a joint federal income tax return. If a joint return is made, the tax is computed on the spouses' aggregate income, and each spouse is fully responsible for the accuracy of the return and is jointly and severally liable for the entire amount of tax shown on the return or found to be owing. But in certain circumstances, a spouse who has made a joint return may seek relief from joint and several liability under procedures set forth in §6015. Section 6015(f) grants the IRS discretion to relieve a requesting spouse of joint liability if, considering all of the circumstances, it would be inequitable to hold the requesting spouse liable for some or all of the unpaid tax. The factors to be considered are set forth in IRS Revenue Procedure 2013-34 and are summarized as follows: the requesting spouse must establish that he or she (1) is no longer married to the non-requesting spouse, (2) would suffer economic hardship if relief were not granted, and (3) did not know or have reason to know that the non-requesting spouse would not or could not pay the underpayment of tax reported on the joint income tax return. Economic hardship exists if satisfaction of the tax liability in whole or in part will cause the requesting spouse to be unable to pay reasonable basic living expenses. Taxpayer provided virtually no evidence of her income sources and held title to properties having significant value in excess of her liabilities. The Court held that because Taxpayer has not established that she would suffer economic hardship if she were not granted relief under §6015(f), the Court concluded that she is not eligible for relief.

Takeaway

In addition to the data relative to Taxpayer's assets and liquidity, the Court noted that her blog indicated that her lifestyle suggested the opposite of economic hardship.

Although the Taxpayer argued that her blog did not reflect reality, the Court was left with nothing to dispute it. Once again, an individual's publication via the internet becomes the hubris that contributes to their fall.

IRS Chief Counsel finds that trust modification constitutes a taxable gift

IRS CCA 202352018, December 29, 2023.

Facts

Taxpayer establishes and funds an irrevocable inter vivos Trust, for the benefit of Taxpayer's child and the child's descendants. Trustee is the current trustee of Trust and satisfies the governing instrument requirement for a trustee of Trust (e.g., must be a person not related or subordinate to Taxpayer within the meaning of IRC §672(c), etc.). Under the provisions of Trust, Trustee may distribute income and principal to or for the benefit of the child in Trustee's absolute discretion. Upon the child's death, Trust's remainder is to be distributed to the child's descendants. Also, under the provisions of Trust, Trust is a "grantor trust" with respect to Taxpayer and therefore all items of income, deductions, and credits attributable to Trust are included in Taxpayer's taxable income. Neither the law of the jurisdiction nor the provisions of Trust requires or provides authority to Trustee to distribute to Taxpayer any Trust assets to satisfy Taxpayer's income tax liability attributable to the inclusion of Trust's income in Taxpayer's taxable income due to the grantor trust status. After the Trust was created, when the child has no living grandchildren or more remote descendants, Trustee petitions the appropriate local state court to modify the terms of Trust. As required by local law, the child and the child's issue consent to the modification. Later that year, the court grants the petition and issues an order modifying Trust to provide Trustee the discretionary power to reimburse Taxpayer for any income taxes Taxpayer pays as a result of the inclusion of Trust's income in Taxpayer's taxable income. Taxpayer petitions the IRS for a ruling of the transfer tax consequences to the beneficiaries of Trust of the modification, specifically with the required beneficiaries' consent, to add the power to distribute to the grantor-Taxpayer, who was not a beneficiary of Trust before the modification.

Holding

The IRS Chief Counsel determined that the modification would constitute a taxable gift from the consenting current beneficiaries to the Taxpayer. Under the governing instrument of Trust, the child and the child's issue each have an interest in the Trust assets. As a result of the modification of the Trust, Taxpayer acquires a beneficial interest in the Trust property in that Taxpayer becomes eligible to receive discretionary distributions of income or principal from the Trust in an amount sufficient to reimburse Taxpayer for any taxes Taxpayer pays as a result of Trust's income being included in Taxpayer's gross taxable income. Thus, in reality, the modification effects a transfer by the child and the child's issue for the benefit of Taxpayer. (The IRS Chief Counsel specifically distinguished this determination from the situations in IRS Rev. Rul. 2004-64 where the original trust provisions provided for a mandatory or discretionary right to reimbursement for the grantor's payment of the income tax.) As a result of the modification, the child and the child's issue each have made a gift of a portion of their respective interests in the Trust property under Treas. Reg. §§25.2511-1(e) and 25.2511-2(b). The Chief

