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Central Intelligence

March 2024

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LIFE-5115 3/24

Appeals Court upholds US District Court LTC fraud conviction

Transamerica Life Insurance Company v. Akop Arutyunyan et al., No. 22-55199 D.C. No. 2:20-cv-04684-ODW-JEM, USCA (9th Cir.) February 22, 2024.

Facts

Insured and Daughter at all relevant times were domiciliaries of California. In 2016, Daughter purchased from Insurer a flexible-premium adjusted life insurance policy with a long-term care insurance rider insuring the life of her father, Insured, with an initial face amount of $500,000. Under the rider, Insurer agreed to pay a monthly benefit when the Insured incurred expenses for "qualified long-term care services." One of the requirements for triggering this long-term care coverage was that the Insured qualify as a "Chronically Ill Individual," which required, among other things, that Insured be "certified by a Licensed Health Care Practitioner" as either suffering from "Severe Cognitive Impairment" or "being unable to perform, without Substantial Assistance from another individual, at least two out of the six Activities of Daily Living (ADLs) for an expected period of at least 90 days due to a loss of functional capacity." These six ADLs involved specified abilities related to "Bathing," "Continence," "Dressing," "Eating," "Toileting," and "Transferring." Insured and Daughter filed a claim with Insurer in December 2018 for benefits, alleging a torn rotator cuff and spinal arthritis that they claimed rendered Insured unable to perform four of the six ADLs. They also claimed to have hired a caregiver to provide Insured with two to five hours of in-home care per day. A nurse conducted an on-site assessment where Insured purported to require a walker for ambulation at all times. Insurer approved the claim and began to pay benefits to Insured. Insurer conducted surveillance of Insured for several months thereafter to verify his representations. It did not. The caregiver never visited Insured's home during the surveillance, although Insured billed for three to eight hours of care per day during that time. Insured was also observed operating "in a highly independent and functional manner, with no apparent limitations at all" (e.g., walking his dog, driving a car, grocery shopping, etc., all without a walker or other assistance). Insurer ordered an independent evaluation and continued its surveillance. Based on this additional information, in January 2020 Insurer terminated benefit payments to Insured and filed this action based on claims of fraud, civil theft, conspiracy, and restitution. At that time, Insurer had paid $109,381.71 in benefits. After two full years of failing to respond to court orders to produce material evidence, the court granted default judgment to Insurer including full restitution of benefits paid, plus damages of $218,763.42 and attorney's fees of $166,394.50. Insured and Daughter appealed.

Holding

It is worth beginning by noting that the Court found the appeal of the lower district court holding to be frivolous both in substance and execution and ordered the defendants and counsel to show why sanctions should not be imposed. Defendants attempt to excuse away their failure to produce documents and other materials because they had objected to the substance of the discovery requests. However, these objections are a separate matter from the court's orders requiring the production and are handled separately. Both courts seem to question whether the objections should be interpreted as anything beyond a delay tactic. The Court also disposed of the defendants' challenge of the district court's default judgment, noting that defendants were given extensive opportunity to participate in the full adjudication on the merits but chose instead to impede progress. Based on the evidence that was presented to the district court, success on the merits appeared very likely.

Takeaway

Ironically, this case was decided by the lack of cooperation by the defendants and not, primarily, on the merits of the factual evidence. For this reason, perhaps the best lesson presented by this case is that long-term care and critical illness riders should be used exclusively for their intended purposes. If abused, the penalties are severe.

Tax Court upholds tax liability for distribution of qualified plan funds despite same being directly seized for criminal conviction

Lonnie W. Hubbard v. Commissioner, T.C. Memo. 2024-16, February 6, 2024.

Facts

Before the events below began, Taxpayer was a resident of Kentucky where he worked as a pharmacist. In December 2015, Taxpayer was indicted for various crimes related to the distribution of controlled substances and listed chemicals under several federal laws. The indictments included allegations with respect to some of Taxpayer's assets including an IRA that he held through his employer at the time. In 2017, Taxpayer was convicted of most of the counts in the indictments by a jury trial and Taxpayer's property named in the indictments, including the IRA, was condemned and forfeited to the federal government. Taxpayer was also sentenced to imprisonment for 30 years and other monetary penalties. Taxpayer remained imprisoned at the time this case was reported. The IRA administrator issued Taxpayer a 1099-R ("Distribution from Pensions, Annuities, Retirement, or Profit-Sharing Plans, IRAs, Insurance contracts, etc.") for the 2017 tax year reporting an early taxable distribution of $427,518 from the IRA. Taxpayer did not file a federal income tax return for 2017 and therefore did not report this early distribution. The IRS prepared a substitute for return ("SFR") for 2017 on behalf of Taxpayer and sent it to him, but he did not respond. In November 2020, the IRS sent Taxpayer a notice of deficiency assessing unpaid tax of $165,353 plus an additional $70,100 in penalties for failure to file and pay. Taxpayer appealed the IRS determination to the Tax Court in February 2021. The IRS immediately moved for summary judgment.

Holding

The Tax Court upheld the determination of liability of the Taxpayer and the assessed amounts. Taxpayer concedes essentially all facts as described by the IRS but objects to the deficiency on the basis that the funds were transferred directly to the US and that he never constructively received them. He also argues that he had reasonable cause for his failure to timely file a return and failure to timely pay the tax shown on the SFR because he was incarcerated in February 2017 and his assets were forfeited. He further asserts that he has earned no income since his indictment in December 2015 and was unable to pay the tax deficiency because of lack of funds. Additionally, he asserts that he did not receive the Form 1099-R from his IRA administrator because his wife divorced him, did not communicate with him, and was not forwarding his mail. Taxpayer emphasizes his history of scrupulously paying his income tax from 2002 through 2015. As usual, the Court begins by enunciating the standard for summary judgment: the Court may grant summary judgment when there is no genuine dispute as to any material facts and a decision may be rendered as a matter of law. The burden is on the moving party (the IRS in this case) to demonstrate that no genuine dispute as to any material fact remains and that it is entitled to judgment as a matter of law. In deciding whether to grant summary judgment, the Court construes factual materials and inferences drawn from them in the light most favorable to the nonmoving party (the Taxpayer). Even with this favorable construction in favor of the Taxpayer, the

Court is still compelled to grant summary judgment to the IRS. The sole factual issue raised by Taxpayer is whether he can be taxed for income attributable to assets that he never actually received. However, where a taxpayer's assets have been forfeited, the courts have consistently found constructive receipt of the assets. The forfeiture does not relieve a taxpayer of the income tax consequences that would have attached had the assets not been seized. Instead, the Court holds that by forfeiting the funds, the taxpayer has realized the benefits of them and must recognize the funds as gross income to the same extent as if the taxpayer had physically received them. The Court finds no reasonable foundation for treating these facts differently than if the Taxpayer had taken a distribution and then the pretax proceeds had been seized, as they would have been. Taxpayer's lack of cooperation cannot be thus rewarded. The distribution by the IRA administrator to the criminal court of the assets was in satisfaction of the Taxpayer's obligations and should be taxed as such. Finally, though sympathetic, the Court finds that incarceration was not reasonable cause for failure to file. In fact, Taxpayer's long history of filing showed he was aware of the obligation.

Takeaway

We have learned from recent cases that a taxpayer may not shield their assets from civil or criminal liability by depositing those assets in a qualified plan. This case goes on to show that those who try will be taxed on distribution of those plan assets just like the rest of us.

Tax Court upholds IRS determination of taxable gift for below-value purchase price of corporate shares

Cynthia L. Huffman, et al. v. Commissioner, T.C. Memo. 2024-12, January 31, 2024.