Counsel went on to provide that the result would be the same if the modification were pursuant to a state statute that provides beneficiaries with a right to notice and a right to object to the modification and a beneficiary failed to exercise their right to object. Notably, the Chief Counsel did not determine the value of the gift made. The Advisory did, in separate sections, note that the difficulty of measurement does not obviate the application of the gift tax and that if the interest cannot be valued based on generally accepted valuation principles, the entire trust could be subject to gift tax.

Takeaway

There has been a great deal of discussion in the industry media about the direct and indirect consequences of this chief counsel advisory. Specifically, questions have been raised whether the finding in the advisory is correct under existing law. Many practitioners feel strongly in each direction, viz., some that the ruling is compelled by existing pronouncements and some that the ruling is clearly in error because the fiduciary duty of a trustee will limit the exercise of its discretion under the modified power. Stay tuned, this is not likely to be the last we hear on this topic.

S Corp losses allowed because transfers between entities were equity rather than debt

Estate of Thomas S. Fry v. Commissioner, T.C. Memo 2024-8, January 23, 2024.

Facts

This action is initiated by Decedent's estate based on actions taken by Decedent during his life. Decedent was the sole shareholder of two S Corporations ("S1" and "S2"). S1 primarily conducted waste collection for a fee and S2 processed the collected waste into commodity by-products for sale. Though separate entities, the companies operated out of the same facilities. S1 did not share its collection fees with S2 and S2 did not pay S1 to take possession of the collected waste from S1. In addition to being the sole owner of both entities, Decedent was the president and treasurer of each, and both companies used the same administrative staff for maintenance, payroll, accounting, and management. The accountant for the companies prepared the tax returns for both companies and prepared Decedent's personal returns. In 2010, S2 became less profitable than was sufficient to meet its financial obligations, losing millions of dollars a year. The following year, Decedent began to cause S1 to transfer some of its cash holdings to S2 to allow S2 to continue operating. The transfers would be directly from S1 to S2 and not to Decedent or any other intermediary. S1 also made direct payments on behalf of (for the benefit of) S2 for fuel, wages, payroll taxes, workers' compensation insurance, and employee benefits. By the end of 2013, the transfers and payments reached a total of $36,255,141. S2 began returning payments and transfers by the end of 2013 and had fully returned all payments and transfers by the end of 2020. No notes were executed for these transactions and no security given for their repayment, though S1 accounted for the payments as "loans payable" and S2 as "due to S1." S2 reported the amounts on its tax returns as debts. In 2013, Decedent claimed a pass-through loss of $4.7 million on his individual income tax return. The IRS issued a notice of deficiency to Decedent disallowing most of the claimed loss because Decedent lacked sufficient basis in S2 because the transfers from S1 were debt and not equity. Decedent appealed this determination to the Tax Court, answering that the transfers and payments made by S1 were constructive distributions to him, which he then contributed to S2, increasing his basis in S2.

Holding

The IRS first argues that IRC §385 binds Decedent (and S1 and S2) to the characterization that the transfers were debt and not equity because that is how they themselves first characterized it. The Court notes the provisions and intent of §385 but points out that no debt instrument was formally issued, so the section can hardly apply. In fact, the Court observes, since its enactment in 1992, §385 had yet been used to bind any taxpayer, individual or corporate, to its initial characterization. The Court states instead that, "[t]he ultimate test of the characterization of a transaction is not necessarily the original intent of the parties. The Court should inquire for each tax year as to the characterization of a transaction as equity or indebtedness. We hold that the determination of an interest as equity or debt will be based on the overall transaction in the context of the relevant factors, rather than the initial characterization of the interest at the time of the filing of the 2013 tax return." Looking to standards established in existing case law, the Court found that a preponderance of factors favored the characterization that an equity interest was created, not one of debt: repayment depended on S2's future success, S1 never obtained a security interest, S1's right to repayment was subordinate to any other creditors, interests of the two businesses were significantly intertwined, interest payments were not expected, S2 could not obtain loans from outside lenders, etc. The Court also found that the transfers and payments by S1 met the tests for constructive dividends to Decedent under existing case law. At the end of the day, there was no reasonable business justification for S1 to make the transfers and payments and, to make sense of its behavior, we are compelled to consider that it was done to serve the interests of Decedent.