Facts

Parents worked for Aerospace, a California company, and over time accumulated approximately 16% of the outstanding stock of Aerospace. Parents' three sons also worked for Aerospace. In 1979, Parents created Trust to hold their stock in Aerospace for the benefit of their sons. One of Parents' sons, C, ultimately became chief executive officer of Aerospace and acquired a small holding of its stock individually as well. In 1990, Parents entered into a buy-sell agreement ("B/S"), with the holder of the largest block of Aerospace stock that gave them the rights to acquire his 43% interest (at the owner's death or by right of first refusal) for $2.00 per share. In 1993, Parents assigned their rights under B/S to C and a few months later, C exercised those rights. However, by separate agreement, instead of $2.00 per share C agreed to pay only $0.4655 per share. Later that same year, C entered into Right to Purchase ("RTP") agreements with S Corp and with Trust under which C acquired the right to purchase, at any time, all other outstanding shares in Aerospace for the aggregate sum of $5 million. The consideration for this purchase option was a payment to each of $2.00 and "other good and valuable consideration." The RTPs imposed the restriction that C would require consent by Parents to sell any shares acquired thereby. In 2007, C exercised all rights under the RTPs, buying all outstanding shares that he did not already own for $5 million. Finally, in 2008, C consolidated ownership of 100% of the shares in Aerospace by transferring ownership to a newly formed LLC in preparation for selling the same. The initial offer for the interests in Aerospace was between $85 million and $105 million. At that same time, C paid several nominal amounts to void and extinguish several outstanding obligations with the transferring entities and creditors of Aerospace. In 2010, Aerospace was sold for $95.75 million. C executed a noncompete agreement for a four-year term after the sale. That same year, Parents' filed their federal gift tax returns for 2007. The IRS sent a notice of deficiency asserting that Parents' made an unreported taxable gift to C in 2007 when C exercised his rights under the RTPs in the approximate amount of $33.2 million (and several other issues not relevant here). The IRS also assessed penalties and fees. Parents appealed the determinations to the Tax Court.

Holding

The Court begins by enunciating the well-worn principle that the determinations of the IRS set forth in a notice of deficiency are presumed correct and that taxpayers bear the burden of showing the determinations are erroneous. If the taxpayer introduces credible evidence with respect to an issue (and meets certain other conditions), the burden of proof shifts to the IRS. Parents challenge the valuations of the interests in Aerospace that C purchased in 2007 and thereby attempt to shift the burden of proof to the IRS. The Court disagrees and holds that more than mere difference of opinion is required to shift the burden. With respect to the gift tax issue, the Court found that evidence provided by Parents failed to override the presumption of correctness by the IRS notice of deficiency. Parents' arguments assume that the RTP agreement provisions setting the price for purchase were bargained for and therefore were conclusive as to the value. The Court applied the provisions of IRC §2703 to determine whether the provisions of the RTP agreements could affect the determination of value. Section 2703(a)(1) provides that the value of any property must be determined without regard to "any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right)." Section 2703(b) provides an exception to §2703(a) for any option, agreement, right, or restriction that meets all of the following requirements: (1) it is a bona fide business arrangement; (2) it is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth; and (3) its terms are comparable to similar arrangements entered into by persons in an arm's-length transaction. If these requirements are satisfied, then the agreement may be respected for valuation. The Court held that the requirements were not in fact met. Despite the$2.00 price that C paid for the RTP options, the Court noted a contemporaneous reduction in C's pay, together with a 2,414% increase in the market value of the shares between option purchase and exercise. Still, the Court found that the RTP agreements were dissimilar in form and substance from agreements either used in the industry at the time or even used by the parties themselves in any other arrangement. Thus, §2703 requires that the Court disregard the RTPs and apply instead only market valuation at the time C acquired the shares. The Court then applied IRC §2512(b) to determine whether a gift is made: where property is transferred for less than adequate and full consideration in money or money's worth, the amount by which the value of the property exceeds the value of the consideration is deemed a gift. Thus, Aerospace stock valued at $31.3 million transferred for $5 million yields a taxable gift in the amount of $26.3 million.

Takeaway

While many clever and complicated arguments were offered by both sides in this case, it seems clear that Parents' liability was created by a failure on the part of their advisors and, arguably, their family members. The Court noted their reliance on long-time advisors, one of whom resigned coincidentally at the beginning of a tax audit. Nonetheless, it is worth noting how receptive the Court was to the taxpayers' arguments in favor of the §2703 issues. In the end, though, they just did not pass muster.

District Court finds willful FBAR violations by couple hiding Swiss account from their accountant

United States v. Juan Reyes et al., No. 1:21-CV-05578 (USDC E.D.N.Y.), January 10, 2024.

Facts

Taxpayers J and C are US citizens married to one another. J had a foreign bank account ("FA") that had transferred from Nicaragua to London and ultimately to Switzerland which held balances in cash, money market deposits, and securities valued at all relevant times between $2 million and $2.5 million. Both Taxpayers had signature authority over FA. Taxpayers directed the bank and paid it a fee to retain all account-related correspondence, or "keep mail," rather than having it sent to Taxpayers at their home address in the US, and directed at least once that the bank send C's credit card statements associated with the account to a family friend's address in Madrid. A document from August 2000, signed by Taxpayers, directed the bank to divest their US securities. Taxpayers' federal income tax returns were prepared by their longstanding Accountant, who would annually send them a "client organizer" on which they were to fill in information and amounts to assist Accountant in preparing the returns. Among the information he sought was whether the client had any foreign income. Taxpayers never returned the client organizer but rather just sent their 1099s. Taxpayers never disclosed the existence of FA to Accountant as he was preparing their income tax returns for years 2010, 2011, and 2012, or at any time before then. J said that they did so because it was "not income in the United States" and Taxpayers "didn't feel the obligation that we have to this country with this account." Accountant prepared the returns and sent them to Taxpayers, who signed and returned them to Accountant for filing. Taxpayers claim that they neither reviewed nor even signed the returns after they had been prepared. On Schedule B of their originally filed joint federal income tax returns for 2010, 2011, and 2012, the "no" box was checked in response to the question of whether Taxpayers had an interest in or a signature or other authority over a financial account (including bank accounts, securities account, or other financial account) in a foreign country. Accountant learned of the FA in 2014 after it had been closed and the funds transferred to a US account, and Taxpayers' attorney requested that Accountant prepare amended returns. The IRS determined that Taxpayers willfully failed to timely report on a Report of Foreign Bank and Financial Accounts ("FBAR") their financial interest in the FA by the deadline for tax years 2010, 2011, and 2012. The IRS assessed FBAR penalties for each Taxpayer's failure to report the FA as follows: $140,017 for 2010, $140,017 for 2011, and $140,017 for 2012, totaling $420,051 for each Taxpayer. Taxpayers appealed and the US moved for summary judgment.

Holding

The US argues that the evidence supports a conclusion that Taxpayers willfully failed to file an FBAR because recklessness is sufficient to establish willfulness and the undisputed evidence shows that Taxpayers acted recklessly. In support, the US argues that the evidence presented establishes that the Taxpayers' conduct constitutes recklessness under established FBAR case law because: (1) Taxpayers submitted federal income tax returns that falsely stated they had no foreign financial accounts during the relevant tax years; (2) they failed to ask their accountant about their responsibilities as to the FA; (3) they understood that interest income from a domestic bank is taxable under US law; (4) they instructed the foreign bank to hold mail related to the FA and not invest in US securities; (5) the FA was a significant percentage of their net worth during the years at issue; and (6) Taxpayers are sophisticated taxpayers, part-owners in real-estate ventures, and individuals surrounded by professionals who "were in positions to either advise them about the implications of the foreign account, or at the very least point them in [the] right direction." Taxpayers argue that summary judgment requires a showing that they intentionally violated the FBAR requirement and that there is a genuine dispute of fact as to whether they did so, because they did not review or sign their tax returns and they believed that they did not have to report the FA. The Court disagreed with Taxpayers. Under 31 U.S.C. §5314, "a United States person with an interest in foreign financial accounts having an aggregate value of more than $10,000 is required each year to file an FBAR." In the case of any person willfully violating any provision of §5314," the government may collect civil penalties up to the greater of (1) $100,000, or (2) 50% of the balance in the unreported foreign account at the time of the violation. The US Supreme Court has stated that "where willfulness is a statutory condition of civil liability," it will generally be construed to include "not only knowing violations of a standard, but reckless ones as well." The Court holds that where a taxpayer provides false information regarding foreign bank accounts by failing to carefully review his income tax return, that defendant has shown reckless disregard toward, and thus has willfully violated, the FBAR reporting obligation (among others). Taxpayers here went further. They ignored repeated annual questions about foreign income and did not list the FA among their accounts on the client organizer sent by their Accountant. There is evidence that Taxpayers intended to keep the FA secret by stopping mail to the US and divesting the FA of US securities, perhaps because Taxpayers knew there were, or might be, tax consequences. Finally, the Court could not believe that Taxpayers would not make their longstanding tax professional aware of an asset that represented 75% to 90% of their wealth. The Court upheld the liability and the calculation, with interest, of $518,170 for each Taxpayer.

Takeaway

There is an old common adage (traceable at least back to Aristotle) that "ignorance of the law is no excuse." In many tax applications, a showing of "willfulness" is either an essential element of a violation or an aggravating circumstance. But intentional, guarded ignorance will often be recognized as willfulness in disguise.

Alabama District Court rules Corporate Transparency Act unconstitutional, though only as applied to named plaintiffs

National Small Business United, et al., v. Yellen, et al., 133 AFTR 2d 2024-XXXX, (DC AL), March 1, 2024.