Takeaway

This case gives us concern that casual readers may be tempted to play fast and loose with corporate assets to serve their own personal interests. That is not the lesson here — ignoring the formalities of one's corporate entities runs the potentially ruinous risk of piercing the corporate veil and all the protections that come with it. The lesson here is that when corporations deal with each other, the IRS and the courts will do what is necessary to make sense of the events. If the only way for the courts to explain the behavior is to infer one or more intermediary steps, and all the tax consequences that these steps imply, good or bad, then that will happen.

Several states amended their state estate tax exemptions for 2024

Facts

Clients' families and affairs continue to grow more diverse and complicated, and farther flung. The average financial professional has clients across two or more jurisdictions with families across the country and beyond. Without knowing and taking consideration of the tax environment in which your clients' beneficiaries live and operate, it is difficult to design a plan to benefit those beneficiaries. The federal basic exclusion amount increased to $13.61 million per taxpayer for 2024, but many states impose their own estate and/or inheritance tax in addition to the federal tax. The laws of these states provide their own rules for how the tax is applied and what amount, if any, is exempt. For this reason, we keep track of the changing estate tax (and other) laws in the many states and maintain that record in our **Know the Law tool**. We take this opportunity, however, to make you aware of relevant changes effective in 2024 in one of those factors, viz., state estate tax exemption levels. As of January 2024, twelve states and the District of Columbia impose some form of estate tax on assets passed at death. (* indicates a change for 2024)

***Connecticut:** Connecticut currently imposes a state estate tax on taxable estates in excess of the federal basic exclusion amount of $13.61 million at a flat rate of 12%, but the amount of estate tax payable may not exceed $15 million. Connecticut also has a gift tax.

***District of Columbia:** Washington DC imposes a district estate tax on taxable estates in excess of its $4.7156 million exemption (up from $4.5288 million in 2023) at graduated rates of 11.2–16%. The exemption is adjusted annually for inflation.

Hawaii: Hawaii imposes a state estate tax on estates in excess of $5.49 million (the federal basic exclusion amount in 2017). The rate tables apply rates from 10% to 20%, but the lower rates currently apply to amounts below the exemption amount. The current exemption results in a tax of 15.7% on amounts above the exemption but not over $10 million, and 20% on amounts in excess of $10 million.

Illinois: Illinois imposes a state estate tax on taxable estates triggered by passing the threshold of $4 million. Note that this is not an exemption or exclusion; once the threshold is exceeded, progressive tax tables apply to the entire taxable estate with rates ranging from 0.8% to 16%.

***Maine:** Maine imposes a state estate tax on taxable estates in excess of $6.8 million, an increase from $6.41 million in 2023. Its exemption is adjusted annually for inflation. Assets in excess of the exemption are taxed at graduated rates of 8–12%.

Maryland: Maryland has the distinction of being the only state that imposes both a state estate tax and an inheritance tax (now that New Jersey has repealed its estate tax). It imposes a state estate tax on taxable estates in excess of its $5 million exemption at rates ranging from 0.8% to 16%, the highest rate applying to amounts of $10.04 million and more. Broad exemptions to the inheritance tax are available to specified family members, but otherwise a flat 10% tax is incurred by the beneficiary.

***Massachusetts:** Massachusetts imposes a state estate tax on taxable estates triggered by passing the threshold of $2 million, increased in 2023 from $1 million. As in Illinois, above, this is not an exemption or exclusion; once the threshold is exceeded, progressive tax tables apply to the entire taxable estate with rates ranging from 0.8% to 16%.

Minnesota: Minnesota imposes a state estate tax on taxable estates in excess of its $3 million exemption at graduated rates of 13–16%.

***New York:** New York imposes a state estate tax on taxable estates (including gifts within three years of death) in excess of a threshold of $6.94 million, up from $6.58 million (the threshold is adjusted annually for inflation). If the taxable estate exceeds the threshold by more than 5%, then the entire taxable estate is subject to tax, otherwise just the excess above the threshold is taxed.