Facts

The Corporate Transparency Act ("CTA") was enacted by Congressional override of President Trump's veto on January 1, 2021, contained in the Anti-Money Laundering Act of 2020 and part of the National Defense Authorization Act of 2021. The CTA requires certain business entities ("reporting company") to file information on their "beneficial owners" with the Financial Crimes Enforcement Network ("FinCEN") of the US Department of Treasury. A beneficial owner is defined as "an individual who ... (i) exercises substantial control over the entity; or (ii) owns or controls not less than 25 percent of the ownership interests of the entity," with some exceptions for children, creditors, and a few others. This information will not be available to the public, but FinCEN is authorized to disclose the information to (1) US federal law enforcement agencies; (2) to certain other enforcement agencies (with court approval); (3) non-US law enforcement agencies, prosecutors or judges based upon a request of a US federal law enforcement agency; and (4) financial institutions and their regulators, with consent of the reporting company. A willful provision of false or fraudulent beneficial ownership information or failure to report complete or updated beneficial ownership information to FinCEN by any person is punishable by a $500 per day civil penalty and up to $10,000 in fines and two years in federal prison. A knowing and unauthorized disclosure or use of beneficial ownership information by any person is punishable by a $500 per day civil penalty, along with a maximum penalty of $250,000 and five years in federal prison. A knowing and unauthorized use or disclosure while violating another federal law or as part of a pattern of any illegal activity involving more than $100,000 in a 12-month period by any person is punishable with a $500,000 fine and ten years in federal prison. In total, FinCEN estimates that the CTA applies to 32.6 million currently existing entities and 5 million new entities formed each year from 2025 to 2034. On September 22, 2022, FinCEN issued final regulations implementing the CTA effective January 1, 2024. Six weeks later, Plaintiff brought this action against Treasury alleging that the CTAs mandatory disclosure requirements exceed Congress' authority under Article I of the US Constitution and violate the First, Fourth, Fifth, Ninth, and Tenth Amendments. The parties agreed that the case could be resolved on dispositive motions without discovery, so the parties cross-moved for summary judgment in early 2023, with the government simultaneously moving to dismiss. Plaintiff describes itself as "an Ohio non-profit corporation that represents and protects the rights of small businesses across the United States," including "over 65,000 businesses and entrepreneurs located in all 50 states." Plaintiff's stated purpose is "to advocate for its members" and their employees, and "to provide its members guidance and data on how to navigate government regulations."

Holding

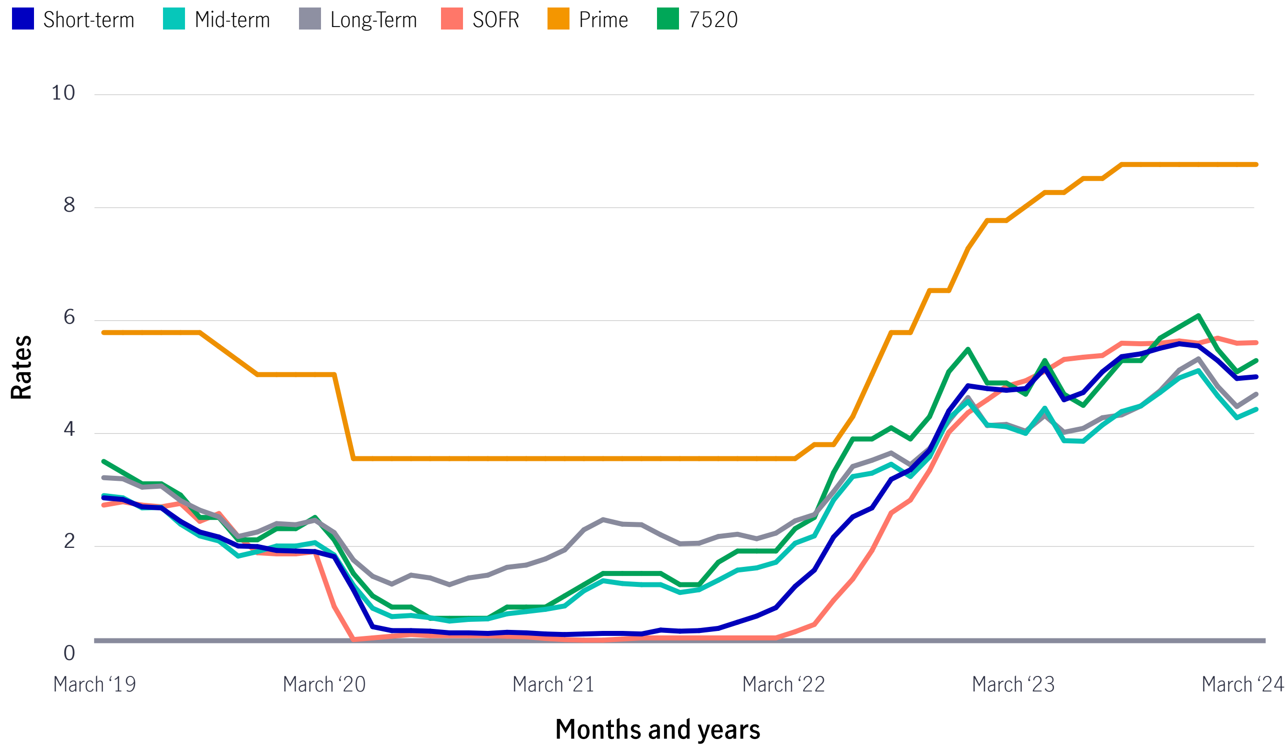
The Court first addresses the threshold matters of both its own jurisdiction and standing by the Plaintiff and disposes of each favorably before proceeding. Thus, on to the main course: where is the constitutional authority for Congress to impose a law such as the CTA? The federal government, and each branch of it, can exercise only the powers granted to it by the US Constitution. The Defendant US government offers three enumerated powers granted to Congress as its authority for the CTA: (1) its foreign affairs powers, (2) the very popular Commerce Clause, and (3) its taxing power. As to foreign affairs, argues the government, the CTA is needed to "protect vital United States national security interests; better enable critical national security, intelligence, and law enforcement efforts to counter money laundering, the financing of terrorism, and other illicit activity; and bring the United States into compliance with international anti-money laundering and countering the financing of terrorism standards." The Court finds this hard to accept, given that corporations are almost exclusively created, governed, and regulated by the individual states—a deliberate decision of the Founders. The Court concludes that the CTA cannot be justified as necessary and proper to carry out Congress' foreign affairs powers. As to the Commerce Clause (Art. I, §8, cl. 3 of the US Constitution), "[t]o regulate Commerce with foreign Nations, and among the several States," the Court concedes that it is now well established that Congress has broad authority under the Clause. The Supreme Court has identified three broad categories of activity that Congress may regulate under its commerce power: (1) the channels of interstate and foreign commerce, (2) the instrumentalities of, and things and persons in, interstate and foreign commerce, and (3) activities that have a substantial effect on interstate and foreign commerce. After extensive analysis of each broad category, the Court ultimately determines that each is founded on regulation of commercial activity. The CTA, however, is not interested in regulating commercial activity in any way. Finally, with respect to the constitutional grant of taxing power to Congress (Art. I, §8, cl. 1 of the US Constitution and Amendment XVI), the government does not suggest that the CTA itself levies taxes or that the penalties are taxes, but that the collection of beneficial ownership information is necessary and proper to ensure taxable income is appropriately reported. Again, the Court finds this an incidental relationship and hardly makes the CTA a necessary and proper application of congressional authority. For these reasons, the Court grants summary judgment to the Plaintiff that the CTA is unconstitutional because it cannot be justified as an exercise of Congress' enumerated powers.

Takeaway

It is noteworthy that the Court's final judgment prohibits the US government from enforcing the provisions of the CTA against these plaintiffs, but it does not enjoin general enforcement of the CTA. ("The Defendants, along with any other agency or employee acting on behalf of the United States, are **permanently enjoined** from enforcing the Corporate Transparency Act against the Plaintiffs.") This judgment will almost certainly be appealed by the Treasury and, without a stay, the CTA remains enforceable. Also worth mentioning, this judgment applies to the CTA as enacted by Congress; state laws such as the New York statute patterned after the CTA are not affected by this judgment. Stay tuned for more developments, which we will report in these pages.

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 March 2019 – March 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
March 2024	4.71%	4.13%	4.40%	5.00%	5.32%	8.50%
February 2024	4.68%	3.98%	4.18%	4.80%	5.31%	8.50%

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

MLINY030724961-1