Oregon: Oregon imposes a state estate tax on taxable estates in excess of its $1 million exemption (the lowest in the nation) at graduated rates of 10–16%.

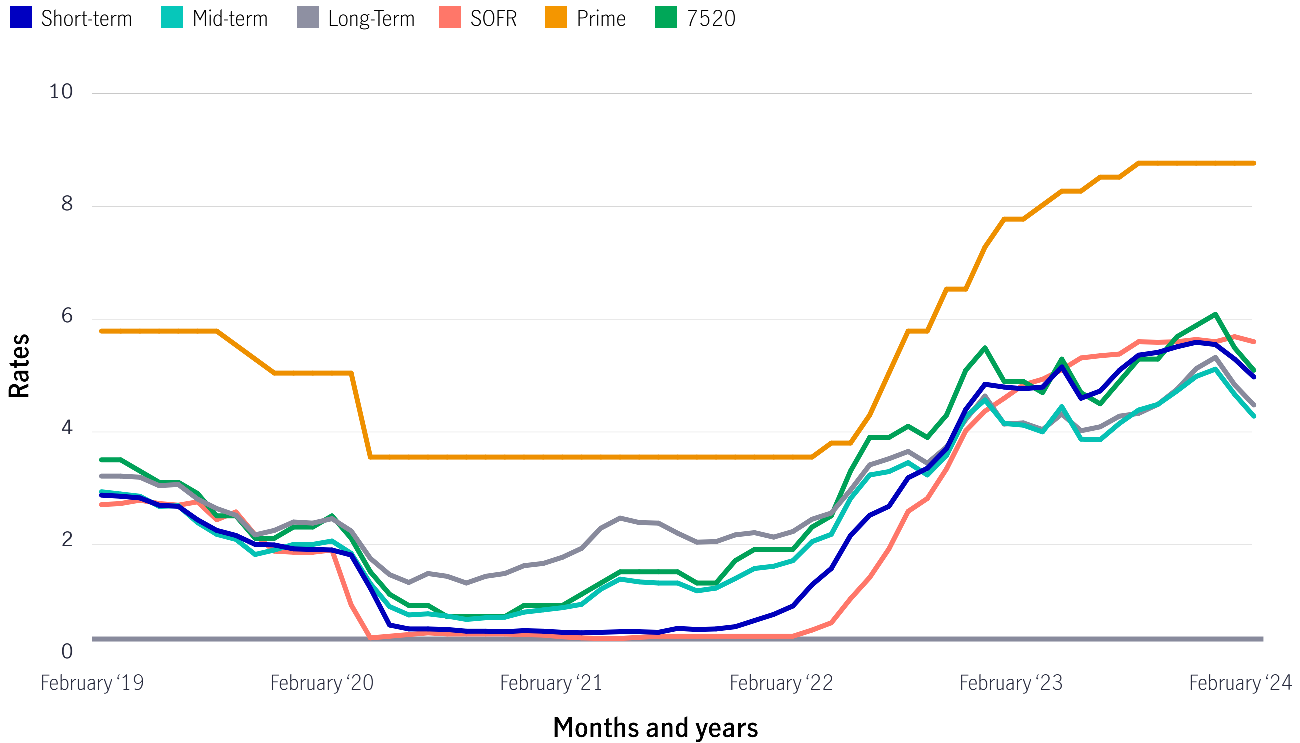
***Rhode Island:** Rhode Island imposes a state estate tax on taxable estates in excess of its $1,774,583 exemption, up from $1,733,264 in 2023. Its exemption is adjusted annually for inflation. Graduated rates range from 0.8% to 16%.

Vermont: Vermont imposes a state estate tax on taxable estates in excess of its $5 million exemption at a flat rate of 16%. Enough said.

Washington: Washington imposes a state estate tax on taxable estates in excess of its $2.193 million exemption (occasionally adjusted but not this year). Rates range from 10% to 20%.

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 February 2019 – February 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
February 2024	4.68%	3.98%	4.18%	4.80%	5.31%	8.50%
January 2024	5.00%	4.37%	4.54%	5.20%	5.40%	8.50%

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

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